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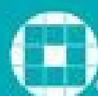
Corporations
and Other Business Entities

Seventh Edition

Steven L. Emanuel



Wolters Kluwer
Law & Business

CORPORATIONS
AND OTHER BUSINESS ENTITIES

SEVENTH EDITION

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Founder & Editor-in-Chief, *Emanuel® Law Outlines* and
Emanuel Bar Review
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The *Emanuel® Law Outlines* Series

Wolters Kluwer
Law & Business

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Published by Wolters Kluwer Law & Business in New York.

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Wolters Kluwer Law & Business
Attn: Order Department
PO Box 990
Frederick, MD 21705

eISBN 978-1-4548-3887-6

Library of Congress Cataloging-in-Publication Data

Emanuel, Steven.
Corporations : and other business entities / Steven L. Emanuel,, Founder & Editor-in-Chief, Emanuel Law Outlines and Emanuel Bar Review; Harvard Law School, J.D. 1976, Member, NY, CT, MD and VA Bars.
— Seventh Edition.
pages cm. — (The Emanuel® law outlines series)
eISBN 978-1-4548-3887-6
1. Corporation law—United States—Outlines, syllabi, etc. I. Title.
KF1414.85.E434 2013
346.73’06—dc23
2013018240

This book is intended as a general review of a legal subject. It is not intended as a source of advice for the solution of legal matters or problems. For advice on legal matters, the reader should consult an attorney.

CHAPTER 3

THE CORPORATE STRUCTURE

ChapterScope

This Chapter discusses the powers of directors, officers, and shareholders, respectively. The main concepts are:

- **Straight vs. cumulative voting:** In all elections for directors, the number of votes a shareholder gets equals the number of shares she holds, multiplied by the number of directors standing for election. But there are two distinct methods by which these shares can be voted, "straight" and "cumulative."
  - **Straight voting:** In ***"straight"*** voting, ***no share*** may be ***voted more than once*** for any given candidate.
  - **Cumulative voting:** In ***"cumulative"*** voting, by contrast, a voter may vote a single share ***multiple times for a single candidate*** (once for each director seat that's open). This increases the ***power of minority shareholders***, since a shareholder may cumulate (i.e., lump together) all his votes so as to be sure to elect a single director.
- **Quorum:** At both a shareholders' meeting and a board of directors' meeting, no action may be taken without a ***"quorum."***
  - **Board meeting:** At a ***board*** meeting, a quorum is usually a majority of the ***directors in office.***
  - **Shareholders' meeting:** At a ***shareholders'*** meeting, a quorum is usually a ***majority of the outstanding shares.***
- **Shareholders' powers:** Shareholders are the owners of stock in the corporation. They have two main sets of powers:
  - **Vote for directors:** First (and most important) they ***elect the members of the board of directors.***
  - **Approval of fundamental changes:** Second, they ***approve or***

disapprove major changes to the corporation. For instance, the corporation cannot sell substantially all of its assets, or merge into another corporation, unless the shareholders so vote.

- **Directors:** The board of directors ***manages the corporation,*** at the ***policy*** level.
  - **Appointment of officers:** A key aspect of directors' powers is that the board votes to ***appoint the "officers" of the corporation***, who are its day-to-day managers. For example, the board elects the president.
  - **Setting of policy:** The board also ***sets major policy.*** For instance, any non-trivial acquisition of another company's stock or assets would have to be approved by the board.
  - **Requirements for board action:** A key focus with respect to directors is, What are the requirements for valid ***action*** by the board? (For instance, there must be a quorum present at a directors' meeting; the board must normally act by majority vote of those present, etc.)
- **Officers:** Officers administer the ***day-to-day affairs*** of the corporation. They are appointed by the board.
  - **Authority of officers:** Whenever an officer acts on behalf of the corporation, a key issue is, Was this action ***authorized***? If the action was not in any sense "authorized," it's ***not binding*** on the corporation. An officer's authority may be ***express***, ***implied***, or ***apparent***.
  - **Ratification:** However, even if the officer acted completely without authority, ***later actions*** by other officers or by the board may amount to a ***"ratification"*** of the act, binding the corporation.

I. GENERAL ALLOCATION OF POWER: SHAREHOLDERS, DIRECTORS AND OFFICERS

A. The traditional statutory scheme: Traditionally, powers have been allocated among the shareholders, the directors and the officers of a corporation in a particular way. Even today, most statutes assume that this allocation of powers will be followed. Therefore, we refer to it as the ***"statutory scheme."*** However, most

modern statutes allow the corporation, if it observes certain formalities, to ***modify*** this scheme.

1. **The statutory scheme:** The statutory scheme may be summarized as follows:

   a. **Shareholders:** The ***shareholders*** act principally through two mechanisms: (1) ***electing and removing directors***, and (2) approving or disapproving ***fundamental or non-ordinary changes*** (e.g., mergers).

   b. **Directors:** The ***directors*** "***manage***" the corporation's business. That is, they formulate policy, and appoint officers to carry out that policy.

   c. **Officers:** The corporation's ***officers*** administer ***the day-to-day affairs*** of the corporation, under the supervision of the board.

2. **Inappropriate structure for very large or very small corporations:** For very large or very small corporations, this statutory scheme does not reflect reality. For instance, a small closely-held corporation generally does not have its affairs managed by the board of directors — the shareholders usually exercise control directly (they may happen also to be directors, but they usually do not act as a body of directors, and the controlling shareholders often disregard any non-shareholder directors). At the other end of the spectrum, a very large publicly-held company is really run by its officers, and the board of directors frequently serves as little more than a "rubber stamp" to approve decisions made by officers.

3. **Modification of statutory scheme:** Modern statutes generally give the corporation the power to modify this traditional statutory scheme where appropriate. This is especially true for closely-held corporations, as is discussed *infra*, p. 134. (For instance, some statutes allow closely-held corporations to reduce the board to one or two members; see *infra*, p. 59.) But unless a particular modification of the statutory scheme is explicitly authorized by statute, the corporation and its lawyer disregard

the statutory scheme ***at their peril***. Much of this chapter is devoted to an explanation of the statutory scheme in detail, together with a description of the consequences if the traditional scheme is not actually followed by the corporation.

4. **Focus of this section:** The rest of this section I is an overview of the division of powers as among the shareholders, directors and officers. Following that, sections II, III and IV examine the mechanisms by which the board, the officers and the shareholders, respectively, exercise their powers.

B. Powers of shareholders: Under the statutory scheme, the shareholders do ***not directly manage*** the corporation, even though they own it. Instead, they can influence the conduct of the business through a number of ***indirect*** methods.

1. **Four methods:** There are four main methods by which the shareholders can influence the corporation's affairs:

   a. **Elect and remove directors:** They have the power to ***elect*** and ***remove directors***;

   b. **Articles of incorporation and bylaws:** They can approve or disapprove of changes to the ***articles of incorporation*** or ***bylaws*** and thereby influence the allocation of power as among themselves, the directors, and the officers. See *supra*, p. 23. (For instance, the powers and duties of executive officers are usually spelled out in the bylaws, so these powers and duties could be cut back or re-allocated based partly on shareholder-approved bylaw changes.)

   c. **Fundamental changes:** They have the right to approve or disapprove of ***fundamental changes*** not in the ordinary course of business, such as a ***merger***, a sale of substantially all of the corporation's assets, or dissolution.

   d. **Void or voidable transactions:** Finally, some transactions by officers or board of directors are ***void*** or ***voidable*** unless ratified by a vote of shareholders. For instance, many transactions between the corporation and a director or officer are voidable on grounds of self-dealing unless the

shareholders ratify the transaction by voting to approve it. See *infra* p. 200.

See generally Nutshell, pp. 155-56.

2. **Election and removal of directors:** Because the shareholders' power to ***elect and remove directors*** is so important, we give it special attention here (as well as on p. 55):

   a. **Election:** Directors are normally elected at ***each annual meeting*** of shareholders. That is, directors normally serve a ***one-year term*** (though of course they can be, and often are, re-elected). See MBCA §8.05(b).

      i. **Staggered terms:** The one common exception to annual terms is that in most states, if the articles of incorporation so provide, the directors may have ***staggered terms***. That is, the directors may be initially divided into, say, three "classes," with one class having a three-year term, another a two-year term and the last a one-year term. This classification device, which is often used today to make it more difficult for a "raider" to replace the board, is discussed further *infra*, p. 451.

   b. **Vacancies:** Shareholders are generally given the power to elect directors to fill ***vacancies*** on the board, but the board of directors also usually has this power. There fore, the filling of vacancies is discussed in the treatment of the board of directors, *infra*, p. 60.

   c. **Removal of directors:** At common law, shareholders had little power to ***remove*** a director during his term of office. But modern statutes have dramatically expanded this shareholder power. The topic of shareholder-removal of directors is discussed more fully *infra*, p. 61, as part of our more general discussion of the ways in which directors may be removed.

3. **No power to bind corporation:** The shareholders do ***not*** have the power to ***conduct business*** directly on behalf of the corporation. (They must operate through their control of the board.) This means that shareholders cannot ***bind the***

corporation by their own direct actions. And this is true even of actions taken by a majority of shareholders, purportedly in the corporation's name — unless the action is somehow ratified by the board or by an officer with power to bind the corporation to the kind of transaction in question (see *infra*, p. 73), the action by the shareholders has ***no effect***.

Example: Sam is a majority shareholder of Corp., but does not sit on the board and is not an officer. He goes to Copy Machine Co. and signs a contract (made out in Corp's name) to purchase a copy machine. The board learns of this before the machine is delivered, and sends a letter to Copy Machine saying, "We're not bound to take this copier, and we don't want it." Copy Machine can't hold Corp. to the contract, because Sam is merely a shareholder (albeit a majority one), not an officer, and shareholders *qua* shareholders can't bind a corporation.

C. The power of directors: Traditionally, state corporation statutes have provided that the board of directors shall ***"manage"*** the affairs of the corporation. These statutes generally view the board not as agents of the stockholders, but as an ***independent institution*** with responsibility for supervising the corporation's affairs. C&E, p. 287.

1. **Shareholders can't give orders:** Thus traditionally (and probably even under recently-revised statutes), the shareholders ***cannot order the board of directors to take any particular action***. It is the board, not the shareholders, who formulate policy; shareholder control is limited to removing directors (see *supra*) or approving or disapproving certain major actions contemplated by the board (e.g., mergers).

2. **Supervisory role:** Although older statutes still say that the board of directors shall "manage" the corporation, the reality is that day-to-day management is carried out by the corporation's ***officers***, under the ***supervision of the board of directors***. Some modern statutes now recognize this fact. For instance, the MBCA says that "All corporate powers shall be exercised ***by or under***

the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be ***managed by or under the direction***, and subject to the ***oversight***, of its board of directors.…” §8.01(b). (The role of officers is described *infra*, p. 72.)

a. Sets policy: Thus today, the board’s main function is to ***set the policies*** of the corporation, and to authorize the making of important contracts. Nutshell, pp. 161-62. It is also the board which declares dividends; this responsibility is given to it specifically by statute. See *infra*, p. 505. Beyond this, it is usually up to the board to initiate fundamental changes in the corporation (e.g., mergers or large asset sales), though these must then be submitted to the shareholders for approval.

D. Power of officers: According to the statutory scheme, the corporation’s ***officers*** serve under and at the will of the board of directors and carry out the ***day-to-day operations*** of the corporation. In practice, of course, the officers frequently have much greater power than this implies, especially in large publicly-held corporations. But the important thing to remember is that, as far as most corporate statutes contemplate, the officers are essentially ***“agents”*** of the board of directors. (This “agency” view has major implications for the power of an officer to bind the corporation as his “principal”; see *infra*, p. 73.)

E. Sharing of responsibility: From the above discussion, it might sound as though shareholders have very little ability to influence the corporation’s affairs, apart from election and removal of directors. However, there are a number of additional ways in which shareholders at least get to ***share*** some of the power over corporate operations:

1. Shareholder resolutions: As noted, shareholders cannot require the directors or officers to take any particular action during the corporation’s day-to-day operations. However, shareholders can seek to ***influence*** the board by exercising their right to adopt ***share-holder resolutions*** that ***recommend*** particular actions to the board (even though the board can’t be

required to follow the resolution's recommendations).

2. **Self-interested transactions:** Also, transactions in which the board or officers are ***personally interested*** are almost always put to a shareholder vote. Thus ***incentive compensation*** plans that cover officers, and arrangements whereby the corporation indemnifies directors or officers against liability (see *infra*, p. 341), are almost always put to a shareholder vote.

   a. **Effect of ratification:** If such a transaction in which directors or officers are personally interested is ratified by the shareholders, this generally does not completely immunize the planned transaction against attack. But individual shareholders who vote for it can't attack the transaction later on; also, approval may make it harder for opposing shareholders to attack the transaction on grounds of general unfairness, by shifting the burden of proof to them from management. (But a court will still set aside a transaction involving officers or directors that is fraudulent or "manifestly unfair." See *infra*, p. 200.) See Nutshell, p. 165.

3. **Fundamental changes:** Lastly, shareholders are always given the power to approve or disapprove of certain ***fundamental changes*** in the corporation. For instance, in most states the following kinds of changes are ineffective without shareholder approval:

   [1] ***mergers***;

   [2] ***sales*** of all or substantially all of the corporation's ***assets***;

   [3] ***amendments*** of the articles of incorporation;

   [4] statutory ***share exchanges*** (see *infra*, p. 310), in which all shareholders are required to exchange their shares for those in another corporation; and

   [5] ***dissolution*** of the corporation.

   But observe that in most states the power to effect these changes does not reside exclusively in the shareholders: Only if the board of directors first decides to put the matter to a shareholder

vote does the vote occur. This is sometimes referred to as the board of directors' ***"gatekeeping"*** function. See, e.g., MBCA §11.04(b) (shareholders only get to vote if the board submits the proposed merger or share exchange to them.)

a. Amendment of bylaws: In recent years, another significant avenue by which shareholders may assert power has begun to emerge: the ability to ***amend*** the corporation's ***bylaws***. Recall (*supra*, p. 23) that most states allow the bylaws to be amended either by the board or the shareholders. Under the law of some states, practically any topic may be covered by a bylaw as long as the bylaw does not conflict with the certificate of incorporation. Although bylaws typically deal with non-controversial ***procedural*** matters (e.g., the date of the shareholders meeting, or how board elections are to be conducted), there is often nothing in state law to prevent bylaws from dealing with weightier matters on which the board and shareholders may disagree. Consequently, the shareholders may be able to change the corporation's policies in major ways over the objection of the board, by voting a bylaw change.

Example: In *Int'l Brotherhood of Teamsters v. Fleming Cos.*, 975 P.2d 907 (Ok. 1999), the court affirmed the right of shareholders of an Oklahoma corporation to pass a bylaw cancelling an ***anti-takeover device*** that the board had enacted.

i. State-law limits on bylaws: But some states do significantly limit the content of bylaws. For instance, in Delaware, "a proper function of bylaws is ***not*** to mandate how the board should decide ***specific substantive business decisions***, but rather, to define the ***process and procedures*** by which those decisions are made." *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008). So a bylaw amendment to the charter of a Delaware corporation would be unlawful if the amendment purported to significantly ***limit the board's discretion*** over substantive matters, especially in a way that deprived the board of its ability to ***exercise its fiduciary responsibilities*** to all

shareholders. See *CA, Inc.* (discussed in detail *infra*, p. 115) for a fact pattern in which such an illegal limitation in a bylaw occurred.

Quiz Yourself on ***THE CORPORATE STRUCTURE*** *(GENERAL ALLOCATION OF POWER)*

15. Alfred Pennyworth is a 51% owner of Metropolis Crimefighters, Inc. Metropolis has two officers who serve as its directors and employees, Batman and Robin. Alfred is not a director or officer of the corporation. Alfred is out shopping one day when he sees a nice, sedate station wagon, the Travel Queen Family Truckster, which he thinks would make a far more sensible company car than the Batmobile. He signs a lease for the Travel Queen on behalf of Metropolis. When Batman and Robin see the Travel Queen, Robin exclaims, “Holy Corporations, Batman! Is Metropolis Crimefighters bound by this lease?” Well — is it?

____

Answers

15. No. The issue here is the extent to which an *owner* of a corporation (i.e., a shareholder) may conduct corporate business. Here, that’s all Alfred is; he’s neither a director nor an officer. The rule is that shareholders have no authority to conduct corporate business; the board of directors has such authority, which it may delegate to officers or subordinates. Thus, a shareholder who is not an officer or director cannot enter into a contract on the corporation’s behalf, unless the board has explicitly given him authority to do so. And that’s true even where the shareholder owns a majority of the shares (and could therefore replace a majority of the board with a compliant one that would do what he wants.) [52]

II. THE BOARD OF DIRECTORS

A. Generally: We cover now the mechanics of the board of directors, including (1) how the board is ***elected***; (2) how it holds

its ***meetings***; (3) what ***formalities*** it must observe in order to take action; and (4) how it may make use of ***committees***.

B. Election of board members: As noted, members of the board of directors are always ***elected by the shareholders*** (with the possible exception of the filling of vacancies; see *infra*, p. 60). Normally, a director's term is one year, and the entire board stands for re-election at the annual meeting of shareholders.

1. Pre-conditions for a valid vote: Before we get into the intricacies of board elections, understand that the stockholder vote to elect directors must satisfy the same basic ***procedural requirements*** as a stockholder vote to take any other action (e.g., to approve the sale of the company.) This means that:

a. Notice: Proper ***notice*** of the time and place of the meeting must be given to all shareholders. See, e.g., MBCA §7.05(a).

b. Quorum: A ***quorum*** must be present. That is, ***more than 50% of the shares eligible to vote*** must be "present," either in person or via a valid proxy. See, e.g., MBCA §7.25(a). (For a discussion of proxies, see p. 97.)

2. Straight vs. cumulative voting: The vote for directors may either be ***"straight"*** or ***"cumulative,"*** depending on the state's corporation statute and the articles of incorporation.

3. Definition of "straight" voting: In ***straight*** voting, each share may be voted for as many candidates as there are slots on the board, but no share may be voted more than once for any given candidate. Directors are elected by a ***plurality*** (not necessarily majority) of the votes cast. See MBCA §7.28(a). Each share has one vote.

Example: In a closely-held corporation, A and B are the sole shareholders. A holds 72 shares and B holds 28. The board has three directors. A's candidates are A1, A2 and A3; B's candidates are B1, B2 and B3. If there is straight voting, A cannot cast more than 72 votes for any single candidate, and (most importantly), B cannot cast more than 28 votes for any candidate. Therefore, A's three candidates will receive 72

votes each, B's three candidates will receive 28 votes each, and *A's candidates will get all the seats on the board*.

4. **Cumulative voting:** The result in the above example looks pretty unfair to B. Although he has almost one-third of the votes, he has no representation on the board. In fact, even if he had 49 votes to A's 51, he still would not get a board seat under straight voting, since each of A's candidates would receive 51 votes and each of B's would get 49. To remedy this inadequate representation of minority shareholders, the device of ***cumulative*** voting was invented. As the name implies, cumulative voting entitles a shareholder to ***cumulate*** or ***aggregate*** his votes in favor of ***fewer candidates*** than there are slots available, including in the extreme case aggregating all of his votes for just one candidate. The consequences are that ***a minority shareholder is far more likely to be able to obtain at least one seat on the board***.

   Example: Assume the same facts as the above example: A has 72 votes, B has 28 votes and there are three directors to be elected. This time, however, cumulative voting is permitted. B can therefore take his entire "package" of 84 votes (28 shares x three seats) and put it all on his single favorite candidate, whom we'll call B1. B1 therefore has 84 votes. Now, no matter how A divides up his 216 votes (72 shares x 3 seats), he cannot come up with three candidates all of whom beat B1. For instance, if he casts 85 votes for A1 and 85 votes for A2 (the minimum necessary for A1 and A2 to beat B1), he has used up 170 votes, and has only 46 votes left to put on A3. Therefore, even though B has only 28% of the shares and 28% of the total votes castable in the election, he is assured of at least one seat on a three-seat board by the device of cumulative voting.

   a. **Formula:** Here is a simple formula that shows the minimum number of shares needed to elect ***one director*** under cumulative voting:

$$\frac{S}{D+1} + 1$$

where S = the total number of shares voting and D = the number of directors to be elected.

Using this formula on our above example, there were 100 shares being voted, and three directors to be elected. Therefore, we have:

$$\frac{100}{4} + 1$$

so that even had B had as few as 26 shares (with A having the remaining 74), B would have been able to elect one director on a three-seat board.

i. Multiple directors: An analogous formula tells the number of shares needed to elect n directors:

$$\frac{nS}{D + 1} + 1$$

To illustrate the use of this formula, suppose there are three shareholders A, B and C, and a total of 100 shares to be allocated. The board of directors will have five seats. A wants to know how many shares he will need if he is to deny seats to B and C (assuming that they act together to pool their votes). A will therefore need to elect all five directors, so the formula gives us (500/6) + 1, or 83 1/3 + 1, or 84 1/3. Actually, we can round the resulting number down to the nearest whole share. Therefore, A needs at least 84 of the 100 shares in order to deny B and C a seat on a five-seat board. See generally Nutshell, pp. 184-88.

b. Mandatory or permissive cumulative voting: As of 2002, all states at least ***permitted*** cumulative voting if the corporation desires it, and some states ***required*** it. Hamilton (8th), p. 551. There are three ways in which cumulative voting is handled in statutes:

i. Mandatory: Seven states make cumulative voting ***mandatory*** by a statutory or state constitutional provision.

Id. In these states, even an amendment to the corporation's articles of incorporation specifically banning cumulative voting will be ineffective.

ii. "Opt in" election: Thirty states permit cumulative voting, but only if the articles of incorporation specifically elect to have it (an ***"opt in"*** election). *Id*. The MBCA follows this path; see §7.28(b).

iii. "Opt out" election: Finally, thirteen states provide that cumulative voting is allowed unless the articles of incorporation explicitly exclude it (an ***"opt out"*** election). Hamilton (8th), p. 551.

c. Trickiness: When cumulative voting is allowed, voting strategy can be quite tricky. Most dramatically, it can be catastrophic to A to use straight voting when, unbeknownst to him, B is using cumulative voting.

Example: A owns 60 shares, B owns 40 shares and the board consists of five directors to be elected. Suppose A is unaware that cumulative voting is allowed and that B will be using it. A therefore casts 60 votes for each of his five candidates, A1, A2, A3, A4 and A5. B, knowing or suspecting that A is doing this, allocates his votes as follows: B1-68, B2-67 and B3-65 (with nothing for a fourth or fifth candidate). By this strategy, B ends up ***controlling the board*** with three directors even though he has only 40% of the shares!

Note: However, B's strategy in the above example could easily backfire if A learns or guesses what is going on. For instance, A can cast 75 votes for each of A1, A2, A3, and A4 (with nothing for A5). If A does so, B's strategy will have backfired — A will have four of the five seats, one more than he would have gotten had B followed the "conservative" cumulative strategy of splitting his votes among only two candidates (the maximum number that he could be sure of electing regardless of A's strategy).

i. Ties: It is poor strategy for a shareholder to create a ***tie***

among his own candidates. The reason is that if there is a tie for the last place on the board, this will result in a ***separate election*** for the last seat, at which cumulative voting will not apply. This may result in the minority shareholder's losing a seat he could otherwise have gotten. See Nutshell, p. 187.

ii. Advance notice: A few states require shareholders to give ***advance notice*** before they use cumulative voting. California, Hawaii, Minnesota, North Carolina and Ohio are among such states. See H&A, p. 496, n. 19. Similarly, MBCA §7.28(d) provides that either: (1) the notice to shareholders of the annual meeting must state "conspicuously" that cumulative voting is authorized, or (2) the shareholder must give 48-hour notice to the corporation that he intends to vote cumulatively (in which case the other shareholders may cumulate without any further notice). This helps eliminate the unfair results that can occur if one shareholder votes cumulatively while the other does not, as in the example *supra*, p. 57.

iii. May change vote until announcement: Unfair surprise is also reduced by the fact that a shareholders' vote is ***not final*** until it is ***announced*** by the chairperson at the meeting. Thus even if in the above example A and B have both cast and submitted their written votes, if A suddenly realizes that B is cumulating, he can resubmit his own votes on a cumulative basis. H&A, p. 496.

d. Reduction in board size: Observe that one way to ***reduce the impact*** of cumulative voting is ***to reduce the size*** of the board.

Example: Suppose that A has 80 shares and B has 20 shares. If there are five seats on the board, cumulative voting assures B of getting a seat. (By the formula on p. 56, even as few as 17 of the 100 shares would guarantee B a seat on a five-person board.) But if the board is reduced to three seats, B will lose his guaranteed seats. Now, by the same formula, B needs at

least (100/4) + 1, or 26, of the 100 shares in order to guarantee himself a seat.

e. Staggered terms: A second, similar way of reducing the effect of cumulative voting, is the use of ***staggered terms*** for the board of directors. That is, the board may be divided into, say, three "classes" of directors, one class elected for a one-year term, another for a two-year term, and the last for a three-year term. Once the initial election of each class has taken place, re-election of each class is for the same term (probably for three years).

Example: A has 79 shares and B has 21. The board has nine seats. If all directors are elected for one-year terms at each annual meeting, B is guaranteed at least two of the nine seats by cumulative voting — by the formula on p. 56,

$$\frac{200}{9+1} + 1 = 21$$

Now, assume that the board is divided into three "classes," each consisting of three directors; class A will stand for re-election in year one, class B in year two, and class C in year three. Each annual election now involves only three directors and B will go from having a guaranteed two seats to having *zero* guaranteed seats (since by the formula on p. 56, a shareholder needs at least 26 of 100 votes to be sure to fill one of three available seats in an election).

i. Upheld by court: The effect of staggered terms on cumulative voting is so severe that in those states where cumulative voting is required by statute or constitution (see *supra*, p. 57), minority shareholders have tried to convince courts that the adoption of staggered terms amounts to an automatic violation of cumulative voting. In one or two states, this argument has succeeded, but in most it has not. See H&A, p. 496, n. 21.

f. Merits of cumulative voting: The merits of cumulative voting depend largely on how widely dispersed ownership is.

In a closely-held corporation, cumulative voting serves the very useful purpose of insuring that the holders of a minority, but significant, stake in the corporation are not "frozen out" from the board. But in a publicly-held corporation whose ownership is widely dispersed, cumulative voting can be more of a nuisance than a value, since it greatly complicates the mechanism of voting by proxy, yet will rarely affect the outcome. See Nutshell, p. 187. Management usually opposes cumulative voting, both on this ground and on the ground that it produces an ***adversarial board***. See K&C, p. 124-25.

g. Removal of cumulatively-elected directors: Recall that in most states today, shareholders have the right to ***remove*** a director without cause at any time during his term. See *supra*, p. 56 (as well as *infra*, p. 62). How does this right, where it exists, interact with cumulative voting? If an election to remove without cause were done by a straight "yes or no" vote at which the majority of votes cast determined the result, the right of cumulative voting would be ***completely nullified***: the holder of fifty-one percent of the shares could allow the minority to use its cumulative votes to elect, say, four seats on a nine-member board, but then could immediately prevail in a majority-vote election to remove those four without cause. Consequently, most states have a special provision to prevent this; see *infra*, p. 63.

C. Number of directors: Traditionally, most statutes require that there be at least three directors. But today, many states allow a board to consist of less than three so long as it is equal to the number of shareholders — thus a one-shareholder corporation can have one director and a two-shareholder corporation can have two directors. (California and New York are among these states. See H&A, p. 551, n. 1.)

1. Minimums abolished: A substantial (and growing) minority of states, in fact, now allow a corporation to have a one- or two-member board ***even if there are more than two share-holders.*** This is now true of Delaware (§141(b)) and the MBCA (§8.03(a)). See H&A, p. 552, n. 2.

a. **Rationale:** There seems little reason to require that there be more than one or two board members merely because there are, say, three shareholders. For instance, suppose that A owns all the stock of a corporation, and is the sole director. If he makes a gift of a few shares to each of his children, all of a sudden he would have to expand his board to three, a move that has no business justification. Nutshell, p. 217.

2. **Stated in articles or bylaws:** The number of directors is usually fixed either in the ***articles of incorporation*** or in the ***bylaws***. Most statutes leave it up to the corporation whether this should be done in the articles or the bylaws; see e.g., MBCA §8.03(a). Observe that if the number is specified in the articles, it may only be changed by shareholder vote; but if it is set in the bylaws, it may usually be changed by the board itself, under the board's general power to amend bylaws (see *supra*, p. 23).

   a. **Restrictions on scope of change:** However, corporation statutes sometimes prevent the board from making very large changes in its size without shareholder approval, even if the bylaws allow the board to change the number of directors. For instance, MBCA §8.03(b) provides that even if the board has power to change the number of directors, it may increase or decrease the board only by ***thirty percent*** or less without shareholder approval.

3. **Variable board size:** Most statutes allow the articles of incorporation or bylaws to set a ***minimum*** and ***maximum*** size for the board, rather than a fixed size. When this approach is followed, either the shareholders or the board may adjust the size within the range, but only the shareholders may change the range itself. MBCA §8.03(b) follows this pattern.

   a. **Rationale:** Observe that the MBCA's handling of changes in the number of directors leaves some scope for the board to make modest changes, but requires shareholder approval for large changes. This is true whether the corporation uses a fixed or variable number of directors. Thus under the MBCA scheme the board may usually decide whether to fill one or a

small number of vacancies without seeking shareholder approval but may not dramatically expand the power of incumbent directors (by refusing to fill a large number of vacancies) without going back to the shareholders. See MBCA §8.03(b); see also Nutshell, p. 219.

D. Filling of vacancies: Most statutes allow ***vacancies*** on the board to be filled ***either*** by the shareholders or by the board, unless the articles of incorporation provide otherwise. See e.g., MBCA §8.10(a).

1. **Term:** Some statutes let the replacement director serve the ***full unexpired term*** of his predecessor. Others require her to ***stand for re-election*** at the ***next annual meeting***. The two rules differ only where the board is staggered (see *supra*, p. 58); under the former rule, if A resigns with two and one-half years left on his three-year term, his successor gets to serve the full two and one-half years, whereas under the latter rule the successor must stand for re-election in six months.

   a. **MBCA:** MBCA §8.05(d) requires that the replacement stand for re-election at the next annual meeting.

2. **Increase in number on board:** Some statutes distinguish between vacancies created by resignation (an "old" vacancy) and those created because the size of the board is increased (a "new" vacancy). States making this distinction usually allow the board to fill old vacancies but not new vacancies. Nutshell, p. 222. But many states have abolished this distinction; see e.g., MBCA §8.10(a), explicitly giving the board the right to fill vacancies "resulting from an increase in the number of directors."

3. **Election by classes of stock:** In many corporations, especially closely-held ones, a key control device is that each separate ***class of stock*** is entitled to elect a certain number of directors. For instance, if a closely-held corporation has A and B classes of stock, the B shareholders might be given the right to elect four of nine board members, even though they had only 25% of the total voting power of the corporation. If a class has the right to elect a specified number of directors, then ***only that class*** may vote to

fill a ***vacancy*** arising from the resignation of one of the directors elected by the class (assuming that it is the shareholders, rather than the board, that fill vacancies). See MBCA §8.10(b).

4. **Dated resignations:** A director may normally submit a ***dated resignation***, that is, a resignation that is to take effect at some future time. The key advantage of such a prospective resignation is that the resigning director may ***participate in the election*** of his successor (always assuming, of course, that the board is authorized, as is usually the case, to fill vacancies). See MBCA §8.10(c). This is particularly important where, without the vote of the soon-to-resign director, the board would be deadlocked between competing factions. See Nutshell, p. 224.

5. **Quorum problems:** Any board action normally requires a ***quorum*** (see p. 63), and that's true of votes by the board to elect new directors to fill board vacancies. Well, what happens if so many directors resign (without first voting for their successors), or otherwise leave the board, that a quorum of the board is no longer possible? Most states have a special rule saying that in this situation, the vacancy can be filled by majority vote of the remaining directors, ***even though no quorum is present.*** See the further discussion of this problem *infra*, p. 64.

6. **Holdover directors:** Virtually all states provide that a director holds office not only for the term for which he is elected, but ***until his successor is elected and qualified***. A director serving beyond the end of his term is called a ***holdover*** director. See, e.g., MBCA §8.05(e) ("[D]espite the expiration of a director's term, the director continues to serve until the director's successor is elected and qualifies or there is a decrease in the number of directors.")

   a. **Rationale:** Without the holdover device, a corporation could become completely deadlocked. For instance, if there were two factions with equal voting power, one faction could refuse to attend an annual meeting or to vote for directors, and the absence of a quorum at the shareholders meeting would prevent any election from taking place; holdover directors

would then be the only directors. Of course, the holdover provision means that in this kind of deadlock situation, the original directors would remain in office forever; the remedy might well be involuntary dissolution of the corporation (see *infra*, p. 154). See also Nutshell, p. 225.

E. **Removal of directors:** When may a director be ***removed***? Most statutes allow this to be done by either a ***shareholder vote*** or by ***court order***.

1. **Shareholder vote:** Most modern statutes provide that directors may be removed by a majority vote of ***shareholders***, either ***with or without cause***.

   a. **MBCA:** Thus MBCA §8.08(a) says that "The shareholders may remove one or more directors ***with or without cause*** unless the articles of incorporation provide that directors may be removed only for cause."

   b. **Minority rule:** Even the ***minority*** of jurisdictions whose statutes do not allow shareholders to remove directors without cause in all circumstances allow it if this right is ***reserved in the articles of incorporation.***

   c. **Protection of groups:** However, removal-of-director provisions are generally drafted so as to ***prevent the majority from undermining*** the effect of cumulative voting and other ***minority-protection devices***.

      i. **Cumulative voting:** For instance, if a corporation has ***cumulative voting***, the statute will normally provide that a director cannot be removed if the number of votes cast against his removal would have been enough to elect him. See MBCA §8.08(c), to this effect.

      Example: X Corp. is a closely-held corporation. A, B and C each have 30 shares, and D has 10 shares. X has cumulative voting, and a 5-member board. (Therefore, each shareholder voting for directors has five votes times the number of shares he holds. By the formula on p. 56, anyone who receives 100/6 + 1, or 17 2/3, votes will be elected.) D

casts all his 50 votes for himself, so he is elected to the board even though no one else casts any votes for him. A, B and C later decide that they wish to remove D.

Under MBCA §8.08(c), if D casts his 50 votes against his own removal, D can't be removed, even though A, B, and C collectively cast all 450 (90 × 5) of their votes to remove him. This is so because §8.08(c) says that "If cumulative voting is authorized, a director may not be removed if the number of votes sufficient to elect him under cumulative voting is voted against his removal," and more than 17 2/3 votes have been cast against D's removal.

d. Majority of those voting: To remove a director, it's not necessary that a majority of all shares outstanding be voted against the director, only that a majority of those votes ***actually cast*** be against the director. (This is an application of the more general rule, discussed *infra*, p. 81, that when an action requires shareholder approval, only a majority of shares actually voted, not a majority of shares outstanding, need be voted in favor.)

e. Meeting required: Also, keep in mind that a shareholder vote to remove a director requires the ***same formalities*** (e.g., a shareholders ***meeting***) as any other shareholder action. (See *infra*, p. 79, for more about the formalities for shareholder action.) In fact, some statutes say that there must be a special meeting of shareholders, at which the removal of the director is one of the ***stated purposes*** of the meeting. See, e.g., MBCA §8.08(d), to this effect.

f. Significance of removal power: There are at least two situations in which the shareholders' power to remove directors ***without cause*** has a sharp practical significance.

i. Control shifts: First, when through a friendly or unfriendly takeover, ***control*** of the corporation ***shifts*** (see *infra*, p. 360), this right of removal allows the new controlling owner to replace directors with "friendly" directors of his own choosing.

ii. **Closely-held corporation:** Secondly, in a ***closely-held*** corporation, the controlling shareholder(s) will frequently want to make sure that directors he elects remain "***friendly***" to him; the unrestricted right of removal helps ensure this. See Nutshell, p. 160.

2. **Court order:** Modern statutes also generally say that a ***court*** may ***order*** a director removed, but only ***for cause***.

   a. **MBCA:** For example, MBCA §8.09 says that the court may order a director removed as the result of a proceeding commenced either by the corporation or by a share-holder's derivative suit, if the court finds both that: (1) the director "engaged in ***fraudulent conduct*** with respect to the corporation or its shareholders, ***grossly abused the position of director,*** or ***intentionally inflicted harm*** on the corporation," *and* (2) "removal would be in the ***best interest*** of the corporation."

   b. **Why used:** Since the shareholders may remove the director without cause, why would a judicial proceeding ever be necessary? There are two situations in which judicial action is the only or better method of removing a director:

      [1] First, the director may be a shareholder and may possess ***such voting power*** that he can block removal by shareholder vote. (For instance, if the director was elected by cumulative voting — see *infra*, p. 56 — and votes he controls were sufficient by themselves to elect him under the cumulative scheme, he will be able to block his removal by casting the same number of votes.) Here, the board's ability to start a lawsuit to remove the director would be crucial.

      [2] Second, recall that the director can only be removed if a ***special shareholders' meeting*** occurs. If the corporation is ***publicly-held,*** and the director refuses to resign when requested to do so, this special meeting will involve considerable ***delay and expense.*** See Official Comment to MBCA §8.09.

3. **No removal of director by board action:** States generally do ***not*** allow the ***board itself*** to remove a director, ***even for cause.***

F. **Procedures for a directors' meeting:** We now examine the procedural requirements for the holding of a directors' meeting, including (1) frequency of meeting; (2) notice; and (3) quorum.

1. **Regular vs. special meetings:** There are two types of board meetings: regular and special. A ***regular*** board meeting is one which occurs at a regular interval (e.g., monthly, quarterly or annually). All other meetings are ***"special."*** The frequency for regular meetings is generally specified in the ***bylaws***.

2. **Notice:** The main distinction between regular and special meetings is that a special meeting must normally be preceded by ***notice*** to the board members, whereas this is not necessary for a regular meeting. Thus MBCA §8.22(b) provides that a special meeting must be preceded by "at least two days' notice of the date, time, and place," unless the articles or bylaws provide for a longer or shorter notice period.

   a. **Waiver:** In any event, a director may ***waive*** the required notice in writing. Also, if a director ***attends*** the meeting without objecting to the lack of notice, he will generally be held to have thereby waived notice. See, e.g., MBCA §8.23(b) (attendance constitutes waiver unless the director not only objects upon his arrival but also refrains from voting in favor of, or assenting to, the proposed action at the meeting.)

   b. **Purpose need not be specified:** The notice of a special directors' meeting need ***not specify*** the business to be transacted at the meeting, and any business may in fact be transacted. This is quite different from the rule governing notices of ***shareholders'*** meetings (see *infra*, p. 80). "As a result there is little practical difference between regular and special meetings of directors." Nutshell, p. 220.

3. **Quorum:** The board of directors may act only if a ***quorum*** is present.

   a. **Percentage required:** If the board has a fixed size, a quorum

is a ***majority of that fixed number***. This is true even though there are ***vacancies*** on the board at the moment.

Example: The articles of incorporation of C corporation provide that it shall have a nine-member board. At the time of a particular directors' meeting, there are two vacancies. A quorum consists of five, not four, board members, since there must be a majority of the total number of seats, not the number of sitting directors.

b. Variable board: But if the articles set up a ***variable-size*** board (see *supra*, p. 60), a quorum is generally set as a majority of the directors ***in office*** at the start of the meeting. See, e.g., MBCA §8.24(a)(2).

c. Lesser number: Some states, but probably still a minority, now allow the articles of incorporation or bylaws to specify a percentage that is ***less than a majority*** as the quorum. For instance, both Delaware (§141(b)) and the MBCA (§8.24(b)) allow the articles of incorporation or bylaws to establish any percentage that is ***one-third*** or greater as the quorum.

d. Super-majority as quorum: Conversely, statutes often permit the articles or bylaws to establish a quorum of ***more than a majority***. See, e.g., MBCA §8.24(a). Such a provision could be used as a control device in a closely-held corporation. For instance, the bylaws could be amended to provide that all three directors must be present for a quorum; this way, a minority shareholder who controls one seat could actively block corporate action by refusing to attend directors' meetings.

e. Quorum must be present at time of vote: The quorum must be present ***at the time a vote is taken*** in order for the vote to constitute the act of the board. Thus even if a quorum is present at the start of a meeting, directors may, by leaving, remove the quorum and thereby prevent further board action. (A different rule applies to ***shareholders'*** meetings, at which all that counts is that a quorum be present at the start of the meeting. See *infra*, p. 82.)

f. Quorum for filling vacancies: We said just above that the board of directors may not take action unless a quorum is present. There is one exception to this rule: In most states, the board may ***fill a vacancy*** even though less than a quorum of directors is present. Carefully-drafted statutes make it clear that this right exists only where the number of directors ***in office*** is less than a quorum; other statutes leave open the possibility that a vacancy may be filled if less than a quorum is present at the meeting, even though more than a quorum is in office.

Example: Corporation has a board whose fixed size is six directors. A quorum would therefore be four. There are two vacancies at the moment. Under the MBCA, three directors at a "meeting" may not fill the vacancy — the number of directors in office is not less than a quorum, even though the number of directors at the "meeting" is. See MBCA §8.10(a)(3) and Official Comment thereto. But some older statutes might be interpreted to allow the three members to fill the vacancies; see Nutshell, p. 221. Observe that under the MBCA approach, on these facts a single board member could prevent the board from ever taking action; by staying away, he could prevent there ever being a quorum to fill the vacancies; therefore the vacancies could never be filled, so there could never be a quorum for purposes other than election of directors. (Eventually, however, the *shareholders* could fill the vacancies.)

G. What constitutes act of board: Normally, the board may take action only by ***vote of a majority of the directors present*** at the meeting. See, e.g., MBCA §8.24(c).

1. Higher number: However, many modern statutes allow the articles of incorporation to specify a ***higher percentage*** than a majority for all or certain board actions. For instance, MBCA §8.24(c) allows a higher number to be required by ***either*** the articles of incorporation or the bylaws.

H. Formalities for board action: Normally, the board of directors

may take action ***only at a meeting***, not by individual action of the directors. Directors, unlike shareholders, ***may not vote by proxy***. Clark, pp. 109-110.

1. **Rationale:** Why should there be a rule that the directors must act during a duly-convened meeting rather than as separate individuals? The traditional rationale for this requirement is that "the decision-making process is likely to function better when the directors consult with and react to one another. A ***group discussion of problems*** is thought to be needed, not just a series of yea or nay responses." Clark, p. 110.

2. **Exceptions to requirement of board meeting:** Under modern statutes there are a few ***exceptions*** to the general rule that directors may act only by duly-convened meeting.

   a. **Unanimous written consent:** First, nearly all states now provide that directors may act without a meeting if they give their ***unanimous written consent*** to the proposed corporate action. See, e.g., MBCA §8.21(a), allowing this unanimous written consent procedure unless the articles of incorporation or bylaws prohibit it. Observe that because the written consents must be unanimous, a ***single director*** who opposes the action can, in effect, require that a meeting be held to discuss the action. Also, note that under this MBCA provision, the consent does not become effective until the ***last director*** has signed the consent; therefore, the consent method ***cannot*** be used as a means of ***ratifying*** a purported corporate action that has taken place before all directors have signed. However, the doctrines of ratification and estoppel discussed *infra*, p. 77, will, if they apply at all, have a retroactive effect in this situation.

   b. **Telephone meetings:** Many states now permit the directors to act by means of a ***telephone conference call***. For instance, MBCA §8.20(b) authorizes the conducting of a meeting by use of "any means of communication by which all directors participating may ***simultaneously hear each other*** during the meeting." This is not really an exception to the requirement of

the meeting, but rather a re-definition of what constitutes a "meeting" — the main purpose of a meeting, that board members be able to simultaneously discuss the proposed matter, is of course carried out when the meeting occurs telephonically.

c. **Ratification:** In a sense, the related doctrine of ***ratification***, discussed *infra*, p. 77, may serve as a substitute for a formal vote of the board at a duly-convened meeting. That is, if a corporate officer takes an action without board authorization (e.g., signs a contract), and the board later learns about it but does nothing to undo the action, the corporation will likely be held to have ratified the action, preventing the corporation from claiming that the action took place without board approval.

I. **Objection by director:** A director may sometimes wish to ***disassociate*** herself from action taken by the board, because she feels that the action is unwise, illegal, or a breach of fiduciary duty. It may be quite important for the director to register her dissent, because if she does not do so, she may be personally liable for the board's action even though she remained silent or orally voiced reservations. (See *infra*, p. 171.) Therefore, the director in this situation should either submit a formal ***written*** dissent or abstention, or should make sure that her oral dissent or abstention is ***entered in the minutes*** of the meeting. See MBCA §8.24(d)(2) and (3).

J. **Composition of the board:** Board members of a publicly-held corporation can be thought of as falling into three categories: (1) ***insiders*** (executives or employees of the corporation); (2) ***"quasi-insiders,"*** i.e., people who have some other significant relationship with the corporation or its chief executive (e.g., the corporation's lawyer or investment banker); and (3) true ***"outsiders,"*** i.e., those who do not fall into either of the two previous classes. K&C, p. 126.

1. **Traditional structure:** Traditionally, corporate boards were usually dominated by insiders and quasi-insiders. This structure

was often criticized on the grounds that it led to a board that merely "rubber stamped" management's decisions, rather than acting as a truly independent force.

2. **Modern trend:** Today, especially among the large publicly held corporations, the trend is to have a ***majority of true outsiders*** on the board. For instance, a majority of the boards of most New York Stock Exchange-listed companies is today composed of true outside directors. K&C, p. 126. The ALI's *Principles of Corporate Governance* recommend that even small publicly-held corporations should have at least three directors who are "free of any significant relationship with the corporation's senior executives" (i.e., class (3) above). See §3A.01(b).

K. Committees: Boards increasingly tend to appoint ***committees*** of their members to carry out certain board functions. A committee typically consists of three or more board members, and is given authority to take certain specified action on behalf of the board. The two most common kinds of committees are the ***audit*** and the ***compensation committees***. ***Executive*** and ***nominating*** committees are also frequently appointed.

1. **Rationale:** There are two main rationales for this increasing use of committees: (1) boards, especially those of large publicly-held corporations, are frequently so large as to be unwieldy, and meet too seldom to stay on top of the corporation's affairs; and (2) some kinds of board actions (e.g., compensation of senior executives) are best handled outside the presence of senior management, and therefore are best handled by a committee composed solely of independent directors.

2. **Model Act:** The MBCA demonstrates the modern trend of facilitating the use of committees. §8.25(a) allows the appointment of committees by the board unless the articles of incorporation or the bylaws specifically prohibit them. With a few exceptions, "each committee may exercise the authority of the board of directors.…" §8.25(d).

   a. **Majority of board:** However, a majority of the ***entire sitting***

board must approve the creation of a committee and the appointment of members to it. §8.25(b). That is, it is not enough that a committee is approved by a majority of the directors present at a meeting containing a quorum (the standard for other types of board action; see *supra*, p. 65). This requirement of an absolute majority reflects the serious authority which can be and often is entrusted to committees.

b. **Off-limits actions:** Under the MBCA, committees are not allowed to take certain very important types of actions. Some of these off-limits actions include: (1) filling vacancies on the board; (2) amending the articles of incorporation or the bylaws; (3) approving or proposing to shareholders actions that require shareholder approval; and (4) authorizing the issuance or re-purchase of shares. §8.25(e). The basic idea behind these limits is to "prohibit delegation of important actions that cannot be overruled or overturned by the board of directors." Nutshell, p. 231.

c. **Allowed actions:** But even with these limitations, committees can take some very important actions in the name of the board, without separate board approval. For instance, a committee may authorize the corporation to take on ***long-term debt*** or to make a large ***capital investment***; it may set the price at which shares shall be issued (so long as the whole board has approved the issuance); it may ***appoint or remove senior management***, and fix the salary of these executives. See Official Comment to §8.25.

3. **Audit committee:** Probably the most commonly-encountered committee is the ***audit*** committee. For example, the New York Stock Exchange now requires every listed company to have an audit committee composed entirely of independent directors, and probably most non-NYSE middle-sized and large corporations have also appointed such a committee. See K&C, p. 122. The audit committee typically meets regularly with the corporation's outside ***auditors*** to review the corporation's financial statements and the audit process. *Id.*

a. **Rationale:** The corporation's outside auditors are usually hired (and fired) by senior management. Therefore, without an audit committee, there is a real chance that management will try to conceal its shortcomings by pressuring the auditors to paint an unduly rosy picture of the corporation's performance. Since audit committee meetings take place outside of the presence of management, the independent directors on the committee can ask the kind of embarrassing questions ("Are earnings being properly stated?" "Are there any contingent liabilities which management hasn't told us about?") that directors would probably not ask at a full board meeting. *Id.*

4. **Nominating committee:** A ***nominating*** committee nominates candidates to run for ***vacancies*** on the board of directors. Without a nominating committee composed largely of outsiders, the chief executive will tend to nominate either insiders, quasi-insiders, or "outsiders" who are in fact his close friends and whom he expects to be loyal to him. Therefore, if the board is to be more than a rubber stamp for management decisions, it must get a truly independent cadre of outside directors; the nominating committee furnishes a way to do this. For this reason, a nominating committee should have at least a majority of outside directors. Probably only a minority of publicly-held corporations have formed nominating committees, but the number is growing rapidly. K&C, p. 123. (Regardless of whether it is the CEO or a nominating committee that nominates candidates, these "official" candidates almost always win the election; only in the rare case of a successful "proxy fight" — see *infra*, p. 120 — does someone not nominated by management or the existing board get elected.)

5. **Compensation committee:** Most publicly-held corporations now have a ***compensation*** committee composed principally of outside directors. Such a committee sets the salaries and other compensation of the chief executive and other senior management. Again, the theory (though not necessarily the practice) is that a committee composed of outsiders will be less dominated by the CEO and will thus be more objective (and

stingier) than the full board would be.

6. **Executive committee:** Many companies have an ***executive*** committee, which essentially performs the functions of the board between meetings of the full board. Such a committee is especially common where the full board meets only a few times a year. *Id*. Unlike the three types of committees discussed above, the executive committee is usually composed of insider or quasi-insider members, since they must be available on short notice and be familiar with the daily affairs of the corporation.

Quiz Yourself on ***THE CORPORATE STRUCTURE*** *(THE BOARD OF DIRECTORS)*

16. Brady Strippers, Inc., a furniture refinishing company, has two shareholders, Mike Brady and Carol Brady, and three directors, who are elected annually. Mike owns 60 shares of Brady Strippers stock, with Carol owning the other 40 shares. All shares can vote. Mike wants to elect Greg, Peter, and Bobby as directors; Carol wants to elect Marcia, Jan, and Cindy.

(a) You represent Carol. What advice should you give her about what she should do to maximize the number of directors she can elect (and is there any special procedural advice you have for her about how to implement your substantive advice)? ______________________________

(b) If Carol follows your advice in part (a), how many directors is she likely to end up with?

(c) If Carol doesn't follow your advice, what's likely to happen?

____

17. The Heavenly Choir Musical Instrument Company has a board of directors whose number is fixed in the charter at 5. Three of these members are Richie Valens, Janis Joplin and the Big Bopper. The three are killed in a plane crash, leaving just two members (less than a majority of board seats, and thus less than a quorum.) Can the two remaining directors fill the vacancies anyway? ______________________________

18. The Acme Electrical Company — "Let us fix your shorts" — has bylaws providing for regular, quarterly board of directors meetings, which are to take place at the company headquarters on the first Wednesday of each calendar quarter, unless a different time or place is set by prior board resolution. A quorum is three of the five directors. One of the directors is Wile E. Coyote. At the most recent quarterly meeting Coyote was not present, but the other four directors were. At that meeting, the board (by unanimous vote of all present) approved an acquisition. As soon as he found out about the acquisition (2 days after the meeting approving it), Coyote challenged it, stating (accurately) that he did not receive constructive or actual notice of the time and place set for the meeting.

(a) Does the lack of notice to Coyote make the board's action invalid?

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(b) What difference, if any, would it make if the meeting had been a special rather than regular quarterly meeting?

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19. Spencer Christian is a member of the board of Pitcairn Travel Agency, Inc. Captain Bligh, another director (and majority stockholder), calls a special meeting of the board of directors to discuss changing the location of the annual meeting from an island in the South Pacific to a town in the Midwest, since this would be far more convenient for the company's directors and shareholders. Christian doesn't receive notice of the meeting; however, he happens to be at company headquarters when the meeting starts. He sits in and offers his opinion — he's hotly against the move. A majority of the directors present vote for it, however. Christian then challenges the change, claiming that the meeting was invalid because he didn't receive clear and timely notice of it. What result? (Assume that there are no quorum issues.) _______________________________

20. Jack is president of the Fee Fi Fo Produce Company. Undertaking a new crop line is considered major enough to require approval of the board of directors. Nonetheless, Jack is at the Cow Tavern one day when Butcher, another patron, proposes to sell him some "magic beans," which Butcher claims will produce giant beanstalks. Fee Fi Fo doesn't plant beans currently. Jack says, "I can't buy the company unless my board of directors approves." Several members of the five-person board are out-of-

town. So Jack telephones each board member, one at a time, and asks them to approve the transaction. Four say "yes," but the fifth, Giant, says "no." Is Jack authorized to enter the purchase contract?

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21. Same facts as the previous question. Now, however, assume that all five directors say "yes."

(a) What procedural step can Jack take to implement the action without a formal board meeting at which a quorum is present?

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(b) Would your answer to part (a) work if Giant persisted in saying "no" to the proposed acquisition, while the other four directors said "yes"? ____________________________

22. Benedict Arnold is a member of the Libber Tea Company board of directors. He has two years left on his board term. The company does not have cumulative voting. George III, Libber Tea's majority shareholder, sells his interest to George Washington. At the next annual shareholders' meeting, Washington says (to everyone's surprise), "I now move to remove Arnold from the board of directors." Washington does not give any reason in support of his desire to remove Arnold. The motion is duly seconded. All shareholders but Washington vote against the motion (i.e., vote to keep Arnold), but since Washington owns a majority of the shares the motion passes. The jurisdiction has enacted the MBCA. Libber's articles of incorporation are silent on the issue of removal of directors.

(a) Putting aside any issues of notice, was Arnold validly removed from the board? ____________________________

(b) Now, focusing solely on the issue of notice, was Arnold's removal handled properly? ____________________________

(c) Would your answer to part (a) be different in a jurisdiction that follows the traditional common-law approach to removal of directors?

____

23. Melmac Phlegm Industries, Inc., has a board of directors with five members. The corporation's charter authorizes cumulative voting. Alf is elected to the board. He's not an especially impressive board member (he makes off-the-wall comments and rarely says anything intelligent), but he

doesn’t do or say anything that would be cause for removal in the jurisdiction. Two major stockholders duly call a special stockholders meeting for the stated purpose of removing Alf from the board. By a vote of 1,000 to 800, the shareholders vote to remove Alf, even though his term has one year left to run. Has Alf been validly removed from the board? ____________________________

Answers

16. (a) You should tell her to use cumulative voting. Of course, depending on the state and on what the company’s charter says, Carol may not be able to bring this about on her own. (For instance, MBCA §7.28(b) allows cumulative voting only if the charter explicitly includes it; if Brady Strippers’ charter doesn’t, then without Mike’s agreement Carol can’t get the charter amended and thus can’t use cumulative voting.)

You should also tell Carol to give *advance notice* to Mike that she’ll be voting cumulatively, if you’re in a jurisdiction that requires such advance notice. See, e.g., MBCA §7.28(d), so requiring.

(b) She’ll elect one director. Under cumulative voting, there’s no limit on how many shares a shareholder can use for any one candidate. The number of shares needed to elect *n* directors is determined by the formula

$$\frac{nS}{D+1} + 1$$

where *S* is the total number of shares voting and *D* is the number of directors to be elected. So to elect one director, Carol would need 26 shares ((100 total shares ÷ 4) + 1). Since she’s got 40 shares (120 votes), she’ll be able to do this. She’ll want to cast at 61 of her votes for her favorite candidate, let’s say Marcia. That way, even if Mike spreads his votes evenly (which is how he comes closest to being able to elect all three of his candidates), he’ll have only 60 votes for each, so Marcia will finish first, and one of his 3 will then lose to the other 2 in a run-off election. (If he splits his votes any other way, Marcia will finish third, and will take the third seat.)

(c) She won’t elect any directors. With straight voting, a shareholder

cannot cast, for any single candidate, more votes than the voter owns shares. Thus, in straight voting, although Carol gets 120 total votes, she can't cast more than 40 of them for any single candidate. Mike is, similarly, limited to 60 votes for any candidate. Therefore, the voting will be: Greg, Peter and Bobby, 60 each, Marcia, Jan and Cindy, 40 each, and Greg, Peter and Bobby will be elected.

17. **In most states, yes — even though they don't constitute a quorum.** Normally, a board election to fill a board vacancy is like any other board action — it must occur at a meeting at which a quorum is present. But to deal with the situation presented in this question, most states recognize an exception: when the number of directors remaining in office is less than a quorum, each vacancy can be filled by a majority vote of the remaining directors. [64] So in such a state, any candidate who got the vote of both of the remaining directors (i.e., a "majority" of the 2 remaining directors) would be elected. See, e.g., MBCA §8.10(a)(3).

18. **(a) No — The business transacted at the meeting was valid.** As a general rule, the board of directors may only take action at a properly convened meeting. The two prerequisites of a properly convened meeting are quorum and notice. The issue here is notice. The general rule is that "regular" meetings — i.e., those whose time and place are fixed by the bylaws or prior resolution — don't require notice of time and place. [63] See, e.g., MBCA §8.22(a) ("Unless the articles of incorporation or bylaws provide otherwise, regular meetings of the board of directors may be held without notice of the date, time, place or purpose of the meeting.") On these facts, the quarterly meetings are provided for in the bylaws. As a result, business at the meeting was valid, even though Wile E. didn't receive particular notice of it.

    (b) The meeting would probably be invalid. Most states *do* require that notice of time and place be given to each director for a "special" meeting, i.e., one which is not a "regular" (e.g., quarterly) one. See, e.g., MBCA §8.22(b) (at least 2 days advance notice of time and place required for a special board meeting.) [63]

19. **The meeting was valid, because Christian waived the notice requirement.** As the prior answer says, for "special" meetings — i.e., those whose time is not fixed by the bylaws or prior resolution — all

directors must receive clear and timely notice of the meetings (which includes the date, time, and place of the meeting). Here, Christian didn't receive notice, so if he hadn't attended a court would allow him to challenge the board action.

However, Christian waived the requirement by showing up at the meeting and not making a prompt objection to the lack of notice. See, e.g., MBCA §8.23(b) ("A director's attendance at or participation in a meeting waives any required notice to him of the meeting unless the director at the beginning of the meeting (or promptly upon his arrival) objects to holding the meeting or transacting business at the meeting and does not thereafter vote for or assent to action taken at the meeting.") [63] Therefore, the vote was valid.

20. **No.** Board action may generally occur only at a duly-noticed board meeting, at which a quorum is present. Most states now treat a director as being "present" if he's part of a telephone conference call. But this "exception" to the requirement of a quorum applies only if enough board members to constitute a quorum are all *simultaneously* on the phone, because the purpose is for them to all be able to discuss the matter at once and receive input from each other. The seriatim phone calls here did not satisfy this requirement. Therefore, no quorum was present, and consequently board action has not occurred. Since the facts say that undertaking a new crop line requires board approval, Jack can't proceed. (If Jack goes ahead anyway and plants the seeds, then the doctrine of "ratification" may apply. [77])

21. **(a) Have them sign a unanimous consent to the purchase.** Nearly all states now provide that directors may act without a meeting if they give their unanimous written consent to the proposed corporate action. See, e.g., MBCA §8.21(a). So all should sign copies of a resolution saying that the board approves the purchase.

    (b) No. For the "written consent" exception to work, the written consent must be ***unanimous***. Thus Giant, by refusing to sign, can force Jack to call a formal board meeting at which a quorum is present. That way, Giant will get to make his arguments in person to the other directors — he may get outvoted, but he's guaranteed a chance to speak against the action.

22. (a) Yes. Under the MBCA, as in most states today, shareholders can (by ordinary majority vote) remove a director from office at any time, without cause. See MBCA, §8.08(a). (This rule does not apply if the articles of incorporation say that directors may be removed only for cause, but the facts tell us that Libber's charter is silent on this point.) Thus the holders' action here sufficed to remove Arnold even though no cause (like fraud, or gross abuse of discretion) was shown. [61]

Observe that this very scenario — change of control — is the scenario in which the ability to remove a director without cause is of greatest importance. Without such an ability, Washington would have to wait until the expiration of Arnold's term, two years from now, before he would have full control of the board. And, in fact, if a majority of the board were friendly with George III and had the same two years to run, then Washington wouldn't be able to exercise any control over the company for two years even though he was the majority owner! So the power of removal-without-cause by vote of a majority of shareholders is very important to merger-and-acquisition law.

(b) No. Under MBCA, §8.08(d), "A director may be removed by the shareholders only at a meeting called for the purpose of removing him and the meeting notice must state that the purpose, or one of the purposes, of the meeting is removal of the director." Since the facts suggest (by the reference to "everyone's surprise") that the notice of meeting did not mention that Arnold's removal would be a purpose of the meeting, the vote was improper. [62] (But Washington could fix the problem at any time, at least under the MBCA. As a more-than-10% owner, he could call a special meeting of shareholders at any time under MBCA §7.02(a)(2), and state that the purpose was to vote on whether Arnold should be removed. [80] Then, he could cast his votes in favor of the motion and remove Arnold.)

(c) Yes. At common law, directors were only removable for cause; that is, for conduct harmful to the corporation, like fraud, incompetence, or disloyalty. Thus under the traditional rule, Arnold could successfully challenge his removal.

23. No. The fact that cumulative voting is authorized by the corporation makes all the difference. In virtually all jurisdictions, if the corporation

has authorized cumulative voting, a director cannot be removed without cause if there are cast against his removal enough votes to have elected him under cumulative voting. (If this were not the rule, the majority could always remove minority-chosen directors, defeating the whole purpose of cumulative voting.) [62] See, e.g., MBCA §8.08(c). Here, there were 1800 shares voting, and the board has 5 seats. Therefore, by the formula for the number of shares which one must control in order to elect one director (further explained in the answer to question 15):

$$\frac{S}{D+1} + 1 \ ,$$

Alf could have been elected so long as at least the following number of shares voted for him:

$$\frac{1800}{6} + 1 = \ 301$$

Since the 800 shares voted against Alf's removal were more than 301, Alf got enough support to have elected him to the board, so he won't be deemed to have been removed. (If the corporation had not authorized cumulative voting, then the analysis would be like that in the prior question, and Alf would be deemed removed by simple majority of those voting.)

III. OFFICERS

A. Meaning of "officer": The term ***"officer"*** is usually used to describe only the more important executives in the corporation. Clark, p. 114. Typically, the term is used to describe those executives who are ***appointed directly by the board of directors***. *Id.*

1. Names of posts: Most older statutes specify the particular officerships that a corporation must have. For instance, many statutes require that there be a president, one or more vice-presidents, a treasurer, and a secretary.

a. Model Act and Delaware: But the modern trend is ***not*** to require specific named positions. For instance, both the MBCA and Delaware leave it up to the bylaws or to the board

to determine what officers there shall be. See MBCA, §8.40(a); Del. GCL §142(a).

2. **Multiple posts for one person:** Whether or not the statute requires certain named officers, nearly all statutes allow one person to hold ***multiple officerships simultaneously***. In a closely-held corporation, for instance, the president will also commonly be the treasurer.

   a. **Exception for secretary:** The one exception is that the ***president*** and ***secretary*** are usually ***not*** permitted to be the ***same*** person. The reason is that the secretary's principal function is to certify that a person signing a document as chief executive officer is in fact that person; it would make little sense to allow *A* in his role as secretary to certify that he, *A*, is in fact the president/CEO — "an imposter would happily certify these facts." K&C, p. 124.

B. **Right to hire and remove:** The board of directors has not only the power to appoint officers, but also the power to ***remove them***, with or without cause. This is true even though the officer has an employment contract that is still in force — the board has authority to fire the officer, but he in turn has the right to sue the corporation for damages (but not the right to specific performance, i.e., the right to be reinstated).

C. **Authority to act for corporation:** Recall that, under the traditional view, the corporation is managed by the board of directors, not by the officers (*supra*, p. 50). Therefore, even when an officer ***purports to act on behalf of the corporation*** and to bind the corporation, his action ***may not be legally sufficient to bind the corporation***. Since the officer is an ***agent*** of his principal (the corporation), the officer's authority to bind his principal is usually analyzed by use of traditional ***agency principles***.

1. **Not automatically binding:** The most important concept to keep in mind is that an officer (even the president) ***will not automatically have authority*** to bind the corporation to a transaction merely by virtue of his office. Only if one of the doctrines described below applies will the corporation be bound

by the act of its officer.

> **Example:** Brown, the treasurer of ABC Corp., promises Gray that ABC will guarantee a debt owed by Black to Gray. The mere fact that Brown is ABC Corp.'s treasurer does not give him authority to bind ABC. Therefore, unless Gray can show that Brown had express authority, implied actual authority, or apparent authority to bind ABC, or that the board subsequently ratified the guarantee (the four doctrines described below), Brown's action will not cause the corporation to be bound to honor the guarantee, even if Brown honestly believes that he had authority to bind the corporation, and even if Gray honestly believed Brown's statement that he, Brown, had authority.

2. **Four doctrines:** There are four doctrines commonly used to hold that the officer has bound the corporation: (1) ***express*** actual authority; (2) ***implied actual*** authority; (3) ***apparent*** authority; and (4) ***ratification***. We will consider each of these in turn.

3. **Express actual authority:** ***Express actual authority*** is the easiest concept to understand. Usually, this comes into existence by an explicit grant of authority to the officer to act on behalf of the corporation. This explicit grant generally comes from either the corporation's ***bylaws***, or in the form of a ***resolution*** adopted by the board of directors.

> **Example:** The board adopts a resolution authorizing the Vice President to negotiate and sign a contract to dispose of one of the corporation's surplus plants. This board resolution constitutes a grant of express authority to the Vice President. Therefore, when he signs the contract on the corporation's behalf, the corporation will be bound, even if it is not usually the case (either generally or in this particular corporation) that vice presidents may sign contracts to sell plants.

4. **Implied actual authority:** The doctrine of "***implied*** actual authority" is a much fuzzier one. It is often described as "authority which is ***inherent in the office.***" Clark, p. 115. There

are two common ways in which implied actual authority can come into existence:

a. **Inherent in post:** First, authority may be ***inherent*** in the particular ***post*** occupied by the officer, measured by the ***common understandings of business people***.

   Example: It is today commonly assumed that the president of a corporation has actual authority to sign at least non-extraordinary contracts (e.g., contracts for the corporation to receive supplies that it needs in the ordinary course of its business). Therefore, if President signs such a supply contract on behalf of Corporation, the court would probably hold that President had implied actual authority to bind Corporation to this contract, even though the board of directors never specifically authorized him to sign either this particular contract or any similar contract — authority to sign such contracts is simply found to be inherent in the presidency of a corporation.

b. **Particular action of board:** Second, the board, by its own ***conduct or inaction***, may have ***implicitly*** granted the actual authority to the officer in question. Thus even if vice presidents in the business world are generally not permitted to sign contracts disposing of surplus plants, the fact that ABC's Corp's board has allowed Vice President to do so in the past without objection, or the fact that the board has known that Vice President was about to sign the particular contract in question, would be enough to clothe Vice President with implied actual authority to sign the present contract on behalf of ABC.

c. **Particular posts:** There has been a lot of litigation about the inherent power of various corporate posts, especially the presidency.

   i. **Presidency:** Traditionally, the ***president*** had little if any authority to bind the corporation merely by virtue of his office. However, this narrow view conflicted with what most non-lawyers thought the president could do.

Therefore, the modern trend is to treat the president as having, by mere virtue of his position, at least the authority to bind the corporation in ***ordinary business transactions***. H&A, p. 596.

(1) Illustration: Thus most courts today would probably hold that the president has implied authority, by virtue of his office, to ***hire and fire*** non-officer-level employees; and the authority to enter into ***ordinary-course contracts*** (e.g., contracts to supply the business' ordinary raw materials requirements, or to sell part of the corporation's output).

(2) Beyond the scope: But other kinds of actions would, even under the more expansive modern rule, probably be found to be ***"extraordinary"*** and thus ***not authorized*** by the president's office alone: ***lifetime employment contracts***; contracts to sell, lease or mortgage ***real estate***; contracts to sell all of the corporation's ***assets***; contracts to issue and distribute ***new stock***; and agreements to ***settle*** important litigation.

See generally Clark, p. 116; Nutshell, p. 238.

ii. Chairman of the board: There is no generally accepted rule about the inherent authority of the ***chairman of the board***. The scope of this post varies dramatically from corporation to corporation — in some companies this post is held by the chief executive officer (with the president being the chief operating officer, or number two executive); in other cases the chairman is largely an honorary figure, who is not the C.E.O. In general, it is not safe to assume that the chairman has ***any*** inherent authority by virtue solely of his position. C&E, p. 302-03.

iii. Vice president; treasurer: A ***vice president*** or a ***treasurer*** probably has little if any authority by virtue of his or her position. However, if a vice president has the appearance of standing close to the top of the corporate hierarchy, (e.g., an Executive Vice President), he may under

the modern, looser, approach to authority be held to have some limited authority in ordinary-course matters. *Id*.

iv. Secretary: The ***secretary*** has one key element of inherent authority in virtually every jurisdiction: He has inherent authority to ***certify the records of the corporation***, including ***resolutions*** of the board of directors. Therefore, a secretary's certificate that a given resolution was duly adopted by the board is ***binding*** on the corporation in favor of a ***third party who relies on the certificate***. C&E, p. 303-04. (But the secretary has no other inherent authority to bind the corporation.)

5. Apparent authority: A third way in which the officer may bind the corporation is by the doctrine of ***apparent authority***. Under this doctrine, when the actions of a ***principal*** (the ***corporation***) give the ***appearance to reasonable persons*** that the agent is authorized to act as he is acting, the principal is held responsible for creating the impression that the agent had actual authority to act; therefore, the principal may not avoid the transaction. K&C, p. 123.

a. Requirements: Thus for the third party to successfully invoke the apparent authority doctrine, he will have to show that: (1) the ***corporation***, by acts ***other than those of the officer***, ***indicated to the world*** that the officer had authority to do the act in question; *and* (2) the plaintiff was ***aware*** of those corporate indications and relied on them. K&C, pp. 123-24.

b. Mere position as source of apparent authority: Sometimes, the plaintiff will be able to point to specific, affirmative conduct by the corporation that indicates to the world that the officer has the authority in question. For instance, if the board of directors is aware that Vice President has routinely been signing large contracts to buy raw materials, and the board does not object, a supplier who can show this past pattern of acquiescence (and who can show he was aware of it at the time of his own contract) would probably succeed in arguing that Vice President had apparent

authority. But often, the mere ***post*** held by the officer, when coupled with ***industry practice***, will be enough to create apparent authority. This is most likely to happen where the action is by the company's president, and the action is of a sort that presidents are usually permitted to take.

Example: The board of directors of Corporation appoints Smith as president. Because the chairman's son has long held the post of vice president for Office Supplies, Smith is handed a board resolution expressly denying that Smith has any authority whatsoever to purchase office supplies for Corporation. Nonetheless, Smith, introducing himself to Supplier as president of Corporation, orders office supplies. Supplier does not know of the special limitation on Smith's authority.

Assume (as is probably the case) that by custom, a person holding the title of president will in most corporations have actual authority to order office supplies. If so, Supplier will probably be able to bind Corporation to the contract Smith signed with him, on an apparent authority theory. The board of directors, by clothing Smith with the title of "president," has indicated to the world that Smith has the authority usually found in that post. If the board wishes to deny Smith that authority, it must bear the burden of ***communicating to the world*** (including to Supplier) that Smith does not have this customary presidential authority. Observe that on these facts, Corporation is bound under the apparent authority doctrine even though it is absolutely clear that Smith did not have any kind of actual authority (not even implied actual authority) because of the resolution. See Clark, p. 117.

c. Representation by agent: For the apparent authority doctrine to apply, it is ***not*** sufficient that the ***agent himself*** represents to the third party that he has authority to enter into the transaction. The indications of authority must come from ***someone else*** in a position of power at the corporation. Thus if Vice President tells Supplier "I have full authority to contract for the purchase of office supplies," this representation does

not create apparent authority, since Supplier should know that Vice President may simply be lying or mistaken about the degree of his authority. (If, on the other hand, the board of directors had appointed him with the title Vice President of Supplies and given him a business card with that title, a person who saw and relied on the card would probably succeed in establishing apparent authority.)

d. The president and "ordinary-course" transactions: As we saw in the example involving Smith and the supplies, *supra*, the mere fact that an officer has been given a common title (e.g., president) will itself be enough to give him apparent authority to do certain transactions. In the case of an officer bearing the title of president, the usual modern rule is that the president has apparent authority "to take actions in the ***ordinary course*** of business, but ***not extraordinary*** actions." C&E, p. 300-01. But where is the line between "extraordinary" and "ordinary"? "A useful generalization is that decisions that would make a ***significant change*** in the ***structure*** of the business enterprise, or the structure of ***control*** over the enterprise, are extraordinary corporate actions and therefore normally outside the president's apparent authority." C&E, p. 301-02.

i. Illustrations: Thus the ***issuance or re-purchase*** of ***shares*** by the corporation, the taking on of significant ***debt***, the making of significant ***capital investments***, the ***sale*** of one of the corporation's ***significant businesses***, or its entry into an important ***new line of business***, would all be "extraordinary" (and thus not within the president's apparent authority) in most circumstances. *Id.*

ii. Comparison with implied actual authority: Observe that a similar "extraordinary vs. ordinary" test is also used to determine whether the president has ***implied actual*** authority to take a particular action. (See *supra*, p. 74.) But even though a given act by a president will often indicate that he has both implied actual authority (by virtue of his position) and apparent authority, the two doctrines are not

the same. Implied actual authority can always be negated by an express board resolution to the contrary (as in the Smith office-supplies example *supra*, p. 75); but the board cannot negate apparent authority unless it communicates this fact to the third person who is relying.

e. Question of fact: In the final analysis, it will often be a ***question of fact*** for the jury whether, taking into account all the circumstances, the officer had apparent authority to do the act in question. That is, there are many situations that are so close to the blurry line between "extraordinary" and "ordinary course" transactions that it cannot be said as a matter of law that the transaction falls into the one class or the other.

6. Ratification: Suppose that at the time an officer acts on behalf of the corporation, he has neither actual nor apparent authority. The corporation may nonetheless be bound by its ***subsequent*** actions, under the doctrine of ***"ratification."*** Under this doctrine, if a person with actual authority to enter into the transaction ***learns*** of the transaction and either expressly ***affirms*** it or even ***fails to disavow it***, the court may find that the corporation is bound.

a. Retention of benefits or reliance by third party: In most of the cases where the ratification doctrine is applied, either or both of two special factors is present: (1) the corporation has ***received benefits*** under the contract, which it has not returned; or (2) the third party has ***relied to his detriment*** on the existence of the contract. Nutshell, p. 240. However, strictly speaking the mere after-the-fact approval or acquiescence of the board ought to suffice, even without either of these two special factors.

b. Full knowledge by board: Of course, the plaintiff who is claiming ratification must show that the ratifier had ***full knowledge*** of the contract. For instance, if the board knows that the president has signed a contract to acquire a company from X, but does not know that the president is receiving a kickback from X or does not know that the contract calls for

the corporation to pay a very excessive price, a court would probably not find that the board's mere failure to object constituted ratification.

7. **A "bullet-proof" means of confirming authority:** The above discussion demonstrates that authority is a tricky concept — a third party will often find it hard to be certain that the corporation officer he is dealing with really has authority to bind the corporation to the proposed transaction. However, there is one "bullet-proof" way in which a third party can be certain that the corporation will be bound: He should "require the person purporting to act for the corporation to deliver, prior to the closing of the transaction, a ***certified copy*** of a ***resolution*** of the board of directors authorizing the transaction in question or directing the named officer to enter into the transaction on behalf of the corporation. The certificate should be ***executed*** by the ***secretary*** or an assistant secretary of the corporation, the corporate seal should be affixed, and the certificate should recite the date of the meeting (or a statement that the resolution was approved by unanimous written consent) and quote the resolution itself." Nutshell, p. 237.

   a. **Rationale:** The reason that such a certificate is binding on the corporation is that, in all states, the corporation is ***estopped*** to deny the correctness of its secretary's certification that a particular resolution was adopted by the board.

Quiz Yourself on
THE CORPORATE STRUCTURE *(OFFICERS)*

24. Frontier Foods, Inc., appoints Betty Crockett treasurer of the corporation, with the express authority to handle corporate funds, and no express authority to do anything else. However, whenever the other officers and employees have their hands full, Betty steps in and helps out by purchasing inventory on the corporation's behalf. She's purchased hardtack for Frontier Foods from the Tuffas Leather Company several times before, and Frontier has always paid the invoices. Betty now makes out a new purchase order for fifty cases of hardtack, and Tuffas

manufactures her order. Before it's delivered, some board members find out that they can get a much better deal on hardtack from a competitor. They try to cancel Betty's hardtack purchase order, claiming that it was unauthorized. Is the purchase order a valid corporate obligation? Cite the doctrines you use in arriving at your answer.

____

25. Dr. Seuss is the corporate secretary for the Sam I Am Company. The company's office manager usually handles the arrangements for the annual meeting of shareholders, and has the express authority to make all necessary contracts regarding the arrangements for the meeting; however, this year the office manager, Bartholomew, has an oobleck virus and can't set up the meeting. Dr. Seuss steps into the void. He looks through the yellow pages and hires the Cat N. Hat Caterers to provide two hundred servings of green eggs and ham.

(a) Assume that the meeting takes place as scheduled. At the meeting, the directors, officers, and shareholders all eat the green eggs and ham. When Cat N. Hat sends its bill, Sam I Am refuses to pay, claiming that Dr. Seuss, as corporate secretary, had no power to bind the corporation. What result? (Cite any relevant doctrines.)

____

(b) Assume for this part only that before the meeting, Cat N. Hat sent a document marked "Confirmation," in which he said, "This confirms that we will supply 200 svgs, green eggs & ham, to your annual meeting on 6/14/13." The confirmation is marked, "Attn: President," and the President in fact sees it. He does nothing for two weeks, during which time Cat N. Hat makes substantial preparations (e.g., he makes a special purchase of green eggs.) Three days before the meeting, the President sends a letter to Cat: "The catering order was submitted to you by Dr. Seuss, acting without proper authority. Consider it rescinded." Can Cat hold Sam I Am to the contract (as opposed to merely recovering in quantum meruit for services already performed)?

____

Answers

24. Yes, on either an"implied actual authority" or "apparent authority" theory. The issue here is whether Betty had authority to bind the corporation. Officers can bind the corporation only if they act within the scope of their corporate authority (unless the corporation subsequently ratifies the officer's action, something that's not relevant to this problem.) There are four types of authority commonly recognized: (1) express actual authority; (2) implied actual authority; (3) apparent authority; and (4) ratification. Here, Betty probably had both "implied actual authority" and "apparent authority."

An officer has "implied actual authority" whenever either: (1) authority is inherent in the particular post occupied by the officer, measured by common business understandings about what people holding that post customarily do; or (2) the corporation, by its own conduct or inaction, has implicitly granted the actual authority to the officer in question. [74] The situation here falls into case (2), because when the corporation on prior occasions allowed Betty to place purchase orders and uncomplainingly paid the bill, the corporation was implicitly giving her actual authority to place such orders. So even if Tuffas hadn't been aware that it was Betty who had placed the prior orders, Frontier would still be bound because it gave Betty implied actual authority.

An officer has "apparent authority" when the corporation indicates to a third person that the officer has authority to act on its behalf, and the third person believes in good faith that such authority exists (whether or not it actually does). [75] So Betty had apparent authority to place the order for hardtack, since Tuffas knew that Betty had placed prior orders with it that the corporation had honored. Therefore, even if Frontier now wishes to change its mind about Betty's authority (or had, unbeknownst to Tuffas, changed its mind before the latest order), Frontier is stuck under the apparent-authority doctrine, because the only issue is what Tuffas reasonably *believed* about Betty's authority, and Tuffas clearly had grounds to believe that Betty's purchase was authorized. (Remember, by the way, that for apparent-authority to apply, the corporation itself, not just the agent, must convey to the third person that the agent has authority. So if there had been no prior orders, and Betty had merely told Tuffas, "I have authority to buy," this would not suffice for apparent authority. It's the corporation's acquiescence in the prior orders by Betty

that makes the difference here.)

25. **(a) Sam I Am is liable, on grounds of ratification.** The issue here is a corporate officer's ability to bind the corporation. As a general rule, corporate secretaries by virtue of their post alone have no authority to bind a corporation, certainly not to a purchase order. (In other words, Seuss had no express authority or implied actual authority at the moment he acted, nor did he have apparent authority.) However, even though an act is unauthorized at the moment it occurs, it can become authorized after the fact, if the requirements for "ratification" are met. Ratification occurs when the corporation either expressly adopts the unauthorized act (e.g., by passing an explicit resolution adopting the act) or implicitly indicates, by conduct or inaction, that it approves of the action. [77] The most common way in which a corporation implicitly indicates its approval after the fact is by retaining the benefits from the transaction. Here, by allowing its employees to attend the event and eat the green eggs and ham, Sam I Am implicitly ratified the contract. Therefore, the company is liable.

    (b) Yes; the company is nonetheless bound. Again, the doctrine of ratification applies. A company can ratify an otherwise-unauthorized act not just by retaining the benefits, but even by remaining silent after learning of the proposed transaction. [77] Such "silent ratification" is especially likely to be found where the other party relies to his detriment on the proposed transaction, while the corporation is remaining silent. So when the President (who by his post clearly had authority to enter into the transaction in the first place or to ratify it later), remained silent for two weeks during which time Cat was relying (purchasing special eggs, etc.), this would constitute ratification even before the affair occurred.

IV. FORMALITIES FOR SHAREHOLDER ACTION

A. Generally: We examine now some of the mechanics by which ***shareholders exercise their right to vote*** on certain aspects of the corporation's affairs. In particular, we examine: (1) the giving of notice of a shareholders' meeting; (2) the quorum for such a

meeting; and (3) the method of voting at such a meeting.

B. Annual vs. special meeting: Nearly all states require a corporation to hold an ***annual meeting*** of shareholders. See, e.g., MBCA §7.01(a). Corporations may also hold a ***"special"*** shareholders' meeting; a special meeting is any meeting other than the regularly-scheduled annual meeting. See MBCA §7.02(a).

1. **No penalty for failure to hold annual meeting:** If the corporation fails to hold an annual meeting, this failure does ***not*** make the corporation's subsequent actions invalid. See MBCA §7.01(c). However, if the annual meeting is not held when scheduled, a shareholder will probably be able to get a court to ***order*** that one be held. See e.g., MBCA §7.03(a)(1) (meeting will be ordered by court on application of any shareholder if meeting has not been held six months after the end of the corporation's fiscal year or fifteen months after its last annual meeting, whichever comes first.)

2. **Purpose of annual meeting:** The purpose of an annual meeting always includes at least the ***election of directors***. (See *supra*, p. 51.) However, the annual meeting may also consider any other relevant issue. According to most statutes, any other issue may be considered even if the issue was not specifically referred to in the ***notice*** given to shareholders. See e.g., MBCA §7.05(b) (notice of annual meeting "need not include a description of the purpose or purposes for which the meeting is called.")

3. **Purpose of special meeting:** A ***special*** meeting is normally called to consider one or a small number of very important matters that cannot wait until the next annual meeting. Unlike the notice of an annual meeting, the notice of the special meeting must ***state the particular issues*** to be raised at the meeting, and no other issues may be considered. See MBCA §7.05(c) and §7.02(d).

4. **Who may call a special meeting:** Statutes vary as to ***who may call*** a special meeting. Such a meeting may always be called by the board of directors. Also, any person or group who is authorized by the ***bylaws*** to call a meeting (e.g., the president,

under many bylaws) may do so.

a. **Called by shareholders:** Also, some (but by no means all) states allow the holders of a certain ***percentage*** of the ***shares*** to call a special meeting. The MBCA goes especially far in this respect: Under §7.02(a)(2) the holders of a mere ***ten percent*** of the shares may cause a special meeting to be held. By contrast, Delaware does ***not*** allow even a larger percentage of shareholders to call a special meeting; only the board or persons authorized in the bylaws may do so; see Del. GCL §211(d).

i. **Raider:** Observe that the MBCA approach gives a ***raider*** (i.e., a person attempting a hostile takeover) important powers: If he gains control of a majority of the shares shortly after an annual meeting, he may call a special meeting, ***remove a majority of the existing directors without cause***, and elect his own slate. Under the Delaware approach, by contrast, he probably has to wait until the next annual meeting to gain a majority of the board. (But in Delaware, the raider could probably accomplish the same result by use of Delaware's unusual provision allowing action to be taken by a non-unanimous majority of shareholders based on their written consent; see *infra*, p. 82.)

C. **Quorum:** Statutes generally require that a ***quorum*** be present at the shareholders' meeting equal to a ***majority of the outstanding shares***. However, the percentage required for a quorum may be ***reduced*** as provided in the articles of incorporation or bylaws.

1. **Minimum:** However, many statutes set a minimum percentage below which not even the articles or bylaws may set the quorum. Many of these require that at least ***one-third*** of the shares be present as the minimum allowable quorum. See, e.g., Del. GCL §216, setting this one-third figure. But the MBCA makes the articles' or bylaws' minimum quorum provision effective ***no matter how low it is***. See MBCA §7.25(a).

2. **Higher numbers:** Conversely, nearly all states allow the

articles or bylaws to set a ***higher*** percentage as the quorum. This is frequently used as a control device in closely-held corporations; for instance, the articles might require ***all*** shares in a close corporation to be present, as a way of letting the minority shareholder veto action of which he disapproves. Nutshell, p. 177.

D. Vote required for approval: Once a quorum is present, the traditional rule is that the shareholders will be deemed to have approved of the proposed action only if a majority of the ***shares actually present*** vote in ***favor*** of the proposed action.

1. Explanation: Observe that this rule contains two important sub-rules: (1) only a majority of the shares ***present***, not a majority of the total shares eligible to vote, must support the proposal being voted on; and (2) a majority of the shares present must ***affirmatively vote in favor*** of the proposal; that is, an ***abstention*** is the equivalent of a vote against.

a. MBCA changes rule: The MBCA ***changes*** the traditional rule with respect to (2), by making abstentions the same as votes that are not cast. §7.25(c) provides that action on a matter "is approved if the votes cast … favoring the action exceed the votes cast opposing the action.…"

Example: Corporation has 1000 shares outstanding. 600 shares are represented at the meeting (a quorum is, of course, 501, assuming that the articles and bylaws do not set a different number). The vote on an action is 280 in favor, 225 opposed and 95 abstaining. Under the traditional approach, the proposal fails, since it needed 301 votes (a majority of the shares present). But under the MBCA, the action is approved 280-225. See Official Comment to §7.25(c); see also Nutshell, p. 178.

b. Election of directors: The rules for elections of ***directors*** are different from the rules for all other action by shareholders. These director-election rules are discussed in detail *supra*, p. 55. Most importantly, a minority of shareholders will frequently be able to elect one or more members of the board

of directors, because of the use of cumulative voting. (Cumulative voting does not apply to shareholder approval of matters other than the election of directors.)

c. **Super-majority for fundamental changes:** Also, the standard rule that a majority is enough to constitute approval does ***not*** apply to certain issues that are of ***"fundamental"*** importance. Most states now allow the articles or bylaws to set a ***higher percentage*** as the minimum percentage needed to approve any given transaction, and many corporations have instituted such higher requirements for fundamental transactions like mergers. Indeed, a "super-majority" voting requirement before the corporation can be acquired by another corporation is a common anti-takeover device today. See *infra*, p. 451.

2. **Breaking of quorum:** Recall that a quorum of directors is required ***throughout*** the directors' meeting. (*supra*, p. 64.) A comparable rule does ***not*** apply to shareholders' meetings. Once a quorum is present at the beginning of the meeting, the quorum is deemed to exist for the rest of the meeting, even if so many shareholders ***leave the meeting*** that the total number present would be less than the number needed for the quorum. See e.g., MBCA §7.25(b) ("[O]nce a share is represented for any purpose at a meeting, it is deemed present for quorum purposes for the remainder of the meeting and for any adjournment of that meeting unless a new record date is or must be set for that adjourned meeting.") Thus if a minority block knows that its presence is required for a quorum, and fears that a proposal it opposes will be passed, it should not attend the meeting at all rather than attending and leaving before the vote on the issue. Nutshell, pp. 178-79.

3. **Written consent:** Just as directors may act by unanimous written consent (see *supra*, p. 65), so nearly all states allow ***shareholders*** to act by ***unanimous written consent*** without a meeting. Such a provision is especially useful in closely-held corporations, where the few shareholders are in agreement, and the holders do not want to waste time on a formal meeting.

Nutshell, p. 179.

a. **Written consent by less-than-majority:** Furthermore, about a dozen states now allow shareholder approval in the form of written consent by the number of votes needed to approve the action, even if this is ***non-unanimous***. See, e.g., Delaware GCL §228(a). Thus in Delaware for ordinary corporate action requiring approval by a majority of the shares, if the holders of a majority sign a written consent to the action, the action will be binding without a meeting, and the minority shareholders will not have the right to dissent publicly at a meeting. (This trend contrasts with the practice as to directors' meetings, where virtually all states require that the directors must either meet or consent unanimously (*supra*, p. 65).)

   i. **Use in takeovers:** Observe that allowing shareholder action to be taken by written majority consent may help a ***raider***: Once the raider acquires a majority of the target's shares, he can carry out shareholder approval of any action needing a mere majority without having to convince the board to hold a special meeting of shareholders. See Nutshell, p. 179.

4. **Meeting in cyberspace:** Traditionally, shareholders have had to be ***physically present*** at the shareholders' meeting in order to count towards a quorum, and to vote. (Unanimous written consent, *supra*, has been the one exception to this rule.) But recently, some jurisdictions have allowed for shareholders meetings to take place ***electronically***, such as via the Internet. For instance, in Delaware the board may authorize shareholders to participate in a meeting "by means of ***remote communication***" and to vote by that same means. Del. G. C. L. §211(a)(2). What Delaware has in mind is a ***"meeting by website,"*** in which shareholders log in, prove that they are authorized, "hear" the proceedings, and vote, all in a web browser. Cf. Hamilton (8th), p. 559, n. 10. The meeting can be in a particular physical location, with shareholders having the choice of attending physically or logging in; alternatively, the statute authorizes the meeting to take place "***solely*** by means of

remote communication," in which case there would be no physical location at all. §211(a)(2)(B).

Quiz Yourself on ***THE CORPORATE STRUCTURE*** *(FORMALITIES FOR SHAREHOLDER ACTION)*

26. Ferdinand de Gama is the chairman of the board of the Cheap & Good Boat Company. Cheap & Good's articles of incorporation have a purposes clause, limiting the company's boat production to pleasure boats no longer than twenty feet. De Gama believes that there is much money to be made in larger, ocean-going vessels. He gets the board to call for a special meeting of the shareholders, to discuss amending the purposes clause in the articles to encompass larger vessels. That's the agenda that's included in the notice to shareholders announcing the special meeting. The corporate president, Marco Polo, convenes the meeting. After the shareholders vote in favor of the amendment, de Gama figures that, since everyone's all together anyway, it would be an ideal place to discuss a merger with the Chinese Junk Company, which specializes in ocean-going vessels. The combined company would be known as the Cheap Junk Company. Discussion takes place, and the shareholders then present approve the merger. Has the merger received proper shareholder approval? ____________________________

27. Popeye tires of life at sea and decides to open a chain of massage parlors, "Sweet Pea Parlors, Inc." There are 100 shares outstanding. Popeye owns 51 shares, Olive Oyl 30 and Bluto 19. Each shareholder is elected to the 3-person board of directors. At a time when each of the three stockholder/board-members has 2 1/2 years to go on his board term, Popeye sells his shares to Sea Hag. (Assume that there are no share-transfer restrictions preventing this.) The corporation's charter is silent on the issue of cumulative voting. Sea Hag wants to join the board of directors immediately (and in fact would prefer to replace all directors with ones beholden to her.) Because of bad lawyering by Sea Hag's lawyer, the share-purchase agreement did not require Popeye to resign from the board, and he refuses to do so now. The state has enacted the MBCA. What procedural step would you advise Sea Hag to take right

away (and how will things work out if she takes that step)?

____

28. Same basic facts as the prior question. Now, assume that, at a duly-noticed shareholders meeting, Olive Oil and Bluto show up, but Sea Hag doesn't. (Nor does Sea Hag give anyone else her proxy). At the meeting, Olive Oil introduces a motion to change the company's accountant. (Assume that this is a proper subject for shareholder action. Also, assume that the charter and bylaws are silent about all issues relevant to this question.)

(a) Assume that both Olive Oil and Bluto vote their shares in favor of the motion. Is the corporation now authorized to change accountants?

____

(b) Assume that Olive Oil votes her shares for the motion, and Bluto votes his shares against it. Putting aside any issue of procedural irregularity with respect to the holding of the meeting, has the motion passed? _____________________________

Answers

26. **No, because the merger was not mentioned as one of the purposes of the meeting.** Shareholders are entitled to notice of both annual and special shareholders' meetings. If the meeting is "special" (i.e., a meeting other than the annual meeting), as is the case here, virtually all states say that the notice must include a statement of the meeting's purpose. [80] See, e.g., MBCA §7.05(c) ("Notice of a special meeting must include a description of the purpose or purposes for which the meeting is called.") What this statement does is limit the scope of what may be discussed at the meeting, since no unstated business can be transacted at the meeting. Since the notice didn't mention the merger, it can't be discussed.

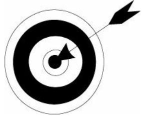
(No statement of purposes is required in the notice for the *annual* meeting, by contrast. But even as to an annual meeting, if a merger will be discussed, shareholders must be told in advance that this will happen, and must be given the details of the plan. See, e.g., MBCA §11.04(d). So even if de Gama was making his merger proposal at the annual meeting as opposed to at the special meeting, the merger couldn't be approved

without this proposal's having been mentioned in the notice-of-meeting.)

27. **You should advise her to call an immediate special meeting of shareholders, at which Sea Hag will move to remove all directors without cause.** Most states now allow the holders of a certain percentage of shares to call a special shareholders' meeting at any time. The MBCA allows any holder or holders of more than 10% to do this (see §7.02(a)(2)). Then, the shareholders can, under the MBCA (as under the law of most states today), remove any director by majority vote, even without cause. So, because the corporation doesn't have cumulative voting, at the meeting Sea Hag can cast all her votes (51% of the total votes cast) to remove all three directors. She can then elect herself to one of the vacancies by majority vote. Then, she can (either as the sole member of the board or as majority shareholder) elect two new directors to fill the vacancies. Thus she gets complete board control without waiting for the prior directors' terms to expire. (If the corporation had had cumulative voting, Sea Hag would only have been able to remove two directors and control the election of their replacements — by the formula on p. 56, she would have had just exactly the 51 shares (153 votes) needed to elect two of three directors, and not enough to elect all three.)

28. **(a) No, because there was no quorum for the meeting.** Unless the charter or bylaws provide otherwise (which the facts say they don't), a shareholder meeting requires a quorum of at least a bare majority of the outstanding shares entitled to vote on the measures at issue. Since only 49 of 100 shares were present, shareholder action could not validly take place.

    (b). Yes, since we're told to ignore the quorum problem. The real issue in this sub-question is whether the fact that less than a majority (i.e., only 49%) of the total shares outstanding voted for the measure prevents the measure from passing. The answer is "no" — all that's required is that a majority of those shares *actually voting* vote for the measure. (States differ in how they treat abstentions, but that's not an issue here.) Since 30 out of the 49 votes actually cast voted for the measure, it passed.



Exam Tips on *THE CORPORATE STRUCTURE*

Here are the main things to watch for in connection with the corporate structure:

- ☛ Whenever your fact pattern describes an attempt to ***remove a director***, here's what you should keep in mind:
  - ☞ The ***shareholders***, by majority vote, can always remove a director for ***cause*** (e.g., fraud, gross incompetence, or a breach of the duty of loyalty).
  - ☞ Also, most modern statutes (including the MBCA) let a ***majority of the shareholders*** remove a director ***even without cause***, unless the corp's charter provides differently.
  - ☞ ***Directors***, even by majority vote, ***cannot*** remove a fellow director even for cause, unless the charter or bylaws specifically say they can.
  - ☞ The ***court*** may (under most modern statutes) remove a director for ***cause*** (e.g., fraudulent or dishonest conduct, or gross abuse of power).
- ☛ If your fact pattern involves the ***removal of an officer*** (e.g., the president), here's what you should remember:
  - ☞ The ***board*** has the power to remove an officer, ***with or without cause***. That's true even if the officer has an employment contract — the board has power to remove the officer anyway (and the officer's only recourse is a suit for damages, not a suit to enjoin the dismissal or to compel reinstatement).
  - ☞ ***Shareholders***, even by majority vote, do ***not*** have the power to remove an officer.
- ☛ ***Election of directors*** is often tested.
  - ☞ The most common issue about election of directors involves ***filling board vacancies***. Here, the usual rule (and the MBCA approach) is that the vacancy can be filled ***either by shareholder vote*** or ***board vote***.
  - ☞ Don't overlook the possibility that a corp. may have ***cumulative voting***. In cumulative voting, a shareholder may ***aggregate his votes*** in

favor of fewer candidates than there are slots available.

Example: A, B and C each own 100 of G Corp's 300 shares outstanding, and are its 3 directors under annual terms. C dies, and D inherits her shares. The bylaws say that a 90% majority is required for election of new directors. You have to say whether, at the next holders' meeting, D can elect herself as a director, against the wishes of A and B. If G Corp. has cumulative voting, D can do so — she can cast all 300 of her votes in favor of herself, and thus come up with a "100% vote" (i.e., 1 vote for each share outstanding) for herself, even if A and B don't vote for her.

☛ You'll sometimes be asked about when shareholders can ***compel the calling of a special shareholders' meeting***. In general, the board is ***not obligated*** to call such a meeting (even if a majority of holders requests it) unless the particular action sought to be accomplished must be approved by shareholders.

Example: P, majority holder of X Corp., wants to remove Pres., the corp's president. P calls for a special meeting of shareholders to consider his motion to fire Pres. The board refuses. P can't compel the board to hold the special meeting, because shareholders don't have the power to fire officers, and therefore don't have the right to call a special meeting to consider the firing of officers.

☛ Issues involving the ***corporate structure*** are often hidden in fact patterns that tell you about the provisions of the corp's ***charter*** and ***bylaws***. ***Be certain to read these charter and bylaws terms carefully***, because they're likely to be implicated in events that you're told about later in the question.

☞ If the facts indicate that the board has taken an action which ***conflicts*** with the corp's ***charter***, remember that the charter can ***only be altered by the shareholders***, not the board — so the board's action is probably illegal.

Example: X Corp's charter says that the board consists of 5 members, who will be elected annually. The board unilaterally votes to expand its size to 9, and to stagger terms. This action will be illegal, because only a majority of shareholders, not a board majority, may vary the

charter.

☛ Whenever you have to decide the validity of a particular board action, check for failure to comply with ***notice***, ***quorum*** and ***meeting*** requirements. In particular:

- ☞ A special meeting of the board must normally be preceded by ***notice*** to the board members. The notice must specify the subject(s) (and no unlisted subject may be discussed).
  - ☞ However, the notice requirement will be deemed ***waived*** as to any director who ***attends the meeting*** and does not object at the start of the meeting to the lack of notice.
- ☞ The board may act only if a ***quorum*** is present.
  - ☞ If the board has a ***fixed size***, a quorum is a majority of ***that size*** (even if there are now vacancies).
  - ☞ If the board has a ***variable size***, a quorum is a majority of the directors ***in office*** at the start of the meeting.
  - ☞ Most states let a corporation's charter or bylaws establish a ***supermajority*** requirement for a quorum. (*Example:* Corp's bylaws say that a quorum will consist of 5 out of its 7 directors. This provision will be given effect, so a meeting at which only 4 of 7 are present will be of no effect.)
- ☞ Normally, the board may take action ***only at a meeting***. Directors must be ***present to vote*** (i.e., they ***may not vote by proxy***). (*Example:* Paul, one of Corp's directors, can't come to the board meeting, so he gives his proxy to Steve, and has Steve vote for him at the meeting. Paul won't be deemed present, and his vote won't count.)
  - ☞ Look out for the possibility of a ***telephone meeting***: in most states (and under the MBCA), if the director is present for a conference call in which a quorum participates, the director is deemed to be in attendance at the meeting, and his vote counts.
  - ☞ The board may take action only upon a vote of a ***majority*** of the directors ***present at the meeting***. (So the action doesn't have to be supported by a majority of directors in *office*, only a majority of those *present*, assuming that a quorum is present.)

☞ If the facts indicate that the meeting/quorum/majority-vote requirements ***weren't met***, consider the possibility that the board action is valid anyway, because the directors subsequently ***ratified*** it by affirming it or failing to disavow it.

Example: No quorum is present when the board purports to approve a contract with a third party. A year later, at a regular meeting, attended by a quorum, a majority of those present vote to approve the transaction. This is a ratification, so the contract is binding as if it had been properly approved the first time. (Same result if the board ***tacitly*** ratifies, as by ***accepting benefits*** under the contract.)

☛ Whenever the fact pattern states that an officer acted on behalf of the corp., consider whether the officer had ***authority*** to bind the corp. under any of these 4 doctrines: (1) ***express actual authority***; (2) ***implied actual authority***; (3) ***apparent authority***; and (4) ***ratification***.

☞ Look for indications as to whether the officer was ***expressly*** authorized to make the contract. An explicit grant of authority usually comes from either the corp's bylaws, or from a resolution adopted by the board. (Usually this form of authority is so easy that you won't find it in your facts.)

☞ If the officer had a ***title*** within the corp. that would typically include the power to make the deal in question, then the officer had ***"implied actual authority"*** (i.e., authority that's "inherent in the office.") (*Example:* Pete, who is actually the Pres. of Corp., signs a deal to buy office furniture "Corp, by Pete, its President." Pete has implied actual authority, because the president of a corporation would typically have authority to make a deal for furniture.)

☞ Look for situations in which ***extraordinary*** action is taken by the corp.'s president, without board approval. Such action is probably ***invalid***, since it doesn't fall within any form of authority.

Example: X Corp. is a 10-employee business with $1 million in annual revenues. Pres., the president of X Corp., signs an agreement to pay a $100,000-per-year lifetime pension to a retiring vice-president. The board isn't told of the agreement, and thus doesn't

authorize it. The contract is probably not enforceable against X Corp., because it was an extraordinary contract, that did not fall within any theory of authority. (For instance, the authority isn't "implied actual," because such a deal is too large and unusual to come within the usual powers of the president of a corp. this size.)

CHAPTER 4

SHAREHOLDERS' INFORMATIONAL RIGHTS AND THE PROXY SYSTEM

ChapterScope

This Chapter focuses on how shareholders can get information about the corporation's affairs, and how (at least for publicly-held corporations) the system of "proxy voting" lets shareholders vote on the corporation's affairs without having to physically attend shareholders' meetings. Key concepts are:

- **Inspection of books and records:** Shareholders are normally allowed by state law to ***inspect*** the corporation's books and records, if they are doing so for a "proper purpose."
- **Securities Exchange Act of 1934:** The "***'34 Act***" is a federal statute that applies to companies traded on a national securities exchange, and to companies traded "over the counter" if the company is above a certain size. The '34 Act requires the company to ***"register"*** its stock, and to continuously ***supply the public with information*** about the company.
- **Proxy rules:** A ***"proxy"*** is a document in which the shareholder ***appoints someone*** (typically management) to ***cast his vote*** for one or more specified actions. For instance, in every public corporation, management annually solicits from each holder that holder's proxy for voting for the board of directors. (This is the means by which a shareholder can vote without physically attending the annual meeting.) The solicitation of proxies is subject to strict SEC rules; these rules include requirements about what ***information must be disclosed*** by the party who's soliciting the proxy. (This information is contained in a ***"proxy statement."***)
    - **Shareholders' proposal:** Under certain circumstances, a minority shareholder may require management to include in management's proxy statement the minority holder's ***proposal for shareholder action***.

- ❑ **Private right of action:** If a proxy statement does not meet the SEC's requirements (e.g., it contains false or misleading information), a shareholder may bring a ***private action*** for money damages, against the party who issued the statement (e.g., the management of the company).
- ❑ **Proxy contest:** A ***"proxy contest"*** is a competition between management and another faction — usually a group of outside insurgents — to obtain shareholder votes. Typically, a proxy contest is for election of ***competing slates*** to the ***board***, and thus is really a competition for ***control*** of the corporation. The SEC has elaborate rules governing proxy contests, which have the effect of somewhat equalizing the outsiders' chances.

I. SHAREHOLDER INSPECTION OF BOOKS AND RECORDS

A. Right of inspection generally: For a shareholder to be able to decide intelligently whether to sell her shares, hold onto them, bring a shareholders' derivative action (see *infra*, p. 317), or otherwise take action on her investment, she needs information. In the case of a publicly-held corporation, the federal securities laws require that much of the needed information be sent automatically to the shareholder; this is discussed below, p. 100, in our treatment of proxy solicitation. But apart from the federal securities regulatory system, ***state law*** generally provides shareholders with a useful alternative method of getting information about the corporation's affairs: This is the right to ***inspect the corporation's books and records***.

1. **Common law vs. statutory right:** This right of inspection can be based upon the common law, a statute, or both.
2. **Common law:** In most states, shareholders have a ***common-law*** right to inspect the corporation's books and records, if they show a ***"proper purpose"*** for doing so. If the corporation does not make the books and records available voluntarily, a shareholder may obtain a ***court order*** compelling the corporation to grant this right of inspection. Clark, p. 97. (What constitutes a

"proper purpose" is discussed further *infra*, p. 92.)

a. **Usually necessary:** The corporation will usually ***not*** voluntarily grant the right of inspection. A corporation's management almost always regards a shareholder request for inspection as a hostile act, and will therefore usually force the shareholder to litigate in order to take advantage of his inspection right. Nutshell, p. 376.

3. **Statutes:** Many states have enacted ***statutes*** codifying this shareholder right of inspection.

a. **Penalties for non-compliance:** A key feature of most of these statutes is that they buttress the shareholders' common-law inspection right by establishing ***penalties*** if the corporation without cause refuses to allow the inspection. Thus the standard management response to assertion of the common-law inspection right — making a shareholder litigate to exercise his right — is a more dangerous option for management under most statutes.

b. **Proper purpose:** Because the right of inspection can be used by a hostile shareholder to harass management or to steal corporate secrets, most statutes continue the common-law requirement that the shareholder have a ***"proper purpose"*** for the inspection. Nutshell, p. 377. See *infra*, p. 92.

c. **Copies:** Virtually all states give the inspecting shareholder the right to obtain ***copies*** of the inspected documents, usually at the shareholder's expense. See, e.g., MBCA §16.03(b) and (d).

d. **Right to bring attorney:** Also, the inspecting shareholder generally has the right to have his ***attorney*** or agent do the inspection. See MBCA §16.03(a).

4. **Model Act:** The MBCA is a good example of a modern statute giving shareholders a fairly broad right of inspection.

a. **Automatic right:** For some types of corporate records, the shareholder has an ***absolute right of inspection***. Under MBCA §16.02(a), the shareholder is automatically entitled to inspect

and copy the following records: (1) the articles of incorporation; (2) the bylaws; (3) board resolutions creating or governing the rights of each class of stock; (4) minutes of shareholders' meetings for the last three years; (5) all written communications to shareholders within the last three years (including financial statements, which under §16.20(a) are required to be given to shareholders); (6) the names and addresses of current officers and directors; and (7) the most recent annual report.

b. Other records: This list of records subject to the "automatic" inspection right is limited to "easy" situations, i.e., to information that is rarely considered highly secret by management. Clark, p. 97. A different MBCA section gives shareholders a ***qualified*** right to inspect more sensitive materials. Under §16.02(b), any shareholder has a qualified right to examine: (1) the ***minutes*** of ***board meetings***; (2) the ***accounting records*** of the corporation; and (3) the corporation's ***list of shareholders***.

i. Proper purpose: Because these three items are more sensitive, and the corporation could be damaged or harassed by their wrongful use, these documents may only be inspected if the shareholder satisfies three requirements: (1) his demand must be made "in ***good faith*** and for a ***proper purpose***"; (2) he "describes with ***reasonable particularity***" his purpose and the records he wants to inspect; and (3) the records are "***directly connected*** with his purpose." Probably these requirements are, collectively, a little more strict than the common law's general "proper purpose" requirement. Clark, p. 98.

c. Penalties: The MBCA follows the recent statutory trend of ***penalizing*** the corporation if it without good cause requires the shareholder to litigate to exercise his inspection right. §16.04(c) provides that if the shareholder goes to court to get an order compelling inspection, the court must require the corporation to pay the costs (including ***attorney's fees***) that the shareholder incurred in getting the court order. (However, the

corporation can avoid this penalty by proving that it refused the inspection "in good faith because it had a reasonable basis for doubt" about the shareholder's right to inspect the records in question.)

5. **Litigant's right:** Shareholder inspection right statutes virtually never displace a ***litigant's*** right to inspect the corporation's records just as he could inspect the records of any other adversary if those records were relevant to the litigation. Thus MBCA §16.02(e)(1) makes it clear that the general shareholder inspection right "does not affect … the right of a shareholder to inspect records … if the shareholder is in litigation with the corporation, to the same extent as any other litigant."

B. Who may inspect: At common law, not only shareholders who are of record but also ***beneficial owners*** of shares have the right of inspection. (Thus one for whom shares are held in trust, or one whose shares are held in "street name" or by a nominee — see *infra*, p. 101 — may inspect.) Statutes vary as to whether they apply to beneficial owners. The MBCA has been amended to include beneficial owners as "shareholders" for inspection purposes. See MBCA §16.02(f).

1. **Size or length-of-holding requirements:** Some statutes restrict the right of inspection to shareholders who have either held their shares for a certain ***time***, or hold more than a certain ***percentage*** of the total shares. These requirements are in theory a means of protecting the corporation against harassment and damage from persons who buy a small number of shares for the sole purpose of conducting an immediate inspection.

   a. **New York:** For instance, New York's BCL §624 generally gives anyone who has held his shares for at least ***six months***, or who holds at least ***five percent*** of any class of shares, the right to examine certain documents (the shareholder list, the minutes of shareholders' meetings, and the current financial statements) without any showing of need or proper purpose.

   b. **Criticism:** This kind of discrimination in favor of older or larger shareholders seems arbitrary. It clearly discriminates

against small shareholders, and there is no reason to believe that small shareholders are more likely to be motivated by an improper purpose than are large shareholders. For this reason, the MBCA has dropped a prior requirement that was similar to the New York six months/five percent requirement. See Official Comment to §16.04.

C. **What records may be examined:** Under most statutes, the shareholder has a right to inspect not merely specified records, but the corporation's ***records in general***. Nutshell, p. 379. Under these broadly-worded statutes, the basic idea is that the shareholder can review any documents that have a ***reasonable bearing upon his investment***. Thus a broadly-written statute might allow the shareholder to inspect contracts, correspondence, accounting records, and anything else that bears reasonably upon the corporation's business or finances.

1. **Accounting records:** Other statutes are more narrowly drawn to restrict the shareholder from seeing especially sensitive documents. For example, some statutes do not allow the shareholder to inspect the underlying ***accounting records***, and limit him to the company's financial statements. Thus as noted above (p. 90), the MBCA does not include accounting records within the list of records that the shareholder has an "automatic" right to inspect.

2. **List of shareholders:** Similarly, some statutes deny the shareholder the right to examine the list of shareholders for fear that this list is especially susceptible to misuse. Thus the MBCA makes this list off-limits unless the shareholder makes a showing of good faith, proper purpose, reasonable particularity and direct connection. See §16.02(b)(3).

   a. **Solicitation of proxies:** The most common reason for which a shareholder will want the list of shareholders is to ***solicit proxies*** from them. If the corporation is publicly held, federal law (*infra*, p. 121) gives the shareholder the right to require the company to either mail the shareholder's proxy solicitation materials itself or to furnish the shareholder list to the

shareholder so that the latter may solicit directly. If the company is not publicly held, most states grant the shareholder access to the list so long as the solicitation is reasonably related to the corporation's business. See *infra*, pp. 92-93 (including the *Pillsbury* case).

D. What is a proper purpose: As we mentioned above, in nearly all states the shareholder will be allowed to inspect corporate records only if he does so for a ***"proper purpose"***. In most states, a "proper purpose" is a prerequisite for any kind of inspection at all; under the MBCA, it is a prerequisite for the inspection of the interesting and sensitive types of corporate documents (minutes of directors' meetings, accounting records and the shareholder list; see §16.02(b)).

1. Definition: There is no universally accepted definition of "proper purpose." The MBCA does not define the term at all. Delaware's definition is reasonably typical: A proper purpose means "a purpose ***reasonably related to such person's interest as a stockholder***." Del. GCL §220(b).

2. Four categories: Shareholders' purposes for inspecting can be placed into four categories which we shall consider in turn: (1) the desire to ***evaluate one's investment***; (2) the pursuit of ***personal goals*** unrelated to ownership of stock in the corporation; (3) the desire to ***deal with other shareholders*** in the corporation as ***investors***; and (4) the desire to pursue ***social or political goals***. As a general rule, (1) and (3) will almost always be found "proper," and (2) and (4) will usually be found improper. See Clark, pp. 100-03.

a. Evaluation of investment: A shareholder's desire to ***evaluate*** his ***investment*** is the easiest situation. Thus the shareholder might want to inspect (1) to determine whether there has been mismanagement (if there are some initial grounds for reasonable suspicion of this); (2) to determine whether the stock's market price currently reflects its intrinsic value; (3) to determine why dividends are not being paid; or (4) to investigate any other aspect of the corporation's

financial condition. All of these inquiries will generally be found to be for ***proper purposes***. Clark, pp. 100-01.

b. Pursuit of unrelated personal goals: Conversely, if the shareholder is pursuing a ***personal goal*** that is unrelated to his status of investor in the corporation, his purpose will be deemed ***not*** proper, and he will not be permitted to inspect. Thus if he wants to get access to ***trade secrets*** which he can sell to a competitor or use himself, or if he wishes to get hold of the shareholder list so that he can sell it to a mailing list rental company for junk mail solicitation, his purpose will not be found proper. Clark, p. 102. Of course, it is only the rare (and dumb) shareholder who will concede that these are his real purposes, so it is generally management that must convince the court that these are the real purposes, a burden that management usually cannot carry.

c. Deal with shareholders as investors: The third category consists of cases where the shareholder wishes to ***contact*** his fellow shareholders to persuade them to take some sort of action regarding the corporation. For instance, she may want to ***solicit proxies*** from them (perhaps to elect an anti-management board of directors), or to initiate a ***tender offer*** for their shares. In this situation, courts generally conclude that the shareholder's desire to have a shareholder list constitutes a ***proper purpose*** since the purpose is closely related to the business and financial affairs of the corporation.

i. Hostility to management: The fact that the shareholder who seeks inspection is ***hostile to management*** does not by itself make his purpose improper. Indeed, this is the very situation in which courts are quickest to affirm the right of inspection. So long as the shareholder shows that he is motivated by the desire to maximize the value of his investment, he will be found to have the right of inspection.

ii. Suit against corporation: Similarly, if the shareholder wants to contact other holders in order to solicit them to join in ***litigation against or concerning the corporation***, this

will not necessarily be an improper purpose.

iii. List of "non-objecting beneficial owners": Some states' shareholder-list statutes have even been interpreted to allow access to lists of people who are ***"beneficial owners" (***see *infra*, p. 122) rather than "shareholders of record."

d. Pursuit of social and/or political goals: Where it is clear that the shareholder is pursuing only ***social or political goals*** that are relatively ***unrelated to the corporation's business,*** most courts will find that the shareholder's purpose is ***improper*** and will therefore deny inspection rights. Thus most courts would agree with the result in the leading case set forth in the following example.

Example: P owns one share of D (Honeywell Corp.) in his own name; he is also the beneficial owner of several hundred additional shares in D. P demands the right to inspect D's shareholder list and all records relating to weapons and munitions manufacture. He admits that his purpose is to bring pressure on D to stop producing munitions for use in the Vietnam war.

Held, for D. A stockholder has the right to inspect shareholder lists and other corporate records only if he has a "proper purpose germane to his economic interest as a shareholder." "Proper purpose" means "concern with investment return." Here, it is clear that P has made no attempt to determine whether holdings in D Corp. would make a good investment; he is not interested in the enhancement of the value of his shares, but merely in persuading the company to adopt his social and political concerns. True, P desires to contact other shareholders and attempt to gain the election to the board of one or more directors who would share his views; but although this might be a proper purpose if tied to the corporation's underlying business, here it is merely an aspect of P's desire to impose his political/social views on the corporation. *State ex rel. Pillsbury v. Honeywell, Inc.*, 191 N.W.2d 406 (Minn. 1971).

Note: Observe that P might have prevailed in *Pillsbury* had he been a little more careful and a little less forthright. He could have done some reasonable investigation into the economic prospects for Honeywell, and then asserted that he believed that its economic prospects over the long run would be adversely affected by the poor public relations stemming from its munitions manufacturing. Probably even the Minnesota court would have accepted this as a proper purpose.

3. **Multiple purposes of which one is proper:** Suppose a shareholder has ***multiple purposes*** for requesting the inspection, of which one (or more) is appropriate and the other(s) not. Here, the Delaware courts have held that inspection must be ***allowed*** — so long as there is ***at least one proper purpose***, the presence of an ***improper*** purpose is ***irrelevant***.

   a. **Court will look to the "real" purpose:** Of course, the court will not blindly accept the shareholder's stated reason(s) for the inspection, and will instead normally try to ascertain the ***"real"*** reasons that are motivating her. If the court concludes that all of the real reasons are illegitimate, the fact that the holder has asserted a different reason that would be legitimate will be irrelevant.

4. **Tie-in between purchase date and the act supplying "reasonable purpose":** Suppose the stockholder wants to investigate possible corporate wrongdoing that ***predates*** the moment when the stockholder bought the stock; should this nullify the stockholder's right of inspection? The Delaware Supreme Court has answered ***"no."*** In *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113 (Del. 2002), the court said, "The date on which a stockholder first acquired the corporation's stock does not control the scope of records available under [the Delaware inspection statute]. If activities that occurred before the purchase date are 'reasonably related' to the stockholder's interest as a stockholder, then the stockholder should be given access to records necessary to an understanding of those activities."

E. Financial reports for shareholders: Suppose the shareholder does not make a formal request to inspect the corporate records. Is there any financial information (e.g., an annual report) that he is entitled to receive ***automatically***, without request? Perhaps surprisingly, in most states the answer is ***"no"*** — the corporation is not even required to send an annual report or annual financial statement to the shareholder. Nutshell, p. 384.

1. **Annual financial statement:** Some jurisdictions, however, require at least an annual financial statement to be sent to each shareholder. See e.g., Cal. §1501(a) (annual financial statement required unless there are less than 100 stockholders and the requirement is waived in the bylaws). See also MBCA §16.20, requiring an annual financial statement to be sent to every shareholder, together with the accountant's or management's discussion of the method by which these statements were prepared.

2. **Public corporations:** A ***publicly held*** corporation is required by the federal securities laws to supply an annual report to all shareholders. The source of this requirement is described *infra*, p. 100.

F. Director's right of inspection: A shareholder's right to inspect corporate records should be compared with the right of a ***director*** to inspect those records.

1. **Scope of director's right:** A director in most states has a much broader, more automatic, right of inspection than does a shareholder. Since the director is interested in management of the corporation and owes a fiduciary duty to the shareholders, most states grant him very broad inspection powers. In fact, some states hold that the director has an ***absolute*** right of inspection, and that his motives are irrelevant.

2. **Misuse:** Most states, however, would deny the right of inspection if it is clear that the director is acting with ***"manifestly improper motives."*** Nutshell, p. 375. For instance, if a director were shown to have an ***interest in a competitor***, and it were demonstrated that the director wanted to inspect the books and

records so that he could aid the competitor at the corporation's expense, most courts would probably deny the right of inspection. But such cases are very rare, and the burden of establishing improper purpose is clearly on the corporation.

II. REPORTING REQUIREMENTS FOR PUBLICLY HELD COMPANIES

A. Overview: For a privately held company, the shareholders' inspection rights described above are the principal way in which the corporation's shareholders can get financial information about the company. For a shareholder with a modest economic investment in a particular corporation, this is often not a very useful right, especially where the corporation requires the shareholder to litigate to exercise his inspection right. But once a corporation becomes ***"publicly held,"*** the shareholder's access to information about it improves dramatically: Under the federal securities laws, the corporation is required to file a great deal of financial information with the Securities and Exchange Commission (SEC), which then becomes available as a public record; also, under SEC rules the public corporation is required to send certain types of financial information to the shareholder automatically. This section II gives a brief overview of the federal securities regulation scheme; sections III-VI then examine in detail the so-called "proxy rules" that are a portion of the federal securities regulation scheme.

1. Two types of public filings: To begin with, there are two main statutes that impose filing requirements on publicly held corporations: (1) the Securities Act of 1933 (the "'33 Act"); and (2) the Securities Exchange Act of 1934 (the "'34 Act").

a. The '33 Act: The '33 Act principally regulates the ***initial offering of securities*** to the public. Under this act, before a corporation may issue shares to the public, it must file a ***"registration statement"*** with the SEC. Part of this registration statement is a "prospectus," which is distributed to any prospective or actual purchaser of shares. Once a corporation issues its shares (and assuming that it does not

make any additional issues), the ’33 Act largely becomes irrelevant. Therefore, we consider its provisions in a later chapter that deals with the initial issuance of securities. See *infra*, p. 539.

2. **The ’34 Act:** In this chapter, our principal concern is with the ’34 Act. That Act requires ***registration*** of the shares of certain companies, and also requires the ***continuous updating*** of information about companies whose shares are so registered. There are two main ways in which a company’s shares may become required to be registered under the ’34 Act:

   a. **Listed stocks:** First of all, if the company’s stock is ***traded on a national securities exchange***, it is automatically required to be registered with the SEC. ’34 Act, §12(a). This means that not only companies whose stock is traded on the New York Stock Exchange and American Stock Exchange, but also companies traded on the various “regional” exchanges (e.g., Philadelphia, Pacific, Boston, etc.), must be registered, ***no matter how small the company*** or the issue of stock.

   b. **Over-the-counter companies of more than a certain size:** Secondly, even companies whose shares are traded ***over the counter*** (i.e., not on any formal stock exchange) must be registered with the SEC if the company is above a certain size. At present, a non-exchange-listed company must generally register with the SEC if it meets ***both*** of the following requirements: (1) the company has assets in ***excess of ten million dollars***; *and* (2) the company has a class of stock held of record by ***500 or more persons***. See ’34 Act, §12(g)(1) and SEC Rule 12g-1 thereunder. It is this “500 shareholder/ten million dollars in assets” provision that requires thousands of over-the-counter stocks to be subject to the SEC reporting requirements. This includes many of the stocks on the NASDAQ Automatic Quotations System, which in many ways functions like a stock exchange but is not considered an exchange for purposes of the ’34 Act.

      i. **Single class of more than 500 holders:** The registration

required under the ’34 Act is not actually registration of the company, but is rather registration of a particular ***class of stock***. In the case of stock not listed on any exchange, it is the class of stock that must have more than 500 record holders before registration will be required.

Example: ABC Corp. has 300 record holders of its common stock and 300 record holders of its preferred stock. Neither of these classes will have to be registered with the SEC under the ’34 Act (unless one of the classes is traded on a national stock exchange), since neither of the classes, by itself, has more than 500 record owners.

ii. **Termination:** Once a class of shares has to be registered under the ’34 Act, even a reduction of assets or reduction of record holders below the number that would have been required for initial registration will not automatically be enough to remove the registration requirements. The company must keep on registering the class unless the number of shareholders in the class drops below ***300***; see ’34 Act, §12(g)(4). This means that even a publicly-held corporation with billions of dollars of assets can terminate its SEC reporting requirements (and thereby ***“go private”***) if it can reduce the number of record holders of its stock to fewer than 300.

c. **Definition of “publicly held”:** There is no official federal meaning to the concept of a ***“publicly held”*** company. The phrase “publicly held” is an informal one, and usually refers to companies that are subject to the ’34 Act disclosure requirements that we’ve just summarized (i.e., companies that are either exchange-listed or have 500 shareholders plus ten million in assets.)

B. What must be disclosed: Once a company has a class of shares that is required to be registered under §12 of the ’34 Act (the companies described in paragraphs A(2)(a) and (b) above), it must then make ***continuous disclosures*** to the SEC. Among the many kinds of filings that are required are: (1) an ***annual report*** each

year on SEC form 10-K; (2) a ***quarterly financial report*** every three months on SEC form 10-Q; and (3) a report of ***major business developments*** (e.g., changes in control, acquisition or disposition of significant assets, resignations of directors, etc.), to be reported within fifteen days of their occurrence on SEC form 8-K.

III. THE PROXY RULES GENERALLY

A. Overview: Few shareholders have the time or inclination to physically attend the shareholders' meeting and vote their shares in person, whether for the election of directors, approval of a merger, or for some other action requiring a shareholder vote. However, recall that shareholder action cannot be taken unless a quorum (usually one-half of the total shares) is represented at the meeting (see *supra*, p. 81). How can a majority of the shares be represented if few of the shareholders are present? The answer is, by use of the ***proxy***. The proxy is a document whereby the shareholder ***appoints someone*** (usually management) to ***cast his vote*** for one or more specified actions.

> **Example:** Consider the most typical case, that of a proxy for voting that is to take place at the upcoming ***annual meeting of shareholders***. X, a shareholder in Corporation, can cast his vote for, say, management's proposed slate of directors, even though X cannot attend. X sends management a signed proxy card (pre-printed by management) on which X authorizes management to cast X's vote in favor of management's slate of directors. Of course, this will only happen if management first sends X this pre-printed form of proxy and requests that X sign and return it to management; if management does this, it is said to be "soliciting" a proxy from X.

1. How SEC regulation fits in: Except in rare cases where management directly controls a majority of the voting shares, the corporation could not function without proxy solicitation. For instance, a slate of directors could never be elected, because a majority of the shares would never be present and voting at the

annual meeting. It is the all-pervasive proxy system that gives the SEC a broad opportunity to regulate: (1) the mechanics of the proxy system; (2) the information that must be furnished to a shareholder when his proxy is solicited; and (3) even more broadly, the information that must be ***furnished to each shareholder annually***, whether or not his proxy is solicited. The SEC's proxy regulations also furnish a shareholder with the means of submitting a proposal to his fellow shareholders, and dictate special requirements for conducting "proxy contests." The focus of this proxy regulatory system is on making sure that investors have ***adequate information*** before they exercise their right to vote by filling out a proxy card. Clark, p. 366.

2. **Who is covered:** The SEC's authority to regulate the proxy process comes from §14 of the Securities Exchange Act (the '34 Act). Section 14(a) makes it "unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange … in contravention of such rules and regulations as the [SEC] may prescribe … to ***solicit*** or to permit the use of his name to solicit ***any proxy*** or consent or authorization in respect of any security … registered pursuant to section 12 of this title.…"

   a. **Registration pursuant to section 12:** Thus a proxy solicitation is covered by the SEC rules if the proxy is solicited concerning stock registered under §12 of the '34 Act. As we saw above, *supra*, p. 96), stock must be registered under section 12 if it is the case that ***either***: (1) the stock is traded on a national securities exchange; or (2) the company has at least ten million dollars of assets and the class of stock in question is held by at least 500 record owners. In other words, if the issuer (the company whose shares are being considered) has to file 10-K's and other regular reports with the SEC, it ***must also obey the SEC's proxy solicitation rules***.

3. **What transactions are covered:** As we just saw from looking at the language of §14 of the '34 Act, the SEC's right to regulate the proxy system is extremely broad: It extends to any solicitation, by any person, of any "proxy or consent or

authorization in respect of any security" that is registered with the SEC. The SEC has in turn promulgated rules that regulate most (but not all) of the transactions that the SEC could, under §14, regulate. SEC rule 14(a)-2 grants certain ***exemptions*** for solicitations that would otherwise be covered. After taking into account these exemptions, here is what is covered by the SEC rules:

a. **Solicitation by management:** If the solicitation is by ***management***, the solicitation of ***even one person*** falls within the SEC rules.

b. **Solicitation by non-management:** But if the solicitation is by ***non-management*** (e.g., it is by an ***insurgent faction*** trying to get its own slate of directors elected to the board), the solicitation is not covered so long as the number of persons solicited is ***ten or fewer***.

   i. **Solicitation of eleven or more:** But if non-management solicits eleven or more people, the solicitation falls within the SEC rules even if none of the people solicited actually grants a proxy to the solicitor. C&E, p. 331.

4. **What is a "proxy":** The SEC's definition of "proxy" is extremely ***broad***. Under rule 14a-1(e), the term includes "every proxy, consent or authorization.…" For example, the proxy need not be a piece of paper; a shareholder's ***oral consent*** to a request will be enough. Clark, p. 368.

5. **Meaning of "solicitation":** Similarly, ***"solicitation"*** is very broadly defined. Here are some of the requests that are deemed "solicitations" by SEC rule 14a-1(k):

a. **Oral requests:** An ***oral request*** for a proxy, even if no proxy card is sent to the person being solicited;

b. **Request not to execute:** A request (written or oral) ***not*** to execute, or to revoke, a proxy ***solicited by someone else***;

c. **Advertisement:** The "furnishing of a form of proxy or ***other communication*** to security holders under circumstances reasonably calculated to result in the procurement,

withholding, or revocation of a proxy." Rule 14a-1(k)(1)(iii). Under this definition a ***newspaper advertisement*** urging shareholders to give or deny one side a proxy would be a "solicitation." (But if the newspaper advertisement merely describes how holders may get copies of the proxy statement, it is not deemed to be a "solicitation". Nutshell, p. 284.)

6. **Communications among shareholders (*Studebaker*):** The very broad definitions of "proxy" and "solicitations" are illustrated by *Studebaker Corp. v. Gittlin*, 360 F.2d 692 (2d Cir. 1966), where the court held that informal contacts by one stockholder with less than fifty other stockholders amounted to a proxy solicitation.

   a. **Facts:** D, a dissident stockholder in Studebaker, wanted to convince shareholders to vote for his proposed directors slate at the upcoming annual meeting. The company refused to give him access to its shareholder list, which he needed for this purpose. He then sued to obtain the right to inspect the shareholder list. Under local (New York) law, D could only gain this inspection right if he held or represented more than five percent of the corporation's shares. (See *supra*, p. 91.) He therefore obtained written authorizations from ***forty-two other shareholders*** who collectively held more than five percent of Studebaker's shares, authorizing him to inspect the shareholder list.

   b. **Holding:** The court held that D's act of ***requesting these other shareholders to authorize him to inspect*** the shareholder list ***was itself a proxy solicitation***. Therefore, D violated SEC rules by making that solicitation without complying with all of the formal requirements for a proxy solicitation (e.g., the filing of proxy materials with the SEC).

      i. **SEC exemption:** But the SEC has effectively ***reversed*** the result in *Studebaker* and similar situations. In 1992, the Commission enacted Rule 14a-2(b)(1), which gives an exemption from the proxy rules for someone who conducts a solicitation of stockholders but "who ***does not … seek …***

the power to act as proxy for a security holder" (subject to some limitations, such as that the person doing the soliciting not be affiliated with the issuer, not be a current board candidate, etc.). So in the *Studebaker*-type situation in which one non-controlling shareholder contacts others to discuss how they should all vote in an upcoming corporate matter, 14a-2(b)(1) is likely to give the contacting holder an exemption from the proxy rules. See A,K&S, p. 193.

B. Four topics: Our remaining discussion of the proxy rules is divided into five main areas: (1) What ***information*** must be disclosed and filed as part of a proxy solicitation (discussed immediately below)? (2) When may a proxy be ***revoked***? (3) What ***private rights of action*** exist for violation of the proxy rules? (4) When must a ***shareholder proposal*** be included by management in the proxy materials? and (5) What special rules apply during a proxy ***contest***?

C. Disclosure and filing requirements: Once a company with stock that is registered under §12 decides to solicit proxies, it must comply with extensive ***filing*** and ***disclosure*** requirements. (Dissident shareholders who want to solicit proxies must also satisfy some of these requirements; these are discussed in the treatment of proxy contests, *infra*, p. 120.)

1. Filing with SEC: Any documents that will be sent to shareholders as part of the solicitation process must first be ***filed with the SEC*** before they are sent to stockholders. Not only the "proxy statement" (defined below), but all other solicitation materials — such as letters, press releases, speeches and even instructions for oral solicitations — must be pre-filed in this manner. (If the solicitation relates only to election of directors or a few other routine matters, and is uncontested, pre-filing is not necessary. See Rule 14a-6(a).)

a. Limited review: The SEC does not conduct a major review of these pre-filed materials. However, if in its cursory review it concludes that information is missing or inaccurate (perhaps because it conflicts with other information on file at the SEC),

it will order revisions to be made. Nutshell, p. 284.

2. **Proxy statement:** Every proxy solicitation must be accompanied or preceded by a written ***"proxy statement"***. Rule 14a-3(a). The proxy statement must disclose, among other things: (1) ***conflicts of interest***; (2) details of any ***compensation plan*** to be voted on; (3) the ***compensation paid to the five most highly-paid officers***; and (4) details of any ***major corporate change*** being voted upon. See Clark, p. 369.

3. **Annual report:** Perhaps even more importantly, the proxy rules effectively require that an ***annual report*** be sent to every shareholder. If the solicitation is by management and relates to an annual meeting at which directors will be elected, the proxy statement must be preceded or accompanied by an annual report that includes, among other items, audited balance sheets and audited profit and loss statements. Rule 14a-3(b).

    a. **Significance:** Since under state law directors must generally be elected at the annual meeting, and since a majority of all shares must be present at the annual meeting for there to be a quorum, management generally has little choice but to solicit proxies for the annual meeting. Therefore, as a practical matter management ***must send an annual report to every stockholder.***

        i. **Management-controlled companies:** In fact, the proxy-solicitation rules apply in practice ***even where management itself controls a majority of the stock***, so that it doesn't need any outsiders to grant proxies or show up at the annual meeting. SEC Rule 14c-3 says that even if management is not soliciting proxies, the ***same annual report*** (with all of the same required disclosures) must still be given to shareholders before the annual meeting, as if proxies were being solicited. So minority holders in management-controlled public companies get essentially the same information (and that same information is filed with the SEC) as in the usual situation in which outsiders hold a majority.

4. **Anti-fraud rule:** In addition to the above provisions that require specific documents to be sent to shareholders whose proxy is being solicited, the SEC has a more general ***"anti-fraud"*** rule concerning proxy solicitations. Rule 14a-9(a) prohibits the use of proxy solicitation materials that contain "any statement which, at the time and in the light of the circumstances under which it is made, is ***false or misleading*** with respect to ***any material fact***, or which ***omits*** to state any material fact necessary in order to make the statements therein not false or misleading.…" If this anti-fraud rule is violated, a shareholder has the implied right to bring a ***private action*** for an injunction or damages; private actions for proxy violations are discussed *infra*, p. 103.

D. Getting the materials to shareholders (the "street name" and "nominee" problems): If management is to solicit proxies from its shareholders, it must know who they are. This poses far more of a problem than you might think, because of the practice of holding shares in "street name" or "nominee name" (terms defined below).

1. **"Record owner" vs. "beneficial owner":** First, consider that a given share of stock may have both a ***"record"*** owner and a ***"beneficial"*** owner. The record owner is the one who is shown on the ***corporation's own books*** as being the owner of that stock. The beneficial owner, by contrast, is the person who has the real, effective economic ownership of the share. For instance, suppose that Minor is a beneficiary under a trust set up by his grandparents, and the trustee for the trust is Mega Bank. If the trust holds shares of stock in X Corp., X Corp.'s transfer records will probably show that Mega Bank is the record owner of the stock. Minor is the beneficial owner of these shares (it is he who takes the actual economic gains or losses), but X Corp's transfer records will not show Minor's name at all.

2. **Street names and nominees:** Today, about 70% of all shares in publicly-held corporations have a record owner who is not the beneficial owner. Apart from the ordinary trustee/ beneficiary situation (illustrated above by our Minor/Mega Bank hypothetical), there are several kinds of procedures that lead to

the beneficial owner's not being shown as the record owner on the issuing corporation's transfer books:

a. **"Street names" at brokerage firms:** First, when an individual buys stock through a broker, the shares will often end up being registered in ***"street name,"*** i.e., the name of the brokerage firm. For example, the individual's shares will be registered in street name if: (1) the individual does not want to bother taking physical possession of the shares, so he decides to leave them with the broker for convenience; or (2) the shares are bought on margin, so that the broker must hold them as collateral.

b. **Nominees:** Second, large institutional investors (e.g., mutual funds and pension funds) generally hold their shares in the names of ***"nominees,"*** usually a partnership of employees formed for just that purpose. Nutshell, p. 277. The issuing corporation knows only that a certain number of shares are owned by, say, Baker & Co., and does not necessarily know for which institutional investor Baker & Co. is the nominee.

c. **Use of depositories:** The development in the last few decades of the system of ***depositories*** makes things even more complicated. Brokerage firms and other large institutions generally do not keep possession of the shares themselves. Instead, over 70% of all outstanding shares are held by four depositories, which are in effect central clearing corporations. By the use of these depositories, many offsetting trades can be netted out, and only the net change of position noted on the depositories' books.

   i. **Depository Trust Co.:** By far the largest of these four depositories is the Depository Trust Co. (DTC), which is a subsidiary of the New York Stock Exchange. All shares held by DTC are shown on the issuer's books as being held by the nominee "Cede and Co." Thus Cede and Co. is the record owner of probably a majority of all publicly-held shares in America!

E. **Requirements for proxy:** The SEC's rules also regulate the form

of the proxy itself.

1. **Contents of card:** The proxy is generally a ***card*** which the shareholder signs, and on which he indicates the side he favors. For example, if the proxy form in question is management's form for soliciting a vote for management's slate of board candidates, the card will typically contain a box to indicate that the holder votes for management's slate as a whole, a box to indicate that the holder is withholding authority to vote for management's slate, and an opportunity to withhold support for any particular member(s) of management's slate.

2. **Undated or post-dated proxy forms:** If in a proxy contest (see *infra*, p. 120) a holder gives a proxy to each of two competing sides, the ***last-dated*** proxy controls. Therefore, the SEC's proxy rules ***prohibit undated or post-dated proxy forms***. See Rule 14a-10.

3. **Ban on broad discretion:** The proxy form may not confer unduly broad ***discretion*** on the recipient. For example, management could not send a proxy form concerning the election of directors, that authorizes management to vote for "whomever it believes to be the best qualified person" Instead, the proxy form must list the names of management's nominees. See Rule 14a-4(d).

4. **Must vote for:** The recipient of the proxy ***must*** vote the proxy as the shareholder has indicated. Thus if management sends Holder a card, and the card has boxes both "for" and "against" a proposal backed by management (as Rule 14a-4 requires it to do), management cannot simply disregard those proxies marked "against" that are returned to it — it must vote them as indicated. Rule 14a-4(e).

F. Revocation of proxies: When may a proxy be ***revoked*** by the shareholder who gave it?

1. **Generally revocable:** Generally, a proxy is ***revocable*** by the shareholder. This is true ***even if the proxy itself recites that it is irrevocable.*** (In that sense, a proxy is like an ordinary offer at

common law — the offer is revocable even if it says it isn't, unless some other special feature, like consideration, is present.)

2. **Proxy "coupled with an interest":** However, all states recognize one major ***exception*** to this general rule of revocability: a proxy is ***irrevocable*** if it meets two requirements: (1) it ***states*** that it's irrevocable; *and* (2) it is ***"coupled with an interest."*** See, e.g., MBCA §7.22(d); Del. GCL §212(e).

   a. **Meaning of "coupled with an interest":** The idea behind the ***"coupled with an interest"*** concept is that the recipient of the proxy (the person who will be authorized to cast the vote on behalf of the proxy-giving shareholder) must have some ***property interest*** in the shares, or at least some other ***direct economic interest in how the vote is cast.*** MBCA §7.22(d) gives a catalog of people who will be deemed to hold a suitable "interest." Here are some:

   - ❑ a ***pledgee*** (e.g., Holder pledges his shares in return for a loan from Bank, and gives Bank, the pledgee, his proxy);
   - ❑ a person who has ***purchased or agreed to purchase the shares***;
   - ❑ a ***creditor of the corporation*** (e.g., Creditor says he won't give credit to Corp. unless Prexy, the controlling shareholder, gives Creditor a proxy that's irrevocable while the debt is outstanding);
   - ❑ a ***party to a voting agreement*** (e.g., A, B, and C are the shareholders in closely-held Corp; they sign a voting agreement to vote their shares together (see p. 137), which impliedly gives the two shareholders in the majority on any ballot an irrevocable proxy to vote the shares of the third).

   b. **Termination of interest:** If the proxy is irrevocable because it's coupled with an interest, the ***irrevocability*** (and the proxy itself) ***lasts only as long as the interest.*** So if, for instance, a borrower who gives the proxy as security for his loan pays off the loan, the proxy will then terminate (even if the proxy document says otherwise).

IV. IMPLIED PRIVATE ACTIONS UNDER THE PROXY RULES

A. Implied right of action generally: Nothing in the '34 act or the SEC's rules expressly gives a ***private investor*** the right to sue if the proxy rules are violated. But the Supreme Court has recognized an ***"implied private right of action"*** on behalf of individuals who have been injured by a violation of proxy rules.

1. Summary of law: We will consider this private right of action in detail below. For now, the right to sue may be summarized as follows:

a. Materiality: The shareholder/plaintiff must show that there was a ***material*** misstatement or omission in the proxy materials. But it is not necessary that the misstated or omitted fact would ***probably*** have caused a reasonable shareholder to change his vote; all that is required is that the fact would have been regarded as ***important***, or would have "assumed actual significance," in the decision-making of a reasonable shareholder. (*TSC Industries*, *infra*, p. 105.)

b. Causation: The plaintiff/shareholder does not have to show that he ***relied*** on the falsehoods or omissions in the proxy statement. Instead, the court will ***presume*** that injury was caused, so long as the falsehood or omission was material (see above) and the proxy materials were an essential link in the accomplishment of the transaction. (*Mills v. Electric Auto-Lite Co.*, *infra*, p. 107.) Thus if proxy solicitation is necessary to gain shareholder approval of a merger, any material falsehoods will be presumed to have "caused" injury to the shareholders since the proxy solicitation process was a necessary part of bringing about the merger.

c. Standard of fault: The Supreme Court has never ruled on whether ***scienter*** (i.e., an intent to deceive) must be shown on the part of the defendants. Some lower courts have held that mere negligence is sufficient.

d. Remedies: If the plaintiff successfully establishes a cause of

action, he may be entitled to damages, to an injunction (i.e., an order blocking the proposed transaction for approval of which the company sought proxies), or in a very extreme case, even an undoing of a consummated transaction.

2. **Implied right of action (the *Borak case*):** The recognition of an implied private right of action on behalf of shareholders for proxy violations occurred in ***J.I. Case Co. v. Borak***, 377 U.S. 426 (1964).

   a. **Facts:** P, a minority shareholder in Case Corporation, sued to enjoin a proposed merger between Case and American Tractor Corp. (ATC). P claimed that Case's managers had engaged in illegal self-dealing, that the merger was unfair to shareholders, and (most significantly for our purposes) that the proxy materials were false and misleading in that they did not disclose the true facts about the merger and its value to shareholders. The district court held that even if P established that there had been proxy violations, the court could not grant damages. By the time the case got to the Supreme Court, the merger had been consummated.

   b. **Supreme Court finds implied right of private action:** The Supreme Court held that private stockholders have an ***implied right*** to bring a federal court action for violation of the proxy solicitation rules. The Court found that Congress, in passing §14(a) of the '34 Act (which gives the SEC the right to set proxy solicitation rules), intended to "prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation." This regulatory scheme was intended to be for the protection of investors, so it was not unreasonable to give investors the right to sue for violations.

      i. **Deterrent effect:** Furthermore, the Court held, "[p]rivate enforcement of the proxy rules provides a necessary supplement to [SEC] action. As in antitrust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement

of the proxy requirements." The Court noted that the SEC has to examine over 2,000 proxy statements a year, and the Commission's own investigatory and enforcement mechanisms are not by themselves adequate to prevent violations.

c. **Remedies:** The Court also stated that if P proved a violation of the proxy rules, the federal district court had the power to grant "all necessary remedial relief." This relief was not limited (as the district court had held) to the granting of an injunction against a not-yet-consummated merger. Thus the Court hinted, but did not find, that damages or even an ***undoing of the already-done merger*** might be appropriate remedies for a violation.

3. **Present state of implied private actions:** During the last few decades, the Supreme Court has become much less eager than in *Borak* to find that a particular statutory provision was implicitly intended by Congress to create a private right of action. Nonetheless, the Court has not overruled or cut back *Borak*, so it continues to be the case that a shareholder who can show that a material violation of the proxy rules has caused injury to him may ***recover damages*** or obtain other relief.

B. **Materiality:** It is not the case that every falsehood or omission in a proxy statement, no matter how trivial, gives rise to a private right of action on the part of each shareholder. A key requirement is that the falsehood or omission be shown to have been ***material***.

1. **Definition of "material":** The Supreme Court has defined "material" in a way that gives this requirement some real bite. "[A]n omitted fact is material if there is a ***substantial likelihood*** that a ***reasonable shareholder*** would ***consider it important*** in deciding how to vote." ***TSC Industries, Inc. v. Northway, Inc.***, 426 U.S. 438 (1976). By this standard, the plaintiff must show a "substantial likelihood that, under all the circumstances, the omitted fact would have assumed ***actual significance*** in the deliberations of the reasonable shareholder." *Id*. To put it still another way, "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." *Id.*

2. **Middle ground:** Thus the Supreme Court in *TSC* steered a middle ground between hard-to-satisfy and easy-to-satisfy standards for demonstrating that the falsehood or omission was material:

   a. **Not easy standard:** It rejected the lower court's standard that material facts include "a fact which a reasonable shareholder ***might*** consider important." The Supreme Court believed that this "might" standard was "too suggestive of mere possibility, however unlikely."

   b. **Rejects most difficult standard:** But at the same time, the Supreme Court declined to hold that the plaintiff must show a probability that disclosure of the omitted fact ***"would"*** have caused a reasonable investor to change his vote. Even if the court concludes that few if any investors would have voted differently had the omitted fact been present, the court will find the omission "material" so long as a reasonable shareholder would have ***considered the information important*** in making his decision on how to vote.

3. **Objective standard:** Observe that the Court's standard for materiality is totally ***objective***: Even if the actual plaintiff was a very skittish or cynical person — who in fact voted to approve a merger but would have changed his vote based upon even a tiny bit of additional information showing the merger was less favorable than it appeared — this will be irrelevant; the test is always what a hypothetical ***"reasonable investor"*** would be likely to do.

4. **Statement of reasons for board action:** Suppose proxy materials contain a ***statement of the reasons*** for which the board is recommending that the corporation or the shareholders take a certain action. If plaintiff shows that this statement of reasons is itself false or misleading, has she made out the requisite "material" falsehood or omission? The answer seems to be two-

fold:

[1] A false statement ***can be "material"*** even though it is couched as a statement of reasons rather than as a statement of facts.

[2] *However*, because the proxy rules are violated only by a statement that is "false or misleading with respect to ***any material fact***," it is not enough for P to show that the speaker ***wasn't really acting for the stated reasons*** or didn't believe them. Instead, P must show that the statement of reasons also "expressly or impliedly ***asserted some-thing false or misleading*** about [the statement's] subject matter." "Proof of ***mere disbelief*** or belief undisclosed should not suffice for liability under §14(a).…" ***Virginia Bankshares, Inc. v. Sandberg***, 501 U.S. 1083 (1991) (another aspect of which is discussed *infra*, p. 108).

a. Statement of reasons can be material: Thus in *Virginia Bankshares*, *supra*, the proxy solicitation materials issued in connection with a merger stated that the board was recommending that the public minority shareholders of the corporation approve the merger, because it would give the minority holders the opportunity to achieve a "high" and "fair" price for their stock. P claimed that the directors did not really believe that the price was high, and were instead proposing the merger (into a wholly owned subsidiary of the majority shareholder) so that the board members could keep their board seats. The directors argued that a statement of the ***reasons*** why the board was recommending the transaction could never be a statement "with respect to … material facts."

i. Court disagrees: But the Supreme Court ***disagreed*** with the directors' position, holding that the reasons why the board was recommending the transaction could often be (and in this case clearly *were*) the sort of information on which a shareholder might well rely in deciding how to cast her vote; therefore, the statements, although they were about reasons rather than directly about "facts," could give

rise to liability.

ii. Must be express or implied misstatement of fact: However, the Supreme Court then attached a big ***caveat*** to its holding. A mere showing that the directors were not acting for the stated reason (and were acting for some other, undisclosed reason), was ***not by itself sufficient***. For instance, the fact that the directors were really motivated by a desire to save their seats, not by any belief that the price was high or fair for shareholders, would ***not*** be enough to confer liability. The Court noted that under the proxy statute, liability can only be premised on a statement "with respect to … material ***fact[s].***" The Court then concluded, "we … hold ***disbelief or undisclosed motivation***, standing alone, ***insufficient*** to satisfy the ***element of fact*** that must be established under §14(a)." Instead, P must show "proof by … objective evidence … that the statement also ***expressly or impliedly*** asserted ***something false or misleading*** about its ***subject matter***."

(1) Satisfied: In *Virginia Bankshares*, this additional element was satisfied: P showed that the price offered was ***in fact not*** "high" or "fair," since there was solid objective evidence that the fair value of the shares was $60, in contrast to the $42 proposed in the merger. Since the statement of reasons (that the price was "fair" or "high") was not only a misleading statement of psychological fact (i.e., misleading on the subject of what was really motivating the directors), but was also an implicit ***misstatement of fact*** (the price was really not "high" or "fair"), P was able to proceed. (But if the price proposed had been fair, but the directors had merely failed to explain that their real motivation was to keep their board seats, P would *not* have been able to go forward.)

(2) P loses anyway: Despite P's victory on whether the proxy misstatements were "material," P ended up losing anyway: he was a member of a class — minority

shareholders — whose consent was not legally needed for the merger, so the misstatements were found to not have "caused" any harm; see *infra*, p. 109.

5. **Disclosure of management wrongdoing:** In *TSC Industries* and *Virginia Bankshares*, as in many private actions brought under the proxy rules, the issue for which stockholders' proxies were sought was whether to approve a merger. In this setting, it is relatively easy to apply the "materiality" rule; the issue is whether the omitted fact would have been considered important by a reasonable shareholder in deciding to vote to approve the merger. But another class of proxy suits involves misstatements or omissions made in connection with the ***annual election of directors***, and the plaintiff's claim is that ***self-dealing*** (or other ***wrongdoing***) by officers and/or directors was not disclosed. Here, it is harder to know how to apply the "materiality" test.

   a. **Self-dealing:** If the proxy materials fail to report accurately that officers and directors have engaged in ***self-dealing***, courts seem relatively willing to find the omission material.

   b. **Simple mismanagement:** But if the false statement or omission relates merely to ***"simple mismanagement"*** as opposed to "self-dealing," courts are more reluctant to find that it is "material."

C. **Causation:** Once the plaintiff has proved that the falsehood or omission was "material," he has another major obstacle to overcome: He must show a ***causal link*** between the misleading proxy materials and some damage to shareholders.

1. ***Mills*** **case:** But here, the Supreme Court has ***eased*** the plaintiff's burden substantially. In ***Mills v. Electric Auto-Lite Co.***, 396 U.S. 375 (1970), the Court held that the shareholder does not have to prove that the falsehood or omission itself "caused" the damage to shareholders. Instead, "a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress, if, as here, he proves that the ***proxy solicitation itself, rather than the particular defect in the solicitation materials***, was an ***essential***

link in the accomplishment of the transaction." How this dramatically eases the plaintiff's burden of proving causation is illustrated by the facts of *Mills* itself.

a. **Facts:** In *Mills*, Plaintiffs were shareholders of Electric Auto-Lite Co. ("Auto-Lite"). Mergenthaler Linotype Co. already owned over fifty percent of the stock of Auto-Lite, was in control of Auto-Lite's day-to-day affairs, and had named all eleven of Auto-Lite's directors. Auto-Lite shareholders were sent proxy materials asking for their approval of a merger of Auto-Lite into Mergenthaler. The materials stated that the board of Auto-Lite had approved the merger, but did not disclose that these directors were all Mergenthaler nominees (so that they would, arguably, approve a transaction desired by Mergenthaler even if it wasn't in the best interest of Auto-Lite's non-Mergenthaler shareholders). Even though Mergenthaler owned a majority of Auto-Lite stock, state merger rules required approval of Auto-Lite's minority shareholders.

b. **Holding:** Mergenthaler argued that the Ps should have to show that this omission "caused" injury to them, i.e., to show that had the omitted information been supplied, enough minority shareholders would have changed their votes that the merger would not have gone through. But the Supreme Court rejected this approach to causation, reasoning that such an approach would involve the "impracticalities of determining how many votes were affected...." Instead, the Ps merely had to show that the merger ***could not have been carried out without the submission of proxy materials to the minority shareholders***; once this was shown (and the materiality of the falsehoods also shown), the requisite causal link would be deemed established.

c. **Remedies:** The Supreme Court's conclusion that the Ps in *Mills* had established a violation of the proxy rules did not automatically entitle them to relief. By the time the case got to the Supreme Court, the merger had already gone through (the Ps had been unwilling or unable to post a bond to obtain a

temporary restraining order against the merger). Therefore, the only possible remedies were money damages or an undoing of the merger. The Court remanded for further proceedings on the damage issue. The trial court awarded damages to the Ps, but the Seventh Circuit reversed this award, because it concluded that the merger terms were fair to the Ps, so that they should receive nothing. The damages aspect of the *Mills* case is discussed further *infra*, p. 110.

2. **Reliance and standing:** Suppose P himself ***refused*** to give management his proxy. When P sues for violation of the proxy rules, the defendant corporation is likely to argue that P has no standing because he was not injured — he was not deceived into giving his consent (since he didn't consent at all). Nearly all courts reject this argument, and ***allow even a plaintiff who did not grant a proxy to sue***. This seems clearly the better reasoning: Even if P did not give a proxy, he may still have been injured by the fact that ***other share-holders*** were ***duped*** into giving a proxy, and into approving the proposed merger or election.

3. **Majority shareholder could approve transaction by himself:** A similar issue is presented when a corporation has a ***majority shareholder*** who controls so much stock that he could effect the proposed action (e.g., election of the board or approval of a merger) ***by himself***, without any minority votes at all. If the majority shareholder was not deceived (e.g., because he was the source of the misrepresentation and the proxy statement, or at least knew the true facts), may the minority shareholders still sue? The Supreme Court has answered ***"no"*** to this question — if the plaintiff is a member of a minority class whose votes were ***not necessary*** for the proposed transaction to go through, the plaintiff ***may not recover*** no matter how material or how intentional the deception in the proxy statement was, because the deception did not "cause" the transaction to go through. ***Virginia Bank-shares, Inc. v. Sandberg***, 501 U.S. 1083 (1991).

   a. **Facts:** In *Virginia Bankshares*, First American Bankshares, Inc. (FABI), a bank holding company, owned 85% of the shares of First American Bank of Virginia (Bank). FABI

wanted to get rid of the 15% public shareholders in Bank. Therefore, the boards of FABI and Bank entered into a merger agreement, whereby Bank would be merged into a wholly owned subsidiary of FABI. FABI (not Bank) hired an investment banking firm to give an opinion on the appropriate price for the minority shares; the investment banker recommended a price of $42. Bank's board agreed to the merger at that $42 price. Bank's minority shareholders were sent a proxy solicitation, in which Bank's directors urged that the merger be approved. In the solicitation, the directors stated that they had approved the merger plan because it would give the minority shareholders the opportunity to achieve a "high" value, and a "fair price," for their stock.

i. **Not necessary:** The entire proxy solicitation was not necessary under state or federal law — Bank could have used a much less extensive "statement of information" to shareholders. But Bank decided to use a proxy solicitation for reasons that are unclear, but that probably included a desire to maintain the goodwill of the minority shareholders by convincing them that they were receiving a fair price. (Under Virginia law, the 85% of Bank's shares held by FABI would, if voted in favor of the merger, have been enough to cause the merger to go through, even if the 15% held by the public had been entirely voted against the merger.)

ii. **Minority approves:** Most minority shareholders gave the requested proxies, which were in effect approvals of the transaction. P was a minority shareholder who did not give the requested approval. The merger went through, and P brought a private damage action for violation of the proxy rules; she asserted that her shares were worth at least $60, not the $42 which she and the other minority holders received. A jury found on behalf of P at trial on all issues.

b. Court rejects liability: But the Supreme Court, by a 5-4 vote, ***overturned the verdict***. The Court held that ***no private recovery for proxy misstatements was available*** to "a member

of a class of minority shareholders whose ***votes are not required by law*** or corporate bylaw to authorize the transaction giving rise to the claim."

i. **Board's reasons irrelevant:** It did not make any difference that the proxy solicitation was motivated by the corporation's desire to avoid bad shareholder or public relations. Nor did it matter that the corporation or its board may, by seeking disinterested-shareholder ratification, have been trying to "immunize" the transaction against later conflict-of-interest attack. (One of Bank's directors was also a director of FABI, and Bank's board approval of the transaction might therefore have been attacked by Bank's minority shareholders on the grounds of director conflict-of-interest, an attack which ratification by disinterested shareholders foreclosed. See generally *infra*, p. 208.)

ii. **Rationale:** Allowing members of a minority shareholder class to recover for misstatements when their vote of approval was not even necessary would give rise to "speculative claims and procedural intractability" — the litigation would get lost in a welter of speculation about why and how badly the board wanted the legally-unnecessary minority-shareholder approval, an issue on which "reliable evidence would seldom exist." Congress could not have intended such a result, the majority held.

c. **Dissent:** The four dissenting Justices would have allowed recovery as long as the solicitation of proxies was an ***"essential link"*** in the transaction (here, the freeze-out merger). Since Bank's board decided that minority shareholder approval should be sought, this was by itself enough to make the solicitation an essential link, the dissenters said.

D. **Standard of fault:** The plaintiff contemplating a private action for proxy violations has a number of possible defendants to sue: the corporation itself, its officers, its directors, and its outside professionals who helped to prepare the materials (e.g., the

corporation's lawyers and accountants). In a given situation, some of these individuals will have been much more closely involved with the preparation of materials than others, and are thus much more likely to have actually known of the falsehoods, or at least to have been in a position where they should have known of them. Therefore, the question arises, What is the ***standard of fault*** which must be shown before a given defendant will be held liable in a private suit for proxy violation? Perhaps surprisingly, this is an issue on which the Supreme Court has never spoken.

1. **"Scienter" not required for insiders:** At least where the defendant is an "insider" (e.g., the corporation itself, its officers and its inside directors), nearly all courts seem to hold that ***mere negligence*** on the part of the defendant is ***sufficient***. That is, ***"scienter"*** (knowledge that the statement is false, or reckless disregard of whether the statement is true or false) is ***not*** required.

2. **Outside directors and other outsiders:** Some courts have also found ***outside directors*** and other outsiders liable based on a mere showing of negligence. If such decisions become common, the outside directors of large publicly held corporations (each of which prepares voluminous proxy materials annually) will face a huge burden: Every director will have to read every word of every proxy statement or related material, in order to avoid being held negligent if there is a misstatement. See S,S,B&W, p. 889.

E. Remedies: Suppose that the plaintiff does overcome the hurdles of proving a falsehood or omission in proxy materials, materiality, and causation; what ***remedies*** is he then entitled to? The Supreme Court in *Mills*, *supra*, p. 107, discussed the possibilities (though it did not state what form of relief would be appropriate in that case). Depending on the situation, the three major possibilities are as follows:

1. **Injunction:** First, if the proxy solicitation was for approval of a proposed ***transaction***, the court may grant an ***injunction*** preventing the transaction from going forward. For instance, in *Mills* itself, the trial court might have granted plaintiffs an

injunction against the consummation of the proposed merger of Auto-Lite into Mergenthaler, until revised proxy materials (including full disclosure) were submitted to shareholders and they reapproved the merger. (But by the time the Supreme Court heard the *Mills* case, decided in favor of plaintiff and remanded to the trial court, this injunction remedy was no longer available, since the merger had been already carried out.)

2. **Setting aside of transaction:** Second, the court may ***set aside*** a transaction that has ***already been carried out***. For instance, it might even order a merger to be undone. However, it will only do this if it concludes, from all the circumstances, that doing this would be fair and in the best interests of all shareholders. It is not surprising that the district court in *Mills*, on remand, declined to do this, since unscrambling a seven-year-old transaction would have been prohibitively expensive and not necessarily advantageous to the shareholders. Indeed, it is probably only in a quite rare case (and one in which the transaction has only recently been completed) that the court will order the transaction to be undone.

3. **Damages:** Finally, the court may order that ***damages*** be paid to the plaintiff and other shareholders. However, plaintiff bears the burden of proving that actual ***monetary injury*** occurred before he can recover money damages.

   a. **Merger:** In the case of a proposed ***merger***, the plaintiff would, to recover money damages, have to show that the merger reduced the actual or potential earnings or value of his investment. For instance, P in *Mills* might have been able to show that at the time of the proxy solicitation the market valued each share of Auto-Lite at $10, but that shareholders received shares in Mergenthaler following the merger worth only $8. (In fact, the 7th Circuit reversed a monetary award for the Ps in *Mills*, after concluding that the original merger price was fair.)

   b. **Damages for action by board:** It will be even harder for plaintiff to recover money damages where his claim is that

proxy materials submitted in connection with the ***election*** of the ***board of directors*** were false. For instance, P might claim that one or more board members had engaged in self-dealing, and that this self dealing was improperly omitted from the proxy materials for the election at which the board member(s) was a candidate. The plaintiff could in theory argue that if the improperly-elected board then took actions which lowered the value of his shares, the false proxy materials (and consequent election) "caused" the injury, since had the board not been elected it would not have taken these actions. But courts generally reject damage claims such as this, on the theory that there is no ***"proximate*** causation" — the link between the falsehood in the proxy materials and the board's conduct is insufficiently close. See C&E, p. 360-61.

c. **Attorneys' fees:** If the plaintiff establishes that there was a proxy violation but is unable to establish monetary damages, he may still be entitled to ***attorneys' fees***. For instance, the attorneys in *Mills* were awarded fees for their work up to the Supreme Court decision.

V. COMMUNICATIONS BY SHAREHOLDERS

A. **Two methods:** So far, we have spoken only about the means by which the company (i.e., ***management***) may communicate with shareholders to solicit their proxies. But the SEC's proxy rules also furnish two elaborate procedures whereby a ***shareholder*** may communicate with her fellow shareholders, to solicit their proxies in favor of her own proposal or against a proposal of management.

1. **Shareholder bears cost:** First, if the shareholder is willing to ***bear the costs*** of printing and postage, SEC Rule 14a-7 requires the company to either mail the shareholder's solicitation or give the shareholder a stockholder list so that the shareholder can do the mailing.

2. **Company bears cost:** Second, in a narrower set of circumstances, Rule 14a-8 requires ***management*** to include a shareholder's proposal in management's own proxy materials, at

the corporation's expense.

B. Shareholder bears expense (Rule 14a-7): If the shareholder wishes to communicate with his fellow shareholders and is willing to ***bear the expense*** of doing so (mainly printing and postage), Rule 14a-7 gives him a broadly-applicable ability to do so. This has been called the ***"mail their stuff or give them a list"*** rule. Clark, p. 370. This phrase is quite descriptive of what the rule does: If the rule applies, management must either mail the shareholder's materials to the other stockholders or give the soliciting shareholder a list of shareholders so that he can do the mailing directly.

Example 1: Management of X Corp. announces that it will be soliciting proxies for approval of a merger into Y Corp. Shareholder, who opposes the merger and wants to persuade his fellow shareholders to deny management their proxies on this issue, may use Rule 14a-7 to help him do this. He may force management to choose between either: (1) mailing to all shareholders the opposing proxy materials that he has had pre-printed; or (2) giving him the shareholder list, so that he can mail these materials himself.

Example 2: Management will soon be mailing its materials to solicit proxies to elect the board of directors at the next annual meeting. Shareholder wants to solicit proxies for his own anti-management slate of directors (i.e., he wants to wage a "proxy contest"). Again, Shareholder may use Rule 14a-7 to force management to either mail Shareholder's proxy materials, or to furnish him with a list of shareholders so that he may do the mailing himself.

1. Requirements for rule: To gain the assistance of Rule 14a-7, the soliciting shareholder must meet only a few simple requirements: (1) his proxy materials must relate to a meeting in which the company will be making its own solicitation (so that a dissident shareholder can't use this rule to require his communications to be mailed when no meeting has been called); (2) the stockholder must be ***entitled to vote*** on the matter; and (3) the shareholder must ***defray the expenses*** that the corporation

will incur in mailing the materials (mainly postage and printing costs).

2. **No length limits or censorship:** If the shareholder meets these requirements, his materials are not subject to any ***length*** limit. (This is in contrast to Rule 14a-8's provision for including shareholders' proposals in *management's* solicitation, under which the entire text is limited to five hundred words.) Also, under 14a-7 management has basically no grounds for ***censorship*** or objection (whereas it has many arguments for exclusion under 14a-8's scheme).

3. **Choice by management:** As noted, management has a choice: It can furnish the list of shareholders to the soliciting shareholder, or it can itself do the mailing on behalf of the shareholder. Management is generally reluctant to surrender its shareholder list (the list might be used for other purposes, such as a later hostile takeover attempt), so it almost always elects to do the mailing itself.

4. **Timing:** To prevent management from unfairly ***delaying*** the mailing, the rule requires that materials be mailed "with ***reasonable promptness.***" However, in the usual case where the mailing relates to an annual meeting, management may put itself on an equal footing with the soliciting shareholder by delaying the mailing until the ***earlier of***: (1) a day corresponding to the first date on which management's proxy materials were mailed in connection with the ***last*** annual meeting; or (2) the first day on which management makes its solicitation this year.

   a. **Rationale:** Date (1) above prevents management from delaying both its own and the shareholder's mailings until so close before the meeting that the shareholder has no opportunity to formulate a reply or drum up support. Thus if management mailed its 2008 materials 60 days before the 2008 annual meeting, it must mail the shareholder's 2009 materials at least 60 days before the 2009 meeting, even if management's own materials won't be going out until a later time. See Clark, p. 371.

C. **Corporation bears expense (Rule 14a-8):** A shareholder who prepares his own proxy materials and uses Rule 14a-7 will bear very substantial expenses. Therefore, that section tends to be used only where the soliciting shareholder has a very large financial stake in the corporation and the matter is of direct and large economic importance (as in the two examples given on p. 112, *supra*). By contrast, Rule 14a-8's ***"shareholder proposal"*** rule costs the proposing shareholder almost nothing, and is therefore today mainly used by persons with small stockholdings who seek to influence the corporation's policies concerning matters of great ***social*** or ***political*** interest. Doing business with South Africa, developing anti-personnel bombs for use in Vietnam, practicing alleged cruelty to animals — these are illustrative of the kinds of policies that shareholders have attacked in the last few decades by use of the 14a-8 shareholder proposal rule.

1. **Included in management's proxy materials:** What makes Rule 14a-8 so attractive to activist groups is that where it applies, the shareholder's proposal must be included in ***management's own proxy materials***. The submitting shareholder bears essentially no expense — he does not have to print up materials, or pay the postage for mailing them. The only real cost is the cost of sending a letter to management submitting the proposal.

2. **Eligibility:** For a shareholder-initiated proposal to be covered by Rule 14a-8, the shareholder must: (1) own either at least 1% or $2,000 in market value of securities in the company; and (2) have held the shares for ***at least one year*** prior to the submission. 14a8(b)(1). Therefore, it is not possible for, say, an activist group to buy a couple of shares just before submitting its proposal.

3. **Initiated by shareholder:** The shareholder's proposal ***does not have to have anything to do*** with any matter that management plans to raise at the meeting. For instance, if management plans to do nothing more at the annual meeting than to elect directors, a shareholder may nonetheless use Rule 14a-8 to put to a vote his proposal concerning, say, the corporation's doing of business in China.

4. **Length of proposal:** A shareholder may submit only ***one*** proposal for inclusion in management's proxy materials. The proposal and its supporting statement may not together exceed ***five hundred words***.

5. **Exclusions:** To limit shareholders' proposals to ones that are reasonably relevant to the voting and meeting process, Rule 14a-8(i) lists thirteen ***exclusions***, under which management may refuse to include the proposal. We will summarily list each of the thirteen, and then give special attention to the several that are most frequently applicable.

   a. **Relating to proposal itself:** Eight of the exclusions relate to the proposal itself:

      i. **(i)(1):** The proposal is ***not a proper subject*** for action by stockholders under ***state law***;

      ii. **(i)(2):** The proposal would result in a violation of ***state, federal or foreign*** law;

      iii. **(i)(5):** The proposal is ***not significantly related*** to the company's business;

      iv. **(i)(6):** The proposal is ***beyond the company's power to implement***;

      v. **(i)(7):** The proposal relates to the company's ***"ordinary business operations"***;

      vi. **(i)(8):** The proposal relates to a ***nomination or election*** of a candidate to the ***board*** of directors, or to a ***procedure*** for such nomination;

      vii. **(i)(10):** The proposal is ***moot*** because the company has already substantially ***implemented*** it; and

      viii. **(i)(13):** The proposal relates to specific amounts of ***dividends***.

   b. **Abuse of process:** The other five reasons for exclusion are an attempt to prevent ***abuse*** of the shareholder proposal ***process***:

i. **(i)(3):** The proposal or supporting statement violates the ***proxy rules*** (including 14a-9's ban on "false or misleading" statements in proxy materials);

ii. **(i)(4):** The proposal relates to a ***personal claim or grievance***, or is designed to further a personal interest not shared with other stockholders;

iii. **(i)(9):** The proposal is ***counter*** to a proposal to be submitted by the company (so that, say, a holder's statement of opposition to a merger plan being advocated by management could be excluded);

iv. **(i)(11):** The proposal ***duplicates*** a proposal of another shareholder for inclusion in the same proxy materials; and

v. **(i)(12):** The proposal deals with ***substantially the same subject matter*** as a ***prior*** shareholder proposal made at a recent prior meeting, unless the earlier proposal received a sufficiently large vote (e.g., at least 3% if submitted only once during the prior five years, at least 6% at the second of two prior submissions during the five prior years, etc.).

c. **Improper under state law:** Subsection (i)(1) allows management to exclude the proposal if "under the laws of the registrant's domicile, [the proposal is] ***not a proper subject for action by security holders***." Since most state corporation statutes entrust the running of the corporation to the board of directors (*supra*, p. 50), and give authority to the shareholders only as to certain specified matters (generally, the election of directors and fundamental structural changes), this exclusion rules out a large portion of possible proposals.

i. **Proposals that an order be given:** Thus a shareholder proposal to the effect that management be ***ordered*** or compelled to do something will always be excludable under (i)(1) if the thing proposed is something that shareholders do not have the right to vote on under the law of the state where the corporation is incorporated. For instance, if, as in most states, shareholders may not propose a merger, but

may merely approve a merger proposed by management, a proposal "that the corporation accept the merger offer recently made by XYZ Corp." would be excludable.

ii. Interference with board's power to exercise fiduciary duties: Similarly, if the shareholder proposal orders the board to behave in a way that would ***violate substantive state law***, that proposal, too, will be excludable. That's because 14a8(i)(2) lets management exclude the proposal "if the proposal would, if implemented, ***cause the company to violate any state … law*** to which it is subject." For instance, since most states do not allow the board of directors to ***abdicate their fiduciary responsibilities***, a proposed bylaw that would have the effect of stripping the board of its power to do what it thinks best for all stockholders in a particular case can be excluded, because the bylaw would, if enacted, violate the "no abdication by the board" rule.

Example: AFSCME (a union-affiliated pension plan and investor) attempts to force CA, Inc., a Delaware-chartered public company, to include in its proxy materials AFSCME's proposed bylaw amendment, which if enacted would require the company to reimburse in all cases the reasonable expenses of any shareholder who runs and funds a successful proxy contest (see *infra*, p. 120) to elect one or more non-management-sponsored directors. CA asks the SEC to rule that the proposal is excludable because it would violate Delaware law. The SEC in turn asks the Delaware Supreme Court to say whether the bylaw, if enacted, would violate Delaware law.

Held (by the Delaware Supreme Court), for management. Enactment of this bylaw ***would not be proper*** under Delaware law. "It is well-established Delaware law that a proper function of bylaws is ***not*** to mandate how the board should decide ***specific substantive business decisions***, but rather, to define the ***process and procedures*** by which those decisions are made." If AFSCME's proposed bylaw were

enacted, that bylaw might require CA's board to reimburse a shareholder group when such reimbursement would be a ***violation of the board's fiduciary duties*** to all stockholders. For instance, such a violation would occur "if a shareholder group affiliated with a ***competitor*** of the company were to cause the election of a minority slate of candidates committing to using their director positions to obtain, and then communicate, valuable proprietary strategic or product information to the competitor." ***CA, Inc. v. AFSCME Employees Pension Plan***, 953 A.2d 227 (Del. 2008).

iii. Recommendations: However, most states permit shareholders to make ***non-binding recommendations*** or ***requests***. Therefore, (i)(1) and (i)(2) do not exclude proposals that are framed as requests, i.e., so-called ***"precatory"*** proposals.

Example: Under the laws of nearly every state, shareholders would not be permitted to vote on whether the corporation should do business in Country X. Therefore, a shareholder proposal reading, "Resolved, that the Corporation cease doing business in Country X" would be excludable under (i)(1). Similarly, a proposed bylaw amendment ("Resolved, that the Corporation's bylaws be amended to prohibit the Corporation from doing business in Country X") would likely be excludable under (i)(2), at least under Delaware law, since it takes away the board's power to make substantive business decisions, in likely violation of state law restricting bylaws to procedural issues (as in *CA, Inc.*, *supra*).

But a proposal phrased as a ***request*** would not be excluded. Thus the proposal might be phrased as "Resolved, that the shareholders of Corporation request the board of directors to consider whether the Corporation should cease doing business in Country X." See Clark, p. 373.

d. Not significantly related to corporation's business: (i)(5) excludes proposals that are ***not significantly related to the company's business***. The actual text of (i)(5) gives a partly

mathematical definition: The proposal is excludable if it "relates to operations which account for less than 5% of the company's total assets at the end of its most recent fiscal year, and for less than 5% of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business."

i. **Explanation:** The 5% tests seem to be the exclusive tests for those proposals which relate solely to economic issues. Thus if the proposal calls for the corporation's Widget division to be divested because it has a poor return on equity or because the cash could be better invested elsewhere, the proposal is automatically excluded under (i)(5) if the Widget division accounts for less than 5% of the company's assets, earnings, and sales.

ii. **Ethical issues:** But if the reason advanced for the proposal relates to ***non-economic*** issues, apparently failure to meet the 5% test is ***not conclusive***; this is the meaning of the phrase "and is not otherwise significantly related to the [company's] business.…" Thus if the proposal is significant because of the ***social*** or ***ethical*** issues that it raises, and these issues are ***related to the corporation's business***, the proposal will not be excludable automatically merely because it doesn't satisfy the 5% tests.

Example: D Corp. has annual revenues of $141 million, with $6 million in annual profits and $78 million in assets. P, a shareholder, submits a proposal urging the board of directors to consider whether the method used by French farmers to force feed geese for the production of pate de foie gras (a product imported by D) causes the geese undue pain and suffering, and if so, whether further importation of the product should be suspended until more humane methods become available. D's sales of pate are $79,000 annually, it has only $34,000 in assets relating to pate, and it loses money on its sales. Thus none of the 5% tests comes close to being satisfied. However, P argues that because of the large ethical and social issues raised by the force

feeding of geese to produce pate, his proposal is "otherwise significantly related" to D's business even though it does not satisfy the 5% tests.

Held, for P. The meaning of "otherwise significantly related" is not limited to economic significance. Since P's proposal raises substantial ethical and social issues, and these issues are tied to significant business activity by D (even though that activity relates to less than 5% of sales, assets and profits), D must include P's proposal in its proxy materials. *Lovenheim v. Iroquois Brands Ltd.*, 618 F.Supp. 554 (D.D.C. 1985).

e. Relates to routine matters: (i)(7) allows the shareholder proposal to be excluded if it relates to conduct of the ***"ordinary business operations***" of the company. In other words, if the matter in question, is ***"too routine,"*** it may be excluded on that basis. In a sense, this is the opposite of the ground for exclusion considered just previously ("not … significantly related to the [company's] business"). This exception covers some of the same ground as the (i)(1) exception for matters that are not a proper subject for shareholder action under state law — in nearly all states, details of day-to-day operations are to be decided solely by the board and management, not by shareholders. For instance, a proposal recommending that the corporation curtail its research and development spending, or one recommending that the corporation launch more (or fewer) new products, would be excludable.

i. Major social, ethical or economic issue: If the proposal raises a major social, ethical, political or economic issue, the "ordinary business operations" exclusion does not apply, even though the matter might otherwise seem to fall within the corporation's routine business. See *infra*, p. 119.

ii. Executive compensation: The SEC holds that proposals concerning ***senior executive compensation*** are ***not*** matters relating to the "ordinary business operations" of the company, and that shareholder proposals on this topic ***may***

not be excluded under (i)(7). Thus a shareholder proposal that the corporation not make ***"golden parachute"*** payments (payments contingent on a merger or acquisition), a proposal that the board set up a Compensation Committee consisting of independent directors to establish executive compensation, and presumably any other proposal whose thrust is to complain that the corporation is ***paying its senior executives too much money***, are all includible. See, e.g., Feb. 13, 1992 Statement of SEC Chairman Richard Breedon.

f. Election of directors: (i)(8) allows exclusion of proposals relating to the ***election of specific individuals*** to the company's board of directors. For instance, (i)(8)(iv) lets the company exclude a proposal that "[s]eeks to ***include a specific individual*** in the company's proxy materials for ***election to the board of directors***[.]"

i. Main significance: The main significance of this exclusion is that a proposal seeking to elect a ***particular slate*** of directors favored by the proposer, or opposing management's slate of directors, ***may not be done through the free "include shareholder's proposal in management's materials" method*** of Rule 14a-8. Instead, a person wishing to solicit proxies for his own slate of board nominees, or to oppose management's slate, must conduct a regular ***"proxy contest,"*** in which he ***bears the cost of mailing his own materials*** under Rule 14a-7 (and complies with the special disclosure rules of Schedule 14B, discussed *infra*, p. 122).

(1) SEC adds a new rule to allow shareholder access: Beginning in the early 2000s, the SEC wanted to at least partially reverse the above ban, so that minority shareholders could sometimes use the company's proxy materials to nominate their own competing slate of directors. Then, in 2010, as part of the Dodd-Frank financial-industry reform statute, Congress gave the SEC explicit authority to do this (though the Commission probably already had that authority). The

SEC promptly responded by enacting a new proxy Rule, 14a-11. The new rule allowed anyone who had owned for the past three years (and still owned) ***more than 3% of a company's shares*** to nominate a slate for up to 25% of the company's board, and to require that the nominating materials be ***included in the company's own proxy materials.***

(2) Big companies oppose: But most public companies hated the idea that every 3% dissident holder would now have an easy and cheap way to nominate a slate of directors to challenge management's nominees. As the president of the Business Roundtable (a group of large public companies) put it shortly after the SEC enacted the new Rule 14a-11, "This is an unprecedented preemption of state corporate law — the bedrock of corporate governance — that will ***turn the boards*** of more than 15,000 publicly-traded companies ***into political bodies and threaten their ability to function.***" Quoted at O&T (6th), p. 251.

(3) Court rejects this rule: The Business Roundtable and the U.S. Chamber of Commerce then sued to overturn the new Rule 14a-11. The U.S. Court of Appeals for the District of Columbia held for the plaintiffs, and ***struck down*** the new Rule 14a-11 as having been improperly adopted. The court found that the SEC had "acted ***arbitrarily and capriciously*** [by] fail[ing] … adequately to assess the economic effects of [the] new rule." ***Business Roundtable v. S.E.C.***, 647 F.3d 1144 (D.C. Cir. 2011).

(4) SEC gives up: Since that loss, the SEC has ***abandoned*** its efforts to give shareholders this right of proxy access for nominations of rival slates. So it remains the case as of this writing (April, 2013) that in the ordinary situation, no shareholder may require a company to put the shareholder's proposed board nominations into the company's own proxy materials.

ii. Proposal to change election rules: What if a shareholder wants to use the free include-shareholders'-materials mechanism not to try to get a *particular* slate of directors elected or defeated, but instead to ***change the company's bylaws*** so as to ***change the procedures*** for how board elections *generally* work? As the result of an important 2011 change to 14a-(i)(8) by the SEC, the answer is that the shareholder ***may*** use the free mechanism for this change-the-procedures purpose.

(1) Right to propose bylaw amendment: In 2011, shortly after the SEC lost the *Business Roundtable* case, *supra*, the Commission changed Rule 14a-8's language. The effect of the change is to remove anything in 14a-8 that might have been interpreted to prevent shareholders from proposing such a general change to a company's bylaws on how elections are to be run. This modification gives dissident stockholders a chance, one corporation at a time, to reverse the result of *Business Roundtable* (and thereby eventually to force management to include nominations of rival slates in management's proxy materials).

Example: Holder is a minority (and dissident) shareholder in Corp, a public company. Holder submits the following proposal to Corp, and demands that it be included within management's proxy materials for the next annual meeting: "Resolved, that Corp's bylaws be changed so that (1) any shareholder owning more than 1% of the company's shares shall be entitled to propose a slate of up to 4 directors as nominees to Corp's Board of Directors; and (2) such a proposed slate shall be included in management's proxy materials at no cost to the proposing shareholder."

Under present (post-2011) Rule 14a-8(i)(8), nothing makes this proposed change to the bylaws excludable by Corp. Therefore, Corp will ***have to include the proposal*** in its next set of proxy materials. Then, if a majority of

the shareholders votes in favor of the proposal, Corp's bylaws will be amended so that the general "no shareholder nominations may be included in management's proxy materials" rule of 14a-8(i) is reversed as to Corp. Thereafter, any holder with 1% of Corp's stock will have the ability, at minimal cost, to force Corp's management to include that holder's rival slate of up to 4 directors as part of management's proxy materials. Cf. K,R&B (8th), p. 553.

(2) Delaware now allows: By the way, the statutory law of Delaware has been changed to specifically ***allow*** such an effort by shareholders to change the company's bylaws to make shareholder slates includable in management's proxy materials. §112 of the Delaware GCL, enacted in 2009, says that a Delaware company's bylaws "may provide that if the corporation solicits proxies with respect to an election of directors, it may be ***required … to include in its proxy solicitation materials*** … one or more ***individuals nominated by a stock-holder.***" Since Delaware state law has always generally allowed stockholders to amend the corporation's bylaws as long as the amendment does not interfere with the board's own responsibilities to manage the business,[1] §112 means that a shareholder proposal to amend the bylaws so as to shift the company to this type of "voluntary proxy access regime" for director elections is now also proper. A,K&S (4th), p. 201.

6. Social/political/ethical problems: Now let's consider shareholder proposals that take a position on major ***ethical/social/political*** issues that have some tangible link to the corporation's affairs — can management exclude these? Even with all of the grounds for exclusion, the courts and the SEC have tended to ***require the inclusion*** of such proposals, as long as they take the form of a recommendation to the board, rather than an order. For instance, the SEC has required the following proposals to be included:

- ❑ a proposal recommending that Motorola cease business activities in South Africa, even though the company did only a minor volume of business in that country;
- ❑ a proposal recommending that Citicorp disclose political contributions made by its executives;
- ❑ a proposal recommending that Eastman Kodak report to shareholders on contracts to develop weapons for the "Star Wars" program; and
- ❑ a proposal recommending that Phillip Morris get out of the tobacco business.

See S,S,B&W, p. 630.

VI. PROXY CONTESTS

A. What a proxy contest is: A ***"proxy contest"*** is, in the broadest sense, any competition between two competing factions (generally management and outside ***"insurgents"***) to obtain shareholder votes on a proposal. The contest is much like a political campaign: Each side typically takes out newspaper advertising, does direct mailing (of proxy materials), makes personal phone calls to important "voters" (i.e., large stockholders), and does anything else in its legal power to gain more votes than the other side.

1. Election of directors: Most proxy contests involve the ***election of directors***, and are thus direct contests for control.

Example: Bumbling Corp. has a solid basic business, but is generally regarded by Wall Street as poorly and sleepily run, so its profits are less than they could be under a more aggressive management. Tycoon, who has made a huge fortune in the real estate business, decides that he could run Bumbling better than its current management. A few months prior to the scheduled annual shareholders' meeting, Tycoon nominates an insurgent slate of directors (including himself and his close associates) for each seat on the board. Management counters with its own slate, consisting mostly of

existing board members running for re-election.

This is a "proxy contest." Each side will now submit its own proxy materials to every shareholder; these materials will contain facts about that side's nominees and arguments why the shareholders should vote for that side. Both sides would also typically take out newspaper advertising disparaging the other's slate, and do massive telephone electioneering of large (usually institutional) stockholders.

If management wins (i.e., its candidates get more votes than Tycoon's) the pro-management slate is re-elected, and perhaps business goes on much as before. If Tycoon's slate wins, the newly-constituted board will probably dismiss the old management, appoint new executives backed by Tycoon (perhaps making Tycoon himself CEO), and may well then sell the corporation's assets or otherwise dramatically restructure.

2. **Non-director fights:** About one-third of proxy fights do not involve the election of directors. Instead, they are contests over some ***proposal*** by management or by a shareholder-insurgent. Usually, the proposal relates to a corporate takeover or restructuring. For instance, management may be proposing anti-takeover defenses (e.g., a "poison pill," see *infra*, p. 452), which the insurgents are opposing because they want to conduct or at least benefit from a takeover. Conversely, an insurgent may have proposed that the board be asked to remove anti-takeover devices or to seek a buyer for the company's assets.

B. Why contests are waged: In most contests today, the insurgent faction hopes to end up in ***operating control*** of the target, whether by owning a majority of the shares or by merely obtaining a majority of the board seats. In theory, a proxy contest will usually be cheaper than a hostile takeover bid (see *infra*, p. 429), since the insurgents do not have to buy any shares. However, the outsider group is much less likely to win or achieve a profitable compromise in a proxy contest than in a takeover bid.

1. **"Wall Street Rule":** One reason why proxy contests usually fail is that traditionally, shareholders usually vote in favor of

management. A shareholder who thinks management is doing a poor job usually ***sells his shares***, so by a natural process the shareholders on hand at the time of a proxy contest do not include very many who are dissatisfied with management. This tendency to vote-by-selling is known as the "Wall Street Rule."

2. **No benefits for loser:** Furthermore, the unsuccessful insurgent group in a proxy contest is generally left with no benefit at all from its expense, whereas the unsuccessful tender offeror usually has built up a sizable minority stake in the company which it can then sell back to the company or to a "white knight" acquirer. (See *infra*, p. 454.) S,S,B&W, p. 1177.

3. **Consequence:** For these reasons, the number of proxy contests has been flat or decreasing in recent years, whereas the number of tender offers has been increasing.

C. **Regulation of proxy contests:** Proxy contests are unlike a political election campaign in one major respect: Whereas in the political campaign each side may say pretty much whatever it wants, the proxy contest is subject to the same stringent SEC proxy solicitation rules as any other solicitation, with some extra regulations to boot.

1. **Three advantages for management:** At the start of a proxy contest, management has three key advantages: (1) as already mentioned, stockholders usually tend to vote for management; (2) management can use ***corporate funds*** to pay for its side of the contest (see *infra*, p. 123); and (3) management knows who the shareholders are (and how much each owns), whereas the insurgents will usually have to litigate to get access to the list, if they can get it at all. (This access is discussed below.) S,S,B&W, p. 1174.

2. **Insurgents' right to get information from management:** The SEC proxy rules very slightly redress this imbalance by requiring management to give the insurgents limited assistance in communicating with shareholders. SEC Rule 14a-7 requires management to tell the insurgents how many stockholders of record there are, how many beneficial owners there are (if

management plans to solicit the beneficial owners through brokers and bankers) and how much it will cost to mail the insurgents' proxy materials to all holders.

3. **Access to list:** It is vital for the insurgents to obtain access to the ***list*** of shareholders. Only through direct access to this list can the insurgents engage in the follow-up electioneering that is usually indispensable (e.g., telephone calls and personal meetings with large holders). Yet the SEC rules do not in fact grant the insurgent this right; however, they may have the right under ***state law***.

   a. **Proxy rules:** Recall that under SEC Rule 14a-7 (discussed extensively *supra*, p. 112), any shareholder who wants to solicit his fellow shareholders may require the corporation (i.e., management) to ***choose*** between furnishing the list of shareholders or mailing the shareholder's materials to all holders. Because of the tactical importance of direct list access, management usually chooses to mail the insurgents' materials rather than to give the insurgents access to the list. As far as the federal proxy rules go, management has the perfect right to do this, and nothing else in the rules gives the insurgents any right to inspect the shareholders list.

   b. **State law:** However, recall that nearly all ***states*** give shareholders some right of inspection of corporate books and records. This right of inspection may include the right to inspect the shareholders list. Whether and when this inspection is available varies sharply from state to state. For instance, MBCA §16.02 allows inspection of the shareholder list, but only if the inspecting shareholder makes his demand "in good faith and for a proper purpose," having described "with reasonable particularity his purpose" for inspection, and shows that the records are "directly connected" with this purpose. (A court would probably hold that the desire to wage a proxy fight is a proper purpose, to which inspection of the shareholders list is directly connected.) Similarly, Delaware GCL §220(b) gives any shareholder the right to inspect the list so long as he has a "purpose reasonably related to [his] interest

as a stockholder"; here, too, the desire to wage a proxy fight should be sufficient.

i. Litigation required: But even where the insurgents seem to have a state-law right to inspect, this right is of course not self-executing, and management will usually require the insurgents to ***litigate*** the issue. This gives management a valuable time advantage (since in the meantime it can be personally contacting large holders to present its own position).

ii. Non-objecting beneficial owners: Some state shareholder-list-access statutes have even been interpreted to allow a shareholder the right to inspect a list of the corporation's ***"non-objecting beneficial owners"*** ("NOBO list"). Recall (see *supra*, p. 101) that the beneficial owner is a person who has the real, effective economic ownership of a share that is held on the corporation's own books in "street name." Thus in *Sadler v. NCR Corp.*, 928 F.2d 48 (2d Cir. 1991), the Second Circuit held that New York law gives any shareholder of a non-New York corporation doing substantial business in New York the right to a NOBO list; in fact, if a NOBO list is required to put both sides in a proxy contest on equal footing, the corporation may be required to ***compile*** the list if it does not already have one.

D. Disclosure required: Both sides in a proxy contest must comply with the usual disclosure and anti-fraud rules of the '34 Act. Thus the insurgents must, like management, make sure that any "solicitation" (including oral solicitation) is ***preceded by a written proxy statement*** (Rule 14a-3(a)). Similarly, both insurgents and management must respect Rule 14a-9's prohibition on any ***"false or misleading" statement*** in the proxy statement or in any other communication (e.g., newspaper advertisements, telephone calls, etc.).

1. Additional disclosure for election: Furthermore, in the usual proxy contest involving the election of directors, the insurgent must file special information about each ***"participant"*** in the

solicitation (with "participant" defined to include anyone who contributes more than $500 to the contest). For each participant connected with the insurgents' side, there must be filed a Schedule 14B disclosing the person's business background, his interest in the corporation's stock, his financial contribution to the proxy fight, and other information that would assist a shareholder in deciding whether the insurgents' slate is more worthy than management's. This information must be filed with the SEC five days ***before*** the group starts its solicitation, thus giving management an early warning that a contest is about to begin.

E. Costs: Proxy contests are costly — today, it is not unusual for each side's costs to be in the millions of dollars. Therefore, each side would like to have the corporation reimburse it for these expenses. The ability to have the corporation reimburse proxy contest expenses is governed by state law. Most states seem to apply the following rules:

1. Management's expenses: All courts agree that the corporation may pay for the basic "bare bones" compliance by ***management*** with federal proxy regulations. Thus the costs of drafting and printing the proxy materials, and of mailing them to shareholders, may clearly be paid by the corporation, since otherwise management would have to choose between not complying with the federal proxy rules or not obtaining a quorum for the shareholders' meeting. Nutshell, p. 294.

a. Other solicitation costs: Of course, the "bare bones" costs just described are only a part (often a very small part) of the total costs on management's side of a proxy contest. Much more significant are the expenses of massive newspaper advertising, retention of proxy-solicitation specialist firms, telephone and private meetings with large holders in many cities, etc.

b. Corporation may pay: Most courts hold that so long as the contest involves a conflict over ***"policy,"*** and is not merely a "personal power contest," the corporation may ***pay for***

management's reasonable expenses in "educating" the stockholders as to the correctness of management's view. Thus in most if not all states, these advertising and other "campaign" costs — even if they only disseminate information that is already in the proxy materials — may be paid for by the corporation. See, e.g., *Rosenfeld v. Fairchild Engine and Airplane Corp.*, 128 N.E.2d 291 (N.Y. 1955).

c. **Always characterizable as "policy":** The requirement that the contest involve "policy" rather than "personal power" has very little bite: Almost any proxy contest can be (and is) characterized as one involving "policy" or "economic issues," rather than as one involving management's desire to stay in control or the insurgents' desire to seize control. Nutshell, p. 295.

2. **Expenses of successful insurgents:** Suppose the insurgents ***succeed*** and end up controlling a majority of the board of directors. The newly-appointed board will then often approve the corporation's reimbursement of the insurgents' proxy-contest expenses. Here, the courts seem to have generally ***allowed*** such reimbursements, if two requirements are satisfied: (1) the contest involved ***"policy"*** rather than being a pure power struggle (the same requirement as for management's expenses, *supra*, p. 123); and (2) the ***stockholders approve*** the reimbursement. See *Rosenfeld v. Fairchild, supra*, to this effect.

a. **Payment for both sides:** If the successful insurgents get their expenses covered, the usual result is that ***both sides*** will end up having the corporation cover their expenses. This is because the former management, before leaving office, will have the corporation pay *its* expenses. Nutshell, p. 295.

b. **Criticism:** Even if shareholders approve the reimbursement of the insurgents' expenses, this is not necessarily a fair or reasonable result. Often, the insurgents will hold a substantial minority of the stock. Therefore, they can get approval from a majority of overall shareholders by convincing a minority of the non-affiliated holders to vote with them. The other

shareholders then end up having the corporation paying (out of their investment, in a sense) for both sides of a proxy contest that may well not have benefited these minority holders at all.

3. **Unsuccessful insurgents:** If the insurgents are ***unsuccessful***, they have virtually ***no chance*** of getting the corporation to reimburse them for their expenses. After all, they have waged an unsuccessful war against management, so management is hardly likely to reward them.

VII. IMPROVED PUBLIC DISCLOSURE BY THE CORPORATION

A. Greater disclosure, generally: At the start of the 21st century, major financial scandals erupted at Enron, WorldCom, Adelphia Communications and other major public companies. Senior executives at these companies seemed to have been "cooking the books" for years. When the book-cooking could no longer be concealed, in many cases the company turned out to be completely worthless (e.g., Enron and Adelphia), and in all cases stockholders suffered major losses. The SEC and Congress responded with several initiatives to improve the quality of financial disclosure by public corporations.

We look briefly here at two of these major attempts to improve the disclosure obligations of public companies: ***Regulation FD*** and the ***Sarbanes-Oxley Act***.

B. Regulation FD: The SEC became convinced that professional investors (e.g., securities analysts) had an unfair advantage over amateur investors, because public companies frequently ***disclosed sensitive information to the professionals before disclosing to the public.*** This gave the professionals a chance to react to the changed information (e.g., by buying up shares in companies with good news or selling shares in companies with bad news) before the amateur public could respond. Therefore, in 2000 the SEC attempted to "level the playing field" by enacting ***Regulation FD*** (which stands for ***"Fair Disclosure"***).

1. **Function of Reg. FD:** Reg. FD changes the rules about selective disclosure in two ways, one dealing with intentional disclosures, and the other with unintentional ones:

- ❑ If a public company ***intends*** to release material nonpublic information to securities analysts or certain other types of outside professional investors, the company must disclose the information ***simultaneously to the public***.
- ❑ And, if the public company realizes that it has ***unintentionally*** disclosed material non-public information to such a professional investor, it must cure the problem by then ***"promptly"*** disclosing that information to the public.

Cf. Hamilton (8th), p. 796.

Example 1: Fred, the header of investor relations for XYZ Corp., has just learned that XYZ's sales and profits for the recently-completed quarter were better than Wall Street expects. Fred would like to be able to tell this news to his buddy, Ralph, a securities analyst who follows XYZ for Big Brokerage Co., at 10 AM, and not alert the public until noon. Under Reg. FD, Fred cannot do this — he must inform Ralph and the public simultaneously. Typically, the public would be informed by a press release or an SEC filing.

Example 2: Same basic facts as above example. This time, however, Fred makes an offhand remark to Ralph in a telephone call, "It looks like it was an unusually good quarter." He then realizes that he's given Ralph material inside information. Fred must see to it that the company "promptly" (essentially, as soon as possible) makes the same information public.

C. Sarbanes-Oxley Act: The most important fallout from the turn-of-the-century corporate scandals has been the passage of the ***Sarbanes-Oxley Act*** by Congress in 2002. Sarbanes-Oxley dramatically increases the responsibilities of people in charge of running the finances of public companies, including the CEO, the CFO (Chief Financial Officer), directors who serve on the

company's audit committee, inside and outside legal counsel to the company, and the company's outside auditor. Here are some of the major responsibilities that Sarbanes-Oxley imposes:

1. **CEO/CFO certification:** Most importantly, the company's ***CEO*** and ***CFO*** must each ***certify the accuracy*** of each quarterly and annual filing with the SEC. More precisely, the CEO and CFO must certify:

   - that each quarterly and annual report "does not contain any ***untrue statement*** of a material fact or omit to state a material fact necessary in order to make the statements made … not misleading";
   - that the financial statements in the report "***fairly present*** in all material respects the ***financial condition and results of operations*** of the issuer[.]"
   - that the signing officer has designed ***"internal controls"*** to ensure that information about the company is made known to the signing officer; the officer must also re-evaluate the effectiveness of those controls each quarter;
   - that the signing officer has disclosed to the company's outside auditors, and to the audit committee of the board, any ***deficiencies in the internal controls***, and any ***fraud*** involving management.

   See §§302(a)(2), (3), (4) and (5) of the Sarbanes-Oxley Act. Cf. Hamilton (8th), pp. 717-18.

   Adding to the stakes for the certifying CEO and CFO, the Act imposes ***criminal penalties*** of up to 10 years imprisonment for a "knowing" violation and up to 20 years for a "willful" violation. See §906 of the Act.

2. **Rules about Audit Committee:** Each company's Audit Committee is much more tightly regulated now, under Sarbanes-Oxley. Each member of the committee must be ***"independent."*** This requirement of "independence" means that (a) no employees of the company or its subsidiaries may be a member; and (b) members may not accept any "consulting, advisory, or

other compensatory fees" from the company, other than fees for belonging to the board or to the committee (so that an audit committee member may not, say, serve as a consultant or lawyer to the company).

3. **Whistle-blower rules:** Corporate ***whistle-blowers*** — employees who report, say, the company's financial misconduct to government authorities — get special protection. It is now a crime punishable by up to 10 years in prison for anyone to knowingly retaliate against a person for supplying truthful information about a federal crime to a law-enforcement officer. (Violations of Sarbanes-Oxley are themselves, of course, federal crimes.) Retaliation is defined to include interference with "the lawful ***employment*** or livelihood" of a person. §1107 of the Act. So ***firing a whistle-blower in retaliation*** is now a ***felony***.

   Example: Suppose that CFO learns that Clerk, a low-level accounting clerk, has just told the SEC about an ongoing financial fraud at the company. CFO fires Clerk so that Clerk will be cut off from further information, and in order to be able to be able to say, "Well, Clerk is just a disgruntled employee who was fired for incompetence." CFO has committed a felony under §1107, and can go to prison for up to 10 years.

4. **Auditor independence:** The company's ***outside auditors*** (the CPAs that perform the annual audit) must also be much more ***independent*** than previously. The auditors must contract with the audit committee of the board, not with management of the company. And the auditors may no longer do other — potentially more lucrative — tasks for the company, such as bookkeeping, designing the computer system that does financial record-keeping for the company, etc. See §201 of the Act.

Quiz Yourself on ***SHAREHOLDERS' INFO. RIGHTS AND THE PROXY SYSTEM*** *(ENTIRE CHAPTER)*

29. Hannibal Lechter Foods, Inc., a privately-held company, makes a popular meal extender for cannibals, "Manburger Helper" ("… when you need a helping hand."). Robinson Crusoe, a 1% shareholder, believes that the directors are cooking the books; however, they refuse to allow him to see the corporation's books to find out if he's right. Under the prevailing approach, does Crusoe have a right to examine the corporation's accounting records for this purpose? ___________________________

30. The Botch Ewlism Food Company has assets of $15 million. It has 350 shareholders of preferred stock and 350 shareholders of common stock. Botch Ewlism's shares are traded over-the-counter.

(a) Does Botch have to file annual and/or quarterly financial reports with the SEC? ___________________________

(b) Is Botch subject to the SEC's proxy-solicitation rules?

____

31. Nyuck-Nyuck Corp. is a huge public company, with its shares traded on the NYSE. The management of Nyuck-Nyuck, consisting of Larry, Curly, and Moe, owns a majority of the stock. Therefore, management doesn't need proxies from anyone else in order to arrange a quorum at the annual meeting, or to cause any properly-noticed shareholder action to be approved at that meeting. Consequently, management would like to be able to skip the cumbersome step of sending anything to outside shareholders before the annual meeting. Is there anything that, according to federal proxy rules, management must send to shareholders before the meeting despite the absence of a proxy solicitation (and if so, what)?

____

32. Sarah Connor owns shares in the Terminator Wrecking Company. Terminator's annual meeting takes place on June 1st, and has a record date of April 15th. On May 1st, Sarah takes out a loan with the Cyborg Bank, pledging as collateral her Terminator shares. Cyborg insists on being granted a proxy as a condition for the loan. Sarah grants the proxy. The proxy says, on its face, that it's irrevocable. Sarah pays off the loan full on May 20th. Sarah shows up at the Terminator annual meeting, intending to vote her shares. Cyborg Bank sends a representative as well, claiming it has an irrevocable proxy and is entitled to vote the shares. Who gets to vote the shares? ___________________________

33. Clampett Oil Company's stock is traded on the NYSE. Clampett's board of directors wants to merge Clampett with the Drysdale Corporation. Clampett's board has to get shareholder approval for the merger, so it sends out proxy materials soliciting proxy appointments to vote on the merger. The proxy solicitation contains the board's recommendation that the merger be approved. However, the proxy materials don'tmention that, because Drysdale owns 54% of Clampett, all of Clampett's directors were named by Drys-dale. (Clampett's charter does not allow cumulative voting). The merger is approved by Clampett's shareholders. Ellie May Clampett, a minority shareholder of Clampett Oil, files suit for an injunction against the transaction, on the grounds that the proxy materials omitted a material issue of fact (Drysdale's domination of Clampett's board).

(a) For this part, assume that according to Clampett's charter, the merger needed to be approved by a two-thirds majority of Clampett's shareholders. Will Ellie May get the injunction she seeks?

____

(b) For this part, assume that only a simple majority needed to approve the merger. Assume also that Ellie May wasn't initially aware of the omission about board domination, voted to approve the transaction, and then found out (after the merger went through) about the domination. She now sues in federal court for monetary damages. (Assume that state law does not allow appraisal rights in this situation, whether or not the holder votes in favor of the transaction.) Will Ellie May get damages?

____

34. Pongo has owned 10% of the voting stock of the Cruella De Vil Clothing Company for several years. Cruella De Vil stock is traded on the NYSE. Pongo hears that management intends to expand its line of furs to include dalmatian pelts, and he's furious. Pongo wants to submit a proposal under the shareholder proposal rule, 14a-8, to be included in management's proxy materials for the upcoming annual meeting. Pongo's proposal asks management to consider not manufacturing clothing made from furs, which currently account for 10% of the company's product line. Management isn't submitting a proposal on the same subject for the annual meeting. Must management include Pongo's proposal in its proxy materials? ______________________________

35. Caesar is the CEO of Imperial Rome Corp., a public company. The company's annual meeting of shareholders will be coming up in a couple of months. Management (meaning Caesar) is going to propose in its proxy materials that all incumbent members of the board be re-elected. Cleopatra, a dissident shareholder who has owned 4% of the company's shares for several years and who is not presently on the board, wishes to run for a board seat. She has prepared a brief statement that lists what she believes to be her credentials to be elected to the board, and the steps she would favor if she were elected. Instead of waging an independent "proxy contest" to be elected to the board, Cleopatra has submitted her statement to management, and has requested that the statement (together with a form of proxy enabling shareholders to vote for her by proxy) be included with management's own proxy materials in the mailing that will go to all shareholders. Caesar would like to find a grounds for rejecting Cleopatra's request. You are counsel to the company. What ground, if any, can you cite to Caesar that would justify Caesar in refusing Cleopatra's request?

36. WorldCon, a public company, issues a quarterly report to the SEC reporting that the company made $100 million that quarter. The quarterly report is accompanied by all required certifications about the accuracy of the report, signed by, among others, Bernie Fibbers, CEO and controlling shareholder of the company. Bernie knows that the $100 million of profit was obtained by improperly treating $200 million of expenses as if they had been capital expenditures (thus changing what would have been an $80 million loss into the reported $100 million profit). You are a federal prosecutor, and you have learned the above facts.

(a) What, if any, juicy federal securities-law charge can you bring against Bernie to put him away for a long time?

____

(b) What will you have to prove to win a conviction on that charge?

____

Answers

29. Yes. Most states let a shareholder examine the corporation's books and

records, provided that this is not being done for an "improper" purpose (e.g., stealing the corporation's secrets so as to compete with it). [90] Confirming or refuting one's suspicions that the books are being cooked certainly qualifies as a proper purpose, so Crusoe should be able to get a court order compelling the company to allow the inspection.

Note that under MBCA §16.02(c), Crusoe would be allowed to inspect the accounting records, but only if: (1) he made his demand "in good faith and for a proper purpose" (satisfied here); (2) he described with "reasonable particularity" why he wanted to do the inspection (e.g., "I think the books are being cooked," which he could honestly say here); and (3) the records are "directly connected" with his purpose (satisfied here). So Crusoe would get the inspection under §16.02(c) (and in fact the corporation would probably have to pay his legal fees in getting the court order, under §16.04(c)). [91]

30. **(a) No.** §12 of the Securities Exchange Act ('34 Act), and SEC Rule 12g-1 enacted under it, describe the companies subject to federal proxy rules. A company qualifies if ***either***: (1) Its securities are traded on a regulated securities exchange (e.g., NYSE); ***or*** (2) The company fits *both* of the following requirements: (a) It has assets greater than $10,000,000, and (b) It has 500 or more shareholders of a class of equity securities (e.g., common stock). [96]

The key to this question is that if a corporation isn't traded on a national exchange (as Botch Ewlism isn't), it must have a *class* of stock held by 500 or more people, not 500 or more shareholders all together. That's the problem here: Botch Ewlism has 700 shareholders, but it doesn't have 500 or more holders of any one class. Thus, it's not subject to the SEC's reporting requirements.

(b) No. A company is bound by the SEC's proxy solicitation rules if, and only if, it's required to file financial reports under the '34 Act. So the negative answer to part (a) compels a negative answer to this part as well. [98]

31. **Yes — management must send each shareholder material "substantially equivalent" to the material that it would have had to send if it were soliciting proxies.** [100] This means that management has to send an *annual report* containing the corporation's financial reports,

plus information about the compensation and stockholdings of management and board members, transactions between management and the corporation, and any matter on which there will be a shareholder vote. This information must also be filed with the SEC. So shareholders get as much information about a management-controlled public company as they do about one that is not management controlled. (But remember, the solicitation and filing requirements don't get triggered if the company is not traded on a stock exchange and doesn't have at least 500 holders of some one class of stock — see the previous question.)

32. Sarah. The normal rule is that a proxy is revocable unless it's ***coupled with an "interest."*** This is true even if the proxy says that it's irrevocable. [102] One of the ways in which a proxy can be coupled with an interest is if the stock is pledged as collateral for a loan. [103] That was the case here, so Cyborg is correct in the sense that the proxy it received *was* irrevocable. However, if the condition that made the proxy irrevocable is *lifted* — in the case of a collateralized loan, the loan is paid off — then the proxy is automatically revoked. As a result, Sarah's entitled to vote her own shares. See MBCA §7.22 (d, f).

33. (a) Yes, probably. Rule 14a-9 of the '34 Act requires that proxy materials be free of misstatements or omissions of "material" fact. Here, the fact that Clampett Oil's directors were all Drysdale's nominees would be likely to influence the Clampett directors' recommendation that the merger be approved. A fact is "material" (so that the proxy materials can't omit or misstate it) if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote" (i.e., if the fact would "significantly alter the 'total mix' of available information"). *TSC Industries*. [105] The omission here certainly seems to qualify: a Clampett shareholder would probably give the Clampett board's recommendation much less weight if she knew that the board was controlled by the acquirer than if she didn't know this. So omission of the fact of board domination renders the proxy materials misleading. A federal court has discretion to issue an injunction against the transaction if adequate proxy materials haven't been sent, and there's a good chance the court in this situation would exercise that discretion. [110]

(b) No, probably. The Supreme Court has held that no private recovery for proxy misstatements is available to "a member of a class of minority

shareholders whose votes are ***not required*** by law or corporate bylaw to authorize the transaction giving rise to the claim." *Virginia Bankshares.* [108] Here, since Drysdale controlled a majority of the common stock, and only a simple majority had to approve the transaction, the merger would have gone through even if Ellie May and all other shareholders apart from Drysdale had voted against it. Therefore, the omission didn't cause things to turn out differently, and Ellie May hasn't really been damaged. (If Ellie May had been duped into surrendering her state-law *appraisal* rights — as would be the case in a state that grants such rights to those dissenting from a merger, but denies appraisal where the holder votes in favor of the transaction — then Ellie May might still have a federal monetary claim, on the theory that the omission deprived her of her appraisal rights. That's why the facts tell you that Ellie's appraisal rights weren't affected by her vote in favor of the transaction.)

34. Yes. Rule 14a-8 of the '34 Act allows shareholders to include proposals in management's proxy solicitation materials. [113] There are significant restrictions on this right; for instance, the shareholder must have owned 1% or $2,000 (market value) of the corporation's voting stock for at least a year, and any shareholder can only submit one proposal for any one meeting. In addition, there are many grounds on which management may omit a proposal. (For instance, the shareholder proposal can't be counter to a management proposal on the same subject; it can't relate to electing or removing directors; it can't be insignificant, personal, or relate to ordinary business; and it can't have been voted down in the recent past.) [113]

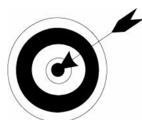
The exclusion that comes closest to fitting these facts is that the proposal must not relate to the "conduct of the ordinary business operations" of the company. But the composition of 10% of the company's product line would probably be held not to relate to the company's "ordinary business operations," especially in light of the extreme public controversy associated with fur products. (Courts have generally held that where the issue is an ethical, social or political one, it doesn't fall within the "ordinary business operations" ban. [117]) So a court would probably order Cruella to include the proposal.

35. That the proposal may be excluded under SEC Rule 14a-8(i)(8)(iv). That Rule lets the company exclude any proposal that "[s]eeks to ***include***

a specific individual in the company's proxy materials for ***election to the board of directors***[.]" This exclusion means that a proposal seeking to elect one or more ***particular*** director(s) favored by the proposer ***may not be done through the free "include shareholder's proposal in management's materials" method*** of Rule 14a-8. [117] So Caesar can reject Cleopatra's request, thus forcing Cleopatra to prepare her own proxy statement under Rule 14a-7 and to pay the costs of mailing it to shareholders.

36. (a) Violations of §§302(a)(2) and (a)(3) of the Sarbanes-Oxley Act, triggering a violation of §906 of the Act. §302(a)(2) of Sarbanes-Oxley requires the reporting company's "principal executive officer" (Bernie) to certify that "based on the officer's knowledge, the [quarterly] report does not contain any untrue statement of a material fact[.]" And §302(a)(3) requires Bernie to certify that "the financial statements … fairly present in all material respects the financial condition and results of operations of the issuer … for the periods presented in the report." §906(a) authorizes an up-to-10-year prison term for certifying any statement covered by §§302(a)(2) and (3) while knowing that the report being certified doesn't meet the requirements of those sections. (The penalty is up to 20 years for a "willful" violation, whatever that means.)

(b) You'll have to prove (a) that the report was false; and (b) that Bernie knew that the report was false when he certified it. You *won't* have to prove that Bernie ordered anyone else in the company to cook the books, or that he otherwise actively participated in the fraud — it's enough simply that he *knew* of the falsehood(s) when he certified that the report was accurate.



Exam Tips *on* ***SHAREHOLDERS' INFORMATIONAL RIGHTS AND THE PROXY SYSTEM***

There are three basic fact patterns that are most likely to be tested in connection with this chapter:

(1) A s/h's request to ***inspect corporate records*** has been denied;

(2) Management has refused to ***include a s/h's proposal*** in its proxy materials; and

(3) A s/h is attempting to ***revoke a proxy.***

☛ In fact patterns where a s/h has asked to ***inspect corp. records***, the most testable issue is whether the s/h has stated a proper purpose for the inspection.

- ☞ Remember that a purpose is proper (so that the corp. must allow the inspection) so long as it is ***reasonably related to the requester's interest as a stockholder***, and not likely to ***damage*** the corp.

  - ☞ Anything that relates to evaluating the investor's ***return on his investment*** is likely to be found proper. (Example: P, a s/h in D Corp., wants to inspect D's records to see how much profit D is making, and how much could be distributed as dividends. This is a proper purpose.)

  - ☞ If the s/h wants a lists of other s/h's so he can ***solicit proxies*** to unseat incumbent management, this is generally a ***proper*** purpose.

  - ☞ On the other hand, a purpose is improper where the s/h requests the info in order to pursue ***personal goals*** unrelated to ownership of stock in the corp. (*Example:* P is a s/h of D Corp., but also is the controlling s/h of a competitor of D, X Corp. P wants to review D's detailed product-by-product revenues and costs. If the court believes that P will use this info. to have X Corp. compete more effectively with D, the court will find the purpose improper.)

☛ Whenever a fact pattern involves a ***shareholder proposal***, consider whether any of the exclusions set forth in SEC Rule 14a-8(i) apply (in which case management may refuse to include the proposal in its proxy materials).

- ☞ Remember that a proposal doesn't have to be included if it concerns a matter that is ***"not a proper subject for action by security holders."*** Thus make sure that that the s/h isn't proposing to ***order management to do something***, if holders don't have the right to make such an order under state law. (Since s/h's don't normally have the right to order the

company to do anything, a lot of proposals are excludible under this ground.)

Example: X Corp. is a nuclear-based utility. An anti-nuke s/h group asks for inclusion of a proposal "ordering the corporation to cease building or operating new nuclear power plants." Because under the law of virtually all states s/h's can't tell the corp. how to conduct its operations, this proposal advocates a step that is "not a proper subject for action by shareholders," and is thus non-includible.

- ☞ But if the proposal is couched as a ***recommendation*** to management or the board, rather than an order, it's ***not*** excludible on this ground. (*Example:* In the above example, if the s/h proposal seeks s/h approval of a *recommendation* to the board that it commission no new nuclear plants, it's probably includible.)

- ☞ If the proposal relates solely to the corporation's ***"ordinary business operations,"*** it's ***excludible*** as too routine. (But if the proposal involves a ***controversial*** problem or issue, it won't fall within the "ordinary business operations" exclusion even if it also relates to the company's routine business operations.)

- ☞ If the proposal relates to the ***election of one or more specific directors***, it's ***excludible*** (so that the s/h group that wants to electioneer has to pay for its own proxy materials). (*Example:* A s/h group opposes management's slate of directors for the upcoming election. The group's statement of reasons for its opposition is excludible, because it relates to the election of particular directors.)

- ☞ If the proposal relates to ***general economic, political, racial, social*** or other similar causes, it will nonetheless be ***includible*** if it has some ***tangible link*** to the corp's affairs.

Example: An anti-nuke group tenders a "no new nuclear power plants" recommendation to a power company that currently uses nuke plants. The proposal will be *includible* even though it relates to a general social/political cause, because it relates to the company's business. But if a general proposal opposing "all uses of nuclear energy" is tendered to a company that neither uses nor proposes to use nuclear energy in any way, it's probably *excludible* as "not

significantly related to the company's business."

- ☛ If the fact pattern relates to a ***proxy***, you're most likely to be tested on whether the s/h may ***revoke*** the proxy.
  - ☞ Here, remember that the rule is that even if the proxy purports to be irrevocable, it's ***revocable unless*** it's ***"coupled with an interest."*** (Only if the recipient is a person who has a legal interest in the stock, or in the corporation, does the proxy meet the "coupled with an interest" requirement. So if the recipient has a ***contract to buy the stock***, or has lent money with the stock as ***pledge***, the proxy can be irrevocable. But an ordinary proxy given, say, to management, is ***revocable even if it says it's irrevocable***.)

1. For an explanation of this limitation, see *CA, Inc. v. AFSCME Employees Pension Plan*, *supra*, p. 115.

CHAPTER 5

CLOSE CORPORATIONS

ChapterScope

This chapter examines some of the special problems of "close corporations," i.e., non-public corporations owned by a small number of shareholders. Most of the chapter discusses various planning devices the shareholders can use to allocate control. We also discuss methods for resolving disputes about how the corporation is to be run. Key concepts:

- **Definition:** A close corporation is a corporation that has the following characteristics:
  - A ***small number*** of shareholders (usually fewer than 20, and often only 1 or two);
  - The lack of any real ***resale market*** for the corporation's stock;
  - (Usually but not always) a controlling shareholder who ***actively participates*** in the day-today ***management*** of the business.
- **Allocation-of-control devices:** Shareholders in close corporations typically use one or more of the following devices to ensure that the minority shareholder(s) will not be ***outvoted*** or ***taken advantage of*** by the majority holder(s):
  - **Shareholder voting agreements:** Under a shareholder voting agreement, some or all shareholders agree to ***vote together*** as a unit on specified matters.
  - **Voting trusts:** Under a voting trust, shareholders relinquish their voting power to a ***"voting trustee,"*** often one who agrees to cast the votes in a prescribed way (e.g., so as to elect certain stockholders to the board). The shareholders retain their economic interest in the business.
  - **Classified stock:** A corporation can set up ***multiple "classes" of stock***, each of which gets different voting rights or financial rights. A common

pattern is for a particular group of minority holders to get its own class of stock, which is guaranteed the right to elect one or more directors.

- ❑ **Super-majority voting and quorum requirements:** These devices provide that certain types of corporate action (e.g., payment of dividends, setting of salaries, sale of the business) can only occur if an especially ***high percentage*** of shares or board votes (e.g., 80%) are cast in favor of the measure, and/or an especially high percentage of shares or board members make up the quorum for the measure. The purpose is to give minority holders ***blocking power***.

- ❑ **Share-transfer restrictions:** The corporation often limits each holder's ability to ***re-sell*** her shares (e.g., by requiring that the shares first be offered to the corporation or to the other holders, before they can be sold to a non-holder).

- **Dissolution:** If the holders are deadlocked, one way to undo the deadlock is for the court to order the corporation ***"dissolved."*** Its assets are then sold, its debts paid, and the surplus distributed to the holders.

I. INTRODUCTION

A. What is a close corporation: There is no single universally-accepted definition of a "close corporation."

1. Massachusetts definition: A definition adopted by Massachusetts, however, encapsulates the concept well. Under this definition, given in *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505 (1975), a close corporation is a corporation meeting these three requirements:

a. Number of stockholders: A ***small number*** of stockholders;

b. Lack of market: The lack of any ***ready market*** for the corporation's stock; and

c. Stockholder participation: Substantial participation by the ***majority stockholder*** in the ***management***, direction and operations of the corporation.

2. Contrast with partnership: It is sometimes said that a close

corporation should be treated almost like a ***partnership***. Indeed, some of the control devices and judicial doctrines we discuss in this chapter have the effect of making close corporations more like partnerships than they would otherwise be. For instance, just as no person can become a member of a partnership without the consent of all partners, shareholder agreements in close corporations often accomplish almost the same result by restricting transfer of the corporation's shares without consent of the other stockholders. Similarly, partners stand in a fiduciary relationship to each other; some courts now impose a corresponding fiduciary responsibility upon stockholders in a close corporation. (See *infra*, p. 162.)

3. **Close corporation statutes:** A typical state corporation statute is geared to the needs of the large, publicly held, corporation. Because a close corporation's needs are usually quite different, a number of states have adopted special ***"close corporation statutes."*** Typically, these statutes are not mandatory — a qualifying corporation must ***elect*** to be covered by the statute. Once covered, a corporation is then permitted (but not required) to enter into certain types of arrangements among shareholders that might not be valid for a regular corporation.

    Example: In many states, under the general corporation statute shareholders are not allowed to make agreements that have the result of tightly restricting the authority of the board of directors. For instance, a shareholder agreement in which both parties agree that X is to be elected president and is to have full control over the policies and operation of the business, might well be held invalid on the grounds that it "sterilizes the board of directors." (See *infra*, p. 141.) But in Delaware, a corporation that has fewer than thirty shareholders, and that has never made a public offering, may elect to be treated as a special statutory "close corporation"; if it does so, this type of shareholder agreement restricting the authority of the board of directors is explicitly validated. See Del. GCL, §§341-356, especially §350.

    a. **Various approaches:** California and Delaware each has a

separate set of provisions applicable only to statutory close corporations. Additionally, other states have special provisions, scattered through their statutes, that apply only to close corporations. (For instance, New York, in BCL §620(c), allows what would normally be the powers of the board to be given to an individual, but only if the corporation is not publicly held.)

b. **Model Act:** Similarly, the MBCA is now accompanied by a special "Model Statutory Close Corporation Supplement" ("MSCCS"), which applies only to corporations that elect to come under it, and which validates certain inter-shareholder arrangements that might otherwise not be valid under the MBCA. The MSCCS applies to any corporation having ***50 or fewer shareholders*** that ***elects*** this treatment. The corporation makes the election by putting a provision to that effect in its articles of incorporation.

   i. **Mandatory provision:** The MSCCS, unlike the Delaware, California and New York approaches to statutory close corporations, does not merely validate certain kinds of arrangements; it also imposes some ***mandatory*** provisions on corporations which elect to be covered by it. For example, whereas the shares of an ordinary corporation are not subject to any share transfer restrictions unless the shareholders so agree (see *supra*, p. 7), shares of a corporation electing to be covered by the MSCCS may not be transferred unless the corporation is given a ***right of first refusal*** to buy the shares, and declines. See MSCCS, §§11-13.

c. **Not generally used:** Only a tiny fraction of corporations eligible for special close corporation status elect to receive this treatment. One reason is that the kinds of arrangements that used to be frequently struck down by courts are now often valid even for corporations not electing this special close corporation statutory treatment. S,S,B&W, p. 444.

B. Planning devices: A shareholder in a large, publicly held

corporation will usually not need the protection of any special contractual arrangement with fellow shareholders or management. The shareholder in a close corporation, by contrast — especially a ***minority shareholder*** in such a corporation — probably will not fare as well economically without a “negotiated arrangement” regarding such matters as who will be on the board of directors, who will be the managers, what salaries and dividends will be paid, how shares may be transferred, etc.

1. **Reasons:** To see why this is so, let us contrast the public shareholder with the shareholder in a close corporation.

   a. **Public shareholder:** The public shareholder expects to realize economic gains from his shares by either or both of two means: the receipt of dividends and/or the ability to sell his shares for a capital gain. The boards and managers of public corporations know this, and will ordinarily attempt to operate the corporation so as to furnish either dividends, share appreciation or both. (If they do not, bad things may happen to them, such as a hostile takeover attempt.)

   b. **Close corporation:** For a shareholder in a close corporation, by contrast, the economic rewards typically come in very different forms from those received by the public shareholder:

      i. **Dividends:** Such small-company shareholders rarely receive much reward from dividends. For one thing, dividends are taxed twice (at the corporate level and then at the shareholder level), so those running the corporation (generally shareholder-managers) will usually try to find other means of funneling money out of the corporation.

      ii. **Salaries:** For instance, the controlling shareholder(s) of a close corporation is usually involved in ***management***, and therefore often wants to pay out some or all of the corporation’s operating profits in the form of ***high salaries*** or bonuses to the managers (including him/themselves). Consequently, a ***minority*** shareholder in a close corporation will be deprived of the fruits of the business’ success unless he, too, is ***employed*** by the corporation so that he can

receive salary/bonuses. But since the company's officers and managers are controlled by the board of directors, and the board normally operates by majority vote, the majority shareholder(s) has power to deny employment and salary to the minority.

iii. Market for shares: Similarly, the minority shareholder cannot usually hope to ***sell*** his shares at a capital gain to a third party who is not affiliated with the corporation — such a buyer would have the same difficulties (e.g., lack of dividends and no guarantee of employment) as the selling shareholder would have. Therefore, as a practical matter the only possible buyers for the minority shares are likely to be the corporation itself or the other shareholders, especially the controlling shareholders. This lack of competition among buyers, in turn, is likely to induce the corporation or the controlling shareholders to make a "low ball" offer for the shares, or no offer at all.

iv. Keeping out strangers: Finally, since most shareholders in a close corporation are active in the management of the business, each shareholder is likely to want to be sure that another shareholder will not sell or give his shares to an "outsider" who would then seek to become active in management, in a way that would lead to discord. For instance, if *A* and *B* are shareholders, *A* may worry that upon *B*'s death, *B*'s shares will go to *B*'s widow, with whom *A* has no working relationship and who may disrupt the corporation's smooth functioning if she demands to become involved in management.

2. Special contractual arrangements: Therefore, the shareholder of a close corporation, especially a minority shareholder, will normally want to make special ***contractual arrangements*** to preserve her chance to benefit economically from the corporation. Her objectives are likely to include:

❑ making sure that she receives ***employment*** with the corporation, including the chance to receive salaries and/or

bonuses that reflect her pro rata share of the company's operating profits;

- ❏ arranging a mechanism whereby upon ***death***, ***retirement*** or other important event her shares can be ***sold back to the corporation*** or to the other shareholders for a fair price;
- ❏ being sure that the ***other*** shareholders will not sell or bequeath ***their*** shares to an outsider who may interfere with the functioning of the business; and
- ❏ being sure that, even though she possesses only a minority vote, she can ***participate in important business decisions***, and perhaps can ***veto*** major changes of policy (e.g., the decision to sell all of the corporation's assets, or to go into an entirely new line of business).

The planning devices we will be looking at in this chapter furnish ways for a shareholder, especially a minority holder, to achieve each of these objectives.

II. SHAREHOLDER VOTING AGREEMENTS, VOTING TRUSTS AND CLASSIFIED STOCK

A. Arrangements at the shareholder level generally: We first examine a trio of arrangements that take place at the ***shareholder*** (rather than director) level: (1) shareholder voting agreements; (2) voting trusts; and (3) classified stock. All of these are methods whereby a minority shareholder can reduce or eliminate the chance that a majority will outvote him and take actions that he would like to prevent.

B. Voting agreements: A ***"shareholder voting agreement"*** or ***"pooling agreement"*** is an agreement in which two or more shareholders agree to ***vote together*** as a unit on certain or all matters.

1. Specific agreement vs. "agreement to agree": Some voting agreements attempt to resolve in the agreement itself exactly how the votes will be cast. Other agreements merely commit the

parties to vote together, without specifying which way the vote is to go; it is then up to the parties to reach agreement in the future.

Example 1: A and B, the only two shareholders of XYZ Corp., sign a shareholder voting agreement in which A and B each agree to vote for each other as directors for so long as the agreement lasts.

Example 2: A owns 60% of XYZ Corp. and B owns 40%. They sign a shareholders' agreement in which each promises that as to any matter on which a vote of shareholders is required (e.g., a sale of substantially all the company's assets, a merger, a major acquisition, etc.) they will confer with each other and vote together as a unit. This agreement does not specify ***how*** they will vote on such matters, since the issues are not even known at the time of the agreement. However, such an agreement assures B that he will not be "outvoted" (and will have an effective veto power) as to major decisions that require a shareholder vote.

2. **Generally valid:** Such shareholder agreements are today generally ***valid***. This is true of both the "specific" and the "agreement-to-agree" types. See, e.g., MBCA §7.31(a) ("Two or more shareholders may provide for the manner in which they will vote their shares by signing an agreement for that purpose.")

   a. **No restrictions on directors' authority:** However, the shareholders can be confident that a court will uphold their voting agreement only if the agreement does not try to deal with matters that are appropriately left to the discretion of the ***board of directors***. A shareholder agreement that does restrict the authority of the board of directors (e.g., an agreement in which the two shareholders of a corporation agree that one of them will serve permanently as President) may be found invalid as an illegal modification of the principle that a corporation's business shall be managed by or under the direction of the board of directors. This very important subject of agreements that limit the board's discretion is discussed extensively *infra*, p. 141.

3. **Time limits:** Generally, voting agreements may remain in force for an ***indefinitely long period*** of time. However, a few states limit such agreements to a specified period (e.g., ten years), as most states do for voting trusts (discussed below). Nutshell, p. 194-95.

4. **Enforcement:** The most interesting legal question concerning voting agreements is how they can be ***enforced***. The problem is that such agreements are not self-enforcing. For instance, if *A* and *B* agreed to vote to elect each other as directors, and *B* reneges and instead votes for *C*, what can *A* do? Without some judicial relief, *A* will simply not be elected, and will be left with a claim for breach of contract. There are two solutions to this problem:

   a. **Proxies:** First, the agreement may expressly provide that each signatory is deemed to give to a third person (let's call him X) an ***irrevocable proxy*** to vote the signer's shares in accordance with the agreement. The proxy holder will then vote the shares as provided in the agreement, and no judicial intervention is necessary.

   Example: A and B, the sole shareholders of XYZ Corp., agree that each will vote to elect the other to the board. The agreement also provides that A and B each give X an irrevocable proxy to vote the shares in accordance with this agreement. When it comes time for the election of directors, X, not A and B, will cast the vote for directors, so neither A nor B will be able to thwart the agreement.

      i. **Must be coupled with an interest:** A proxy is a form of agency — the shareholder is the principal, and the one to whom he gives the proxy is his agent. Under general agency principles, even a proxy that purports to be "irrevocable" may be revoked by the shareholder at any time until the vote is cast. This would make the use of supposedly irrevocable proxies in a shareholder agreement valueless. However, courts have long recognized that a proxy that is given in return for ***consideration*** — usually called a proxy

"coupled with an interest" — may be truly irrevocable. (See *supra*, p. 102). Most courts today hold that where a shareholder has purchased stock in a close corporation in reliance on the existence of a shareholder agreement and the creation of proxies, a sufficient "interest" exists to make the proxies truly irrevocable. Also, some states have simply statutorily eliminated the requirement of an interest for the proxy to be irrevocable. See S,S,B&W, pp. 453-54. However, in some states there is still a risk that the "irrevocable" proxy referred to in a shareholder agreement will be found to be in fact revocable, and thus useless as an enforcement device.

b. Specific performance: The other method of enforcing a shareholder voting agreement is by court-ordered ***specific performance***. That is, the court orders the breaching shareholder to cast his vote as prescribed in the shareholders' agreement. The difficulty is that courts are sometimes ***reluctant*** to order a stockholder to vote a certain way, and instead conclude that this is a matter to be resolved between the shareholders themselves.

Example: Mrs. Ringling, Mrs. Haley, and Mr. North are the three shareholders of Corporation (which operates the Ringling Brothers-Barnum & Bailey Circus). Mrs. Ring-ling and Mrs. Haley sign a voting agreement, in which each agrees to consult and confer with the other and to vote their shares together on any issue put to a stockholder vote. They also agree that if they can't agree on how the shares should be voted, their lawyer, Mr. Loos, shall act as arbitrator. At a subsequent shareholders meeting to elect directors, Mrs. Haley and Mrs. Ringling disagree, and the arbitrator is called in. Mrs. Ringling agrees to vote her shares in accordance with the arbitrator's decision, but Mrs. Haley refuses to do so. The chairman rules that the arbitrator may cast Mrs. Haley's vote (i.e., that Mrs. Haley should be deemed to vote as the agreement provides). For reasons that are unclear, Mrs. Ringling (not Mrs. Haley) sues to overturn the election. The

court of equity holds that the agreement is valid, and orders a new election at which the agreement is to be followed (with the arbitrator casting the votes if Mrs. Ringling and Mrs. Haley cannot agree).

Held (on appeal), the agreement is valid. (This is not a disguised voting trust and therefore need not be held illegal for failure to meet the statutory formalities for such trusts.) However, the lower court was wrong in holding that the agreement created an implied irrevocable proxy (which would allow the arbitrator to cast the votes of a noncomplying shareholder). Instead, Mrs. Ringling's remedy for Mrs. Haley's failure to follow the agreement should be that Mrs. Haley's votes will ***not be counted***. In other words, the court denies specific performance of the agreement (since specific performance would mean allowing the arbitrator to cast Mrs. Haley's vote as he deems fit). *Ringling Bros.-Barnum & Bailey Combined Shows v. Ringling*, 53 A.2d 441 (Del. 1947).

Note: Observe that although Mrs. Ringling was the nominal victor in the suit (the agreement was held valid, and her adversary was found in breach), this was a Pyrrhic victory — what Mrs. Ringling wanted was to have Mrs. Haley vote the same way as she did, so that they would outvote Mr. North. Instead, by refusing specific performance, and ordering that Mrs. Haley's vote not be counted, the court allowed Mr. North to achieve a stalemate with Mrs. Ringling, the very result Mrs. Ringling tried to avoid by making the agreement in the first place.

i. Statutory and judicial relief: Today, many if not most courts would ***give*** Mrs. Ringling the specific performance she desired. A number of states have enacted statutes that make the voting agreements specifically enforceable. MBCA §7.31(b), for instance, provides that "a voting agreement created under this section is ***specifically enforceable***." Also, as noted above, if the agreement expressly grants a proxy to the other party or grants a third person the right to cast votes in accordance with the

agreement (a provision which the agreement in *Ringling* did not specifically contain), most courts today would probably recognize that proxy as valid.

C. Voting trusts: A second device by which shareholders can agree to limit their voting discretion is by use of a ***"voting trust."***

1. Mechanics: To create a voting trust, the shareholders who are part of the arrangement ***convey legal title*** to their shares to one or more ***voting trustees***, under the terms of a voting trust agreement. S,S,B&W, p. 452. The shareholders become "beneficial owners" or "equitable owners" of the shares. Usually they receive a "voting trust certificate" representing their equitable interest. They are entitled to receive dividends and their share of proceeds of any sale of corporate assets. But they ***no longer have voting power*** — votes are cast by the trustees in accordance with the instructions in the voting agreement.

Example: Eager and Willing are entrepreneurs who want financial backing for their new venture, Corporation. Vulture, a venture capitalist, agrees to supply the financing in return for a one-third interest, but only if he can be certain of controlling the board of directors (and thus certain of being able to discharge Eager and Willing from their posts as officers if they don't run the business effectively). Eager and Willing therefore sign (perhaps reluctantly) a voting trust agreement that appoints Vulture as voting trustee; Eager and Willing convey legal title to their shares to Vulture, and receive a voting trust certificate in return. Vulture now has complete shareholder voting authority (and can thus elect and remove all directors), but Eager and Willing will still receive, collectively, two-thirds of any dividends and two-thirds of any net proceeds if the corporation is sold.

2. Generally valid: Originally, courts were reluctant to enforce voting trust agreements. But today, nearly all states have statutes ***authorizing*** voting trust arrangements. S,S,B&W, p. 453. However, these statutes usually ***regulate*** voting trusts. Most statutes impose these requirements:

a. **Maximum term:** First, the statutes generally set a ***maximum term*** for the voting trust. Generally, the maximum term for such a trust is ***ten years***. Clark, p. 777. See, e.g., MBCA §7.30(b) (ten year limit, but at any time some or all parties may sign an extension agreement, which may continue the trust as to them for up to ten years from the signing of the extension).

b. **Disclosure:** Secondly, most statutes require ***public disclosure*** of the trust's terms, so that the existence and terms of the trust will not be hidden from other shareholders. For instance, MBCA §7.30(a) requires that the trust, together with the list of all shareholders participating in it, must be delivered to the corporation's offices, where it can be inspected by other shareholders.

c. **Writing:** Lastly, nearly all states require that the trust be ***in writing***, and that the trust be implemented by a formal transfer of the shares on the transfer records of the corporation. See, e.g., MBCA §7.30(a).

3. **Powers of trustees:** The voting trustees are subject to the ***fiduciary obligations*** of trustees. In general, they may exercise only those powers that are specifically spelled out in the trust, and unless the trust expressly permits they may not vote in a way that ***damages*** the beneficial owners that they represent. H&A, p. 532-33. For instance, suppose the corporation needs funds, and its stockholders agree to create a voting trust in which third persons are made trustees in return for advancing funds to the corporation; unless the trust expressly authorizes otherwise, the trustees cannot act to the detriment of the beneficial owners they represent (e.g., the trustees cannot vote to issue new stock to themselves, or vote to favor creditors over stockholders). See *Brown v. McLanahan*, 148 F.2d 703 (4th Cir. 1945).

4. **Effect of failure to comply:** Precise compliance with all the terms of the statute is very important. In most states, an arrangement that is found by the court to be a voting trust will be held to be ***entirely invalid*** if it fails to meet all the statutory

requirements. Nutshell, p. 200. For instance, if the state sets a maximum length of ten years for the trust, and the trust agreement does not state a maximum length, many states would treat the entire arrangement as unenforceable. *Id*.

a. **MBCA loosens rule:** But MBCA §7.30(b) ***relaxes*** this rule: If the trust does not specify a term, or specifies a term longer than ten years, the trust will be enforceable, but only for ten years.

D. Classified stock and weighted voting: Another way in which the shareholders can re-allocate their voting power, and ensure minority stockholders a bigger voice than they would otherwise have, is by the use of ***classified stock***. The corporation sets up ***two or more classes*** of stock, and then gives the classes ***differing voting powers*** or financial rights. By this means, a minority stockholder may be given voting rights equal to those of the majority even though he does not have equal financial rights. Similarly, two equal shareholders may give a third person (even one who has no real ownership interest) a vote to break a tie between them.

1. **Generally valid:** This use of different classes and weighting of votes is generally ***valid***. Even states that have traditionally been suspicious of attempts to re-allocate voting power by use of voting agreements and voting trusts nearly always uphold the use of classified stock for this purpose.

2. **Representation for minority:** Observe that the use of different classes furnishes an easy way to insure that the minority gets a ***disproportionate*** (perhaps even equal) number of directors.

   Example: A owns 90% and B owns 10% of Corporation. There are to be three members of the board. A and B agree that B should always be able to elect one director, even though he holds only 10% of the shares. Cumulative voting (*supra*, p. 41) would not suffice to guarantee B this director, since A can cast more votes for each of three nominees than B can for a single one. The problem can be resolved by creating two classes of stock: Class A (to be owned entirely by A) and

Class B (to be owned entirely by B). The certificate of incorporation would be amended to state that one of the three seats on the board is to be elected by a majority vote of the class B shares. So long as B continues to control all of the class B shares, he will be assured of always being able to elect a director.

III. AGREEMENTS RESTRICTING THE BOARD'S DISCRETION

A. How problem arises: So far, we have looked only at shareholder agreements where the participants limit their discretion ***as shareholders*** (e.g., they agree to vote for a certain slate of directors). As we have seen, these shareholder agreements are nearly always valid. A quite different and more severe problem is posed when shareholders agree to restrict their discretion ***as directors***. Such an agreement may be found to violate the principle that the ***business shall be managed by the board of directors***; a number of cases, mostly older ones, hold that agreements that ***substantially fetter the discretion*** of the board of directors are ***unenforceable***.

1. Rationale: The courts holding that director-fettering agreements are invalid seem generally to be worried that such agreements will be unfair to ***minority stockholders*** who have not signed the agreement, and possibly to the public (including creditors). The courts reason that the board of directors has a fiduciary obligation to the corporation, all of its shareholders and its creditors; an agreement that results in the board of directors' not being able to use its own best business judgment might result in unfair and unnecessary injury to a minority shareholder who did not agree to the restrictions on the board, or to a creditor.

Example: Suppose that A, B and C each own one-third of the stock of Corporation. A and B sign a secret agreement in which they agree: (1) to vote for each other for the next 20 years as directors; and (2) to cast their votes as directors for 20 years in such a way as to elect A chairman and B president,

regardless of whether each does a competent job in that post. Assuming that the state of incorporation requires that a corporation's affairs shall be managed by or under the board of directors, the court will probably refuse to enforce the agreement if it is attacked by C, who can show that A or B's conduct as chairman or president is adversely affecting the value of his investment in Corporation.

2. **Statutory reform:** A number of states have enacted special statutory provisions treating as enforceable shareholder agreements that vest management decisions in the shareholders rather than in the board. But in the absence of such a statutory provision, most courts will still probably refuse to enforce an agreement that fetters the board, at least where the agreement is attacked by a minority shareholder who did not consent to it, and who can show that his interests are adversely affected. In other words, you should not simply assume that any contractual agreement by shareholders/directors about how they will act as directors, will be enforceable. Indeed, some courts may refuse to enforce even an agreement that actually injures no one, if the court concludes that the agreement effectively "sterilizes" the board of directors.

B. The New York case law: The leading line of cases limiting the enforceability of agreements that restrict the board's discretion has arisen in New York. We will consider two well-known New York cases, and then attempt to synthesize present New York law:

1. ***McQuade:*** In *McQuade v. Stoneham and McGraw*, 189 N.E. 234 (N.Y. 1934), the majority shareholder (Stoneham) and two minority shareholders (McQuade and McGraw) agreed that all would use their best efforts to keep one another in office as directors and officers at specified salaries. Subsequently, Stoneham and McGraw refused to try to keep McQuade in office as director and treasurer; after he was dropped from these posts he sued for breach.

   a. **Holding:** The New York Court of Appeals found that the shareholder agreement was ***invalid***, and thus held for the

defendants. The court reasoned that stockholders may not, by agreeing among themselves, place "limitations … on the power of directors to manage the business of the corporation by the selection of agents at defined salaries." In other words, the board must be ***left free*** to exercise its own business judgment. The agreement here prevented the board from doing that, by purporting to restrict the board from firing McQuade from his treasurer's post. (Separately, the court also concluded that since McQuade was a New York City magistrate at the time of the contract, his employment was invalid under a local statute.)

2. ***Clark v. Dodge:*** But just two years later, the New York Court of Appeals seemed to soften its prohibition of contracts that restrict the board's discretion, in *Clark v. Dodge*, 199 N.E. 641 (N.Y. 1936). In *Clark*, P owned 25%, and D 75%, of two corporations. They signed an agreement whereby D was to vote for P as director and general manager, and to pay him one-fourth of the business' income, so long as he remained "faithful, efficient and competent." D argued that this agreement violated the *McQuade* rule, since it purported to restrict the discretion of the board of directors.

   a. **Holding:** But the Court of Appeals ***upheld*** this business arrangement, despite *McQuade*. The court seemed to rely on two respects in which this agreement was different from the one struck down in *McQuade*: (1) ***all*** shareholders had signed the agreement, and there was no sign that anyone would be injured by the contract; and (2) the impairment of the board's powers was "negligible," apparently since P could always be discharged for cause, and his one-fourth of income could be calculated after the board determined in its discretion how much should be set aside for the company's operating needs.

3. **Synthesis:** Synthesizing *McQuade*, *Clark* and other New York cases, the law in New York seems to be that to be valid, the agreement: (1) must not harm creditors, the public or non-consenting shareholders; and (2) must involve only an ***"innocuous variance"*** from the rule that a corporation's

business should be managed by the board. Also, it may be a requirement that ***all shareholders consent*** (or at the very least that the person now attacking the agreement have previously consented to it). See Nutshell, p. 174.

a. ***Zion:*** The New York courts today may in fact be more willing to uphold director-fettering arrangements than would be guessed from *McQuade* and *Clark*. For instance, in *Zion v. Kurtz*, 405 N.E.2d 681 (N.Y. 1980), all stockholders agreed that they would not cause the corporation to engage in any business transactions over Zion's objection. The corporation was incorporated in Delaware, and under Delaware law this arrangement would have been valid had the corporation elected to be treated as a statutory close corporation and placed in its articles of incorporation a special provision electing to have the corporation run by the shareholders rather than the directors. The corporation here had done neither.

i. Arrangement upheld: But the New York court viewed these omissions as technical ones that could be remedied by a court order; it therefore ***enforced*** the arrangement.

ii. Significance: It is hard to know what to make of this case, since it was a New York court interpreting Delaware law. However, the case probably indicates that the New York courts are now somewhat more willing to uphold director-fettering arrangements, at least those ***approved by all shareholders and injuring no one.***

C. Other jurisdictions: Other jurisdictions are probably also becoming more willing than they used to be to ***approve*** arrangements that interfere to some extent with the discretion of the board of directors, even if no statute expressly authorizes such an arrangement.

1. ***Galler*** **case:** Probably the leading non-New York case showing this modern liberal trend is ***Galler v. Galler***, 203 N.E.2d 577 (Ill. 1965).

a. Facts: The two principal owners of the corporation,

Benjamin and Isadore, each owned 47.5% of the stock. They signed a shareholders' agreement in which they agreed to pay certain dividends each year and to pay, in the event either should die, a specified pension to his widow. Benjamin died, and Isadore refused to carry out the agreement.

b. **Holding:** The Illinois court upheld the agreement, even though it limited the discretion of the board of directors. The court required an agreement to satisfy three tests before it would be enforced: (1) there must be ***no minority interest*** who is ***injured*** by it; (2) there must be no injury to the public or to creditors; and (3) the agreement must not violate a clear statutory prohibition. This agreement satisfied these requirements.

c. **Importance to closely-held corporation:** Perhaps more importantly, the Illinois court in *Galler* stressed the importance of broad and enforceable stockholder agreements in the close corporation context. An investor in a close corporation "often has a large total of his entire capital invested in the business and has no ready market for his shares should he desire to sell. He feels, understandably, that he is more than a mere investor and that his voice should be heard concerning all corporate activity. Without a shareholder agreement, specifically enforceable by the courts, insuring him a modicum of control, a large minority shareholder might find himself at the mercy of an oppressive or unknowledgeable majority."

2. **Summary of modern view:** So the modern, increasingly prevalent view seems to be that a shareholder agreement that substantially curtails the discretion of the board of directors will nonetheless be ***upheld*** if it: (1) ***does not injure any minority shareholder***; (2) does not injure creditors or the public; and (3) does not violate any express statutory provision (the three requirements set forth in *Galler*).

IV. SUPER-MAJORITY VOTING AND QUORUM

REQUIREMENTS

A. Why super-majority techniques are used: A common and effective technique for giving a minority shareholder effective veto power over the corporation's major decisions is the ***"super-majority"*** voting or quorum requirement. There are numerous variations on this technique, all of which require more than the usual "simple majority" (50%) vote or quorum. These requirements can be applied either to shareholder action (the percentage of votes needed to constitute shareholder approval, or the percentage of votes which must be present to constitute a quorum at the shareholders' meeting) or action by the board (again, the percentage of votes needed for a quorum, or the percentage of votes needed to pass the measure).

> **Example 1:** A owns two-thirds and B owns one-third of the stock of Corporation. B is worried that A will cause Corporation to make unwise acquisitions. Therefore, A and B cause Corporation to amend its certificate of incorporation to require that 80% of shareholders approve any major acquisition. Now B has effective veto power over acquisitions.
>
> **Example 2:** A, B and C each own one-third of the stock of Corporation. They hold the only three seats on the board of directors. Since A and B are brothers, and C is not related to either of them, C worries that A and B will vote together as a block on the board. Therefore, Corporation amends its charter to provide that board action must be by unanimous vote. Now, C can prevent A and B from "ganging up" on him at board meetings.
>
> **Example 3:** A, B, C and D each own 25% of Corporation. If the usual "majority constitutes a quorum" rule applied for shareholder meetings, A, B and C could hold a meeting without D's presence, and two of the three could therefore deliver shareholder approval. To prevent this, they agree that a quorum for a shareholders' meeting will consist of at least 80% of all votes, and they amend the charter to so provide. Now, a meeting cannot be held unless all four shareholders are

present, and (assuming that the usual majority vote rule is not changed), it will take three of the four of them to approve any measure.

B. Traditional restrictive view: Traditionally, courts have been ***reluctant*** to enforce such super-majority voting or quorum requirements, on the grounds that such requirements: (1) interfere with the democratic "majority rule" principle and (2) are likely to lead to deadlock. Courts have been most likely to strike down a super-majority provision if it requires ***unanimity***.

C. Modern statutes permit: But virtually all states today ***permit*** super-majority quorum and voting requirements, even ones setting unanimity as the required threshold. In most states, this has been accomplished by ***statutes*** that explicitly permit such techniques.

1. MBCA: For instance, the MBCA allows for super-majority requirements: Under §7.27, a super-majority quorum or voting requirement for shareholders may be established if it is placed into the articles of incorporation. Under §8.24(a), either the articles or the bylaws may set a super-majority quorum requirement for the board of directors, and under §8.24(c) either the articles or bylaws may set a super-majority voting requirement for directors.

2. Changing a requirement: Observe that a minority shareholder who succeeds in having a super-majority voting or quorum requirement imposed through modification of the articles of incorporation or bylaws has really accomplished nothing, unless he has some way to prevent a simple majority from ***rescinding*** those provisions. For instance, if *A* owns two-thirds and *B* one-third of Corporation, a requirement in the articles of incorporation that acquisitions and mergers must be approved by a 75% vote of shareholders will be worthless if the articles of incorporation can themselves be amended by simple majority vote: *A* can simply vote to rescind the super-majority provision.

a. Protection: Therefore, the stockholder who will benefit from the super-majority provision should make sure that ***the same super-majority vote is needed for an amendment of the***

provision. Thus in the scenario set out just above, *B* should insist on a provision in the articles of incorporation stating that "any amendment to these articles shall be by a vote of 75% of the stockholders."

b. Automatic protection: Some statutes give this kind of "anti-amendment" protection ***automatically***. Thus MBCA §7.27(b) provides that "an amendment to the articles of incorporation that adds, changes, or deletes a greater quorum or voting requirement must meet the same quorum requirement and be adopted by the same vote … required to take action under the quorum and voting requirements then in effect or proposed to be adopted, whichever is greater."

V. SHARE TRANSFER RESTRICTIONS

A. Reasons for restrictions: The stockholders of a close corporation will usually agree to ***limit the transferability*** of shares in the corporation. For instance, they may agree that no holder may sell the shares to an outside party until the corporation has first been given the right to buy them at a pre-established price (***"first option"***), or the right to buy them by matching what the outside person is willing to pay (***"right of first refusal"***). Or, they may agree that the corporation has a firm obligation to buy the shares, and the stockholder has the obligation to sell them, at a pre-established price upon the happening of certain events (e.g., the stockholder's death, retirement or termination of employment with the corporation).

1. Rationale: There are three main reasons why most shareholders in close corporations believe that some sort of transfer restriction is a good idea:

a. Veto over new colleagues: First, in a close corporation stockholders are usually heavily involved in management, and must cooperate with each other. Each shareholder/ manager is likely to want to have some say over whom he must work with. If *A* has the unfettered right to transfer his shares to whomever he wishes, this is tantamount to allowing him to

thrust upon *B*, his fellow shareholder, an ***unwanted colleague***. Therefore, share transfer restrictions give the shareholders of a corporation a power analogous to the right of *delectus personae* in the partnership context, i.e., a right to ***veto the admission of a new partner***.

b. **Balance of control:** Second, the holders of a close corporation usually have worked out a fairly delicate ***balance of control***. This balance may be upset if shares can be freely transferred.

Example: A and B, the sole shareholders of X Corp., have worked together for years and have agreed on a balance of power whereby the Corporation will only take actions to which both shareholders agree. The Corporation has no share transfer restrictions, and B now sells half of his shares to C and half to D. Now the situation is unstable: C and A may combine to outvote D, D and A may combine to outvote C, or C and D may combine to create a stalemate. There is likely to be a lot of intrigue and uncertainty, which will probably be detrimental to the firm's ability to function.

c. **Estate liquidity:** Finally, if a stockholder ***dies***, a large portion of his estate may be represented by shares in a close corporation. Estate taxes will have to be paid on the actual market value of this stake, yet the lack of a ready market for a minority stake in a close corporation may prevent the estate from selling even enough shares to pay estate taxes. Therefore, a mandatory buy-sell agreement — whereby the corporation is obligated to buy, and the estate obligated to sell, some or all of the decedent's shares at a pre-established price — may be the best way of making sure that the estate can receive the necessary funds.

B. General rule: Courts are far more willing than they used to be to uphold share transfer restrictions.

1. **Traditional rule:** Traditionally, share transfer restrictions have been viewed as ***"restraints on alienation."*** Therefore, such restrictions have often been struck down on the grounds that they

are ***unreadable***.

transferred by ***gift*** or ***bequest***. *Id*.

2. **First option at fixed price:** A second device is the ***"first option."*** This is similar to the right of first refusal, except that the price is determined by the agreement creating the option. Usually this is done by inserting some kind of ***formula*** into the agreement (e.g., a provision that the option is at a price equal to "book value"). Valuation methods are discussed *infra*, p. 113.

   a. **Advantage:** An advantage of this method is that, unlike the right of first refusal, the option method can handle the situation where the shares are proposed to be transferred by ***gift*** or ***bequest***.

3. **Consent:** Third, a shareholder's transfer of stock may be made subject to the ***consent*** of the board of directors or the other stockholders.

   a. **Disadvantage:** Consent powers, since they might be used to unreasonably restrict alienation, are likely to be more closely scrutinized by the courts for "reasonableness" than the above two methods. See *infra*, p. 152.

4. **Buy-back rights:** The three above methods are triggered only if a shareholder makes a decision to transfer the shares. A ***buy-back right***, by contrast, is given to the corporation to enable it to buy back a holder's shares on the happening of certain events, ***whether the holder wants to sell or not***. For instance, the corporation might be given the right to repurchase shares of a holder/employee upon that person's ***retirement*** or termination of employment. Clark, p. 765. The corporation is ***not*** obliged to exercise its buy-back right.

5. **Buy-sell agreement:** A ***buy-sell agreement*** is similar to a buy-back right, except that the corporation is ***obliged*** to go through with the purchase upon the happening of the specified event. Most often, the corporation and the shareholders will make a buy-sell agreement under which the corporation must re-purchase the shares upon the ***death*** of a shareholder/ employee. This guarantees the holder's estate of a market for the shares and

enough funds to pay estate taxes.

For a good general overview of these five methods, see Clark, pp. 764-65.

D. Who has right to buy: Any of the above restrictions may run in favor of ***either*** the ***corporation*** or the ***remaining shareholders***.

1. **Purchase by corporation:** Typically, the ***corporation*** is given the first opportunity to purchase the shares, and only if it does not do so are the remaining shareholders given this right. An advantage of this approach is that it makes it easy to preserve the positions of the remaining shareholders relative to each other — the re-purchased shares are simply retired as treasury stock, and the remaining shareholders automatically maintain the same voting power vis-a-vis each other as they had before.

2. **Purchase by remaining shareholders:** If the corporation does not repurchase, or the restriction runs in favor of the remaining shareholders rather than the corporation, typically the shareholders have the right to repurchase in ***proportion*** to their existing holdings. If all exercise this right, their relative positions are preserved. If one or more do not repurchase, the unpurchased shares must generally be offered to the other shareholders *pro rata*. If there are more than a few shareholders, this process of offering and reoffering can get unwieldy, so it is usually better to have the offer run to the corporation, at least in the first instance. Nutshell, p. 211.

3. **Redemption vs. cross-purchase:** As a matter of nomenclature, if the corporation has the right to do the buying, the agreement is called a ***"redemption"*** agreement (the shares are "redeemed" by the corporation). If the other shareholders have the right, the agreement is called a ***"cross-purchase"*** agreement.

E. Notice and consent to restrictions: If a shareholder signs an agreement imposing a transfer restriction, he has clearly received notice of that restriction and consented to it, so the restriction will be applied to him as long as it is reasonable. But in a number of other situations, the holder will be able to argue either that he had

no notice of the restriction at the time he purchased his shares, or that he did not consent to the restrictions. Special rules have evolved to determine whether the holder is bound in this situation. In general, the rule is that a holder who purchased without either ***actual or constructive notice*** of the restriction will ***not be bound*** by it. We must consider two different fact patterns:

1. **Subsequent purchaser without notice:** First, consider a person who purchases shares ***without actual knowledge*** of pre-existing restrictions at the time he makes the purchase. Such a purchaser will ***not be bound*** by the restrictions unless the restriction was ***conspicuously noted*** on the ***share certificates***. The reason is that UCC §8-204(a) provides that "a restriction on transfer of a security imposed by the issuer, even if otherwise lawful, is ineffective against any person without actual knowledge of it unless … the security is certificated and the restriction is noted conspicuously thereon.…"

   a. **Meaning of "conspicuous":** UCC §1-201(10) defines "conspicuous" as follows: "A term or clause is conspicuous when it is so written that a ***reasonable person*** against whom it is to operate ***ought to have noticed it***. A printed heading in capitals … is conspicuous. Language in the body of a form is 'conspicuous' if it is in larger or other contrasting type or color.…" Therefore, the certificate should have notice of the restrictions written in capital letters, larger type size, or color, in order to be certain to be conspicuous. Also, reference to the restriction should be on the ***front*** of the certificate. (But if the transferee has ***actual*** notice, then he is bound by the restrictions even if the certificate is silent.)

      Example: A single line of small type on the front of the stock certificate refers to a 14line small-type paragraph on the reverse. This paragraph in turn refers in very general terms to transfer restrictions in the articles of incorporation. *Held*, the transfer restrictions were not "conspicuous" as required by §8-204(a), because "something must appear on the face of the certificate to attract the attention of a reasonable person when he looks at it." *Ling & Co. v. Sav. & Loan Ass'n*, 482 S.W.2d

841 (Tex. 1972).

2. **Non-consenting minority holder:** Now, consider a person who is ***already a share-holder*** at the time the restrictions are imposed. For instance, suppose the restrictions are imposed by an amendment to the articles of incorporation or the bylaws, and the shareholder does not vote in favor of these changes although he is aware that they are about to be implemented. Courts and statutes are ***split*** as to whether the non-consenting minority shareholder is bound.

   a. **Modern trend:** The modern trend is probably ***not*** to bind the non-consenting shareholder. See, e.g., MBCA §6.27(a), providing that "A restriction ***does not affect shares issued before the restriction was adopted*** unless the holders of the shares are parties to the restriction agreement or voted in favor of the restriction."

F. **Removal of restriction without consent:** Now consider the converse problem: If a restriction is in force, may it be ***removed*** without unanimous consent? If the restriction is embodied in a shareholders' agreement, this is of course a contract that may not be amended without unanimous consent. But if the restriction is imposed in the bylaws or the articles of incorporation, the issue is less clear, since the bylaws and the articles may normally be amended by majority vote. Probably most courts would hold that a ***unanimous vote is necessary***.

G. **Valuation:** All but one of the transfer restrictions described above require a ***valuation*** to be placed on the stock at some point. (The sole exception is the right of first refusal, in which the price is automatically set by what the outsider is willing to pay.) As you might expect, devising a method of setting the price at which the corporation or remaining shareholders are to acquire the disposing shareholder's shares is very tricky. Four methods are commonly used: (1) the "book value" method; (2) the "capitalized earnings" method; (3) the "mutual agreement" method; and (4) appraisal.

1. **The "book value" method:** Many companies use some variant of the ***"book value"*** method of valuation. "Book value" is an

accounting concept, derived directly from the corporation's ***balance sheet***. According to accepted accounting principles, book value is equal to the corporation's balance sheet ***assets*** minus its balance sheet ***liabilities***.

a. **Advantage:** One advantage of the book value method is that book value is a number that can be objectively determined by quick inspection of the balance sheet. Therefore, the parties are less likely to become embroiled in a dispute about this number than they are where other methods are used.

b. **Historical cost:** But a disadvantage is that book value will often be much less, or much more, than the company is really "worth" to an outside buyer. One reason for this is that under accounting conventions, assets are carried on the company's books at their ***historical cost*** rather than being adjusted to reflect market values. For instance, if the corporation acquired Blackacre, a parcel of land, in 1940 for $2000, the balance sheet will still show $2000 as the value of the asset, even if its market value is now $2 million. Therefore, the parties may be wise to agree in advance that book value shall be calculated only after marketable assets are adjusted to their current values.

   i. **Goodwill:** Conversely, balance sheets often include assets listed at historical prices that may never be realized. For instance, if Corporation acquires the stock of XYZ Corp, much of the purchase price may be allocated to the "***goodwill***" account. ("Goodwill" in an acquisition is roughly the amount by which the purchase price exceeds the book value of the acquired assets). This goodwill will probably remain on the books of Corporation indefinitely, even though it may have no practical value at all. Therefore, the parties may want to agree that book value should be computed without any value attributed to goodwill.

c. **Generally upheld:** Whatever method of computing the book value the parties agree upon, the court will usually ***enforce*** their decision, even if it turns out that the method chosen

produces a figure that is shockingly low (or high) compared with the actual market value at the time of sale.

2. **The "capitalized earnings" method:** Alternatively, the shares may be valued by the ***"capitalized earnings"*** method. In theory, this method will produce the most accurate approximation of market value. Clark, p. 766. This method attempts to estimate the ***future earnings*** of the business, and then discounts these earnings to present value by using a discount rate that is appropriate for investments with similar characteristics. *Id.*

   a. **Refined method:** The main difficulty with this method is that reasonable people can disagree by a large factor as to the future earnings of the company and the appropriate discount rate. Therefore, most agreements using the "capitalized earnings" method refine it by: (1) taking recent ***past*** earnings as a predictor for future earnings and (2) agreeing on a discount rate (or a formula for calculating the discount rate) at the time the agreement is signed.

   Example: The parties might agree that future earnings will be calculated by taking the average earnings over the past three years prior to the sale, increasing this average by 15%, and then discounting by the then-current United States Treasury bill rate plus 3 percentage points. Suppose that the company has earned an average of $1 million per year over the last three years, and that the treasury bill rate at the time of sale is 8%. The value of the company would be computed as follows:

$$\frac{\$1{,}000{,}000 \times 1.15}{0.11} = \$10{,}454{,}545$$

See Clark, p. 766.

   b. **Salaries:** Another difficulty in using the "capitalized earnings" method is that past or future earnings may be distorted by the fact that the principals have taken unusually large salaries. Therefore, the agreement will often compute earnings without subtracting any principals' salaries, or after subtracting only salaries that would be reasonable for the work actually performed.

3. **The "mutual agreement" method:** A third method, the "***mutual agreement***" method, typically has several stages. At the time the agreement is signed, the parties agree upon an initial fixed valuation (e.g., $2 million). But they also agree that at defined intervals (e.g., annually) or from time to time, they will ***mutually agree*** upon an adjusted number to reflect changes in actual market value.

   a. **Failure to agree:** This method can produce dispute and inequity if the parties do not in fact attempt to revise the number as time goes by, or if the parties turn out to have sharply different interests so that they cannot agree on a fair revised number. For instance, if A is much older than B, and the parties agree to adjust from time to time the price at which the estate of the first to die will sell the shares back to the corporation, A will have the incentive to insist upon a much higher figure than B, and they may never be able to agree.

4. **Appraisal:** Finally, the parties can agree to have the price determined by an ***appraisal*** of the company at the time of transfer, to be performed by a neutral third party. If this method is chosen, it is important to agree upon a procedure for choosing the appraiser (e.g., by agreeing to have the appraisal performed by an arbitrator selected according to the rules of the American Arbitration Association). See S,S,B&W, p. 483.

H. **Funding of buy-sell agreement:** It may be a problem for the corporation or the remaining shareholders to ***fund*** their purchase of the transferror's shares. This problem is especially severe in the case of a ***buy-sell*** agreement, since here the corporation or remaining shareholders have a ***duty***, not merely an option, to purchase.

1. **Life insurance:** Since the main use of buy-sell agreements is to repurchase the shares of a stockholder who ***dies***, buy-sell agreements are often funded by having the corporation purchase ***life insurance*** on each shareholder. If the amount of the policy is enough to cover the estimated purchase price for that holder's shares, there will be no funds needed beyond those provided by

the policy.

2. **Installment payments:** Alternatively, the parties can agree that the shares will be purchased by the ***installment*** method. Typically, there is a down payment, followed by quarterly or annual payments at a reasonable interest rate. Often this method is combined with the insurance method — the insurance policy furnishes the down payment, and the remaining payments are made out of the corporation's earnings over the following years. (Using the corporation's earnings to make the payments works best if the purchase is being made by the corporation rather than the surviving shareholders, since otherwise the survivors will have to pay taxes on the dividends they receive from the corporation before they turn around and pay out this money to the estate.)

I. **Requirement of "reasonableness":** Recall that at common law, share transfer restrictions are deemed "restraints on alienation." Even today, transfer restrictions are fairly strictly scrutinized, and will be upheld only if they are "***reasonable.***" Also, they will be ***narrowly*** construed. (For instance, a restriction on "transfer" may well be interpreted not to prevent a bequest or legacy. C&E, p. 501).

1. **Outright prohibitions and consent requirements:** Courts are especially likely to strike down an ***outright prohibition*** on the transfer of shares to third parties — the court is likely to hold that denying the shareholder the chance to sell to anyone except his fellow shareholders or the corporation is *per se* unreasonable. Nutshell, p. 207. Similarly, a provision that shares may not be sold to outsiders without the ***consent*** of the other shareholders and/ or corporation is likely to be found unreasonable, if the provision is drafted in a way that permits the others to withhold their consent arbitrarily. *Id.*

2. **Options, first refusals, and buy-sell agreements:** The remaining types of restrictions — first option, right of first refusal, buy-backs and buy-sell agreements — are more likely to be found "reasonable." In general, if the mechanism chosen by

the parties is reasonable ***at the time the method is agreed upon***, it will probably be found reasonable even though it turns out to produce a price that is much higher or much lower than the market price at the time of sale.

3. **Statutes:** A number of states have enacted ***statutes*** that expressly validate certain types of share transfer restrictions that might otherwise be held “unreasonable” at common law.

   a. **Delaware:** For instance, Delaware GCL §202(c) specifically validates first refusals, first options, buy-sell agreements and consent requirements. §202(c) even validates outright prohibitions on the transfer of shares to “designated persons or classes of persons” if such designation is “not manifestly unreasonable.” (For instance, a corporation might flatly prohibit transfer of its shares to any ***competitor***.)

   b. **MBCA:** Similarly, MBCA §6.27(d) expressly validates most types of restrictions. This section is very similar to the Delaware provision, except that consent requirements are upheld only if they are “not manifestly unreasonable.” So a flat requirement that the corporation and all other shareholders consent to a prohibition (with no further provision that consent will not be unreasonably withheld) probably would be struck down by a court interpreting the MBCA, at least if the refusal to consent on the actual facts was unreasonable.

VI. RESOLUTION OF DISPUTES, INCLUDING DISSOLUTION

A. **Dissension and deadlock:** A close corporation is to some extent like a family. The shareholders are usually active in management, and if they do not get along well together the corporation’s operations are likely to suffer. Advance planning — use of techniques like a shareholders’ voting agreement, super-majority requirements and the other techniques described above — may reduce the likelihood that shareholders’ disagreements will hurt the corporation, but they certainly do not eliminate this possibility.

Furthermore, in many close corporations no advance planning is ever done, and the parties may find themselves at odds with nothing but the general corporation statute of the jurisdiction to guide them as to their rights. Therefore, the law must deal with two related inter-shareholder problems: ***dissension*** and ***deadlock***.

1. **Meaning of "dissension":** "Dissension" refers to squabbles or disagreements among the shareholders. For instance, the holders may disagree about whether to enter a new line of business, rent a particular piece of real estate, employ the son-in-law of one of them, or almost any other business-related matter.

2. **Meaning of "deadlock":** "Deadlock" refers to a scenario in which the corporation is ***paralyzed*** and prevented from acting. Usually deadlock arises from some aspect of the ***control structure*** that the shareholders have adopted.

   a. **Three types:** There are three common ways in which the corporation may become deadlocked:

      i. **Two 50% holders:** Two factions each own exactly 50% of the outstanding shares, and cannot agree;

      ii. **Even number of directors:** There is an even number of directors, each of the two factions has the voting power to elect exactly half of the directors, and the two sets of directors cannot agree; or

      iii. **Minority holder has veto:** A minority shareholder has, through a shareholder voting agreement, super-majority requirement or some other means, obtained a veto power over corporate action, and exercises that veto.

      See Nutshell, p. 258.

   b. **Deadlock at shareholder level vs. director level:** Observe that deadlock may occur at either the shareholder or director level, or both.

      i. **Shareholder level:** If deadlock occurs only at the ***shareholder*** level, the result is not usually immediately catastrophic: The holders may not be able to elect new

directors, but in most states the directors elected before the deadlock arose will remain in office until successors are elected (see, e.g., MBCA §8.05(e), to this effect), so there will still be a board that can take action.

ii. Director level: Deadlock at the ***director*** level is more immediately dangerous. Here, the board's inability to take action may prevent the corporation from functioning (though a strong president may be able to run the company effectively, perhaps while ignoring the deadlocked board). See Nutshell, p. 259.

3. Buyout of one faction: Even if the disagreements are not resolvable, the shareholders will often be able to deal with the problem by a ***buy-out*** — one faction buys the other's shares at a mutually acceptable price.

a. Quandary of minority shareholder: However, the factions will find it hard to come to a mutually acceptable buy-out arrangement if they have sharply different amounts of ***bargaining power***. For instance, consider the minority stockholder who has not been able to preserve any veto power by voting agreement, super-majority provision or otherwise. Such a minority holder may say to the majority holder, "Buy me out," but the majority holder has little incentive to do so at a fair price. Indeed, the majority holder has the ability to "soften up" the minority holder by refusing to have the corporation declare a dividend, refusing to employ the minority holder, or otherwise denying the minority holder economic benefits from his equity in the corporation; the majority holder can then make a "low ball" offer for the minority holder's shares, or can refuse to make any offer at all.

b. No right to compulsory buy-out: You might think that the law would deal with this situation by giving a minority holder the right to ***compel the majority*** to buy-out his shares at a fair price. But in fact, ***no state*** gives the minority holder an automatic right to compel a buy-out regardless of the circumstances. (A few states do allow the judge to order a

buy-out at a fair price if specified statutory criteria are met, such as the existence of deadlock or oppression of the minority. See *infra*, p. 157.)

i. Rationale: Probably the two main reasons for this absence of a general right to compel a buy-out are: (1) such a compulsory buy-out would give the minority holder a power to "***hold up***" the majority, i.e., the power to extract unfair concessions in return for not exercising this right; and (2) the existence of such a right might ***impede the corporation's operations***, by suddenly draining the cash needed for the buyout.

c. Dissolution and other techniques: Instead, the law attempts to deal with dissension and deadlock by giving courts a number of discretionary remedies. The most important of these is the ability to compel a ***dissolution*** of the corporation; judicially-ordered dissolution is discussed extensively below. Other techniques include: (1) the appointment of provisional directors, custodians and receivers; (2) the use of a judicially-ordered buy-out in lieu of dissolution; and (3) the modern trend of imposing on the majority a ***fiduciary obligation*** to the minority, for breach of which damages may be awarded. We consider each of these in turn following treatment of dissolution.

B. Dissolution: The most important judicial remedy for dissension and/or deadlock is for the court to order that the corporation be ***involuntarily dissolved***. Dissolution means that the corporation ***ceases to exist*** as a legal entity. The corporation's assets are sold off, its debts paid, and any surplus distributed to the shareholders.

1. Powerful weapon: A decree of dissolution thus offers a shareholder, especially a minority shareholder, a way to ***cash in*** on his investment in the corporation, without the consent of the other shareholders.

2. No general right to dissolution: However, ***no*** state gives a shareholder an ***automatic right*** to a judicially-ordered dissolution. Instead, each state has a statute setting forth the

specific grounds for which dissolution may be granted. These statutes are usually ***strictly construed***, and only if the shareholder shows that one of the statutory grounds applies will the court order involuntary dissolution.

3. **Model Act:** The MBCA is fairly typical.

   a. **Four showings:** Under MBCA §14.30(a)(2), a shareholder may obtain dissolution only if he shows one of four things:

      i. **Director deadlock:** that the ***directors*** are ***deadlocked*** in the management of the corporation's affairs, in a way that is causing injury to the corporation or its shareholders (§14.30(a)(2)(i)); or

      ii. **Oppression:** that the directors or those controlling the corporation have acted in a manner that is ***"illegal, oppressive, or fraudulent"*** (§14.30(a)(2)(ii); or

      iii. **Shareholder deadlock:** that the ***shareholders*** are ***deadlocked*** in voting power, and have failed to elect successor directors "for a period that includes at least ***two consecutive annual meeting dates***" (§14.30(a)(2)(iii)); or

      iv. **Waste:** that the corporation's assets are being ***"misapplied or wasted"*** (§14.30(a)(2)(iv)).

   b. **Harm usually required:** Observe that none of these four MBCA showings permits a shareholder to dissolve the corporation merely because he thinks he would be better off cashing out his investment. In fact, for three of the four, the shareholder must show actual and serious ***harm*** or abuse. Only in the "shareholder deadlock" situation is a finding of serious harm or abuse not needed, and there the shareholder will have to show that at least two annual meetings have occurred at which no successor directors could be elected. Nutshell, p. 260.

4. **Judge's discretion:** Most states have held that even if the statutory criteria are met, the decision whether to grant dissolution is left to the ***judge's discretion***. C&E, p. 523. Thus the court is usually free to deny dissolution if dissolution would

be ***unfair*** to one or more shareholders. For instance, suppose that: (1) dissolution is requested by the dominant shareholder, (2) a forced sale will destroy any "going concern" value, and (3) the court believes that the shareholder requesting dissolution will be able to buy up the assets at a bargain price and continue in business without the other shareholder's receiving a fair portion of the business' going concern value. In this situation, the court is likely to ***deny dissolution*** even if the statutory criteria are met.

5. **Profitability:** If the corporation is ***profitable***, the court is less likely to use its discretion to dissolve, than where it is not profitable. However, "profitability is not an absolute bar to dissolution." C&E, p. 524.

6. **Dissolution as remedy for deadlock:** Nearly all states allow the court to order dissolution as a remedy for shareholder or director ***deadlock***. Again, however, remember that even where deadlock is shown, the court may decline to order dissolution because this would be unfair to shareholders.

7. **Dissolution as remedy for oppression:** More recently, many states have added ***"oppression"*** of a shareholder as a statutory ground for dissolution. If a minority shareholder can show that the majority has used its voting power to treat the minority holder unfairly, and to deprive him of the economic benefits of his ownership, the court is able to order dissolution in most states. The court may find such oppression even though the majority has not acted fraudulently or illegally.

   Example: P1 works for Corporation for 42 years, and then resigns. P2 works for Corporation for 35 years, and is then fired. Each is a minority stockholder in Corporation. While the two were employed by Corporation, they received the benefits of corporate ownership in the form of either dividends or extra compensation, in proportion to their stockholdings. After the Ps leave Corporation's employ, the remaining shareholders change the method by which they pay out Corporation's earnings — instead of paying based on stock ownership, they pay based on services rendered to the corporation. The

majority also alters a long-standing unofficial practice whereby Corporation buys back the shares of employee shareholders when they leave Corporation's employ. The Ps thus are left with no way to derive any economic value from their minority holdings in Corporation. They petition for dissolution.

Held, for the Ps. The New York statute permits judicial dissolution if the petitioners show that they hold at least 20% of a corporation's shares and have been "oppressed." The majority's conduct here constituted "oppression": "A shareholder who reasonably expected that ownership in the corporation would entitle him or her to a job, a share of corporate earnings, a place in corporate management, or some other form of security, would be oppressed in a very real sense when others in the corporation seek to defeat those expectations and there exists no effective means of salvaging the investment." Here, the Ps' expectation that they would receive distributions proportional to stock-holdings, and that Corporation would buy back their shares if their employment ended, were objectively reasonable, so the change in corporate policy did oppress them. Therefore, the court will order dissolution of Corporation. (But the majority may avoid dissolution by buying back the Ps' shares for what the court determines to be a fair price). *Matter of Kemp & Beatley, Inc.*, 473 N.E.2d 1173 (N.Y. 1984).

a. **Definition of "oppression":** What kind of conduct by the majority constitutes "oppression" of the minority, so that the statutory right to dissolution is triggered? There seem to be two main classes of majority shareholder behavior that will constitute "oppression": (1) self-dealing; and (2) squeeze-out moves.

   i. **Self-dealing:** ***Self-dealing*** occurs when the majority holder engages in corporate transactions that ***benefit the holder at the corporation's expense.*** For instance, self-dealing might be found if the majority stockholder caused the corporation to ***purchase supplies*** at an inflated price

from another company in which the majority holder had an interest. Clark, p. 792.

ii. **Squeeze out moves:** ***Squeeze-out moves*** occur when the majority attempts to ***exclude the minority*** from either: (1) the ***economic benefits*** of corporate ownership; or (2) participation in the corporate ***decision-making process***. For instance, if the majority holder declines to pay dividends even though the corporation is profitable, declines to employ the minority holder, or declines to pay him anything more than an ordinary salary, this would cause the minority holder to lose the benefits of ownership. Or, if the majority holder used his control of the board to disregard all suggestions by the minority stockholder/director, or refused to let the minority holder be voted onto the board, this might be found to be such a denial of opportunity to participate in corporate decision-making that it would constitute "oppression". See generally Clark, p. 792.

b. **Relation to "fiduciary obligation" doctrine:** As we will see below, *infra*, p. 161, a number of courts have now begun to find a general ***fiduciary obligation*** on the part of the majority stockholder to the minority stockholder in a close corporation. In general, the kinds of acts by the majority that would violate this fiduciary obligation (e.g., refusal of employment, refusal to pay dividends, etc.) would also constitute "oppression." Clark, p. 792.

8. **Non-statutory grounds:** Some courts will occasionally grant dissolution based on ***non-statutory grounds***. For instance, if the applicable dissolution statute recognizes deadlock but not oppression as grounds for dissolution, in some states the court may use its ***equitable powers*** to compel dissolution for oppression even though this ground is not mentioned in the statute. However, it is generally not easy for the petitioner to convince the court to use its non-statutory dissolution powers. Clark, pp. 793-94.

9. **Buy-out in lieu of dissolution:** It will often make more

economic sense for one shareholder to ***buy out*** the other rather than permit judicially-ordered dissolution to occur.

a. **Rationale:** If the corporation is dissolved and its assets sold off piecemeal, any "going concern" value will be destroyed. Most businesses have at least some going concern value — that is, most businesses are worth more alive than dead. Therefore, in the usual case one party will buy out the other, or they will agree to sell the going business to a third party, instead of permitting the court to order a liquidation.

b. **Judicial order:** Furthermore, a number of states have now enacted statutes that take account of the fact that a buy-out will often be more sensible than a dissolution. Some of these statutes give the party opposing dissolution the right to buy out the shares of the party seeking dissolution at a judicially-supervised fair price (even if the party seeking dissolution does not want this). Other statutes allow the court to ***order*** a buyout in lieu of a dissolution. But under these statutes, the buy-out may only be ordered if the statutory criteria for dissolution are met; remember that no state gives a minority shareholder the automatic right, regardless of circumstances, to compel a buy-out of his interest (*supra*, p. 154).

C. **Dissolution of an LLC:** Most states allow for judicial dissolution of ***LLCs***, just as for corporations.

1. **Greater private-ordering:** But there is an important distinction between corporations and LLCs when it comes to dissolution. Shareholders of a corporation do not necessarily have (though they may have) a shareholder agreement detailing how the corporation is to be run, and dealing with such issues as dissolution and buyout. Members of an LLC, by contrast, *must* have an "operating agreement," detailing at least some aspects of how the LLC is to be run (see *supra*, p. 12). Therefore, it's more likely that the members of the LLC will have made their ***own private agreement*** dealing with issues like the break-up of the company than is the case for shareholders of a typical corporation. This ought to mean that use of judicial dissolution

will be needed ***less often*** than in the corporation case — for instance, if the members of the LLC have signed an operating agreement giving any member the right to withdraw and receive the value of her membership interest, this "buyout" clause ought to reduce the need for judicial dissolution.

a. **Buyout as substitute for LLC's dissolution:** There is another reason why judicial dissolution is less likely in the LLC case than the corporate one. In the corporate setting, the "default" rule (i.e., the one that the court will follow if the parties have not reached their own agreement) is that ***no shareholder is entitled to compel the other(s) to buy him out*** if they have a disagreement — so dissolution is essentially the *only* statutory (as opposed to contract-based) remedy for impasse or oppression. But the default rule for LLCs, in most states, is exactly the ***opposite***: the default rule is that any member may resign, and thereupon ***withdraw the value of her membership interest.***

   i. **Delaware applies:** For instance, ***Delaware*** applies this default rule. See Del. LLC Act, §18-604: "[U]pon resignation, any resigning member is … if not otherwise provided in [an operating] agreement, … entitled to receive, within a reasonable time after resignation, the ***fair value of his [LLC] interest*** as of the date of resignation based upon his right to share in distributions from a limited liability company." So in Delaware, as in most states, if the agreement is ***silent*** on the issue of withdrawal and/or buyout, the dissident member is effectively ***entitled to a mandatory buyout*** under this default rule, making it less likely that dissolution will be needed.

2. **The "reasonably practicable" standard:** But suppose that the operating agreement ***specifies*** that a resigning member is ***not*** entitled to a mandatory buyout. Does the resigning member (or a member who would like to resign) have the ability to cash out the fair value of her interest by causing the LLC to be ***judicially dissolved*** over the objection of the other member(s)? The short answer is ***"no"*** — LLC statutes almost ***never*** give a member a

unilateral right to dissolve the LLC if the operating agreement is silent on the issue of dissolution. Instead, state LLC statutes typically specify ***very limited grounds*** for which the court may decree dissolution. Most statutes allow dissolution only where it is ***not reasonably practical*** to carry out the business in the manner contemplated by the operating agreement.

The ***Delaware*** LLC Act follows this approach. The Act lists ***only one ground*** for judicial dissolution: the court may decree dissolution of the LLC on application by any member "whenever it is ***not reasonably practicable*** to ***carry on the business*** in conformity with [the operating agreement]." §18-802.

a. **Factors to be considered in Delaware:** The Delaware statute does not specify what factors the court should consider in determining whether it is "reasonably practicable" to carry on the business in accordance with the operating agreement. But the cases show that there are ***three circumstances*** that, when present, are likely to persuade the Delaware courts to approve dissolution. As the leading case on the subject puts it, these circumstances are that:

   [1] "[T]he members' vote is ***deadlocked at the Board level***";

   [2] "[T]he ***operating agreement*** gives ***no means of navigating*** around the deadlock"; and

   [3] "[D]ue to the ***financial condition of the company***, there is effectively ***no business to operate."***

   Fisk Ventures, LLC v. Segal, 2009 WL 73957 (Del. Ch. 2009). The court in *Fisk Ventures* explained that the three factors ***need not all be present*** for the court to approve dissolution. But the cases suggest that typically, dissolution will be granted because either *both factors [1] and [2] exist* (i.e., a deadlock that cannot be navigated around) or *factor [3] exists* (bad financial condition prevents operation of a viable business), or all three.

b. **Illustration (*Fisk Ventures v. Segal*):** *Fisk Ventures, supra,*

illustrates the kind of fact pattern in which the Delaware courts will decree a dissolution over the objection of some members of the LLC.

i. **Parties:** P (Segal) was a biochemist who formed Genitrix, LLC ("the LLC"). The business's main asset was a patent licensed from university research labs, which could not be assigned except pursuant to a sale of the entire business. D (Fisk Ventures) was a venture capital investor that invested nearly $1 MM in the LLC, in return for which it received various rights, including (1) certain anti-dilution protections if additional money was to be raised; and (2) a "Put Right," under which D had the right to require the LLC to buy back its stock after a certain date (which by the time of the litigation had long since arrived).

ii. **LLC structure:** The Board of the LLC had five members, with P and D each appointing two. The operating agreement said that no Board action could occur except by vote of 75% of the Board; this meant that either P or D could in effect ***veto any Board action***. The agreement also said that the LLC could be wound up or dissolved only by consent of 75% of the Board or by a decree of judicial dissolution.

iii. **Conflict:** The LLC ran out of money, and by the time of suit no longer had an office or any revenue. D brought suit to have the company dissolved and the patent license sold to the highest bidder. P objected to the dissolution on the grounds that it would be reasonably practicable to continue operating the business if only D would either (1) waive its anti-dilution rights so that additional money could be raised from third persons (which P was confident could be done), or (2) exercise its Put Rights so that the LLC could buy out D's interest and then raise new funds.

iv. **Dissolution ordered:** The Delaware Court of Chancery found for D, and ***granted a dissolution.*** The court concluded that all three of the circumstances (listed above)

that should be looked to in deciding whether carrying on the business was no longer "reasonably practicable" were present.

[1] Deadlock: First, the Board was ***deadlocked***, since 75% of the Board members had to approve any action, and P and D could each prevent the 75% from being achieved by withholding their two votes. As the court put it, "This type of charter provision, unless a 'tie-breaking' clause exists, is almost always a recipe for disaster … [and] unfortunately, the parties are behaving true to form."

[2] No way to navigate deadlock: There was no way to ***navigate this deadlock*** under the operating agreement. P argued that D should be required to exercise its Put Right, so as to avoid the deadlock. But the court held that the Put Right was an ***option belonging to D***, not to P or the LLC; "it would be inequitable for this court to force a party to exercise his option when that party deems it in its best interest not to do so."

[3] Lack of funds: The lack of funds made it ***impractical to carry on the business.*** Again, P argued that if the court simply ordered D to exercise its Put Right, P could then raise new funds to both carry out the buy-back of D's stock and exploit the value of the patent (perhaps by selling it to a third party). If the company were forced into dissolution, P argued, the value of the patent would be lost. But the court concluded that the value of the patent could likely be preserved just as well through a court-ordered dissolution and sale and through a continuation of the LLC's existence.

[4] "Unclean hands": P made one last-ditch argument: that D was trying to put the company into dissolution so that it could ***buy the assets at fire sale prices***, and was thus using its leverage under the operating agreement in an unfair way. Therefore, he argued, D had ***"unclean hands,"*** preventing it from being entitled to the equitable relief of court-ordered dissolution. But the court rejected this

argument, too: D had expressly negotiated all of the rights it held under the operating agreement, and D was therefore "perfectly within its rights" to exercise its negotiated leverage to benefit solely itself. The court was "in no position to ***redraft*** the [operating agreement] for these ***sophisticated and well-represented parties***." Therefore, dissolution was the only available remedy.

D. Alternatives to dissolution: Dissolution is not the only way of dealing with deadlock and/or dissension in the close corporation. We consider briefly a number of other methods:

1. **Arbitration:** The shareholders may agree to have their disputes subjected to ***arbitration***. Most states now have a policy of encouraging arbitration; for instance, in most states arbitration agreements are irrevocable, and an arbitrator's award may then be entered as an enforceable judgment.

2. **Provisional directors:** A number of states allow the court to appoint a ***provisional director***. Most commonly, a provisional director can be appointed to ***break a deadlock*** on the board. See, e.g., Cal. Corp. Code §308. Once the tie is broken, the provisional director is normally removed. The provisional director has no powers beyond those of an ordinary director. Clark, p. 797.

   a. **Impartiality:** Many state statutes explicitly require that the provisional director be ***impartial***.

      i. **Where statute is silent:** Where the statute does ***not explicitly say*** that the provisional director must be impartial, courts have tended to say that he need ***not*** be.

3. **Custodian:** Many states allow the court to appoint a ***custodian***. A custodian has the power to ***run the business***. See, e.g., Del. §352, allowing the appointment of a custodian to run any deadlocked close corporation.

4. **Receiver:** Nearly all states allow the court to appoint a ***receiver***. Unlike a custodian, the job of the receiver is to ***liquidate*** the corporation rather than to continue it. Therefore, a

receiver is usually only appointed for a dying corporation. Clark, p. 796.

5. **Statutory buy-out right:** As noted (*supra*, p. 157), some states allow the court to order a judicially supervised ***buy-out*** in lieu of dissolution, if the requirements for dissolution are met.

6. **Fiduciary obligation of majority to minority:** Last and probably most significant, a few states have formulated a theory of ***fiduciary obligation*** to resolve close corporation disputes. These courts, especially the Massachusetts courts, have held that ***a majority stockholder in a close corporation has a fiduciary obligation to a minority shareholder***, and must behave towards him in good faith. Violation of this obligation can be compensated by an award of ***damages***. This "fiduciary obligation" doctrine is important as a method of resolving disputes, because it gives the courts that apply it a method of rectifying the minority holder's grievances without the very strong medicine of dissolution.

   a. **Application to share repurchase:** For instance, an important Massachusetts case helps minority shareholders by holding that if a corporation ***repurchases*** shares from one stockholder, it must ***offer to repurchase from other holders on the same basis***. ***Donahue v. Rodd Electrotype Co.***, 328 N.E.2d 505 (Mass. 1975).

      i. **Facts:** The facts of *Donahue* illustrate how this "fiduciary obligation" doctrine can sometimes protect minority holders in circumstances where dissolution would formerly have been the only method of protecting them. P was a minority holder in a corporation who had inherited her shares from her husband, an employee of the corporation. The corporation had previously bought back shares from its majority stockholder at a high price. It refused to buy a similar portion of P's shares back from her at anything close to that price, thus leaving her with a largely unmarketable interest.

      ii. **Holding:** The court held that the corporation was

required to repurchase shares from P in the same portion, and at the same price, as it had purchased from the majority holder. The court phrased its rationale broadly: "Stockholders in the close corporation ***owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another.*** … [This is the duty of] ***utmost good faith and loyalty***. … [Stockholders] may not act out of avarice, expediency or self-interest.…" Where the controlling shareholder causes the corporation to buy back shares from him and not from minority holders, he is effectively using corporate funds for his personal benefit, in violation of this strict duty of good faith. (The court defined a "close corporation" to be one which has a small number of stockholders, no ready market for its shares, and substantial participation by the majority stockholder in the management of the company.)

b. "Squeeze-outs": If the majority attempts a classic "squeeze-out" of a minority holder, the majority holder may be found to have violated this fiduciary obligation. For instance, if the majority ***refuses to pay dividends***, and refuses to employ the minority holder, so that the minority has no way to participate in the economic fruits of ownership, this may be a violation of the majority's fiduciary obligation.

i. *Wilkes* case: For instance, the highest court of Massachusetts extended the "fiduciary obligation" doctrine of *Donahue* to cover this kind of squeeze out in the later case of ***Wilkes v. Springside Nursing Home, Inc.***, 353 N.E.2d 657 (Mass. 1977). P and three other stockholders each owned 25% of the corporation. Each holder participated in management, and received an equal salary. Relations between P and one of the other stockholders deteriorated, and the other holders caused the corporation to ***terminate P's salary and to drop him from the board.*** The court found that the other holders had violated their fiduciary obligation to P by this squeeze-out, since it stripped P of his ability to obtain his expected return on his

investment.

ii. "Legitimate business purpose" test: But the *Wilkes* court was careful to make it clear that not every act by the majority that is disadvantageous to a minority stockholder will be a breach of this fiduciary obligation. Instead, the majority's conduct will be upheld if there was a ***"legitimate business purpose"*** for it, and that purpose could not have been achieved by a different course of action less harmful to the minority holder. Here, the majority stockholders had not shown a legitimate business purpose in dropping P from the payroll and from the board, so they had violated their fiduciary obligation to him.

c. Obligation of minority stockholder: One lower Massachusetts court has even gone so far as to hold that a ***minority*** stockholder has a fiduciary obligation to his co-stockholders, if the minority holder has been given a veto power over corporate actions.

Example: Dr. Wolfson is one of four equal shareholders in a corporation that owns real estate. The corporation's charter gives each stockholder an effective veto power over any corporate decision. Over the objections of the other three stockholders, Wolf-son refuses to allow the corporation to pay a dividend out of its surplus. Consequently, the corporation is assessed substantial penalties by the IRS for excess accumulations of earnings.

Held, Wolfson's refusal to allow a dividend was motivated more by his personal tax considerations and dislike for his fellow shareholders than for the corporation's benefit. Therefore, Wolfson must reimburse the corporation for the loss it suffered from his unreasonableness (the amount of the IRS penalties). The court will declare a dividend if Wolfson does not agree to one on his own. *Smith v. Atlantic Properties, Inc.*, 422 N.E.2d 798 (App. Ct. Mass. 1981).

d. Non-Massachusetts cases: So far, the doctrine that stockholders in a close corporation owe each other a fiduciary

obligation of utmost good faith has principally been applied in Massachusetts. But a few non-Massachusetts cases have also applied the doctrine. See Clark, p. 800.

i. Delaware rejects: But other states, most notably Delaware, have ***rejected*** a special fiduciary-obligation approach to close corporations. The Delaware decision doing so is *Nixon v. Blackwell***,** 626 A.2d 1366 (Del. 1993).

(1) ***Donahue*** **approach rejected:** The court rejected in *Nixon* the approach of Massachusetts in cases like *Donahue*. The court phrased the issue as "[w]hether there should be any special, judicially-created rules to 'protect' minority stockholders of closely-held Delaware corporations," and concluded that "[i]t would do violence to normal corporate practice and our corporation law to fashion an *ad hoc* ruling which would result in a ***court-imposed stockholder buy-out*** for which the parties had not contracted."

Quiz Yourself on ***CLOSE CORPORATIONS*** *(ENTIRE CHAPTER)*

37. The Three Musketeers Toy Company, a close corporation, makes war toys — "My First Uzi," "Baby's Teething Grenade," "Battlin' Scuds 'N' Patriots," etc. Aramis owns 60% of Three Musketeers' voting stock; Athos and Porthos each own 20%. Three Musketeers's board of directors has three members, who are elected via cumulative voting. Athos and Porthos agree in writing that before voting for directors they will confer and agree upon a mutually-acceptable candidate, so that they will be sure that between them they elect at least one director to the board. The agreement is to last three years. Before the very next annual meeting, Athos changes his mind and votes his shares in favor of Aramis's nominees.

(a) Is the voting agreement valid? ______________________________

(b) Assume that the court finds the agreement valid. What relief will the court most likely award? ______________________________

38. March Hare and Mad Hatter are minority shareholders of Alice's Wonderland Travel Adventures, Inc., a close corporation. Hare and Hatter sign a document under which both agree that Hare will have the power to vote both his own and Hatter's shares on any issue put to a shareholder vote. At the same time, Hatter also transfers physical possession of his shares to Hare. The agreement has a duration of eight years. No one knows about the agreement except the two signatories, and Hatter's shares remain listed on the corporation's books as belonging to Hatter. At the next shareholder meeting, Hatter purports to vote his shares, but Hare says that he has the power to vote them (and shows the document to the corporate secretary). The secretary goes to court for a ruling as to who may vote the shares. Assume that the MBCA is in force.

(a) If you are representing Hatter, what argument will you make to the judge? ______________________________

(b) If you are representing Hare, what argument will you make to the judge? ______________________________

(c) What is the most likely result? ______________________________

39. The I-Say-Boy Dairy Company, a close corporation, has four shareholders, with Foghorn Leghorn and Miss Prissy between them owning 60% of the voting stock. The two minority shareholders are Dawg and Weasel. Foghorn and Prissy agree between themselves to elect themselves as two of the three members of the board of directors and to appoint themselves officers at a combined annual salary of $400,000, regardless of the company's level of sales and profits. Two years later (while the agreement is still in force), Foghorn and Miss Prissy stick to the agreement. The combined $400,000 in salaries is somewhat excessive in light of the company's modest sales and profits, but there's enough cash in the company till to pay the salaries for now. The agreement complies with applicable procedural statutes. Dawg sues to have the agreement declared invalid. Will he succeed?

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40. The Lady Macbeth Suicide Hotline, Inc., is a five-year-old close corporation. Macbeth owns 700 shares, and Banquo owns the remaining 300. At an annual meeting, Macbeth votes his shares to amend the bylaws to grant the company a right of first refusal on any subsequent stock

transfer. Banquo votes against the amendment and, boy, does that make Macbeth mad. Thereafter, Banquo wants to transfer his shares to Fleance, who's willing to buy them for $10 a share. Under the prevailing modern approach, must Banquo first offer the shares to the company at $10 a share? ____________________________

41. The Jekyll & Hyde Cosmetics Company, a close corporation, has, and has always had, bylaws providing that, before a shareholder may sell his shares to a third party, the corporation has a 60-day option period during which the corporation can purchase the shares at the "book" (i.e. net asset) value as stated on the company's most recent balance sheet. This valuation method was agreed upon by the shareholders 20 years ago, at a time when book value was the most common method for valuing a business such as this one. Dr. Jekyll owns 10% of Jekyll & Hyde's shares. He wants to sell, and so notifies Jekyll & Hyde. Jekyll & Hyde's chairman, Shelley, writes back, offering the current book value, $25 a share. Jekyll balks, since the market value of the shares is now around $100 a share. (Cosmetics businesses now typically sell for a substantial multiple of book value, due to a change over the last 20 years in how the market values successful companies in this industry.) Jekyll tries to sell to Walton at $100 a share. The company refuses to issue a new certificate in Walton's name. The company seeks to rescind the sale and to compel Jekyll to accept the company's price. What result?

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42. Ricky Ricardo is founder, chairman of the board, and president of the Ricky Ricardo Babaloo Club, Inc., a close corporation. He owns 60% of Babaloo's voting stock. When he retires, Babaloo buys some of his shares for $1,000 a share. Lucy Ricardo, a minority shareholder, immediately thereafter offers her shares to the corporation at $1,000 each. Babaloo claims it can't afford to pay that much, offering instead $400 a share. (In reality, the corporation could easily afford to pay the $1,000.)

(a) If you represent Lucy, what argument will you make with respect to the company's obligation to Lucy? ____________________________

(b) Will you succeed with the argument you made in part (a)?

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37. (a) Yes. Virtually all courts today hold that voting agreements — including those which, like this one, are of the "agreement to agree" type — are valid and enforceable. [137]

(b) Specific performance, in that Athos's shares will be voted in favor of Porthos's nominee, so that that nominee is sure to be elected. With three directors, under cumulative voting it takes at least 26% of the shares to elect one director. (See the formula on p. 56). So if the court casts Athos's shares in favor of Porthos's nominee, putting 40% of the total voting power behind that nominee, the latter is certain to be elected.

Note that in earlier days, a court was more likely to cancel any votes cast by Athos in violation of the agreement than to order that Athos's vote be cast in a particular way. Such "relief" would be useless to Porthos, because Aramis would still elect the entire board, since Porthos's 20% would not be enough to elect a single director, even under cumulative voting. See *Ringling Bros. v. Ringling*, involving similar facts. [138] Porthos thus does much better under the modern approach.

38. (a) That this is an attempted voting trust, which is invalid because not previously disclosed to the corporation. Under MBCA §7.30 (as under most modern statutes), "voting trusts" are legal, but only if several quite stringent requirements are met. In particular, "[T]he trustee shall prepare a list of the names and addresses of all owners of beneficial interests in the trust, together with the number and class of shares each transferred to the trust, and deliver copies of the list and agreement to the corporation's principal office." §7.30(a). Such a trust does not become effective until "the date the first shares subject to the trust are registered in the trustee's name." §7.30(b). Since the shares here were never registered to Hare as trustee, and the document was never filed with the corporation, if it's a voting trust it never became effective (you would argue on Hatter's behalf). [140]

(b) That the arrangement is a valid voting agreement, not an invalid voting trust, and that it's therefore specifically enforceable. MBCA §7.31 says that "Two or more shareholders may provide for the manner in which they will vote their shares by signing an agreement for that purpose. A voting agreement created under this section is not subject to

the provisions [on voting trusts].” If the court agrees that this is a “voting agreement” rather than an attempted “voting trust,” it doesn’t matter that the corporation wasn’t aware of the arrangement, because there’s no requirement of disclosure. If the court accepts this characterization, the agreement will be specifically enforceable. [139]

(c) Probably Hare’s argument will prevail, and the arrangement will be specifically enforced. Other than the physical transfer of shares, there’s nothing in this arrangement (so far as the facts tell us) that forces the conclusion that this was intended to be a true trust, as opposed to an agreement. So the court will probably conclude that the parties’ intent will be better carried out by treating it as an agreement, and enforcing it, than by treating it as a nullity.

39. Yes, probably. Agreements restricting director discretion in a close corporation are generally valid if they comply with applicable statutes ***and*** they don’t harm creditors or minority shareholders. [144] Here, the agreement between the majority shareholders that they will vote themselves excessive salaries harms the minority shareholders (Dawg and Weasel) by leaving less money for dividends and other corporate activities. (It may also harm creditors — the facts don’t give us enough information to know.) Since the agreement harms the minority shareholders, a court will probably hold it invalid. At the very least, this will mean that if either Foghorn or Miss Prissy changes his/her mind about voting the high salaries, the other won’t be able to sue. (It’s less clear whether Dawg will be able to get a court to intervene if both Foghorn and Miss Prissy continue to vote for the high salaries once the agreement is struck down.)

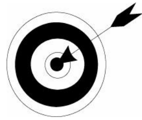
40. No, because Banquo’s shares aren’t subject to the transfer restriction. The modern approach is to refuse to apply the restrictions to previously-issued shares. [149] For instance, MBCA §6.27(a) provides that “A restriction does not affect shares issued before the restriction was adopted unless the holders of the shares are parties to the restriction agreement or voted in favor of the restriction.” Here, since there is no “restriction agreement” (just a newly-enacted bylaw), and since Banquo didn’t vote in favor of the bylaw, he’s not bound as to any shares that he already owned at the moment the restriction came into effect. (But if he bought additional newly-issued shares, while on actual or constructive

notice of the restriction, he *would* be bound as to these shares, even if he never agreed to the restriction.)

41. **The company wins.** The issue here is whether the bylaw, granting the corporation an option to repurchase shares from its shareholders at book value, is valid even where it produces a price that's much below market value. The general rule is that a restriction on stock transfer is valid if the person taking the shares has notice of the restraint and the restraint is "reasonable." The focus here is on the "reasonableness" element, since the shares are worth four times the option price. However, most courts say that if the mechanism chosen by the parties was reasonable *at the time the method was agreed upon*, the method will be deemed reasonable even though later trends make the price produced by the method very high or low viewed as of the moment of adjudication. [152] Since the facts tell us that the book-value method was reasonable at the time it was adopted, the fact that valuation methods have changed will not invalidate it. Thus even though the method produces a very below-market price now, the restriction is binding. At the very least, the court will allow the company to continue to refuse to recognize the transfer to Walton. If Jekyll is unlucky, the court will hold that Jekyll's notice of intent to sell gave the company a temporarily-irrevocable option to acquire the shares at the $25 price, and will order specific performance by Jekyll.

42. **(a) That the company (and Ricky as controlling shareholder) owes a fiduciary duty to Lucy to treat her as favorably as it treated Ricky, and thus repurchase her shares at the same $1,000 price.**

    (b) Yes in Massachusetts; probably not in most other jurisdictions. A few states have in recent years held that a majority stockholder in a close corporation has a fiduciary obligation to each minority stockholder, such that the majority holder must behave in good faith towards the minority holder. If the state falls into this group, it would be likely to agree with this argument by Lucy that the company must repurchase Lucy's shares on the same terms as Ricky's, assuming that its financial condition still permits it to do so. The Massachusetts court in *Donahue v. Rodd Electrotype* so held, on almost exactly these facts. [161] However, *most* courts (including those in Delaware) would probably *not* agree that such a fiduciary obligation exists merely because of the close-corporation context, so Lucy would probably lose in most non-Massachusetts courts.



Exam Tips on *CLOSE CORPORATIONS*

The most frequently-tested issue regarding close corporations is the ***validity of s/h voting agreements.***

- Be on the lookout for agreements that ***limit the discretion of the board of directors***. Although s/h agreements are generally ***valid***, an agreement which substantially restricts the authority of the board will be ***struck down*** if it either: (i) violates a statutory provision; (ii) ***injures a minority s/h***; or (iii) injures the corp's creditors or the public.
  - You're most likely to see a s/h agreement in which a majority of the holders agree to ***put and keep a particular person*** (perhaps one of the majority) into a ***key job***, and a minority-holder objects. Here, "injury to the minority-holder plaintiff" should be the focus of your answer.

    Example: A, B and C together control 75% of the stock of D Corp, and they are its sole directors. They sign a s/h agreement that says that unless all vote to cancel the agreement, all will cast their board votes so as to put and keep A in the President's position. P, a 10% holder, does not have a board seat, and now sues A, B and C (and the corp.) to have the voting agreement stuck down. If P can show that A is not doing an appropriate job running the business (or is otherwise injuring P by the way he's running it), the court may strike down the agreement. But if P doesn't show this, the court will probably uphold the agreement even though it substantially restricts the directors' freedom of action.

- Agreements under which each of the signers agrees to vote so as to ***elect all of the signers to the board*** are generally ***valid***.
  - A closer question is whether a person who then ***buys (or gets a gift of) stock from one of the original signers*** is bound by, or gets the benefit of, such an "all s/h's agree to elect all s/h's to the board" agreement. The answer is probably "yes," at least where the shares are conspicuously ***marked*** with the fact that there is a voting agreement

that governs.

Example: A, B and C are the only s/h's in D Corp. All agree that all will vote so as to put all 3 on the board. C (who has too few shares to be able to vote herself to the board if no one else votes for her) dies, and bequeaths her shares to E. A and B refuse to vote E to the board. E sues to enforce the agreement. You should say that there's a good chance that a court will hold that the original signers intended that both the benefit and burden would "run" with the stock, in which case the court will require A and B to vote E onto the board (but E must vote for them as well). You should also point out that this result is more likely if the shares were marked with notice of the agreement than if they're not.

☞ Look for s/h agreements which contain ***share transfer restrictions.***

- ☞ Remember that a person who purchases shares ***without actual knowledge*** of preexisting restrictions will ***not*** be bound unless the restrictions were ***conspicuously noted*** on the share certificates.

- ☞ If the fact pattern involves a right of ***first refusal*** (by the corporation or by the other shareholders), the restriction normally applies only if the shares are ***sold***, not if they are to be transferred by a ***gift*** or ***bequest***.

☛ Fact patterns on close corps sometimes pose the issue of whether one party can compel ***dissolution*** of the corp.

- ☞ Keep in mind that most statutes (e.g., the MBCA) allow the court to order dissolution at the request of one s/h, if certain conditions occur. Most states allow dissolution if:

  - ❑ The ***s/h's*** or the ***directors*** are ***deadlocked*** in a way that prevents the corp. from operating; or

  - ❑ The directors (or controlling s/h's) are ***oppressing*** or ***defrauding*** a minority holder; or

  - ❑ The corp's ***assets*** are being ***wasted***.

☞ If the fact pattern involves an ***LLC*** rather than a corporation, remember that the jurisdiction probably allows judicial dissolution on factors similar to those for corporations. If it's a Delaware LLC, cite to the Del. LLC Act, allowing the court to decree dissolution of the LLC "whenever it is

not reasonably practicable to carry on the business in conformity with the [LLC agreement.]"

☞ If the parties are ***deadlocked*** and the operating agreement doesn't supply a way to navigate around the deadlock, that's likely to be enough to make carrying on the business "not reasonably practical."

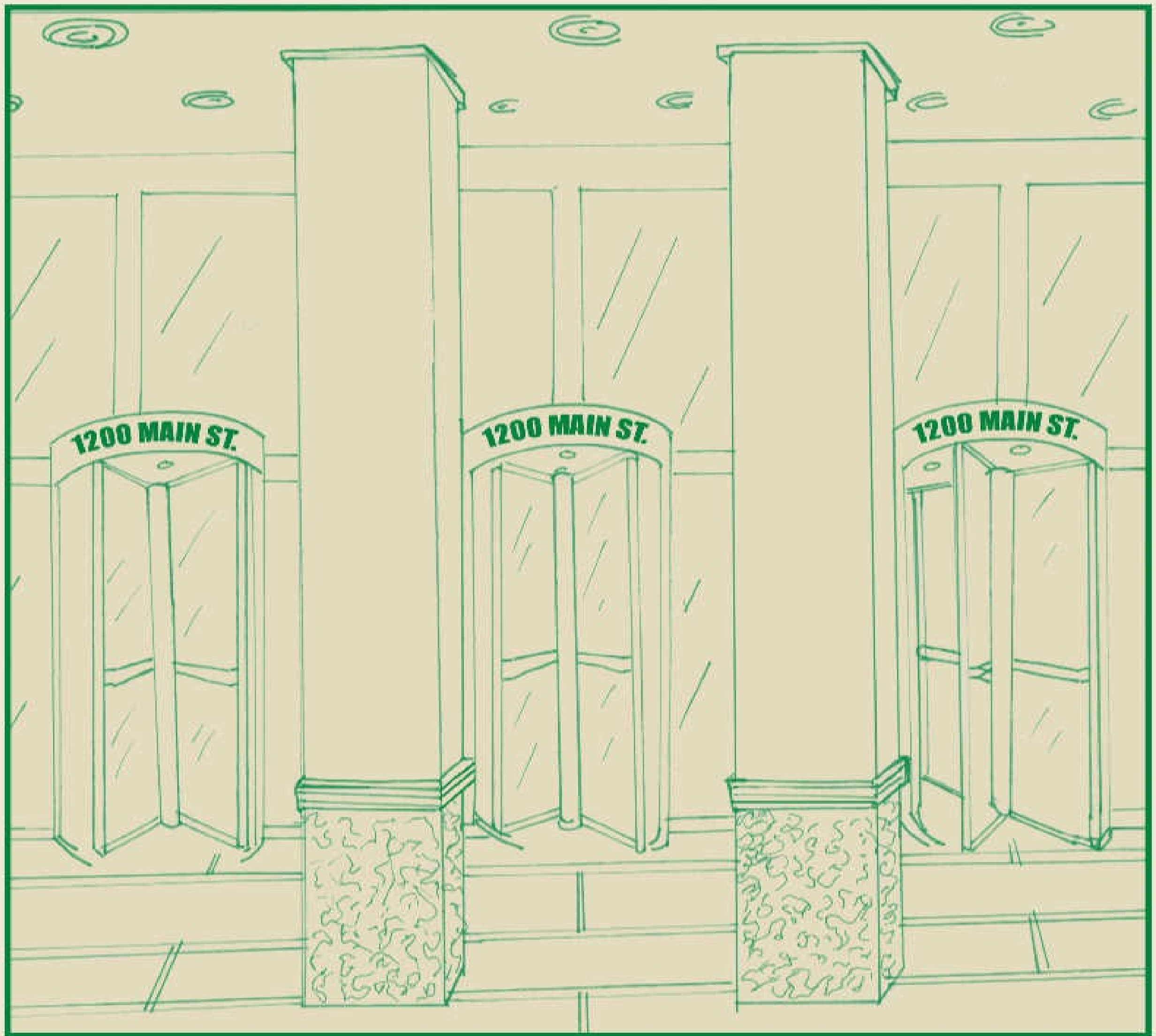
Example: LLC has two members, Al and Bill. The operating agreement says that an additional capital raising can only be done with the consent of both Al and Bill. The company runs out of money. Al is prepared to invest more for a bigger stake, but Bill doesn't like Al's terms and doesn't propose any terms of his own; instead Bill petitions for dissolution. The court (especially in Delaware) is likely to say that this deadlock is enough to making carrying on the business impractical, and therefore that Bill is entitled to judicial dissolution.

EXAMPLES & EXPLANATIONS

Corporations

Eighth Edition

Alan R. Palmiter



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Corporations

Eighth Edition

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Published by Wolters Kluwer in New York.

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Library of Congress Cataloging-in-Publication Data

Palmiter, Alan R.
Corporations / Alan R. Palmiter, Howard L. Oleck Professor of Business Law, Wake Forest University.—Eighth edition.
pages cm.—(Examples & explanations)
Includes index.
eISBN: 978-1-4548-6065-5
Corporation law — United States. I. Title.
KF1414.85.P35 2015
346.73'066 — dc23

2014049604

PART III

Shareholder Voting Rights

CHAPTER 6

Shareholders' Role in Corporate Governance

More than 200 years ago, Blackstone described the corporation as a "little republic." Conceptually, this description is still apt. The *statutory model* for the corporation sets out a republican form of governance:

- **The shareholders (the corporation's electorate)** elect directors annually and vote on fundamental corporate transactions. Although they are nominal "owners" of the corporation, shareholders do not participate in managing the corporation's business or affairs. The shareholders, even a majority, cannot act on behalf of the corporation—this is left to the board of directors.
- **The board of directors (the corporation's legislative organ)** is the locus of corporate authority. "All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors." MBCA §8.01(b); see also Del. GCL §141(a). The board acts independently from the shareholders, rather than as an agent. Directors have fiduciary duties to the corporation and the body of shareholders (see Chapter 11).
- **The officers (the corporation's bureaucracy)** are delegated the day-to-day management of the corporation and are answerable to the board. All authority to act for (and to bind) the corporation originates in the board of directors (see Chapter 30).

Corporate law protects shareholders' financial position through three principal mechanisms: voting rights, litigation rights to enforce management accountability, and liquidity rights to sell their shares. This part considers voting rights and the shareholders' role in corporate governance:

- the purposes of shareholder voting (§6.1) and its use in publicly traded corporations (§6.2) and closely held U.S. corporations (§6.3)
- the matters on which shareholders vote, the voting process, and the methods for electing directors (Chapter 7)
- judicial supervision of the voting process (Chapter 8)
- federal regulation of proxy voting in public corporations (Chapter 9)
- the liability for proxy fraud regime (Chapter 10)

Shareholder voting is a study in U.S. corporate federalism, as well as the division of labor between the legislative and judicial branches. *State corporate statutes* establish the structure of shareholder voting, including compulsory annual elections of directors and shareholder voting on fundamental corporate changes. *State courts* supervise the fairness of the voting process through judicially created fiduciary duties. *Federal regulations*, authorized by federal statute, fill a perceived gap in the state-enabled voting structure by mandating disclosure in connection with proxy voting in public corporations. *Federal and state courts* ensure the fairness of transactions on which public shareholders vote under judicial antifraud standards that assume voting by reasonable shareholders.

Note on Shareholders as "Owners"

Sometimes it is said (metaphorically) that shareholders "own" the corporation. But, as you study the role of shareholders in the corporation, you will notice the many things shareholders *cannot do* under the traditional model. They cannot act on the ordinary business and affairs of the corporation. Thus, they cannot bind the corporation contractually (see Chapter 30); they cannot select and remove *officers* (even for cause); they cannot fix employees' compensation; and they cannot have the corporation pay dividends (see §31.1). Furthermore,

shareholders cannot compel or overturn particular board decisions, unless the board failed to comply with the corporate statute or the corporation's constitutive documents (see §3.3.3) or the directors breached their fiduciary duties (see Chapter 11).

§6.1 PURPOSES OF SHAREHOLDER VOTING

Shareholder voting has many functions. It gives self-help remedies to the shareholder majority—

- to elect directors to the board (usually on an annual basis)
- to approve fundamental corporate changes adopted by the board (such as amendments to the articles, mergers, and dissolution)
- to initiate limited changes to the governance structure (by making non-binding proposals to the board and amending the bylaws)

Voting gives shareholders the power to protect their position as last-in-line claimants of the corporation's profits. Majority voting prevents a minority from holding up useful change or extorting concessions from the majority. Although other corporate constituencies (such as employees, creditors, or bondholders) could in theory have voting rights, shareholders value these rights more highly than other constituents and pay for them when they invest.

Shareholder voting operates in tandem with shareholder litigation rights. The power of shareholders to replace lax or inept directors justifies deferential judicial review of directors' judgment in making business decisions. Likewise, shareholder approval of transactions involving managerial self-dealing or other conflicts of interest reduces the judicial scrutiny that would otherwise apply. When shareholders are prevented from exercising their voting right—as when the board changes the voting rules to thwart a shareholder insurgency to replace the board—judicial review is heightened.

Shareholder voting is critical to shareholder liquidity rights and the "market in corporate control." Because shares are sold with voting rights,

buyers of a majority of shares acquire the power to install their own board and thus replace incumbent management. The availability in public trading markets of sufficient shares to constitute a voting majority creates strong incentives for managers to act consistently with shareholder interests.

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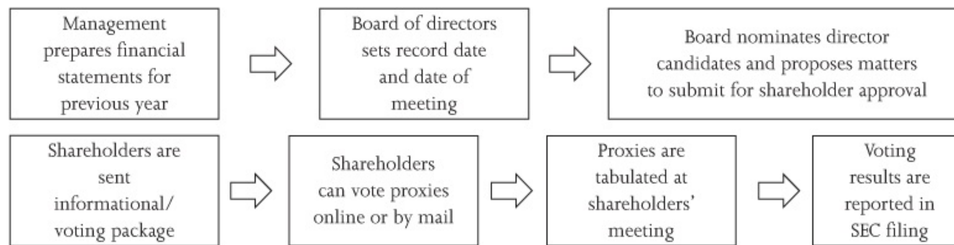
§6.2 SHAREHOLDER VOTING IN PUBLIC CORPORATIONS

The reality of shareholder voting in modern public corporations diverges from the theoretical model. In public corporations, shareholders typically participate in the election of directors less fully than the model assumes. Historically, public shareholders have been mostly passive. They generally send their *proxies* (that is, authorize the voting of their shares) for the slate of directors and the transactions proposed by incumbent management. It is unusual for an insurgent to offer an alternative slate of candidates or for a management initiative to be defeated. Nonetheless, with the rise of institutional shareholders over the last two decades, shareholder initiatives in the form of nonbinding resolutions have become a prominent feature of U.S. corporate governance (see §9.4.2).

§6.2.1 Proxy Process

In the United States equity shares typically carry voting rights. In a public corporation, given the logistical difficulties and expense of assembling all of the corporation's shareholders, voting is mostly by proxy—in effect, absentee ballot. As a result, the process of soliciting and voting proxies effectively takes the place of the shareholders' meeting. The actual meeting is often a sparsely attended public relations event.

Here is a flowchart of a typical shareholders' meeting in a public corporation:



Proxy voting is usually an annual rite of spring that takes place after the company's management and its auditors have prepared financial statements for the previous year. (For the legal mechanics of shareholders' meetings, see §7.2.) The board of directors sets the date of the annual shareholders' meeting and then selects a "record date" used to identify which shareholders will be entitled to notice and to vote at the meeting. Under state law, only record shareholders vote. Beneficial owners must give their voting instructions to those who hold their shares in the company's records. The board (often by a nominating committee) then proposes director candidates, and the board decides which matters to submit for shareholder approval.

To solicit proxies, management sends to shareholders *at corporate expense* a voting package containing an annual report, a proxy disclosure document, a proxy card, and a return envelope. Since 2007, the SEC allows companies to send shareholders a notice that these materials are available online. Exchange Act Rel. No. 55,146 (2007) (permitting shareholders to always request printed materials). After receiving the notice by regular mail or email, shareholders can go online and vote their proxies electronically. This "notice and access" method reduces the costs of voting, which ultimately are borne by shareholders.

Dissemination of proxy materials is complicated by the situation that most public shareholders are beneficial owners, not record owners. This means shares are owned on the corporate books by a nominee, typically a brokerage firm, for the benefit of its investor-customers. Under SEC rules, the corporation must send proxy materials or notice of online access either (1) to the record owner for distribution to beneficial owners or (2) to beneficial owners who do not object to having their nominees furnish their names and addresses ("non-objecting beneficial owners," or "NOBOs"). Depending on brokerage firm practice, beneficial owners either complete the proxy card themselves or instruct the firm (the record holder) on how to complete it. A prior practice in which brokerage firms decided how to vote shares for which they had not received voting instructions is now prohibited

under stock exchange rules mandated by the Dodd-Frank Act. See §11.5.2.

Shareholders receive their voting packages (whether by mail or online access) a few weeks before the scheduled meeting. The cover letter from the board chair invariably asks shareholders to vote promptly to avoid the expense of a second mailing. Few individual shareholders read the proxy materials, though many complete the proxy card or vote online as recommended by management. Institutional shareholders, which now hold more than 70 percent of voting shares in the largest public corporations and often rely on proxy advisory firms, have become increasingly independent and activist.

Although you might have seen the fictionalized shareholders' meeting in the 1987 film *Wall Street*, where Gordon Gekko delivered his memorable "greed is good" speech, real-life shareholders' meetings are less dramatic. Instead, they typically follow a quite predictable script. Directors are nominated and other voting matters proposed. Votes, cast mostly by proxy holders, are taken. With the important business done, the company's senior executives describe company results and plans, and respond to (usually) polite shareholder questions. If shareholders get unruly, the meeting chair can end the meeting. Although state law permits any shareholder to nominate her own slate of directors or to propose a proper shareholder resolution, the effort would be futile unless the shareholder has already solicited and obtained proxies. Many corporate bylaws also prohibit shareholder nominations or proposals if not submitted well in advance of the meeting—a so-called "advance notice" bylaw. In the end, the shareholders' meeting is largely a formality, for the votes have already been "cast" in the proxy cards. In fact, to avoid surprises, the votes will often have been tabulated before the meeting.

§6.2.2 History of Public Shareholder Voting

Separation of Ownership and Control

In 1932, two Columbia professors Adolf Berle (law school) and Gardiner Means (economics) combined to write *The Modern Corporation and Private Property*, an influential book that systematically identified the separation of corporate ownership and management in U.S. public corporations. The authors pointed out that when stock ownership is widely distributed and no group of shareholders has a sufficient interest to control the company's

affairs, management becomes “a self-perpetuating body even though its share in the ownership is negligible.” They found that 44 percent of the country’s largest 200 companies were under “management control.”

Central to the Berle and Means thesis of management control was the ineffectiveness of shareholder voting as a control device in public corporations. They found that when shareholders hand over their votes to individuals selected by existing management, the proxy mechanism leaves control in the hands of the board of directors, who “virtually dictate their own successors.” Although shareholders can replace incumbent directors by soliciting proxies for an insurgent slate of candidates, they found proxy contests to be rare.

In reaction to the gloomy Berle and Means story of the separation of management and ownership in public corporations, Congress created the Securities and Exchange Commission in 1934 to (among other things) promulgate a federal regulatory regime for proxy voting. Despite SEC rules that mandate disclosure by management when soliciting proxies and compel shareholder access to the proxy machinery, shareholders in publicly traded corporations did not leap at the invitation to participate in corporate governance. During the 1950s and 1960s, proxy contests for board control were no more frequent than before the SEC rules. Management’s candidates and initiatives won and insurgent’s candidates and initiatives lost, each by wide margins. By the 1970s, many academics had come to accept shareholder apathy as insoluble—indeed “rational.” Any shareholder dissatisfied with management had little choice but to exercise the “Wall Street rule” and sell his shares.

Institutional Shareholders

In the 1980s public shareholders began to use their powerful, latent control over managers despite the practical weaknesses in shareholder voting. Shareholders’ power first arose not from voicing their views through voting, but from their ability to exit and sell their shares. During the takeover boom of the 1980s, the voting power carried by shares served as the linchpin for hostile stock acquisitions and takeovers. Public shareholders could sell to an acquirer, who consolidated the voting power of dispersed shareholders to replace the board and acquire control of the company. Takeovers—and their threat—provided the discipline that atomistic voting had not.

But as the era of hostile takeovers came to an end in the late 1980s, a new

era in U.S. corporate governance began. In the 1990s institutional shareholders emerged as a powerful new corporate actor. As Berle and Means had noticed 60 years ago, large shareholders have relatively more incentives to become informed about management and proxy contests, and they are more likely to vote than other shareholders. The collectivization obstacles that discouraged any one shareholder from taking the initiative—because any gains would have to be shared among all shareholders—are overcome when a group of institutional shareholders organize against management.

Who are institutional shareholders? They take many forms, but are essentially financial intermediaries that hold large pools of investments for their beneficiaries: pension funds (private and public), mutual funds, insurance companies, bank trust departments, hedge funds, endowments. As of 2009, institutional shareholders controlled 73 percent of the outstanding stock of the largest 1,000 U.S. public companies—up from 16 percent in 1965, 38 percent in 1980, 49 percent in 1990, and 61 percent in 2000. Institutional ownership is also increasingly concentrated. The ten largest institutional owners of each of the top 25 U.S. companies hold together on average 28.9 percent of the company's voting stock.

These trends are due to a combination of factors. Tax rules encourage employers and workers to contribute to retirement plans, which are invested in pension funds and mutual funds. And individual shareholders seeking diversification have moved from holding individual stocks to investing in mutual funds. As of 2011, mutual funds held 23.9 percent, and pension funds (both private and government) held 17.0 percent of U.S. public equities.

Institutional Activism

Institutional shareholders have fiduciary obligations to manage and vote the shares they hold for the exclusive benefit of their beneficiaries. Although institutional shareholders have traditionally voted with management, often because they rely on management for investment business, this culture of acquiescence is changing. Pressure from regulators—such as the SEC (which oversees mutual funds) and the Department of Labor (which oversees private pension funds under ERISA)—has led institutional shareholders to take their voting responsibilities more seriously. Disclosure of voting policies and actual votes, required by SEC rule in 2003 for mutual funds, has exposed voting by institutional shareholders to greater scrutiny. Greater "indexation"

(diversification of investment portfolios to track the performance of whole markets) makes it difficult for institutional shareholders to follow the "Wall Street rule." An indexed institutional shareholder that disapproves of a company's management cannot simply sell its stock without defeating indexation—and so must become active in monitoring and voting.

Institutional shareholders have in some dramatic instances been successful in asserting their new power. In the 1990s, under pressure from institutional shareholders, corporate boards of prominent corporations (such as General Motors, Sears, American Express) ousted management, divested businesses, made structural governance changes, and revised dividend policies. Nonetheless, the corporate financial scandals of the early 2000s and the collapse of the largest U.S. investment banks in 2008 have led many to question the effectiveness of institutional shareholders in monitoring and disciplining wayward management. Moreover, diversification requirements (often imposed by law) prevent many institutional shareholders from holding a meaningful percentage of stock in a given company, thus diluting their effectiveness as monitors.

The story of institutional activism is still evolving. In the late 1980s and early 1990s, institutional shareholders used a strategy of confrontation. In record numbers insurgents proposed alternative board slates and initiated proposals for structural reforms to enhance shareholder control. During the late 1990s, institutional shareholders turned to nonvoting strategies. Some larger institutions adopted policies of "relationship investing" to establish ongoing communications with company management. In the 2000s, many institutional shareholders have followed the voting recommendations of proxy advisory firms (such as Institutional Shareholder Services), which have assumed significant influence in the design of executive compensation packages and the terms of contested mergers. In addition, shareholder proposals on such governance matters as majority voting for directors and shareholder nomination of directors have received majority support, increasingly leading management to undertake reforms.

Lately hedge funds, which often buy positions in companies planning to sell after the company undertakes structural or governance changes, are becoming the most prominent shareholder activists. For some observers, hedge funds (with other institutional shareholders as their natural allies) realize the decades-old hope that institutional shareholders would be able to collectivize and serve as a disciplinary force for the benefit of all

shareholders. Hedge funds seem particularly suited to their activist role for a couple reasons. First, hedge fund managers are highly compensated for making successful investments and thus have incentives to undertake short-term turnarounds of portfolio companies. Second, hedge funds are expected to focus on achieving high absolute returns rather than returns pegged to a benchmark.

For others, hedge funds distort corporate governance by forcing managers to focus on short-term results, when most investors (such as employees in 401(k) retirement plans) would be better served by longer-term corporate planning. Activism by hedge funds, often supported by institutional shareholders (such as mutual funds, pension funds and insurance companies), may not be in the long-term interests of those who invest in these institutional intermediaries. That is, greater "shareholder power" may not necessarily translate into greater "investor protection."

§6.2.3 Voting Incentives for Public Shareholders

The greater activism of institutional shareholders in the governance of public corporations derives from the voting incentives large shareholders have compared to small shareholders. For a smaller shareholder who identifies value-producing reforms, there is little incentive to try to collectivize other shareholders. The insurgent must be prepared to commit significant time, money, and effort to overcome shareholder apathy. Expenses for an insurgent in a contested board election, for example, have been estimated to range between $5 million and $10 million.

If an insurgent loses, she absorbs the full costs of the contest; she cannot seek contribution from other shareholders or the corporation. If she wins, she may be able to obtain reimbursement from the firm, but any gains she creates will be shared with all other shareholders. Her portion of the gains is limited to her pro rata shareholding in the firm—usually quite small. In short, she must risk substantial amounts to create gains in which other shareholders will share even though they risked nothing. This "free rider" phenomenon leads rational small shareholders to do nothing to overcome voting "collective action" obstacles.

An insurgent's problems are compounded by the "rational apathy" of most small shareholders confronted with competing proxy solicitations. If an individual shareholder holds a small stake in a firm as part of a diversified

portfolio, he has little incentive to spend time educating himself about the merits of any given proxy contest. Is management doing poorly? Will the insurgents improve the company's performance? Small shareholders will perceive (rationally) that the time spent becoming familiar with the contestants and the issues will not be worth any potential gains to his portfolio. It is not surprising, given the informational position of most small shareholders, that they follow a general rule of thumb: Vote for the incumbents. Small shareholders, it is said, awaken from their apathy only when presented with a premium bid in a takeover.

For larger shareholders, voting incentives are very different. Institutional shareholders have much larger stakes in individual companies, and there are fewer of them. It is not unusual in larger U.S. companies for the company's top ten institutional shareholders to hold 20—30 percent of its voting shares. Collective action by institutions is also easier under SEC rules that since 1992 have facilitated shareholder communications. In addition, for institutional shareholders it is not rational to be apathetic about the corporation's management and reform possibilities. Even though an institutional activist must share any gains it produces with all other shareholders, the institution's larger shareholding (and the greater ease in forming shareholder coalitions) may make its activism worth the effort. Finally, institutional shareholders (indexed or not) cannot easily exercise the "Wall Street rule" and sell their stock when they become dissatisfied with management. The very selling of a large block of stock drags down the stock's market price.

Hedge funds (largely unregulated investment pools for wealthy individual and institutional investors) have also changed the U.S. corporate governance landscape. Activist hedge funds make money for their investors by identifying under-performing public companies and then seeking, through proxy fights or litigation, to oust the company's incumbent management or change its business strategies. Hedge funds have enlisted the support of institutional shareholders, both through their voting and the lending of voting shares to the hedge funds.

In addition to activism by hedge funds, voting recommendations by proxy advisory firms (particularly Institutional Shareholder Services, or ISS) have been influential in how shareholders, especially institutional shareholders, vote on such matters as contested mergers, shareholder proposals on governance topics, "just say no" campaigns against individual directors, and

lately “say on pay” proposals in which shareholders indicate their support (or opposition) to the company’s executive pay practices. The ISS posts voting guidelines for how it will advise shareholders to vote—and corporate boards will often tailor their actions to conform to the guidelines.

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§6.3 SHAREHOLDER VOTING IN CLOSE CORPORATIONS

In closely held corporations (those with few shareholders and no ready market for their shares), things are quite different. (See Chapter 25.) Shareholders who own a majority of the shares can exercise their voting power to elect the board, giving these owners virtually unfettered control of the business. Controlling shareholders, who often rely on the corporation as a source of livelihood, assume a far more active role in the corporation’s governance than the statutory model contemplates.

For minority shareholders in a close corporation, voting rights are usually not a meaningful protection. Nor can these shareholders sell their shares in a public market if they become displeased with the majority’s management. Instead, minority shareholders must negotiate for special voting rights (such as supermajority voting, see §26.1.1; cumulative voting, see §26.1.2; or class voting, see §26.2.2) or negotiate limits on the majority’s discretion, specifying by agreement how the corporation is to be run (see §26.4). They may require that, as in a partnership, important decisions be made by unanimous consent (see §26.4), or they may negotiate for contractual withdrawal rights comparable to those of partners on dissolution (see §26.3).

CHAPTER 7

Voting Structure

Voting by shareholders is prescribed by corporate statutes. Modern statutes are mostly enabling, authorizing a wide variety of voting schemes as specified in the corporate articles and bylaws. Yet corporate law defines an immutable core. Shareholders must receive voting rights; elections of directors must occur with regularity; shareholders must approve any fundamental corporate transactions; shareholders must have access to specified corporate information; shareholders' meetings must comply with minimal procedures; and shareholders must be able to remove wayward directors.

This chapter describes the matters on which shareholders can vote and the information to which they are entitled (§7.1), how shareholders vote and the nature of shareholders' meetings (§7.2), and the methods by which shareholders select the board (§7.3). The next chapter describes judicial protection of shareholder voting, which derives from essential aspects of the statutory voting structure—such as the requirement of regular shareholder meetings and the prerogative of shareholders to choose the composition of the board. The following chapters describe federal proxy regulation, which piggybacks on the state-enabled voting scheme by overlaying a system of mandatory disclosure in public corporations (Chapter 9) and proxy fraud rules that apply when public shareholders exercise their voting rights (Chapter 10).

§7.1 SHAREHOLDERS' GOVERNANCE ROLE

The traditional corporate model gives shareholders—the "electorate" of the corporate republic—an oversight role in corporate governance. Shareholders can choose the board's composition, vote on fundamental corporate changes, and initiate corporate reforms. To protect these powers, corporate law gives shareholders access to specified information and judicial recourse.

Note on Voting Rights

Generally, common shares carry voting rights, though some classes of common shares are issued with limited or even no voting rights. Treasury shares (that is, common shares repurchased by the corporation) do not have voting rights. But common shares held by the corporation in a fiduciary capacity, such as in a pension plan, do have voting rights. Preferred shares sometimes have voting rights, though they may be conditioned on certain events (such as a longstanding failure to pay dividends) or limited to certain matters (such as charter amendments that negatively affect the rights of preferred shares). As a general matter, debt does not carry voting rights.

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§7.1.1 Election and Removal of Directors

Shareholders have the power to elect directors at the initial shareholders' meeting and then at every annual meeting thereafter. MBCA §8.03(d); Del. GCL §211(b). Shareholders can also remove directors before their term expires—for cause or without cause depending on the statute and the articles of incorporation. MBCA §8.08 (with or without cause). Control over the composition of the board is at the heart of the shareholders' governance role (see §7.3 below).

§7.1.2 Approval of Board-Initiated Transactions

Shareholders have the power to approve some transactions initiated by the board.

Fundamental Corporate Changes

Shareholders are entitled to vote on fundamental corporate changes initiated by the board of directors, including amendments to the articles of incorporation (MBCA §10.03; Del. GCL §242), mergers with other corporations (MBCA §11.04; Del. GCL §251), sales of substantially all of the corporate assets not in the regular course of business (MBCA §12.02; Del. GCL §271), and voluntary dissolutions (MBCA §14.02; Del. GCL §275). Fundamental corporate changes and accompanying voting rights are more fully described in Chapters 35 and 36.

"Dilutive" Issuance of Shares

Shareholders are entitled to vote when the corporation issues shares that will significantly dilute existing shareholders. Under both the MBCA and stock exchange rules for listed companies, prior shareholder consent is required when the shares to be issued have at least 20 percent of the voting power of the voting shares outstanding before the issuance. See MBCA §6.21(f); NYSE Rule 312.03(c)(2); NASDAQ Rule 4350(i)(1)(C)(ii)(b) (similar).

Conflicting Interest Transactions

Shareholders sometimes are permitted to vote (when the board permits it) on transactions with the corporation in which directors have a conflict of interest, such as when the board contracts work to another company owned by a director's family member. MBCA §8.63; Del. GCL §144(a)(2). In addition, shareholders are permitted to vote to approve the indemnification of directors, officers, or others against whom claims have been brought because of their relationship to the corporation. MBCA §8.55(b)(4); Del. GCL §145(a) (see Chapter 15).

§7.1.3 Shareholder-Initiated Changes

Shareholders can initiate *on their own* changes in corporate governance and structure.

Amendment of Bylaws

Shareholders have the power to adopt, amend, and repeal the bylaws—the governance document that specifies the internal functioning of the

corporation. See MBCA §10.20; Del. GCL §109 (board also has power, if in the articles). Even if the board shares the power to amend the bylaws, whether by statute or in the articles, the board's power is coterminous with the shareholders. See Official Comment to MBCA §10.20 ("shareholders always have the power to amend or repeal the bylaws"); Del. GCL §109(a) (board power does not divest or limit power of shareholders). Many states do not permit the board to amend bylaws approved by shareholders. MBCA §10.20(a)(2) (if shareholder-approved bylaw "expressly" so provides).

What is the scope of the shareholders' power to amend the bylaws? The question has become more important as institutional activism has increased. In a case of first impression, the Oklahoma Supreme Court held that Oklahoma law permits shareholders to adopt a bylaw that restricts board implementation of shareholder rights plans (see §39.2.3). *Int'l Brotherhood of Teamsters General Fund v. Fleming Cos.*, 975 P.2d 907 (Okla. 1999). Not finding any statutory or case law in Oklahoma that suggested rights plans were the exclusive province of the board of directors, the court concluded that a bylaw requiring any rights plan to be submitted to shareholders at the next annual meeting was within "the proper channels of corporate governance."

In a case with wide-ranging implications, the Delaware Supreme Court held that a bylaw *requiring* the reimbursement of election expenses (see §8.1.2) to shareholders who successfully propose a dissident "short slate" (fewer than half the directors on the board) would violate Delaware law. *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008) (issued in response to SEC certification of legal question). The court concluded that the bylaw would unlawfully prevent directors from exercising their full management discretion if their fiduciary duties required them to deny expense reimbursement for such a slate. That is, the power of shareholders to amend the bylaws under Del. GCL §109(a) must be consistent with the power of the board to manage the corporation under Del. GCL §141(a).

At the same time, the Delaware court stated that the proposed bylaw related to the process of director elections and was a proper subject for shareholder action under Delaware law. Thus, it would have been valid had it contained a "fiduciary out" that permitted the board to deny reimbursement if required by the directors' fiduciary duties. Although bylaws may not "mandate how the board should decide specific substantive business decisions," they may "define the process and procedures by which those

decisions are made."

What if a controlling shareholder seeks to amend the bylaws for the shareholder's selfish reasons? The Delaware courts have held that bylaw amendments initiated by a controlling shareholder are invalid if they have an inequitable purpose and effect. See *Hollinger International, Inc. v. Black*, 844 A.2d 1022 (Del. Ch. 2004), *aff'd*, 872 A.2d 559 (Del. 2005) (invalidating bylaw amendments approved by controlling shareholder that sought to strip independent directors of their power to consider strategic direction opposed by controlling shareholder).

Amendment of Articles

Most statutes give the board of directors the exclusive power to initiate amendments to the articles of incorporation. See MBCA §10.03(b); Del. GCL §242(b). A few statutes, however, permit shareholders to initiate these amendments, and others describe the procedure for their adoption without specifying who initiates the amendment.

Most statutes do not permit shareholders to initiate other corporate actions even when they are entitled to approve the action. In most states the board must initiate mergers, sales of substantially all assets, and voluntary dissolution—the shareholders are entitled only to approve or reject the board's initiatives. MBCA §11.04, Del. GCL §251(a) (merger); MBCA §12.02, Del. GCL §271(a) (sale of all assets); MBCA §14.02, Del. GCL §275(a) (dissolution).

Nonbinding Recommendations

Shareholders can make nonbinding, precatory recommendations about governance structures and the management of the corporation, including matters entrusted exclusively to the board. In public corporations, such recommendations are often brought as shareholder proposals under the procedures of SEC Rule 14a-8 (see §9.4.2). Lately, the making of these proposals has moved management to undertake significant reforms, particularly in matters of corporate governance.

In the leading case on the subject, the court held that shareholders could properly make a nonbinding recommendation that the corporation's former president be reinstated, even though the recommendation had no binding effect on the board. *Auer v. Dressel*, 118 N.E.2d 590 (N.Y. 1954). The court reasoned that shareholders can express themselves on corporate matters to

put directors on notice—a kind of nonbinding poll.

§7.1.4 Informational Rights

To facilitate shareholders' voting powers, corporate law gives shareholders the right to receive information from the corporation—in the form of regular financial reports and the right to inspect corporate books and records.

Financial Reports

The MBCA, but not Delaware's corporate statute, requires the corporation to provide shareholders with annual financial information, including an end-year balance sheet, income statement, and statement of changes in shareholders' equity (see §31.2.2 for accounting description). MBCA §16.20. The financial information must be audited by a public accountant or include a statement by a corporate official either that the information was prepared on the basis of "generally accepted accounting principles" or that explains any deviations from GAAP.

For close corporations, these reports constitute the only periodic disclosure to shareholders mandated by law. (Federal securities law requires public corporations to prepare, file, and disseminate annual and quarterly reports. See §§9.3.1, 21.2.) Unlike the disclosures made by public corporations, which are available to the public after filing with the SEC, the financial information prepared by close corporations need not be publicly disclosed. The only requirement is the filing of an annual report with the state's secretary of state, which sets forth the name and address of the corporation (and registered agent), the names and business addresses of its directors and principal officers, a brief description of its business, and information on shares authorized and issued. MBCA §16.22; cf. Del. Corp. Franchise Law §502 (annual franchise tax report, requiring similar information but not business description or information on corporate officers, except one signing report).

Inspection of Corporate Books and Records

Corporate statutes codify shareholders' common law rights to inspect corporate books and records. MBCA §16.02; Del. GCL §220. Most statutes extend inspection rights to beneficial owners, not just record shareholders. MBCA §16.02(f); Del. GCL §220(a)(2). ("Record shareholders" appear as

owners of shares on the company's records; "beneficial owners" have voting and investment power over shares held in record name by another person, typically a brokerage firm.)

The MBCA and Delaware's corporate statute specify somewhat different inspection rights. Delaware's statute makes shareholder lists available as of right 10 days before a shareholders' meeting. Del. GCL §219(a). Books and records (a broad category under Delaware law) and a shareholders' list more than 10 days before a shareholders' meeting are available for inspection upon a showing of a "proper purpose." Del. GCL §220(b).

The MBCA makes the articles of incorporation, bylaws, and minutes of shareholders' meetings available as of right. MBCA §§16.01(e), 16.02(a). The MBCA makes other records—such as board minutes, accounting records, and shareholder lists—available for inspection only upon a showing of a "proper purpose." MBCA §16.02(b), (c).

Courts have found a proper purpose if the shareholder's request for records relates to the shareholder's interest in his investmentin the corporation—such as to investigate corporate wrongdoing, to bring a shareholder lawsuit, or to initiate a takeover or a proxy contest. Thus, management must provide internal financial records to a shareholder seeking to value her investment or uncover mismanagement. See *Security First Corp. v. U.S. Die Casting and Dev. Co.*, 687 A.2d 563 (Del. 1997) (stating that shareholder has burden to show credible evidence of possible mismanagement to obtain inspection of books and records).

But management need not provide records to a shareholder planning to give them to competitors or seeking to advance a political agenda unrelated to his investment. Cf. *Conservative Caucus v. Chevron Corp.*, 525 A.2d 569 (Del. Ch. 1987) (permitting inspection of shareholders' list by shareholder seeking shareholder support of a proposal that corporation stop doing business in communist Angola given alleged economic risks to corporation); *State ex rel. Pillsbury v. Honeywell, Inc.*, 191 N.W.2d 406 (Minn. 1971) (denying inspection of shareholders' list by shareholder seeking to communicate antiwar beliefs to other shareholders).

Lately, the right to inspect "books and records," particularly under Delaware's inspection statute, has proved an indispensable tool for shareholders seeking to file derivative suits or class actions. See *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) (suggesting that plaintiffs have "tools at hand" to develop necessary facts for pleading purposes in derivative suit

challenging executive compensation). Inspection is all the more important because discovery is not available in defending a motion to dismiss on the grounds of demand futility in Delaware derivative litigation (see §18.3.3) or failure to allege particular facts creating a strong inference of scienter in a federal securities fraud class action (see §22.3.2).

In Delaware, the requesting shareholder must identify specific, already-existing documents and show how they are "essential" to the articulated purpose for the documents. See *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113 (Del. 2002) (allowing inspection of third-party documents). A shareholder seeking to investigate corporate wrongdoing must present evidence establishing a "credible basis" of possible wrongdoing; a mere suspicion is not enough. See *Seinfeld v. Verizon Communications, Inc.*, 909 A.2d 117 (Del. 2006) (disallowing inspection of documents related to allegedly unauthorized and excessive executive compensation). In addition, shareholder-plaintiffs who bring derivative suits may seek inspection even during the course of the litigation, though it is "preferable" to file a suit for books and records before beginning derivative litigation. See *King v. VeriFone Holdings, Inc.*, 12 A.3d 1140 (Del. 2011).

Many large businesses are organized using parent-subsidiary structures. In 2003, Delaware revised Del. GCL §220 to allow for inspection of the "books and records" of a Delaware corporation's subsidiaries, provided the corporation could obtain such documents through the exercise of control over the subsidiary. Under §220, such inspection can be denied if it would violate an agreement between the corporation and the subsidiary or if the subsidiary has a legal right under applicable law (such as that of the jurisdiction of its incorporation) to deny inspection.

The right to a shareholders' list, valuable to a proxy insurgent, creates some ambiguity. Most statutes specify a "shareholder list," without specifying whether it refers to the relatively useless "stock ledger" list of record shareholders or the more valuable computer-readable list of beneficial (or "street name") owners. Courts have generally not required that management create a list not already in existence.

Note on Inspection Rights in LLC

Most LLC statutes provide their members inspection rights similar to

(and sometimes more extensive than) those provided shareholders. See ULLCA §408(a) (inspection for "proper purposes"). For example, Wisconsin LLCs must provide any member upon "reasonable request … true and full information of all things affecting the member." See *Kasten v. Doral Dental USA, LLC*, 733 N.W.2d 300 (Wis. 2007) (interpreting statute to be limited to "things" affecting financial interest of member). Whether an LLC member's request is reasonable (much like a shareholder request for inspection) depends on its scope, the reasons for the request, the importance of the information to the member, and whether the information could be obtained elsewhere. See *Sanders v. Ohmite Holding, LLC*, 17 A.3d 1186 (Del. Ch. 2011) (permitting LLC member to seek inspection of books and records for period before becoming member).

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§7.1.5 Enforcement of Shareholder Rights

Shareholders can enforce their voting powers and informational rights in *direct* actions against the corporation or directors. In some situations, corporate statutes specify expedited judicial review and summary orders. See MBCA §7.03, Del. GCL §211(c) (summary order for failure to hold annual or special meeting); MBCA §16.04(a) (summary order for inspection of corporate information); MBCA §16.04(b) (expedited review of shareholder application for inspection of board records, accounting information, and shareholder lists); Del GCL §220(c).

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§7.2 MECHANICS OF SHAREHOLDERS' MEETINGS

For the most part, shareholders act by voting at formal meetings. The statutory rules for shareholders' meetings are meant to assure informed, majority suffrage. They specify how meetings are called, the notice shareholders must receive, the number of shares that must be represented at a meeting, and the manner in which votes are counted.

§7.2.1 Annual and Special Meetings

There are two kinds of shareholders' meetings: annual (or regular) meetings at which directors are elected and other regular business is conducted (MBCA §7.01, Del. GCL §211(b)) and special meetings called in unusual circumstances where shareholder action is required. MBCA §7.02.

Bylaws usually specify the timing and location of the annual meeting. Cf. Del. GCL §211(c) (permitting board to hold meeting by "remote communication" without physical location). All corporate statutes require an annual meeting, and many permit shareholders to apply to a court to compel a meeting if one is not held within a specified period. See MBCA §7.03(a)(1) (within 6 months of end of fiscal year or 15 months of last annual meeting); Del. GCL §211(c) (within 30 days after designated date or 13 months after annual meeting).

Special meetings to vote on a merger or take other extraordinary action must be specially called by the board, the president (if allowed by statute or in the bylaws), shareholders who hold a requisite number of shares (as specified in the statute or bylaws), or other persons designated in the bylaws. See MBCA §7.02 (special meetings can be called by board, person authorized in articles or bylaws, or shareholders holding 10 percent of the voting shares); cf. Del. GCL §211(d) (special meeting can be called only by board or person authorized in certificate or bylaws).

The shareholders' meeting is conducted by a chair as designated in the bylaws or by the board. The chair has wide latitude to decide the order of business and the rules for conducting the meeting. See MBCA §7.08. The meeting need not be conducted according to Robert's Rules of Order, and the corporation can have bylaws that require advance notice of any shareholder nominations or resolutions.

§7.2.2 Notice

Shareholders entitled to vote must be given timely written notice of annual and special meetings.

Record Date

To determine which shareholders are entitled to vote, the board sets a *record date* before the shareholders' meeting. MBCA §7.07 (record date may not be

more than 70 days before meeting); cf. Del. GCL §213(a) (no more than 60 days nor less than 10 days before meeting). Only shareholders "of record" whose holdings are reflected on the corporation's books as of that date—sometimes referred to as *record owners*—are entitled to notice and to vote.

Contents of Notice

In general, the notice requirements under state law are minimal. The notice describes the time and location of the meeting and sometimes summarizes the matters to be considered. MBCA §7.05; Del. GCL §222 (including for meeting by means of "remote communication"). For *annual* meetings at which only directors will be elected and other ordinary matters discussed, the notice need only state the date, time, and place of the meeting. MBCA §7.05; Del. GCL §222. Under some statutes, if any extraordinary matter will be discussed at an annual meeting, notice of the matter must be given. Notice of *special* meetings must specify the purposes of the meeting as well as time and location of the meeting. MBCA §7.05(c); Del. GCL §222(a).

State-required notice is thus perfunctory compared to the detailed federally mandated disclosure required in proxy statements in public corporations (see §9.3.1).

Timing of Notice

For both annual and special meetings, the notice must arrive in time for shareholders to consider the matters on which they will vote, but not so early that the notice becomes stale. Many statutes require that notice be given at least 10 days, but no more than 60 days, before a meeting. MBCA §7.05(a); Del. GCL §222(b).

Defective Notice

Shareholders can waive notice before, at, or after the meeting. MBCA §7.06; Del. GCL §229. Many statutes provide that a shareholder's attendance at a meeting (other than to object to improper notice) constitutes a waiver of notice. MBCA §7.06(b); Del. GCL §229. If notice is defective and the defect is not waived by all affected shareholders, the meeting is invalid and any action taken at the meeting is void.

§7.2.3 Quorum

For action at a shareholders' meeting to be valid, there must be a quorum. Statutes typically set the quorum as a majority of shares entitled to vote. MBCA §7.25(a); Del. GCL §216(a). Quorum requirements prevent a minority faction from acting at a shareholders' meeting without the presence of a majority. Some statutes allow the quorum to be reduced in the articles or bylaws to one-third. Del. GCL §216(a); but see MBCA §7.25(a) (allowing reduction in the articles without limitation).

Once there is a quorum at a meeting, most statutes provide that it cannot be broken if a shareholder faction walks out in the middle of the meeting. MBCA §7.25(b). Refusing to attend a meeting, however, may be a useful tactic for shareholders seeking to exercise their control rights. In close corporations a unanimous quorum requirement is sometimes used to ensure minority shareholders have a veto. See §26.1.1.

§7.2.4 Appearance in Person or by Proxy

Shareholders can appear at a shareholders' meeting, for purposes of a quorum and to cast their votes, either in person or by proxy. MBCA §7.22(a); Del. GCL §212. If voting is by proxy, state statutes require only that the proxy appointment be in writing and signed, including by electronic transmission. See MBCA §7.22; Del. GCL §212(b). The proxy, which creates an agency relationship in which the shareholder (the principal) grants the proxy holder (the agent) the power to vote her shares, can give the proxy holder full discretion or be subject to specific instructions. Unless irrevocable, the proxy can be revoked by the principal at any time by (1) submitting written notice with the corporation of an intent to revoke, (2) appointing another proxy holder in a subsequently dated proxy, or (3) appearing in person to vote. (The validity of irrevocable proxies and their use as a control device in close corporations is taken up in §26.2.3.)

In general, corporate statutes limit the duration of a proxy to 11 months—long enough for only one annual shareholders' meeting. MBCA §7.22(c); cf. Del. GCL §212(b) (three years).

§7.2.5 Voting at Shareholders' Meetings

Who Votes

Only shareholders of record actually cast votes. If shares are held by a nominee, as happens in most public corporations (see §19.2.1), the actual owners ("beneficial owners") must instruct the record owner how to vote their shares or to whom to give a proxy.

In general, each share is entitled to one vote. See MBCA §7.21 (each outstanding share, regardless of class); Del. GCL §212(a). The articles can specify multiple classes of shares with voting rights, including on a conditional or special basis. See MBCA §6.01(b) (requiring that articles authorize one or more classes of shares that together have unlimited voting rights). For example, preferred shares (see §4.1.3) often receive voting rights to elect a majority of the board whenever dividends on the preferred shares have not been paid for a given period. Some statutes even permit bondholders to have voting rights. See Del. GCL §221.

The articles can deviate from the one-share/one-vote standard and create, for example, supervoting shares or voting caps on any shareholder who holds a specified percentage of shares. See MBCA §6.01(c)(1) (permitting special, conditional, or limited voting rights, or no right to vote); *Providence & Worcester Co. v. Baker*, 378 A.2d 121 (Del. 1977) (upholding charter provision that reduced voting rights to one vote per 20 shares for any shareholder who owned more than 50 shares and capped voting rights for any shareholder who owned more than 25 percent of the company's shares).

In the late 1980s, the SEC attempted to federalize the one-share/one-vote rule by mandating that the U.S. stock exchanges delist any company that created different classes of voting shares, such as through a reclassification in which management holds supervoting shares and public shareholders low-voting shares. SEC Rule 19c-4 (1988). The SEC rule was struck down as an unauthorized federal intrusion into state corporate law. *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990). Nonetheless, bowing to congressional pressure, the stock exchanges voluntarily instituted a one-share/one-vote requirement for listed companies along the lines of the SEC rule.

Corporate statutes prohibit a majority-owned subsidiary (that is, a corporation whose voting shares are majority-owned by another corporation) from voting the shares of the parent corporation. See MBCA §7.21(b); Del. GCL §160(c). This circular voting arrangement, if permissible, would enable a corporation's board to dilute the voting rights of the corporation's shareholders by placing the corporation's voting shares in a controlled subsidiary, which would vote them as directed by the corporation's board.

Majority Vote

Under many statutes, shareholder approval of board-initiated transactions—such as mergers, sale of assets, or dissolution—requires the favorable vote of an *absolute majority* of the outstanding shares entitled to vote. See Del. GCL §242(b) (charter amendment), §251(c) (merger), §271(a) (sale of assets), and §275(b) (dissolution). This means abstentions and no-shows effectively count as votes against the proposal. For example, if there are 1,000 voting shares outstanding and a quorum of 600 are represented at a meeting, a proposal must garner at least 501 votes to be approved.

Other statutes require shareholder approval only by a majority of shares represented at a meeting at which a quorum is present—a *simple majority*. See MBCA §7.25(c) (revised in 1999); Del. GCL §216(2) (unless specified otherwise). In the example above, a proposal would be approved if it received at least 301 votes. This means abstentions of shares represented at a meeting count as votes against the proposal, but shares not represented are neutral.

According to corporate statutes, voting for directors is not by majority vote, but instead by *plurality vote*. See MBCA §7.28(a); Del. GCL §216(3). This means that a director is elected if there are more votes for him than for other candidates. For example, if three board positions are open, the three candidates receiving the most votes are elected—even if none receives a majority. Unless the articles (or sometimes the bylaws) specify otherwise, abstentions or withheld votes (even if a majority) do not count against a director. See §7.3.2 below. In the past few years, however, many public companies (in fact, 99 of the 100 largest public companies) have abandoned plurality voting and have amended their articles or bylaws to adopt majority voting—with the result that no director can be seated without receiving a majority of shareholder votes. See Del. GCL §216 (shareholder-approved bylaw amendment specifying vote needed to elect directors may not be amended by board).

Election Inspectors

To determine the shares represented at a meeting, count votes, determine the validity of proxies, and resolve voting disputes, state statutes authorize the corporation to appoint inspectors to inspect proxies and votes. MBCA §7.24; Del. GCL §231. Often the corporation's accounting firm is chosen as election inspector.

The inspector's actions are subject to judicial review, though under standards deferential to the inspector's good faith judgment. Inspectors have broad latitude to accept facially valid proxies or reject those that raise reasonable doubts. Given their ministerial role, however, inspectors may not resort to extrinsic information (beyond the face of the proxy) to decide the validity of proxies. See *Salgo v. Matthews*, 497 S.W.2d 620 (Tex. App. 1974) (refusing to require the inspector to investigate beneficial ownership of bankrupt record owner); Del. GCL §231(d) (permitting the inspector to examine extrinsic information, but only to reconcile inconsistent proxies). The corporation and its election inspectors are not liable in damages for accepting or rejecting proxies in good faith. MBCA §7.24(d).

§7.2.6 Action by Consent

Under most statutes, shareholders can act without a meeting by giving their written consent. See Del. GCL §211(b) (permitting annual meeting by written consent). Action by consent has the same effect as action at a valid shareholders' meeting. Some statutes that allow the procedure require shareholder consent to be unanimous. MBCA §7.04(a). But most states, including Delaware, now require only that the consents represent the minimum number of shares that would be required to approve an action if the meeting were actually held. Del. GCL §228 (no prior notice required). Thus, for action requiring an absolute majority, consent by a majority of outstanding shares suffices.

To determine which shares are entitled to act by consent, the board must set a record date or, if not, the record date is the first date that written consents are delivered to the corporation.

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§7.3 ELECTION OF DIRECTORS

§7.3.1 Qualifications and Number of Directors

Directors need not be shareholders, residents of the state of incorporation, or have any other special qualifications. MBCA §8.02; Del. GCL §141(b). The statutes require only that directors be individuals (sometimes at least 18 years old) who meet the qualifications (if any) prescribed in the articles or bylaws.

The number of directors on the board is specified in the articles or the bylaws. MBCA §8.03(c); Del. GCL §141(b). Frequently, the articles specify a variable range, with the actual number of directors fixed in the bylaws. The range can be changed only with shareholder approval, but the number of directors within the range can be set by the board. Many statutes once required a minimum of three directors, but most now permit a board of one director. MBCA §8.03(a); Del. GCL §141(b).

§7.3.2 Voting Methods

General Rule—Annual Election by Straight Voting

Generally, all directors face election at each annual shareholders' meeting. MBCA §8.03(d); Del. GCL §211(b). The general method for electing directors is by straight (plurality) voting—the top vote-getters for the open seats are elected. MBCA §7.28(a); Del. GCL §216(b). Under straight voting, shareholders vote their shares for each open directorship, which means a shareholder holding a majority of the shares can elect the entire board of directors.

To illustrate, suppose the articles of AB Corp. authorize five directors and there are two shareholders: Alphonse owns 51 shares and Byron owns 49 shares. Under straight voting, Alphonse and Byron would each cast their votes five times for five different candidates. Each of Alphonse's five candidates would receive 51 votes; each of Byron's five candidates would receive 49 votes. Alphonse's slate—the top five vote-getters—is elected.

Cumulative Voting

To ensure board representation for larger minority shareholders, some state statutes (and even some state constitutions) require cumulative voting. In the remaining states, cumulative voting is permissive and applies if adopted in the articles or sometimes the bylaws. See MBCA §7.28 (articles); Del. GCL §214 (certificate of incorporation).

Cumulative voting, unlike straight voting, allows minority shareholders to accumulate all of their votes and allocate them among a few or even one candidate. This increases the chances of board representation for minority shareholders. Cumulative voting, however, only applies to electing directors, not to shareholder voting on other matters.

The operation of cumulative voting can be tricky and involves some arithmetic. Suppose that Alphonse has 70 shares and Byron 30 shares. Under cumulative voting in an election of five directors, Alphonse would have a total of 350 (70 times 5) votes to distribute among his candidates as he chooses; Byron would have 150 (30 times 5) votes. If Byron votes intelligently, cumulative voting assures him at least one director. If Byron casts all of his 150 votes for his candidate, Alphonse cannot prevent the candidate's election. But Alphonse, if careful, can cast his 350 cumulative votes to elect the four other directors.

Cumulative voting has pitfalls for the unwary. If Alphonse spreads his votes unevenly or too thinly, he might elect only three or even fewer directors. Suppose Alphonse casts his votes and Byron responds as follows:

Alphonse (350 votes)		**Byron (150 votes)**	
Agatha	150	Bernice	50
Arthur	150	Bertrand	50
Alexis	20	Beatrice	50
Andrew	20		
Astor	10		

The top five vote-getters are Agatha, Arthur, Bernice, Bertrand, and Beatrice. By his inept voting, Alphonse placed only a minority of directors on the board despite owning 70 percent of the voting shares. To avoid such surprises, many statutes require advance notice of cumulative voting. Either the notice of the shareholders' meeting must state that cumulative voting is authorized or a shareholder planning to exercise her cumulative voting right must give notice before the meeting. MBCA §7.28(d) (notice to shareholders must be "conspicuous" or shareholder must give notice within 48 hours of meeting). How should Alphonse and Byron plan their strategies? There is a mathematical formula for determining how many shares assure the election of a director (or a given number of directors) and thus the optimal voting strategy under cumulative voting:

$$E = (N \times S)/(D + 1) + 1$$

where

E = number of shares needed to elect desired number of directors
N = number of directors that shareholder desires to elect
S= total number of shares authorized to vote

D = total number of directors to be elected

The (N x S)/(D + 1) part of the formula represents the equilibrium point where there would be a voting tie. To break the tie, a shareholder needs only a fraction more—hence the formula's requirement that something be added. Unless the corporation recognizes fractional voting, the needed shares must be pushed up to the next whole number, either by rounding up or adding one. In our example, where AB Corp. has 100 voting shares and five directors are to be elected, the formula produces the following results:

Number of directors you want to elect	Number of whole shares you need
1 director	100/6 + fraction = 16.67 + fraction = 17
2 directors	200/6 + fraction = 33.33 + fraction = 34
3 directors	300/6 + fraction = 50 + 1 = 51
4 directors	400/6 + fraction = 66.67 + fraction = 67
5 directors	500/6 + fraction = 83.33 + fraction = 84

According to this table, Alphonse's 70 shares assure him of electing at least four directors because he holds more than 67 shares but less than 84. If Alphonse casts all of his votes equally (or nearly so) for four candidates, he can elect four directors. Byron is assured of electing only one director because his 30 shares are greater than 17 but less than 34. Byron should cast all of his votes for one candidate to assure representation on the board.

Cumulative voting is not the only way to assure board representation. In close corporations with few shareholders, board representation can be assured by agreement (see §26.2) or classes of stock (see below). Cumulative voting is unusual in public corporations and is found most often in middle-sized corporations with approximately 50 to 500 shareholders.

Staggered Board

An exception to the one-year election cycle is a staggered (or classified) board, in which only some of the directors are elected at each annual meeting. A staggered board must be specified in the articles or, in some states, the bylaws. MBCA §8.06 (articles); Del. GCL §141(d) (charter, initial bylaws, shareholder-approved bylaws). A staggered board is classified into groups of directors, each group with a multiyear term. For example, on a twelve-person staggered board divided into three equal groups, only four directors are up for election each year, and each director's term is three years. To ensure a majority of the board is up for election at least every two years, many statutes

specify that there be no more than three groups of directors. MBCA §8.06; Del. GCL §141d.

There are a number of reasons for a staggered board, some less laudable than others. First, a staggered board assures greater continuity in board membership from year to year because all of the directors are not subject to annual recall. Second, a staggered board reduces the number of directors up for election each year, and a majority of shareholders can effectively avoid minority representation on the board even if there is cumulative voting. For example, if Alphonse and Byron have a corporation with a staggered board with two classes in which two directors are elected one year and the remaining three the next year, Alphonse's 70 percent share will allow him to elect all of the directors each year. Third, it takes longer for shareholders (even those holding a majority of a company's stock) to replace the members of a staggered board because only part of the board is up for election each year. For this reason, staggered boards (along with limitations on removing directors without cause) often are used by incumbent management to discourage unwanted takeovers (see §34.2).

In the past few years, under pressure from activist shareholders who have submitted shareholder proposals urging that all directors stand for election each year (see §9.4.2), many public companies have dismantled their staggered boards. In fact, from 2002 to 2008, the proportion of the 1500 largest pubic U.S. companies with staggered boards fell from 62 percent to 47 percent, and among the 100 largest public companies the proportion fell from 44 percent to 16 percent.

Class Voting

Board representation can also be built into the corporation's capital structure. MBCA §6.10(a); Del. GCL §151(a). The articles can specify that certain classes of stock elect their own directors. For example, AB Corp.'s articles might specify that Class A common shareholders elect three directors and Class B common shareholders elect two directors. Classifying the board, whether in a close or public corporation, can distribute representation between different shareholder camps.

Majority shareholders can also use class voting to undermine a minority shareholder's cumulative voting rights. By amending the articles to create a new class of stock and assuming ownership of the new class, the majority can elect a greater proportion of directors than had been the case under

cumulative voting. MBCA §8.04.

Holdovers

A director holds office until a successor is elected and qualified. MBCA §8.05(e); Del. GCL §141(b). This assures that the board remains intact and functional even if an annual shareholders' meeting is not held or there is a voting impropriety or a voting deadlock among shareholders. If a shareholder deadlock persists, some statutes permit a shareholder to petition a court for involuntary dissolution. See MBCA §14.30 (shareholder deadlock and failure to elect successor director for two consecutive annual meetings).

Enforcement

Shareholders may bring direct actions against the corporation for failure to seat a properly elected director. Procedural defects, such as election of the wrong number of directors or under an improper method, voids the election unless shareholders acquiesce in or ratify the results.

In addition, shareholders can sue the corporation if the board fails to observe procedural requirements intended to ensure full representation and board inclusiveness—such as notice, quorum, and voting rules at board meetings. See §7.1.5 above. Actions taken by the board that do not comply with these requirements are void, and shareholders can challenge them in a judicial proceeding.

§7.3.3 Removal of Directors

Built on the republican notion that legislators may remain in office during good behavior, the common law allowed shareholders to remove directors only for cause—such as fraud, criminal activity, gross mismanagement, or self-dealing. Most statutes today give shareholders greater latitude to remove directors during their term—with or without cause. MBCA §8.08(a) (removal with or without cause, unless articles specify otherwise); Del. GCL §141(k) (same). In addition, some states allow directors to be removed in a judicial proceeding brought by the corporation or by shareholders holding a specified percentage of shares. MBCA §8.09 (judicial removal for "fraudulent or dishonest conduct, or gross abuse of authority" when in the best interests of the corporation).

Procedures for Removal (Corporate Due Process)

When a director is to be removed (whether for cause or without), shareholders must be given specific notice that removal will be considered at a meeting. MBCA §8.08(d). In addition, directors to be removed for cause have corporate "due process" rights (a vestige of corporate republicanism) to be informed of the reasons for removal and to answer the charges. See *Campbell v. Loew's, Inc.*, 134 A.2d 852 (Del. Ch. 1957) (requiring service of specific charges, adequate notice, and full opportunity for director to meet accusations by a statement in company's proxy solicitation).

Removal under Cumulative Voting

To prevent the majority from circumventing minority representation under cumulative voting, nearly all state statutes specify that a director elected under cumulative voting cannot be removed if any minority faction, with enough shares to have elected him by cumulative voting, votes against his removal. MBCA §8.08(c) (the Official Comment indicates that this restriction applies whether removal is with or without cause); Del. GCL §141(k) (only for removal without cause). For example, if 20 shares would have been enough to elect a director under cumulative voting, then he cannot be removed if 20 shares are voted against his removal. Delaware courts, however, have treated removal *for cause* as an absolute prerogative of the majority. See *Campbell v. Loew's, Inc.*, 134 A.2d 852 (Del. Ch. 1957) (holding that stockholders have inherent power to remove directors for cause even if elected under cumulative voting).

Filling Vacancies

In general, the board or the shareholders can fill board vacancies created by the removal, death, or resignation of directors or the creation of new directorships. MBCA §8.10. Shareholders can exercise this power, however, only at an annual or special shareholders' meeting. See MBCA §7.21. Under some statutes, any midterm replacement (even if filling for a director with a staggered term) must stand for election at the next annual shareholders' meeting. See MBCA §8.05(d). Some statutes limit the board's authority to fill vacancies, particularly when directors are removed or new directorships created, on the theory that the board cannot usurp the shareholders' power to elect directors. Delaware courts have stated that shareholders have the

inherent right between annual meetings to fill newly created directorships. See *Campbell v. Loew's, Inc.*, 134 A.2d 852 (Del. Ch. 1957) (upholding proposal of minority faction to amend bylaws to increase size of board and fill vacancies with its candidates).

Examples

1. Graphic Designs, incorporated in an MBCA jurisdiction, designs and produces commercial art. Shirley is the majority shareholder and the dominant member of the five-person board of directors. The company president is Buck. Shirley offers her friend Jenny, a highly qualified commercial artist, a job at Graphic Designs.
   a. If Jenny accepts the offer, is the corporation bound under the agreement?
   b. Shirley, as majority shareholder, instructs the board and Buck to hire Jenny, but they balk. How can Shirley force the board or Buck to follow her instructions?
2. Graphic's five-person board authorizes Buck to fire all of the company's commercial artists and replace them with a computer that would generate graphic designs. Shirley is upset about the board's action.
   a. As majority shareholder, she signs and submits a written consent that purports to remove all of the directors. Will this work?
   b. She calls a special shareholders' meeting to remove the incumbent directors and Buck. Will this work?
   c. She calls a shareholders' meeting to vote on a shareholder resolution requiring the board to reverse its decision. Will this work?
3. Graphic's articles specify a board of between three and seven directors, the exact number to be "fixed by the board of directors in the bylaws." The current bylaws call for five directors. Shirley wants to change the balance of power on the board at the next annual shareholders' meeting by proposing
   a. an amendment to the articles that would fix the number of directors at seven, with any vacancies to be filled by the shareholders. Is this proper?
   b. an amendment to the bylaws that would increase the number of directors from five to seven. Is this proper?

c. an amendment to the bylaws that mandates that any shareholder must give notice of nominations to the board at least 60 days before the shareholders' meeting. Is this proper?

4. Mildred, a minority shareholder of Graphic, is convinced that Shirley's new directors—who dutifully rescinded the computer decision—were unduly influenced by the company's commercial artists. Mildred is considering a derivative suit against the directors.
   a. She wants to inspect minutes of last year's board meetings. Must the corporation provide the minutes?
   b. She wants to inspect Graphic's list of shareholders so she can contact them about joining her suit. Must the corporation provide the list?
   c. She wants the board to summarize its reasons for rescinding the computer decision. Must the board summarize its reasons?
5. Graphic's articles are silent on the question of how directors are elected. Nine directors sit on Graphic's board.
   a. How are Graphic's directors elected?
   b. Shirley owns 78 of Graphic's 100 shares. Mildred owns the remaining 22. How many directors can Mildred elect under a straight voting scheme?
6. Graphic's articles specify that the corporation's board is to be elected by cumulative voting. The bylaws specify a board of nine directors.
   a. With 22 of 100 shares, how many directors is Mildred assured of electing to the board?
   b. Shirley has heard that Mildred plans to cast her 198 cumulative votes in the following manner: Mary (66), Manny (66), Morton (66). Can Shirley take advantage of this information to increase her representation on the board?
7. Shirley becomes unhappy with the directors Mildred has elected to Graphic's board. With six of her nominees on the nine-person board, Shirley considers some strategies for the board to pursue. Consider the legality of
   a. an amendment to the articles that would eliminate cumulative voting.
   b. an amendment to the articles that would reduce the number of directors to three.
   c. an amendment to the articles classifying the nine-person board into

three groups, each group’s members coming up for election once every three years.

d. an amendment to the bylaws to stagger the board in this way.

8. Milton, one of Graphic’s directors elected by Mildred, has begun a competing graphic design business using secret customer lists he obtained as a director of Graphic.

   a. Before he does further damage, Shirley wants him removed from the board and calls a special meeting for that purpose. If Graphic’s articles state that directors can only be removed for cause, can she remove Milton?

   b. At the meeting, Shirley votes her 78 shares to remove Milton, and Mildred votes her 22 shares against removal. Is Milton removed?

   c. Shirley considers other options to remove Milton. What other recourse does she have?

   d. Milton resigns. Graphic’s articles state that “The board of directors shall have the authority to fill any midterm vacancies on the board.” Shirley nonetheless calls a special shareholders’ meeting to fill the vacancy left by Milton’s resignation. Can she?

Explanations

1. a. No. As a shareholder Shirley has no authority either to act on behalf of the corporation or to bind the corporation contractually. Unless the corporation has special governance arrangements that permit shareholders to act as partners, which must be stated in the articles, such authority resides solely with the corporation’s board of directors. MBCA §8.01(b).

   b. She cannot. Under the traditional corporate structure, Shirley is limited to electing directors and hoping they do as she wants. The board has the sole power to authorize Jenny’s employment and delegate this authority to a corporate officer. If the current directors and officers fail to authorize Jenny’s employment, Shirley has a couple of options. She can elect new directors at the next annual shareholders’ meeting and hope they comply with her wishes. MBCA §8.03(d). Or, as a 10 percent shareholder, she can call a special shareholders’ meeting to remove and replace the incumbent directors with others of her choosing. MBCA §8.08. The removal route, however, might be a problem if the articles

of incorporation or the statute allow removal only for cause or if the articles only allow the board to fill midterm vacancies. MBCA §8.10.

2. a. No. The MBCA, like many state statutes that allow shareholder action by written consent instead of a vote at a meeting, requires that the consent be unanimous. MBCA §7.04; cf. Del. GCL §228.

   b. In part. As the holder of more than 10 percent of Graphic's shares, she can demand a special shareholders' meeting. MBCA §7.02(a)(2) (demand on corporation's secretary). She must have a proper purpose for the meeting.

   Removal of directors is a proper purpose, but removal of officers is not. The MBCA permits shareholders to remove directors with or without cause. MBCA §8.08(a). The removal and appointment of officers, however, is within the sole discretion of the board of directors. MBCA §8.40(a) (appointment by board), §8.43(b) (board can remove officers with or without cause).

   c. No. Some courts have held that shareholders can approve nonbinding, precatory resolutions concerning the management of the corporation. (The SEC has adopted a similar view in its shareholder proposal rule, which requires that such resolutions be "significantly related" to the company's business and not related to "ordinary business operations." See §9.4.2.) Shirley's resolution, however, is not phrased as a request, but a demand. This shareholders cannot do.

   If her resolution had "urged" the board to reconsider its decision, it would satisfy the proper purpose requirement. By linking the board's decision to employee morale and arguably company profitability, the resolution properly relates to the corporation's economic well-being.

3. a. No. Amendments to the articles must be adopted by the board of directors for approval by the shareholders. MBCA §10.02.

   b. Yes. Shareholders have an inherent power to amend the bylaws. MBCA §10.20. Even though the bylaws state the power to fix the size of the board rests with the directors, the MBCA makes the board's power at most coterminous. According to the courts, this is a mandatory right that cannot be waived.

   An interesting question is whether the board could negate Shirley's bylaw amendment by changing the bylaws again to move the size of the board back to five. The MBCA explicitly provides that a

shareholder-initiated bylaw amendment cannot be altered by the board, if the amendment expressly so provides. MBCA §10.20(a)(2). To protect her initiative from circumvention, the revised bylaw should state that it can be revised or rescinded only by the shareholders.

c. Probably. Courts have permitted shareholder-proposed bylaws to amend the procedures by which directors are elected. *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008) (indicating shareholder-proposed bylaw amendment to require reimbursement of reasonable expenses of shareholder nominating a "short slate" of directors is valid, so long as directors are not prevented from exercising their fiduciary duties). In fact, advance-notice bylaws are common, and their validity has not been questioned.

4. a. Perhaps not. The MBCA permits shareholders to demand "excerpts from minutes of board meetings" if the demand is made for a "proper purpose." MBCA §16.02(b)(1), (c). Bringing a derivative action—for the benefit of the corporation and the shareholders as a group—would seem to be such a purpose. Nonetheless, her request as currently formulated may be too broad in that it seeks all board minutes for the past year and thus goes beyond the shareholder's interest in challenging the board's rescission of its computer decision. The MBCA requires that the records be described with "reasonable particularity" and that they relate "directly" to the stated purpose. The board could refuse her demand on this basis.

Support for a cautious understanding of the inspection right comes in a Delaware case where the court denied an inspection request by a public electronics company that had acquired a minority position in a family firm in the same line of business. *Thomas & Betts Corp. v. Leviton Mfg. Co.*, 681 A.2d 1026 (Del. 1996). The court found the minority shareholder's asserted purposes insufficient. First, the court found no "credible basis" for investigating possible waste and mismanagement. Second, the court concluded the public company had become a locked-in minority shareholder and had no reason to investigate the company's valuation.

Nonetheless, more recent Delaware cases have encouraged shareholders to seek inspection before bringing a derivative suit. Some have even reformulated the shareholder's request to ensure its validity.

b. Perhaps. A shareholder demand to inspect the shareholders' list must be for a proper purpose. MBCA §16.02(c). Courts have held that the burden to show an improper purpose is on the corporation. The corporation—that is, the board and current management—may argue that a shareholders' list is not relevant to bringing a derivative action. Courts, however, have interpreted the proper purpose test broadly. Unless Mildred seeks to use the list only to harass or advance her own personal interests, it would be enough if she argued that additional shareholder-plaintiffs will help defray the costs of the derivative litigation and add weight to the challenge of the directors' action.

c. Probably not. Most courts have limited shareholder inspection requests to documents already in existence. See *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113 (Del. 2002) (permitting inspection of documents prepared by third parties that predated the requesting shareholder's investment). To impose a duty to compile or assemble information would go well beyond the limited inspection rights provided by the statute.

5. a. Straight voting, each year. Under the MBCA, unless the articles specify otherwise, all directors are up for election at each annual shareholders' meeting. MBCA §8.05(b). Each Graphic shareholder may vote for nine director candidates, and the top nine vote-getters for the nine open seats are elected. MBCA §7.28(a) (plurality voting). Cumulative voting and staggered terms apply only if specified in the articles. See MBCA §§7.28(c), 8.06.

b. None. Under straight voting, Shirley and Mildred each will cast their votes nine times for nine candidates. Each of Shirley's nine candidates will receive 78 votes, and each of Mildred's will receive 22 votes. The nine top vote-getters will be Shirley's slate; Mildred does not have the power to elect any directors.

6. a.Two directors. The cumulative-voting formula provides the answer:

$$E = (N \times S)/(D + 1) + 1$$

where

E = number of shares needed to elect desired number of directors
N = number of directors that shareholder desires to elect

S = total number of shares authorized to vote
D = total number of directors to be elected

To assure herself seats on the board, Mildred needs the following:

Number of Directors	Number of Voting Shares
1 director	11 shares [1 × 100/(9 + 1) + 1]
2 directors	21 shares [2 × 100/(9 + 1) + 1]
3 directors	31 shares [3 × 100/(9 + 1) + 1]

Therefore, Mildred's 22 shares give her the power to elect at least two directors.

Under cumulative voting, Mildred will have a total of 198 votes (22 times 9) to distribute among her candidates. If she casts 99 votes for each of two candidates, there is no way Shirley can cast her 702 votes (78 times 9) so that *more* than seven of her candidates receive more than 99 votes. At best, Shirley can cast 100 votes for each of seven of her candidates, but she will have only two votes left to cast for her eighth and ninth candidates.

b. Yes. Shirley can distribute her 702 votes among nine candidates, casting 78 votes for each. Shirley will elect all nine directors in this way—the top nine vote-getters will all be her candidates. By spreading her votes among three candidates, Mildred dilutes her cumulative voting power.

7. a. Legal. Assuming the board proposes the amendment and shareholders approve it, the articles may be amended to delete a provision not required in the articles. MBCA §10.01(a). Cumulative voting under the MBCA is an opt-in right and can be removed by action of the board and majority approval of the shareholders.

To protect her right to minority representation from majority action, Mildred should have insisted on "anticircumvention" provisions in the articles. These provisions could have required, for example, that any changes to cumulative voting rights, the size of the board, the authorization and issuance of additional voting shares, or the staggering of directors' terms be approved by a supermajority vote. See §8.08(c) (director cannot be removed, if cumulative voting is authorized, if the votes sufficient to elect him voted against his removal).

b. Legal. As a practical matter, the reduction in board size will destroy the effectiveness of cumulative voting. Even though Mildred can continue to accumulate her votes, her 22 shares are no longer sufficient to elect a director. According to the cumulative-voting formula, a shareholder must have 26 voting shares to be assured of electing one director on a three-person board.

The effectiveness of cumulative voting is not assured under the MBCA. Nonetheless, the amendment would seem to "materially and adversely affect" Mildred's voting rights, and Mildred may have appraisal rights that allow her to dissent from the change and force the corporation in an appraisal proceeding to pay her the fair value of her shares. See MBCA §13.02(a)(4)(iv) (see Chapter 37).

c. Legal. The effect would be similar to reducing the size of the board. Mildred would no longer be assured the ability to elect a director despite her continuing right to cumulate her votes. Only three directors would come up for election each year, and Shirley could elect all of them. See *Humphreys v. Winous Co.*, 133 N.E.2d 780 (Ohio 1956) (upholding classification of board despite statute requiring cumulative voting).

d. Not legal. Shirley cannot adopt a classified board through a bylaw amendment. The MBCA requires that a staggered board be provided for in the articles. MBCA §8.06 (articles "may provide" for staggered terms); §8.05(b) (terms of "all directors" expire annually, unless terms are staggered under §8.06).

8. a. Yes. Milton's misappropriation of the company's trade secrets is not only illegal under state law, but also a breach of his fiduciary duties (see §16.2). There is cause for his removal.

b. No. Under the MBCA, Milton cannot be removed if the number of shares needed to elect him under cumulative voting are voted against his removal. MBCA §8.08(c). Eleven shares would have been sufficient to elect Milton [100/(9 + 1) + 1], and Milton cannot be removed if eleven (or more) votes are cast against his removal. See §7.3.2 (cumulative voting formula).

This means that Mildred can prevent his removal, even though there is cause. Mildred has the power to decide whether Milton's transgressions warrant removal, on the theory that she could reelect him

if she so desired.

c. Shirley can seek to have Milton removed by judicial order. Under the MBCA, a 10 percent shareholder can have a director removed if the court finds the director engaged in “fraudulent or dishonest conduct” or “gross abuse of authority or discretion,” and that his removal is in the corporation’s best interests. MBCA §8.09. Milton’s misappropriation of company trade secrets, particularly if it posed a continuing risk of damage to Graphic’s business, would seem to easily meet this test.

d. Probably. Even though the provision might be read to give the board *exclusive* authority to fill vacancies, a strong argument can be made that shareholders nonetheless retain an inherent authority to fill vacancies. See *Campbell v. Loew’s, Inc.*, 134 A.2d 852 (Del. Ch. 1957) (shareholders have inherent authority to fill board vacancies). The MBCA is ambiguous. It specifies that board vacancies can be filled by shareholders or directors, unless the articles provide otherwise. MBCA §8.10. Although it is possible to read this to permit waiver of shareholder authority to fill vacancies, the provision can also be read only to permit the waiver of board authority. This second reading is consistent with other MBCA provisions that, for example, give shareholders nonwaivable authority to remove directors for cause. See MBCA §8.08(a).

CHAPTER 8

Judicial Protection of Voting Rights

In theory, shareholder voting gives shareholders a role in corporate governance. In practice, shareholder voting creates the potential for opportunism. Insurgents who seek board control may have objectives at odds with the interests of the shareholder majority. And incumbent directors may seek to entrench themselves by manipulating voting procedures or by creating structures that diminish shareholder voting rights.

This chapter describes judicial protection of "corporate democracy"—judicial limits on insurgents, including restrictions on vote buying and reimbursement of election expenses (§8.1), judicial scrutiny of board manipulation of voting procedures and voting structures (§8.2). These protections complement other voting protections, such as the voting rules under state law (Chapter 7), the federal disclosure regulations for proxy voting (Chapter 9), and the proxy fraud rules (Chapter 10).

§8.1 LIMITS ON INSURGENT OPPORTUNISM

To protect shareholders in public corporations from their own rational passivity and their difficulties in collectivizing, courts have developed rules that minimize risks to shareholders of a manipulative or opportunistic insurgency.

§8.1.1 Vote Buying

Ownership and control are separated when a shareholder, for a price, agrees to vote his shares as directed. Early courts condemned corporate vote buying and declared it to be illegal per se. They doubted the incentives of vote buyers to maximize corporate value consistent with the interests of shareholders and creditors. Some courts reasoned that vote buying in the corporation is no different than in politics, and corporate legitimacy demands the independent judgment of each shareholder.

Yet few corporate statutes prohibit vote buying. See N.Y. BCL §609. Instead, courts have cautiously come to accept vote buying, just as corporate statutes have come to recognize other devices that separate voting and economic rights—voting trusts, dual-class voting structures, and irrevocable proxies. See §§7.2, 26.2.

Nonetheless, vote buying in public corporations presents special risks, including coerced changes in control or even bad faith corporate conduct that damages the corporation (such as looting). The leading vote-buying case is *Schreiber v. Carney*, 447 A.2d 17 (Del. Ch. 1982). In that case, a large shareholder, facing a substantial tax liability if the company were reorganized, withdrew its opposition to a proposed reorganization after the corporation agreed to loan the shareholder sufficient funds to avoid the tax liability. Accepting the shareholder had essentially sold his discretionary voting power, the court concluded that transfers of voting rights without the underlying economic interest are not necessarily illegal "unless the object or purpose is to defraud or in some way disenfranchise the other stockholders." Because the reorganization was meant to benefit the shareholders and the tax-related loan was fully disclosed, the court decided there was no fraud or disenfranchisement. The court warned, however, that vote buying "is so easily susceptible of abuse it must be … subject to a test for intrinsic fairness."

Although modern courts have not yet decided a case of naked vote buying, they have permitted the transfer of voting rights when related to an otherwise legitimate corporate transaction:

- As part of an out-of-court settlement in which the corporation agrees to pay an insurgent's proxy expenses, the insurgent grants an irrevocable

proxy to management. *Weinberger v. Bankston*, No. 6336 (Del. Ch. 1987).

- To facilitate a negotiated merger, corporate management convinces an institutional shareholder to support the merger by promising it new business as a co-manager of the deal. *Hewlett v. Hewlett-Packard Co.*, No. 19513 (Del. Ch. 2002) (noting that judicial suspicion of vote-buying agreements is "difficult to reconcile" with corporate statute's "explicit validation of shareholder agreements").
- To stave off an insurgent, corporate board agrees to add shareholder to its slate of nominees on promise the shareholder will support board in proxy fight. *Portnoy v. Cryo-Cell Int'l, Inc.*, 940 A.2d 43 (Del. Ch. 2008) (but invalidating agreement that shareholder would buy more shares and vote with board, on promise board would add a new seat for shareholder's nominee).

The legitimacy of vote buying may depend on whether the buyer is a fellow shareholder or management. While shareholders may arguably be free to do whatever they want with their votes, management's use of corporate assets to buy votes is problematic and may require a showing there is no deleterious effect on the corporation or the corporate franchise.

Lately, hedge funds (investment pools that buy shares in companies and then seek to bring about company reforms) have developed ingenious ways to acquire corporate votes without also acquiring corporate shares—a decoupling of control and ownership. One technique is to borrow shares from institutional investors on the record date set for a voting contest, thus obtaining the right to vote without purchasing a financial interest. Another technique is for hedge funds to buy shares of a company, while at the same time buying "put" options that give the fund the right to sell the shares at a specified price. Thus, the fund acquires voting rights without bearing the usual financial risks of ownership. These techniques have been controversial, and academic critics have called for greater transparency and even regulation of these techniques—but no case has yet addressed this form of vote buying.

§8.1.2 Payment and Reimbursement of Election Expenses

As Berle and Means observed more than half a century ago, management

control over the voting machinery in public corporations arises from the board's control of the corporate purse strings. See §6.2.2. The rule on election- related expenses (such as preparing and mailing proxy materials to shareholders and placing advertisements in financial publications) is easily stated: the corporate treasury pays the expenses of incumbents, win or lose; insurgents can hope for reimbursement only by winning. The effect is to significantly discourage insurgents seeking board control through the voting process.

The few cases on election expenses grant the board wide discretion to authorize corporate payment of incumbents' voting-related expenses. They need only relate to corporate "policy," as opposed to a "purely personal" quest for power. See *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 128 N.E.2d 291 (N.Y. 1955). Because any control or issue contest can be characterized as a question of how the corporation should be managed (policy), not who should do it (personal), all of the incumbents' expenses are payable by the corporation. Although courts have said these expenses must be "reasonable," no reported decision has denied incumbents less than complete payment.

The board has equally ample discretion to refuse reimbursement of voting expenses of outsiders. Except in rare cases—only if an insurgent wins an election contest, installs a new board that approves reimbursement, and successfully solicits shareholder ratification of the board's action—can the insurgent expect reimbursement. See *Rosenfeld* (permitting reimbursement if proxy contest was over "policy" not "personality," and shareholders approved the payment). In that case, shareholders end up funding both sides in the campaign.

In an important case, the Delaware Supreme Court upheld the legality of a shareholder-proposed bylaw amendment requiring the reimbursement of reasonable election-related expenses incurred by insurgents seeking to seat fewer than a majority of directors on the board. *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008). The court concluded that bylaw amendments relating to the process of director elections (including expense reimbursement) are a proper subject for shareholder action, provided the bylaws allow directors to exercise their fiduciary duties, such as to deny reimbursement for a dissident slate inimical to corporate interests.

§8.2 REVIEW OF MANAGEMENT ACTIONS AFFECTING VOTING RIGHTS

§8.2.1 Board's Role in Shareholder Voting

Shareholder voting contemplates that the board of directors, like a legislature in political voting, administers the voting mechanism. The board oversees the *voting procedures*—choosing the location and date for the annual shareholders' meeting; calling special meetings; setting the record date that fixes which shareholders are entitled to vote; imposing advance notice requirements for nonmanagement candidates and proposals; conducting the shareholders' meeting through its choice of the meeting's chair; and tabulating votes, including proxies and consents. See Chapter 7.

In addition, the board can create voting structures that dilute the shareholders' franchise. The board establishes the corporate *voting agenda*—nominating its slate of candidates; setting the size of the board; proposing amendments to the articles of incorporation; recommending fundamental corporate changes, such as mergers and sales of assets; seeking approval of compensation plans and other corporate transactions; and deciding which shareholder proposals to censor.

By virtue of its role in administering and setting the agenda for shareholder voting, the board of directors faces deep conflicts of interest. Incumbent directors have personal incentives to use the board's voting-related powers to preserve their incumbency by manipulating voting procedures, erecting structural barriers, or deciding the matters on which shareholders vote. Yet the board is the logical administrator of the voting mechanism and the natural locus of corporate innovation and change.

§8.2.2 Manipulation of Voting Process

Courts have strictly scrutinized board manipulation of the voting process during a pending voting contest. Such manipulation is treated as inequitable—a presumptive breach of fiduciary duty. *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971). Unless the board can articulate a "compelling justification" for its action, courts intervene to protect "established principles of corporate democracy." *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651

(Del. Ch. 1988).

The following board manipulations of the voting process have been held invalid:

- advancing the annual meeting date in a way that burdened insurgents in a pending proxy contest. *Schnell v. Chris-Craft Industries, Inc.,* 285 A.2d 437 (Del. 1971).
- postponing the annual meeting date where opposing proxies already gathered by an insurgent would expire by the time of the rescheduled meeting. *Aprahamiam v. HBO & Co.,* 531 A.2d 1204 (Del. 1987).
- establishing bylaws that imposed waiting periods, advance-notice requirements, inspection, and record-date procedures for shareholder action by written consent when they unnecessarily delayed shareholder action. *Allen v. Prime Computer, Inc.,* 540 A.2d 417 (Del. 1988).
- adjourning a shareholders' meeting that prevented the defeat of a board-recommended proposal to increase the number of shares available for an executive compensation plan. *State of Wisconsin Investment Board v. Peerless Systems Corp.,* No. 17637 (Del. Ch. 2000).

The *Blasius* "compelling justification" standard, however, applies only when the "primary purpose" of the board's action is to impede the shareholders' opportunity to vote. Thus, courts have actually shown remarkable deference if the board creates voting procedures when no voting contest is on the horizon. For example, the board may adopt an advance-notice bylaw that requires any shareholder to notify the corporation in advance of a shareholders' meeting of its intention to nominate a slate of directors or propose other action at the meeting. *Stroud v. Grace,* 606 A.2d 75 (Del. 1992). The board can even withdraw a record date and thus impede a potential insurgency, provided no meeting date had yet been set or proxies yet solicited. *Stahl v. Apple Bancorp*, 579 A.2d 1115 (Del. Ch. 1990).

Lately, many companies have amended their advance-notice bylaws to specify that shareholder activists seeking to place a nominee on the company board must disclose not only their holdings of company stock but also any derivatives (options and short positions) they may have in the stock. Companies have also specified that the submission of a nominee must comply with the advance-notice requirements, which are deemed the

exclusive procedure for nominating directors. The greater specificity was spurred by a Delaware decision that ambiguous bylaw provisions are to be interpreted in favor of insurgent shareholders. See *Jana Master Fund, Ltd. v. CNET Networks*, 954 A.2d 355 (Del. Ch. 2008).

Nonetheless, there may be limits to the ability of shareholders to amend election-related bylaws to favor an insurgency. For example, when a bidder proposed a bylaw amendment that would accelerate the timing of the company's annual meeting, thus to circumvent the otherwise lengthy process of removing staggered board members, the court held that the bylaw would be inconsistent with the staggered board provisions in the articles and the Delaware statute. See *Airgas, Inc. v. Air Products and Chemicals, Inc.*, 8 A.3d 1182 (Del. 2010) (concluding that word "annual" in company charter and Del. GCL §141(d) cannot mean four months).

§8.2.3 Interference with Voting Opportunities

The courts have been ambivalent about board actions that revise the corporation's voting structure either by shifting voting power to management-friendly shareholders or by adopting arrangements that make it more difficult for a shareholder majority to exercise control. Board actions *during a voting contest* that undermine shareholder voting rights, even though they do not manipulate or interfere with the voting process, have been invalidated as breaches of directors' fiduciary duty. But board actions *outside a voting contest* that reduce shareholder voting rights have been validated as within the board's prerogatives.

The following board actions have been invalidated for unilaterally undermining shareholder voting rights:

- issuing new stock to friendly shareholders to dilute an insurgent who has started or is threatening a proxy fight. *Condec Corp. v. Lunkenheimer Co.,* 230 A.2d 769 (Del. Ch. 1967).
- issuing high-voting preferred shares whose effect is to strip the relative voting power of common shares upon any transfer. *Unilever Acquisition Corp. v. Richardson Vicks,* 618 F. Supp. 407 (S.D.N.Y. 1985).
- increasing the board size, and then filling the resulting vacancies, to nullify an insurgent's pending consent solicitation to place its nominees

on the board. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

Shareholders also have a right to elect directors endowed with full powers to undertake corporate reforms. Thus, the board cannot adopt a poison pill plan (see §39.2.3—*Moran v. Household Int'l*) that can be rescinded only by incumbent directors or their chosen successors—a so-called dead hand or continuing director plan. Such plans deny to shareholders the right to choose directors with full decision-making authority and constrain directors in exercising their fiduciary duties. *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998) (invalidating delayed redemption "dead hand" plan); *Carmody v. Toll Brothers, Inc.*, 723 A.2d 1190 (Del. Ch. 1998) (invalidating "dead hand" plan as creating less equal directors and disenfranchising shareholders who elect directors committed to redeeming the poison pill).

Nonetheless, the courts have given boards significant latitude *outside a voting contest* to take preemptive actions that weaken shareholder voting. This is particularly true when an informed shareholder majority approves the defensive action. For example, courts have accepted the validity of "shark repellent" charter amendments that make voting insurgencies and hostile takeovers more difficult, even though studies show they diminish share value. Under the business judgment rule—a presumption that directors act with due care and in good faith, see §12.2—courts have upheld such shark repellents as supermajority voting requirements, high-voting shares, staggered boards, aggregation caps on voting power, provisions dictating board size, and elimination of written consent procedures. See *Providence & Worcester Co. v. Baker*, 378 A.2d 121 (Del. 1977) (voting cap on any shareholder with more than 25 percent of company's shares); *eBay Domestic Holdings v. Newmark*, 16 A.3d 1 (Del. Ch. 2010) (applying business judgment rule to staggered board provision).

Judicial deference also increases when the board defends against a two-step proxy contest or tender offer (see §34.1), even if the defense dilutes shareholder voting power. For example, the board may engage in a repurchase program of company shares to increase the relative voting power of nonselling directors so long as a proxy contest remains a "viable alternative" for the insurgent or bidder after the repurchase. *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995) (applying *Unocal* test,

see §39.2.3, to decide that repurchase program was proportionate response to "coercion" of low-price tender offer). But the board cannot amend the bylaws to require that any future bylaw changes be approved by a two-thirds supermajority when the amendment would make it "mathematically impossible for an insurgent to prevail" and effectively give insiders an insurmountable blocking position. *Chesapeake Corp. v. Shore,* 771 A.2d 293 (Del. Ch. 2000) (invalidating amendment under both *Unocal* and *Blasius* standards of review).

§8.2.4 Deviations from One-Share/One-Vote

Adding nonvoting or multiple-vote shares to the voting structure can significantly alter shareholder voting power. For example, if the corporation issues low-voting shares to new shareholders, while management retains high-voting shares, the nonmanagement shareholders are effectively disenfranchised.

Corporate law once imposed a one-share/one-vote requirement, but modern corporate statutes permit deviations. MBCA §6.01(c)(1); Del. GCL §151(a). Courts have generally upheld dual-class recapitalizations in which some shares receive disparate voting rights so long as the plan is approved by shareholders after full disclosure. For example, in *Williams v. Geier*, 671 A.2d 1368 (Del. 1996), a control group proposed a recapitalization (amendment to the articles) that was then approved by a shareholder majority, which gave existing shareholders ten votes per share and any new shareholder only one vote for the first three years of ownership. The effect was to entrench management since any hostile acquirer would, by virtue of the plan, only be able to acquire low-voting shares. The Delaware court upheld the plan, approved by informed shareholders, under the business judgment rule.

But if shareholder approval is coerced, courts have invalidated such recapitalizations. See *Lacos Land v. Arden Group, Inc.*, 517 A.2d 271 (Del. Ch. 1986) (invalidating issuance of new class of super-voting, nontransferable common shares likely to be taken only by company's CEO, since CEO publicly threatened he would block any future control transaction if shareholders did not approve the recapitalization).

Although deviations from the one-share/one-vote norm are common in close corporations, they are far less prevalent in public corporations. The

stock exchanges, though permitting the issuance of low-voting shares to new investors, prohibit listed companies from engaging in dual-class recapitalizations or the issuance of super-voting shares. NYSE Listed Company Manual §313.00(A). This listing requirement was the result of pressure from Congress after the SEC sought to impose a one-share/one-vote standard by rule, which was successfully challenged as beyond the agency's authority and an encroachment on state corporate law. See *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (invalidating Rule 19c-4).

Nonetheless, some public corporations have dual-class voting structures —such as Google and Facebook—that were put into place when the company went public. Proponents of dual-class shares argue that these voting structures allow management to focus on long-term performance, rather than short-term results. Nonetheless, some studies find that companies with dual-class voting tend to under-perform companies with traditional one-share/one-vote structures. Recognizing this, some have proposed that dual-class voting rights be linked to the length of share ownership, with shareholders holding their shares for longer periods receiving full or high-voting rights (and shareholders that engage in short-term trading and holding for shorter periods having low-voting rights). In this way, long-term shareholders would come to have a greater say in the corporation's direction.

Examples

1. Conestoga Partners is an activist hedge fund—that is, a private investment firm that looks for companies whose assets are underutilized or mismanaged. Once it identifies a target, Conestoga buys a strategic stake in the company and then urges the company's management to make the business more profitable or face a takeover. Usually, management restructures the business as suggested; sometimes Conestoga replaces the board and sells the company. In any event, Conestoga usually garners a handsome profit. Recently Conestoga identified a target: Gillick Industries, a publicly traded corporation that manufactures shaving products.
    a. Conestoga and a couple other large shareholders form the Gillick Activist Shareholders Pact (GASP), open only to shareholders holding more than $1,000,000 of Gillick's shares. When they join, GASP members must agree to vote their shares as directed by the group. Is this secret arrangement valid?

b. GASP contacts Ray King, Gillick's founder and largest shareholder. King has lately been displeased with Gillick management and agrees to vote for GASP's board candidates on the condition GASP pay him 10 percent of any spike in share prices before the election. Is this valid?

2. On April 1 Conestoga nominates four candidates to Gillick's 12-person staggered board. In its proxy solicitation Conestoga says its candidates are committed to putting the company up for sale. As the shareholders' meeting approaches, trading in Gillick stock intensifies.
   a. Gillick's bylaws specify that the annual shareholders' meeting will be held on the first Tuesday of May. The Gillick board, however, sets the record date to be March 1. As a result, recent purchasers (mostly arbitrageurs hoping the proxy contest succeeds) will not vote. Is the board action valid?
   b. Gillick's board follows through on a preexisting plan to place 25 percent of Gillick's stock in a newly created ESOP. A voting trustee will vote this stock according to employee instructions. Is the issuance to the ESOP valid?
   c. Gillick's board issues new zero-coupon debentures as a dividend on its common shares. Each debenture, which calls for interest and principal to be payable in five years, has a face value of $10—about one-fifth the current value of Gillick's common shares. The debentures, which can trade only with the common shares, contain a provision that adjusts the face value to $2 if any of Gillick's directors are replaced without management consent. Is this issuance valid?
3. Conestoga's candidates are defeated by a narrow margin.
   a. After the election Conestoga asks Gillick to reimburse it for its voting-related expenses, arguing that the election contest resolved a matter of corporate policy. Is Conestoga entitled to reimbursement?
   b. During the campaign, Gillick's management placed numerous newspaper ads questioning the composition of Conestoga's investor group. The ads, paid for with company funds, say the group includes a shadowy foreign billionaire. In fact, the ads are false. Must Gillick's management reimburse the company for this deceptive advertising?

c. In a recount, Conestoga's slate of candidates is elected. Conestoga asks the new board to be reimbursed for its voting-related expenses. The board complies. Is this valid?

4. After the election the new Gillick board majority reviews the company's situation and comes to support incumbent management. The board authorizes the sale of some of Gillick's less profitable operations—not quite what Conestoga and GASP had in mind.

   a. The proxy materials supporting the Conestoga candidates were clear. Their campaign was based on the company being sold. Can Conestoga and GASP demand the board sell the company as a majority of shareholders had wanted?

   b. Anticipating that Conestoga might buy more shares and mount another proxy fight, Gillick's board adopts a poison pill plan. The plan calls for the dilution of any person who acquires more than 20 percent of Gillick's shares unless the board first redeems the poison pill rights. The plan specifies that only directors nominated by the board can make this redemption. The board explains that this ensures only directors independent of an insurgent or bidder will evaluate the merits of any outside bid. Is this poison pill valid?

   c. Gillick's board also decides to concentrate voting rights in friendly hands. It issues a new class of super-voting shares with ten votes per share. If sold, the super-voting shares automatically convert to regular low-voting shares. The idea is that only long-term shareholders (loyal to management) will hold the super-voting shares. Assuming Gillick is listed on the NYSE, is this valid?

Explanations

1. a. Yes, under state law; no, under federal law. State corporate law—see §§26.1, 26.2—places no restrictions on the ability of shareholders (regardless of the size of their holding or their sophistication) to vote their shares as they please. So long as shareholders do not formally relinquish their votes to another, through an irrevocable proxy or voting trust or a vote-buying arrangement, a shareholders' voting agreement is valid. MBCA §7.31 (voting agreements are specifically enforceable); Del. GCL §218(c). The assumption of "corporate democracy" is that shareholders can decide what is in their best interests, including through

secret mutual action. In addition, by retaining control of their vote, shareholders who are parties to a voting agreement can readily protect themselves against a coparty's noncompliance or other opportunism.

Federal disclosure law—see §§9.3, 10.2, 38.1—requires transparency in voting agreements among public shareholders. Conestoga and the other GASP members are a "group" for purposes of the shareholding disclosure requirements of federal securities laws. Because the GASP members (whose combined holdings exceed 5 percent) reached an understanding to affect control of a publicly traded corporation, they must disclose their identity and intentions to the remaining shareholders and management. See §13(d), Securities Exchange Act of 1934; see also §38.1. Form 13D may be required even if GASP's initial formation was exempt from the proxy rules' filing and distribution requirements for proxy-related discussions limited to fewer than 10 shareholders. See §9.3.5. In addition, when Conestoga and GASP solicit shareholder proxies, they will be obligated to disclose the nature of their agreement under the proxy rules (Form 14A, Item 4, see §9.2) and under judicial antifraud standards (see §10.2).

b. Perhaps valid. Although the agreement involves bald vote buying, recent courts have suggested that shareholders can do with their votes as they please. Nonetheless, perhaps drawn to the analogy of political vote buying, courts continue to scrutinize vote buying to be sure neither the corporation nor other shareholders are harmed. No harm is apparent.

2. a. Probably invalid. The MBCA, like other corporate statutes, contemplates that the board has the power to control the voting process, including the setting of a record date for determining which shareholders are entitled to notice and to vote. MBCA §7.07 (record date set in bylaws or by board, provided at least 70 days before the meeting); MBCA §10.20(a) (board has power to amend the bylaws). The board's setting of the record date is thus within its powers.

But the board's action, even if authorized, may violate the directors' fiduciary duties. The effect of the "backdated" record date is to dilute the voting power of recent purchasers, particularly the arbitrageurs. Because the shareholders' meeting date was already set (in the bylaws) and the board set a record date with no apparent

business justification except to thwart the pending shareholder insurgency opposed by management, a court could find the directors acted inequitably. Cf. *Stahl v. Apple Bancorp*, 579 A.2d 1115 (Del. Ch. 1990) (accepting board's setting of record date to impede a potential insurgency, but where no meeting date had yet been set). Absent "compelling justifications," the action would constitute a breach of the directors' fiduciary duties. See *Schnell* and *Blasius* (see §8.2.2). Courts have found "compelling justifications" for board interference with the voting process only when the board was in the process of selling the corporation and the board concluded the shareholders needed more information. *Mercier v. Inter-Tel (Delaware), Inc.,* 929 A.2d 786 (Del. Ch. 2007) (board delayed a merger vote by 25 days to provide more information to shareholders).

b. Probably valid. Conestoga could argue that the ESOP is an entrenching device that dilutes the voting power of existing shareholders and makes the insurgency more difficult. In a similar case, a Delaware court assumed that employees as voters in an ESOP are likely to side with current management in any control contest, since faced with the choice of their jobs or a better return on their ESOP investment they would opt for job security. *Shamrock Holdings v. Polaroid,* 559 A.2d 257 (Del. Ch. 1989) (unsolicited insurgent with plans to sell company "will inevitably raise concerns about job security"). The ESOP issuance thus had an entrenching effect.

   Nonetheless, the ESOP's entrenching effect does not resolve the matter. The standard of review is determinative. In *Polaroid,* the court reviewed an ESOP issuance under a lower *Unocal*-proportionality standard (see §39.2.3) on the theory the ESOP responded to a pending hostile tender offer that was later withdrawn to be replaced by a proxy solicitation. The *Polaroid* court, finding the ESOP would increase employee morale and firm productivity, upheld the defense as proportional to the hostile tender offer. But another case held that an ESOP created during a pending two-step proxy contest/tender offer constituted a breach of the incumbent board's fiduciary duties under the heightened *Schnell-Blasius* standards. *AT&T v. NCR Corp.,* 761 F. Supp. 475 (S.D. Ohio 1991). Generally, ESOPs and other stock issuances that affect the allocation of voting power receive deferential business judgment review if the transaction is planned and

implemented outside the context of a pending voting contest.

In our example, the ESOP was already under consideration and not exclusively a defensive response. This strongly suggests that a court would use less scrutiny. The ESOP would easily pass muster as a business decision to increase employee productivity and loyalty. That it also realigned shareholder voting power would not be determinative.

c. Probably invalid. The debentures penalize shareholders for exercising their voting rights, apparently in the name of corporate stability. If incumbent directors (or their chosen successors) are maintained in office for five years, shareholders receive a significant cash dividend. If any are replaced, shareholders receive a much smaller dividend. Although any unpaid dividends would remain in the corporate treasury, retention by management of free cash flow generally hurts share prices. Shareholders will be leery of replacing management and jeopardizing share value.

Courts have applied searching scrutiny of actions that dilute shareholder voting rights during a voting contest without commensurate business justifications. Although courts have accepted stock issuances that dilute shareholder power, the issuances have passed scrutiny when justified as legitimate corporate financing. Courts have also accepted temporary entrenchment measures designed to give incumbents time to accomplish a pending merger. When the board's business justifications are more tenuous, such as claims of amorphous corporate stability, entrenching action receives searching scrutiny. For example, a "dead hand" poison pill that provided for redemption only by incumbent directors or their chosen successors was invalidated for effectively precluding shareholders from voting for directors with full management power, including to approve a tender offer in a two-step takeover. See *Carmody v. Toll Brothers, Inc.* (Del. Ch. 1998) (see §8.2.3). In our case, the debenture issuance has little to recommend it. It came during a pending voting contest, it was not approved by shareholders, and it lacked substantial justification. Under the "corporate democracy" philosophy of *Schnell-Blasius*, the issuance violates the board's fiduciary duties.

3. a. No. An insurgent has no right to reimbursement unless the board authorizes it. As a practical matter, Conestoga can hope to be

reimbursed only if it wins control of the board and the shareholders ratify the payment of the insurgent's voting-related expenses. See *Grodetsky v. McCrory Corp.*, 267 N.Y.S.2d 356 (Sup. Ct. 1966) (refusing to award reimbursement of dissident shareholder's election-related expenses even though dissident had successfully led voting campaign against wasteful corporate transaction). Although the proxy fight was over a policy issue—whether the company should be sold—reimbursement is not a matter of right. The matter lies in the discretion of the *incumbent* board. Otherwise, unsuccessful insurgents could claim reimbursement from the corporate treasury despite the shareholder majority's rejection of their position and failure to achieve board control.

b. Perhaps. Management's false ads breached a duty of honesty owed shareholders during the voting contest. See §10.3. Like other manipulations of the voting process, management's *material* deceptions constitute a breach of fiduciary duties. Deceived shareholders could sue directly or derivatively, and an appropriate remedy for the manipulation might be to compel management to bear the costs of its false campaign.

   Is the composition of GASP's membership "material"? State courts have borrowed the formulaic test of materiality from federal proxy antifraud case law: whether it is substantially likely that a reasonable shareholder would consider the information important in deciding how to vote. See *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) (§10.2.2). Arguably, reasonable shareholders would be less willing to support GASP if there were some indication of an international plot to plunder the company. On the other hand, reasonable shareholders might not care about GASP's makeup, instead focusing on the merits of GASP's desire to sell the company. Nonetheless, that Gillick management apparently believed shareholders would find GASP's composition relevant to their voting decision would seem to make it material.

   In addition, the federal proxy rules prohibit any solicitation that is materially false or misleading. See §10.2.2. GASP and other Conestoga shareholders have a private cause of action. Although a new election would seem a logical corrective award, federal courts have broad discretion in formulating relief.

c. Perhaps not. Reimbursement of a successful insurgent's voting-related expenses is a conflict-of-interest transaction. The new directors have a self-interest in reimbursing themselves. For this reason, courts have required that reimbursement be ratified by a shareholder majority. *Rosenfeld* (see §8.1.2). Notice that this approach is more restrictive than that applicable in a derivative suit, where courts regularly authorize corporate payment of successful shareholder-plaintiffs' litigation-related expenses. See §18.1.2. Nonetheless, the reimbursement rule reflects the general judicial approach to corporate voting: shareholder sovereignty is paramount.

4. a. No. Victory in a proxy fight can be fleeting. Unless the insurgent places a majority on the board, the directors are under no obligation to institute the insurgent's "platform." Without winning a board majority, the most the insurgent can hope for is that the directors will exercise their business judgment to adopt the insurgent's agenda and that the increase in share value will justify the effort for the insurgent.

For this reason, insurgents rarely seek less than majority representation on the board. Further, to provide shareholders a tangible reason to vote for the insurgent, insurgents will often propose a recapitalization plan or tender offer that promises an immediate increase in share value. Although proxy fights in the 1960s and 1970s were often waged by former managers seeking to regain their positions, recent insurgents rarely wage proxy fights to gain merely a long-term management position.

b. Probably not. The poison pill plan dilutes the power of shareholders to elect a board fully empowered to undertake corporate reforms. Delaware courts have invalidated similar plans on the ground that they interfere with shareholder democracy and are not authorized by corporate statute. See Del. GCL §141(d) (permitting directors with greater voting powers, only if approved by shareholders). Board-created limits on the powers of directors—namely, successor directors who cannot redeem a poison pill—is inconsistent with directors' fiduciary duties and board powers. *Quickturn Design Systems, Inc. v. Shapiro* (see §8.2.3).

c. Probably not. The NYSE listing standards (see §7.2.5) adopt a flexible policy toward high-voting shares and recognize "the circumstances and

needs of listed companies." The listing rules specifically permit issuances of high-voting shares issued in an initial public offering. But the NYSE policy states that existing public shareholders cannot have their voting rights "disparately reduced or restricted," including by the issuance of super-voting stock. NYSE Listed Company Manual §313.00(A).

Thus, Gillick would have had to adopt this dual-class voting structure before it sold shares publicly, as Google did when it went public in 2004. Google's capital structure consists of two classes of shares. Class B shares have ten votes per share, and Class A shares have one vote per share. When Class B shares are sold, with few exceptions including transfers between the founders, they convert automatically to lower-voting Class A shares. In its 2004 IPO, Google sold only lower-voting Class A shares to the public. As Class B shareholders continue to sell, the Google founders' voting power only increases! And, to keep things interesting, in 2014 Google split the Class A shares into two—with each Class A share becoming one Class A share (one vote) and one Class C share (no vote). Perhaps not surprisingly, the low-voting Class A shares trade at a slight premium compared to the non-voting Class C shares. Corporate voting does, indeed, have value.

CHAPTER 9

Federal Regulation of Proxy Voting

As we have seen, shareholders in public corporations vote primarily by proxy. But proxy voting creates opportunities for management abuse. If management obtains open-ended proxies from shareholders, management gets a "rubber stamp." If management does not inform shareholders how their proxies will be voted, management escapes accountability. And if management prevents shareholders from seeking proxies for their own initiatives, management's control becomes virtually airtight.

State law authorizes proxy voting, but does not significantly regulate its potential for abuse. To protect shareholders from management overreaching —common before federal regulation—federal rules promulgated under the Securities Exchange Act of 1934 ("Exchange Act") regulate proxy voting in public corporations.

This chapter describes federal proxy regulation of the content and process of proxy voting. It describes the nature and source of federal proxy regulation (§9.1), the scope of the federal proxy rules (§9.2), their formal requirements (§9.3), and the rules permitting shareholder-initiated proposals (§9.4). Chapter 10 describes the state and federal regimes that govern proxy fraud.

Note on Terminology

Technically, a "proxy" is the agency relationship that arises when a

shareholder grants the authority to vote her shares to another person—namely, the "proxy holder." Sometimes the word "proxy" is used (ambiguously) to describe the signed writing by which this agency is created and that describes the powers of the proxy holder. See MBCA §7.22 (requiring that proxy be in writing and limiting duration to 11 months, unless otherwise specified); cf. Del. GCL §212(b) (limited to three years). For clarity's sake, the SEC rules refer to the signed writing as the "proxy card" and the disclosure document as the "proxy statement."

§9.1 FEDERAL PROXY REGULATION—AN OVERVIEW

Federal proxy regulation by the Securities and Exchange Commission (SEC) promotes fair corporate suffrage with a multipronged attack against proxy abuse:

- **SEC-mandated disclosure.** Rules of the SEC require that anyone (including the board of directors) soliciting proxies from public shareholders must file with the SEC and distribute to shareholders specified information in a stylized "proxy statement."
- **No open-ended proxies.** The SEC proxy rules, beyond disclosure, prescribe the form of the proxy card and the scope of the proxy holder's power.
- **Shareholder access.** The SEC proxy rules equalize access to the proxy process in public companies by requiring management (1) to mail shareholders' material and bill for the cost or to provide a shareholder list and (2) to include "proper" shareholder proposals with company-paid proxy materials, subject to a number of conditions.
- **Private remedies.** Federal courts have inferred a private cause of action for shareholders to seek relief for violations of the SEC proxy rules, particularly the rule prohibiting false or misleading proxy solicitations.

Congress did not directly regulate shareholder voting. Instead, it

delegated the task to the SEC, whose proxy rules derive from §14(a) of the Exchange Act.

> It shall be unlawful for any person, by use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 12 of this title. (emphasis added)

Let's parse. First, the jurisdictional reach of §14(a) is effectively unlimited—the "or otherwise" language means Congress has gone as far as the Constitution permits. Second, §14(a)'s prohibition applies to proxy solicitations involving securities registered under §12 of the Exchange Act—this means publicly traded corporations (see §9.2.1 below). Third, the prohibition applies to "proxy solicitations"—a broad concept (see §9.2.2 below). Fourth, the proxy solicitation must comply with SEC rules on filing, disclosure, and distribution of proxy materials (see §9.2.3 below).

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§9.2 REACH OF THE SEC PROXY RULES

§9.2.1 Public Corporations—Registration under the Exchange Act

The SEC proxy rules apply to companies whose securities are registered under §12 of the Exchange Act. Registration also compels the company to file periodic reports of business and financial information with the SEC. See §21.2. (Registration under the Exchange Act, which allows a company's securities to be publicly traded, is different from registration under the Securities Act of 1933, which allows securities to be sold to public investors.)

Registered (or *reporting*) companies fall into two categories:

- **Listed companies.** Companies whose securities (whether debt or equity) are listed on a national stock exchange. Exchange Act §12(a). Listing is voluntary. The New York Stock Exchange, for example, permits listing of companies with at least 2,200 U.S. shareholders and pretax earnings

of at least $10 million for the previous three years.

- **OTC companies.** Companies whose equity securities are traded on the over-the-counter (OTC, see §19.2) markets—specifically, any company with more than $10 million in assets *and* at least 2,000 shareholders (or 500 nonaccredited shareholders) of record at year's end. Exchange Act §12(g) (revised by JOBS Act of 2012, with different thresholds for banks and bank holding companies); SEC Rule 12g-1 (asset threshold increased to $10 million in 1996). Once *both* the asset and shareholder thresholds are surpassed, the company must register with the SEC within 120 days.

Once registered, a company may deregister only under specified circumstances. A company registered because its securities are listed on a stock exchange is no longer subject to the registration requirements once its securities are delisted. Exchange Act §12(d). Deregistration of an OTC company is more difficult. Deregistration is possible only when: (1) there are fewer than 300 shareholders of record; or (2) there are fewer than 500 shareholders of record and the company's total assets have not exceeded $10 million for its last three fiscal years. Rule 12g-4. The SEC takes the view that once an OTC company is registered, thus triggering the full range of federal protections for its shareholders, deregistration should not come easily.

§9.2.2 Definition of Proxy Solicitation

The federal proxy rules apply only to *proxy solicitations.* Although you might imagine a proxy solicitation refers to the formal document that accompanies management's request for shareholders to return a proxy card, the proxy rules are much broader. SEC Rule 14a-1(l) defines a "solicitation" to include: (1) *the obvious*—the informational document accompanying the proxy card; (2) *request to sign*—any request for a proxy even if a proxy card does not accompany it; (3) *request not to sign*—any request to not sign or to revoke a proxy; and (4) *the sly*—any other communication "under circumstances reasonably calculated to result in" shareholders signing, not signing, or revoking a proxy. The SEC also defines "proxy" broadly to include any action that gives or withholds authority concerning issues on which shareholders may decide—for example, when shareholders give written consents to an action taken without a shareholders' meeting (see

§7.2.6). Rule 14a-1(f).

Federal courts construed these definitions liberally, leading to protests that the SEC was overregulating communications among shareholders. In 1992, the SEC responded to this criticism and amended its proxy rules to exempt a variety of shareholder communications from its filing and distribution requirements. We consider how the amended rules affect some leading cases.

Part of Solicitation Plan

In *Studebaker Corp. v. Gittlin,* 360 F.2d 692 (2d Cir. 1966), a shareholder who planned a proxy contest to elect a new board sought the company's shareholders' list under a state law that gave inspection rights only to shareholders holding at least 5 percent of the company's shares. When the dissident shareholder obtained authorizations to inspect the list from 42 other shareholders whose holdings totaled more than 5 percent, management sued to block the inspection on the theory the dissident's request for authorizations constituted an illegal proxy solicitation. The court agreed, holding that a proxy solicitation includes any communication to shareholders that asks for action that is *part of a "continuous plan" leading to the formal solicitation of proxies*—a broad notion, indeed. The court pointed out that the definition of proxy includes "authorizations" and the dissident group's effort to obtain authorizations for an inspection was part of a "continuous plan" intended to end in a formal proxy solicitation. To ensure that shareholders are informed even in the preliminary stages of a voting contest, the court required the dissident group to start again with a proper proxy filing, distributed to all solicited shareholders.

The 1992 amendments to the SEC proxy rules explicitly reject the implications of this broad notion of solicitation when nonmanagement shareholders communicate with other shareholders. The shareholder communication rules permit shareholders to communicate so long as they do not seek to act as a proxy and do not furnish or ask for a proxy card. Rule 14a-2(b). Otherwise, such communications are not subject to the filing, disclosure, and distribution requirements of the proxy rules. The exemption, however, does not apply to communications by management, director nominees, or those already in a proxy fight with management. And exempt communications remain subject to Rule 14a-9, the rule that prohibits proxy

fraud, if they qualify as a “solicitation” under the “continuous plan” test.

Under the current proxy rules, even though the dissident group in *Studebaker* would not be subject to the filing, disclosure, and distribution requirements—because the gathering of authorizations did not involve seeking proxies—the group might nonetheless be forced to disclose their intentions. The SEC rules applicable to control transactions require the filing of an SEC disclosure document (Schedule 13D) by any 5 percent group of shareholders who intend to act together to vote their shares. See Rule 13d-5(b) (see §38.1).

Public Criticism of Management

In *Long Island Lighting Co. v. Barbash*, 779 F.2d 793 (2d Cir. 1985), the court applied a “chain of communications” theory to hold that a newspaper ad could be a proxy solicitation if motivated to advance a pending shareholder insurgency. In the case, a public interest group had paid for a newspaper ad urging that LILCO be sold to a public power authority and accusing LILCO of mismanagement in raising rates to build an unnecessary nuclear power plant. Without mentioning him, the ad tended to support the position of a local political candidate (and LILCO shareholder) who had succeeded in having a special shareholders’ meeting called to consider a sale of the company. The court held that a fact finder could conclude that the ad was “reasonably calculated” to influence shareholders’ votes and was thus a “solicitation” under the proxy rules even though it did not mention proxies and purportedly addressed matters of “public interest” in a general publication.

To some, this result borders on a violation of First Amendment free speech rights. Read literally, the court’s holding could turn every expression of opinion about a public corporation into a regulated proxy solicitation. If so, any person stating an opinion would be required to prepare a proxy statement and mail it to every shareholder being “solicited”—if a public opinion, this would mean all shareholders.

The current SEC rules, as amended in 1992, would exempt this kind of communication if the speaker neither seeks authority to act as a proxy nor requests a proxy card. See Rule 14a-2(b). Thus, a public interest group commenting on a shareholder vote—provided the group is not aligned with management or acting on behalf of a director nominee or someone seeking

control—is under no filing, disclosure, or distribution obligations. The "solicitation," however, remains subject to the SEC proxy fraud rule. In addition, the amended rules go one step further to exclude from the definition of "solicitation" (and thus from the proxy fraud rule) a public announcement by an unaffiliated shareholder on how she intends to vote and her reasons. Rule 14a-1(l)(2).

§9.2.3 Mandatory Disclosure When Proxies Not Solicited

In some circumstances, as when a majority of a public corporation's shares are held by a parent company, it may be unnecessary for approval of a corporate transaction to solicit proxies from minority shareholders. Nonetheless, the proxy rules require the company to file with the SEC and send shareholders, at least 20 days before the meeting, information similar to that required for a proxy solicitation. Exchange Act §14(c); Reg. 14C and Schedule 14C. These filings can become the basis for shareholder challenges to the transaction, such as a suit asserting breach of fiduciary duty, even though the solicitation of proxies is unnecessary.

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§9.3 FORMAL REQUIREMENTS OF SEC PROXY RULES

To enable shareholders to make an informed voting decision, the SEC proxy rules (1) specify the disclosure that must accompany (or precede) every proxy solicitation, (2) specify the form of the proxy card, (3) require the preliminary filing of the proxy statement and proxy cards for SEC staff review, and (4) prohibit false or misleading proxy solicitations.

§9.3.1 Mandatory Disclosure in Proxy Statement

Any time a shareholder's proxy is solicited, a "proxy statement" must accompany or precede every solicitation. Rule 14a-3(a). The proxy statement must contain information specified in Schedule 14A—a set of itemized instructions specifying the disclosures required in the proxy statement. The

disclosure required depends on who is soliciting the proxy.

- **Management solicitation.** If management (or technically, the board of directors) solicits proxies, Schedule 14A requires information about the corporation, the background of all director nominees, the compensation of the company's CEO and four highest-paid employees and their stock holdings, and any other matters being voted on. It must also include a report by the board's compensation committee. If the solicitation is for the annual election of directors, management also must send to shareholders the corporation's annual report. Rule 14a-3(b). For many companies, this is the only requirement (state or federal) of periodic corporate communications to shareholders. Cf. MBCA §16.20 (requiring that shareholders be provided annual financial statements).
- **Nonmanagement solicitation.** If the solicitation is by someone other than management, such as a dissident shareholder or outside insurgent group, Schedule 14A requires that they tell about themselves, the background of their nominees, and any other matters on which they seek a proxy.

§9.3.2 Form of Proxy Card

So that shareholders do not give management (or anyone else) a carte blanche, the federal proxy rules specify the form of the proxy card. Rule 14a-4. The proxy card must state who is soliciting it and the matters to be acted on, and must leave a space for it to be dated. For the election of directors, the card must allow a shareholder to withhold a vote on directors as a group or individually. A nominee cannot be elected if he is not named in the proxy card. Rule 14a-4(d)(1). For other matters, shareholders must have a chance to vote for or against each matter to be acted on. A shareholder can give her proxy holder discretionary voting power if the proxy card states in **boldface** type how the proxy holder intends to vote. The proxy holder must then vote in accordance with the instructions.

Management can retain the authority to vote in its discretion on matters that it does not know, before the solicitation, are to be presented at the meeting. See Rule 14c-4(c)(1). Thus, the proxy statement need only mention

those proposals that are reasonably likely to be submitted. Once a shareholder undertakes an independent solicitation for a proposal, however, the company must send shareholders a supplemental statement explaining clearly how it will exercise its discretionary authority, subject to contrary instructions from shareholders. *Union of Needletrades, Industrial and Textile Employees v. May Department Stores Co.,* 1997 WL 714886 (S.D.N.Y).

§9.3.3 Filing and Distribution of Proxy Statement

If proxies are solicited, each shareholder must be sent a copy of the proxy statement. Since 2007, the SEC has specified procedures for companies to send shareholders a notice of an online proxy statement and instructions on how to vote their proxies online, something that has saved companies more than $140 million annually in printing and mailing expenses. Exchange Act Rel. No. 55,146 (2007) (permitting shareholders to always request printed materials); Exchange Act Rel. No. 61,560 (2010).

Any person soliciting proxies must file *preliminary* copies of the proxy statement and the proxy card with the SEC at least ten days before they are sent to shareholders. Rule 14a-6. The SEC staff reviews and comments on these preliminary materials, giving filers a chance to make changes that conform to the staff's views on disclosure adequacy. Management need not make a preliminary filing if the solicitation is routine and relates to nothing more than the election of directors, selection of auditors, or shareholder proposals at an annual meeting.

All *final* proxy materials, whether or not filed preliminarily, must be filed with the SEC at or before the time they are sent to shareholders. (Like other SEC filings, proxy statements are available through EDGAR on the SEC's website *www.sec.gov* and can also be found on company websites under "investor relations" or "SEC filings.")

Shareholders whose solicitations are exempt from the distribution and disclosure requirements because they do not seek proxy authority and do not have a substantial interest in the matter must nonetheless file a notice with the SEC that attaches all of their written soliciting materials. Such notice is required only of shareholders who own more than $5 million of the company's shares and is not required for oral solicitations, public speeches, press releases, or published or broadcast opinions. Rule 14a-6(g).

§9.3.4 Prohibition against Proxy Fraud

At the heart of the proxy rules is the prohibition against any solicitation (written or oral) that is false or misleading with respect to any material fact or that omits a material fact necessary to make statements in the solicitation not false or misleading. Rule 14a-9. In addition to supplying the information required by Schedule 14A, the proxy statement must also fully disclose all material information about the matters on which the shareholders will vote.

Rule 14a-9 does not specifically authorize shareholders to sue for false or misleading proxy solicitations. Yet federal courts have inferred a private cause of action, which we discuss in Chapter 10.

§9.3.5 Exemptions from Proxy Rules

The proxy rules exempt some "proxy solicitations" from the filing, disclosure, and distribution requirements. Some solicitations are exempted, but remain subject to Rule 14a-9, the proxy fraud rule: solicitations by those not seeking proxy authority and without a substantial interest in the matter; nonmanagement solicitations to less than 10 persons; and advice by financial advisors in their ordinary course of business. Rule 14a-2(b)(1-2).

Other solicitations are completely exempt from the proxy rules, including the proxy fraud provisions: communications by brokers to beneficial owners seeking instructions on how to vote the owners' shares, Rule 14a-2(a)(1); requests by beneficial owners to obtain proxy cards and other information from brokers that hold their shares, Rule 14a-2(a)(2): and newspaper advertisements that identify the proposal and tell shareholders how to obtain proxy documents, Rule 14a-2(a)(6).

Examples

1. Video Palace, Inc. (VPI), owns and operates a video rental chain. VPI's management has solicited proxies for its slate of directors at the next annual shareholders' meeting. An insurgent, Garth, solicits proxies for his alternate slate of directors.
   a. Wayne, a VPI shareholder, first returns management's proxy card but then changes his mind and sends Garth's card. Who has Wayne's proxy?

b. VPI management gives notice of the annual meeting but does not disclose that company earnings fell 60 percent last year. Is this information required under state law?

c. The VPI board plans to issue already authorized stock to Jessica. The issue would bring her holdings to 35 percent, and VPI management would own 20 percent. Must VPI solicit proxies at the upcoming meeting?

2. The board does not issue shares to Jessica, and Garth's insurgency fails. As next year's annual meeting approaches, VPI management begins to plan its proxy solicitation. Consider whether VPI is subject to Exchange Act registration.

   a. At the end of its last fiscal year, VPI had assets of $11 million and 650 shareholders of record, of whom 550 are nonaccredited investors and 100 are company employees who had received stock compensation. The non-employee shareholders acquired their shares in a public offering exempt from registration under §3(a)(11) of the Securities Act of 1933—the intrastate offering exemption.

   b. At the end of its last fiscal year, VPI had assets of $11 million and 400 shareholders of record, though 650 beneficial owners of its shares. Also, last year VPI made a public offering of debt securities registered under the Securities Act.

3. VPI registers under the Exchange Act. Two years later, VPI struggles financially, and its assets fall below $8 million.

   a. VPI management does not want to bother with periodic disclosure and the SEC proxy rules. The company has 700 shareholders of record. Can it terminate its Exchange Act registration?

   b. VPI repurchases some of its stock, reducing the number of record shareholders to 450. Can VPI terminate its Exchange Act registration?

   c. VPI repurchases more stock, reducing the number of record shareholders to 100. Can VPI terminate its Exchange Act registration and avoid registration indefinitely?

   d. A few years after going private, VPI makes a large public offering. The company specifies that new stock must be held in street name with a specified list of qualified nominees. This keeps the number of record shareholders below 2,000. Can VPI avoid Exchange Act

registration in this way?

4. The FBI is investigating several VPI directors and executives for conspiring to distribute “pirate” videos through local VPI outlets.
   a. Garth sends letters to 15 other shareholders suggesting they begin a derivative suit challenging the directors’ actions as a breach of fiduciary duty. Are these letters a proxy solicitation?
   b. Garth appears on a financial talk show and says the directors should step down while the FBI concludes its investigation. Garth mentions he is thinking of running his own slate of directors at the next annual meeting. Are these statements proxy solicitations?
   c. Garth sends letters to 15 large VPI shareholders and suggests they discuss a special shareholders’ meeting to remove the offending directors “for cause.” Garth has enough shares under state law to call the meeting himself but will need the votes of the other shareholders in any proxy fight. Are these letters a proxy solicitation?
5. When VPI’s management learns of Garth’s activities, the company takes out newspaper ads claiming that “VPI only rents properly licensed videos” and suggests that “competitors jealous of VPI’s success” have planted false accusations. The ads do not mention Garth or possible shareholder action.
   a. Are the ads proxy solicitations?
   b. The ads are true. Can Garth seek to enjoin them?
   c. Before placing the ads, the company had already distributed copies of its proxy statement to all shareholders. Do the ads violate the proxy rules?
   d. After filing and distributing its proxy statement, management sends letters to its shareholders stating that Garth’s accusations are false and Garth is “trying to tear down the company.” Do these letters violate the proxy rules?

Explanations

1. a. Garth does. If the writing naming Garth bears a later date, the later-signed appointment revokes the earlier proxy. See §7.2.4. The election inspector will accept Garth’s authority if the writing by Wayne on its face revokes his prior proxy to management. The only issue under state

law would be whether Wayne granted management a proxy "coupled with an interest," thus making it irrevocable. This is unlikely unless his proxy related to a pledge, purchase, loan, employment, or voting agreement. See MBCA §7.22; Del. GCL §212(e) ("interest in stock" or "interest in corporation generally").

b. Generally, no. Most state statutes do not require more than notice of an annual meeting's location, time, and date. See MBCA §7.05; Del. GCL §222. If VPI is a public corporation, however, the "complete candor" duty of *Vickers v. Lynch* (see §10.3) may require management to disclose material adverse information with its notice and proxy statement.

c. No proxy solicitation is necessary. Whether directors are elected by majority or plurality voting, management's slate will be elected if Jessica and management combined their votes.

If VPI is a public corporation, even when proxies are not solicited, the federal proxy rules require management to file an information statement with the SEC and to distribute it to shareholders entitled to vote. Reg. 14C. This gives shareholders notice of any state rights they may have to challenge the election.

2. a. VPI must register under the Exchange Act and thus is subject to the proxy rules. VPI meets the conjunctive test of §12(g) of the Exchange Act: at year-end its assets exceeded $10 million, and it had at least 500 non-employee, nonaccredited shareholders of record. See Exchange Act §12(g) (as revised by JOBS Act of 2012, setting threshold at 2,000 shareholders or 500 nonaccredited shareholders, but excluding persons who received their shares pursuant to an employee compensation plan); see also SEC, *Jumpstart Our Business Startups: Frequently Asked Questions* (Apr. 11, 2012) (providing guidance on exclusion of employee-issued shares). Here, because the company has 550 non-employee, nonaccredited shareholders, it satisfies the shareholder threshold of §12(g).

The Securities Act exemption is irrelevant to the question of registration under the Exchange Act. The Exchange Act mandates periodic disclosure about reporting companies to facilitate trading in the stock of publicly traded companies; the Securities Act seeks to provide public investors information when they invest in a company's

securities offerings.

b. VPI is not subject to the proxy rules. A company is subject to the proxy rules only if its securities are registered under §12 of the Exchange Act. Unless VPI's debt or equity securities are listed on a stock exchange, it is not subject to §12 registration because it has fewer than 500 *record* shareholders (whether or not accredited) at year's end. Exchange Act §12(g). Beneficial shareholders are not counted for these purposes.

Although VPI's public offering of debt securities makes it subject to the reporting requirements of the Exchange Act under §15(d) of the Exchange Act, it is not subject to the proxy rules except by registering under §12. Not all reporting companies are subject to the proxy rules.

3. a. No. Although the value of VPI's assets has fallen below the $10 million threshold for initial registration, SEC rules do not permit termination of registration if the number of shareholders of record exceeds 500, regardless of asset value. Rule 12g-4. The SEC takes the view that public shareholders come to rely on periodic disclosure and SEC proxy regulation, and its rules make "deregistration" difficult.

b. Perhaps. It depends on how long VPI's assets have remained below the $10 million mark. If the number of record shareholders falls below 500 (though remains above 300), SEC rules permit termination of registration only if year-end assets have not exceeded $10 million for the each of the last three fiscal years.

c. Yes. If VPI "goes private"—whether by repurchasing its own stock, engaging in an issuer self-tender, or structuring a squeeze-out merger—it can deregister. Once deregistered, the company is no longer subject to the periodic disclosure and proxy rules of federal securities law.

d. No. Under the literal terms of §12(g), it would seem an OTC company could avoid Exchange Act registration by using street-name registration to keep the number of record shareholders below 2,000 (or 500 nonaccredited shareholders). This ruse circumvents the purposes of the Exchange Act. Periodic disclosure and fair proxy voting are as important to beneficial owners as record shareholders. The SEC rules define record shareholders to include beneficial owners if the company has reason to know that the form in which securities are held is "used primarily to circumvent" the registration provisions of the Exchange Act. Rule 12g5-1(b)(3).

4. a. Probably not. It is difficult to characterize the letters as being part of a "continuous plan" leading to the formal solicitation of proxies. See *Studebaker Corp. v. Gittlin* (§9.2.2). A derivative suit, brought by a shareholder on behalf of the corporation to vindicate a corporate right, will not necessarily lead to a proxy contest.

   Unless Garth's motives are to use the suit as part of a strategy leading to a proxy solicitation—for example, because the suit will provide free and damaging publicity about the directors—it is unlikely the letters will be deemed proxy solicitations. To do so would significantly hamper shareholder oversight of management abuse, undercutting the very purpose of the federal proxy rules.

b. Yes, but they are probably exempt solicitations. Garth's comments seem to be part of a plan leading to a proxy solicitation, and the proxy rules define them to be a proxy solicitation.

   Nonetheless, the 1992 amendments to the proxy rules exempt solicitations by those who do not seek power to act as a proxy *and* do not furnish or ask for a proxy card. Rule 14a-2(b). At this point, Garth is just testing the waters for an insurgency and is not asking for proxies. This exemption would not apply, however, if Garth is already a board candidate (or is paid by someone who is a candidate) or is a 5 percent shareholder who has declared a control intention.

c. Yes, but they may be exempt. Garth's letters to his 15 fellow shareholders seem to be part of a "continuous plan" leading to the formal solicitation of proxies, fitting the judicial definition of "proxy solicitation." These early communications, without an accompanying proxy statement, may "poison the well" and lead shareholders to join Garth's cause without full information. On the other hand, regulating preliminary steps to organize a proxy fight may discourage shareholders such as Garth from taking the first steps in exercising their control rights. Some courts have refused to treat preliminary organizational contacts as falling within the proxy rules. See *Calumet Industries, Inc. v. MacClure*, 464 F. Supp. 19 (N.D. Ill. 1978) (discussions among shareholders to organize a proxy fight not a "solicitation" because of the impracticality of preparing a preorganization proxy statement).

   Even if the letters are technically "proxy solicitations," the

exemption for nonmanagement shareholder communications would apply unless Garth is "seeking the power to act as a proxy." See Rule 14a-2(b). If Garth is asking for shareholder "authorizations" to call a special meeting, the letters might constitute a nonexempt solicitation. But if he is simply asking for preliminary showings of interest—because he already holds enough shares to call the meeting himself—the letters may not even be proxy solicitations or are at most exempt solicitations. (Notice the exemption for communications to no more than ten shareholders does not apply.)

5. a. Probably, yes. Under a "chain of communications" theory, the ads seem "reasonably calculated" to influence shareholder voting on the removal of the accused directors. The decision to place the ads seems to have been related to Garth's threatened insurgency. No exemptions apply to these management communications.

   Nonetheless, a court might conclude the ads were primarily meant to answer pirating rumors that might have hurt business and to protect the reputations of the directors rather than to influence shareholder voting. After all, no shareholders' meeting involving the charges has yet been called. In the end, management's motives behind the ads are determinative. See *Long Island Lighting Co. v. Barbash* (§9.2.2).

   b. Yes, if they are proxy solicitations. If management did not file a proxy statement and disseminate the statement to shareholders before placing the ads, they can be enjoined for failing to comply with the rule's filing and disclosure requirements. It makes no difference that the ads are absolutely truthful and well-meaning. As we will see, they can be enjoined either by the SEC or by a shareholder in a private action. See §10.1.

   c. No, unless the ads were materially false or misleading. The proxy rules do not prohibit communications that affect shareholder voting, but mandate only that such communications be made after filing and distributing a proxy statement. This gets the essential information on the table.

   d. Perhaps. The personal attack on Garth may violate Rule 14a-9's prohibition of false or misleading proxy solicitations. To prevent heated and not terribly informative shouting matches, the SEC treats as misleading under the rule "material which … impugns character,

integrity or personal reputation."

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§9.4 SHAREHOLDER INITIATIVES

In a public corporation, shareholder voting initiatives face large obstacles. A shareholder who identifies a value-producing idea generally must commit financial resources for a proxy campaign—something rarely justified given the usual shareholder's relatively small holding. Even when a shareholder is willing to make the effort, the shareholder must overcome management's domination of the corporate-funded proxy mechanism.

The SEC proxy rules attempt to overcome these impediments in two ways. First, management can be compelled to help a shareholder communicate with fellow shareholders—but at the shareholder's expense. Second, in specified circumstances, management must include "proper" shareholder proposals in the company's proxy mailings to shareholders—at *corporate* expense.

§9.4.1 "Common Carrier" Obligation under Rule 14a-7

The federal proxy rules aid shareholders willing to pay for soliciting other shareholders. Rule 14a-7 requires management to mail, either separately or together with the corporation's proxy materials, any shareholder's soliciting materials if the shareholder agrees to pay the corporation's reasonable expenses. There is no limit on the length of the materials, nor does the SEC rule allow management to refuse if it objects to their contents.

Management can avoid this "common carrier" obligation by providing a list of shareholders, including intermediaries. This significantly expands the shareholder's rights under state law, which generally allows the shareholder only a list of shareholders upon the showing of a "proper purpose" (see §7.1.4). As a practical matter, however, management is often reluctant to provide the shareholders' list because it can be used for personal solicitations or beyond a shareholder proxy solicitation—such as in a takeover contest.

§9.4.2 Shareholder Proposals under Rule 14a-8

The SEC shareholder proposal rule seeks to promote shareholder democracy by allowing shareholders to propose their own resolutions using the company-financed proxy machinery.

The shareholder proposal rule has gone through three stages. During its early history in the 1940s and 1950s, proponents used the rule to seek changes in corporate governance—proposing such things as mergers and more liberal dividend policies. In the 1970s and 1980s, many proponents used the rule to focus public attention on corporate social responsibility—proposing such actions as divestment from South Africa, environmental protection, and increases to (or reductions of) affirmative action plans. Since the mid-1980s, with the advent of institutional shareholder activism, many proponents have again focused on corporate governance issues—proposing such things as greater board answerability, increased shareholder voting powers, and elimination of antitakeover devices. At the same time, many proposals continue to deal with social policy issues (such as climate change and sustainability). Today approximately 300 to 400 public companies receive a total of about 900 shareholder proposals each year.

During the rule's first 40 years, shareholder proposals were markedly unsuccessful. Of the thousands submitted for shareholder vote before 1985, only two were approved. Since 1985, however, proposals on corporate governance issues have fared better, regularly obtaining majority approval and increasingly leading management to make changes. Remarkably, labor unions have emerged as the most aggressive of all shareholder proponents, making proposals aimed at maximizing investment returns through such reforms as declassification of boards, caps on executive pay, and shareholder access to the director nomination process.

The following tables illustrate the changing nature of the rule during four representative periods. The first table shows the kinds of proposals excluded by management, which the rule requires be submitted for SEC review. The second table shows the kinds of proposals that the SEC upon review found to be includable under its always-changing interpretation of Rule 14a-8.

Proposals Excluded by Management				
*Type of Proposal**	*1981–1982*	*1991–1992*	*2001–2002*	*2011-2012*
Governance	26.5%	35.4%	47.3%	43.5%
Operational	44.6%	30.2%	33.1%	30.1%
Social/Political	28.9%	34.4%	19.6%	26.4%
Total	100.0%	100.0%	100.0%	100%

Proposals Found Includable by SEC				
*Type of Proposal**	*1981–1982*	*1991–1992*	*2001–2002*	*2011-2012*
Governance	18.2%	41.2%	55.7%	23.7%
Operational	18.9%	3.4%	49.0%	20.0%
Social/Political	37.5%	18.2%	41.4%	30.4%
Total	24.1%	21.9%	48.7%	24.1%

*Categories:

Governance proposals: structure and composition of board, poison pills, shareholder voting
Operational: executive compensation, production/business matters, company communications
Social/political: environmental, sustainability, political, consumer, labor

Notice that "governance" proposals over time have become more frequent and generally have been treated more favorably by the SEC than other proposals. Notice also that "social/political" proposals, though never the mainstay of shareholder proposal activity, have lately been favored by the SEC even more than "governance" or "operational" proposals. (By the way, the reason for the very low inclusion rate for "operational" proposals in 1991—1992 is that the SEC then viewed any proposal dealing with executive compensation to be excludable as "ordinary business;" in the late 1990s the agency changed its view.)

Current SEC Rule

In 1998 the SEC responded to a congressional call to reappraise the shareholder proposal process. Exchange Act Rel. No. 40,018 (1998). While leaving the rule's structure largely intact, the SEC adopted some important policy changes and redrafted (and renumbered) the rule using a "Plain English" question-and-answer format. The revamped SEC rule begins as follows:

> Question 1: What is a proposal? A shareholder proposal is your recommendation or requirement that the company and/or its board of directors take action, which you intend to present at a

> meeting of the company's shareholders. Your proposal should state as clearly as possible the course of action that you believe the company should follow. [Rule 14a-8(a)].

Rule 14a-8 Procedures

Any shareholder who has owned (beneficially or of record) 1 percent or $2,000 worth of a public company's shares for at least one year may submit a proposal. Rule 14a-8(b)(1) (Question 2; dollar amount increased in 1998). The proposal must be in the form of a resolution (only one) that the shareholder intends to introduce at the shareholders' meeting. Rule 14a-8(c) (Question 3).

Shareholders must submit their proposals in a timely fashion. For an annual meeting, this will generally be at least 120 calendar days before the date proxy materials were sent for the last year's meeting. Rule 14a-8(e) (Question 5; information on submissions and deadlines can be found in last year's proxy statement). If the proposal is proper (see below), management must include it in the company's proxy mailing to shareholders. The proposal, along with a supporting statement, can be up to 500 words. Rule 14a-8(d) (Question 4). Management's proxy card must give shareholders a chance to vote for or against the proposal. Rule 14a-8(a) (Question 1).

If management decides to exclude a submitted proposal, it must give the submitting shareholder a chance to correct any deficiencies. Rule 14a-8(f) (Question 6; requiring management to give notice within 14 days of submission, and shareholder to respond within 14 days). If management intends to exclude the proposal, management must file its reasons (and a copy of the proposal) with the SEC for review. Rule 14a-8(j) (Question 10; reasons must include opinion of counsel if based on state or foreign law). The SEC staff issues a "no-action" letter if the staff agrees with management. Over time this procedure has created a body of SEC "common law" on the meaning of the rule.

Proper Proposals

Rule 14a-8 contains a dizzying list of 13 reasons for management to exclude a shareholder proposal. Rule 14a-8(i) (Question 9; formerly Rule 14a-8(c)). The list has undergone periodic changes, and the SEC's interpretation of its terms has ebbed and flowed. Management can exclude a proposal if it fits *any* of the categories specified in the rule. The SEC-created exclusions serve three central purposes.

(1) Proposals inconsistent with centralized management. Four of the exclusions aim at proposals that interfere with the traditional structure of corporate governance:

- **Not "proper subject."** Management can exclude proposals that are not a "proper subject" for shareholder action under state law. Rule 14a-8(i)(1). In *SEC v. Transamerica Corp.,* 163 F.2d 511 (3d Cir. 1947), the court upheld the propriety of proposals for shareholder election of independent public auditors, for changing procedures to amend the company's bylaws, and for requiring that a report of the annual meeting be sent to shareholders. Phrasing proposals to be *precatory*—that is, as advisory suggestions rather than as mandates—further assures their propriety under state law. See Note to Rule 14a-8(i)(1) (noting that "recommendations or requests" to the board are usually proper under state law); see also *Auer v. Dressel,* 118 N.E.2d 590 (N.Y. 1954) (see §7.1.3). Frequently, proposals will ask for management to conduct a study or issue a report, without compelling specific action.

  Recently, an important question has been whether bylaw amendments that require specific action are proper subjects under state law. See §§3.14, 7.1.3.
- **Not "significantly related."** Management can exclude proposals that are not "significantly related" to the company's business. Rule 14a-8(i)(5). To be significant, the proposal must relate to operations that account for at least 5 percent of total assets, net earnings, or gross sales. Or the proposal must be "otherwise significantly related" to the company's business. Beginning in the 1970s, the SEC has adopted a broad view of what is "otherwise significantly related." According to the SEC, matters relating to ethical issues, such as complying with the Arab boycott of Israel or carrying on business in South Africa, could be significant even though not from a purely financial standpoint. See also *Lovenheim v. Iroquois Brands, Ltd.,* 618 F. Supp. 554 (D.D.C. 1985) (holding to be "significantly related" a resolution calling for a report to shareholders on forced geese feeding even though the company lost money on goose pate sales, which accounted for less than .05 percent of revenues).
- **"Ordinary business operations."** Management can exclude proposals that relate to the company's "ordinary business operations." Rule 14a-

8(i)(7). The SEC's interpretation of this exclusion has been checkered. In the 1970s and 1980s, the SEC accepted proposals dealing with such things as construction of nuclear power plants and employment discrimination on the theory they do not relate to "ordinary business" because of their economic, safety, and social impact. In 1992 the SEC reversed course and decided that proposals concerning employment policies (such as equal employment or affirmative action plans) can be excluded as "ordinary business." See *Cracker Barrel Old Country Store, Inc.*, SEC No-Action Letter (October 13, 1992). The Second Circuit ultimately agreed that the SEC could reinterpret the rule without a formal rulemaking proceeding. *New York City Employees' Retirement System v. SEC*, 45 F.3d 7 (2d Cir. 1995). But after widespread criticism the SEC announced in its 1998 rule revision a return to its pre—*Cracker Barrel* approach of case-by-case review into whether employee-related shareholder proposals raise significant social policy issues.

- **Related to dividend amount.** Management can exclude proposals that relate to the specific amount of dividends. Rule 14a-8(i)(13). This recognizes a fundamental feature of U.S. corporate law that the board has discretion to declare dividends, without shareholder initiative or approval.

(2) Proposals that interfere with management's proxy solicitation. The rule has four exclusions for proposals that threaten to interfere with orderly proxy voting:

- **Related to nomination or election to office.** Management can exclude proposals that relate to a specific nominee (seeking his disqualification or removal, questioning his character, or seeking to have him included in the proxy materials). Rule 14a-8(i)(8) (amended in 2010). This exclusion prevents dissidents from "clogging" the company's proxy statement with their own candidates or views on management's nominees. An earlier version of this aspect of the rule had been interpreted by the SEC to prevent shareholders from adopting procedures to nominate their own candidates to the board. The 2010 rule change made clear that shareholders can propose bylaw amendments that create procedures for shareholders to nominate directors to the

board—so-called proxy access. Exchange Act Rel. No. 62, 674 (2010).

- **Conflicts with management proposal.** Management can exclude proposals that "directly conflict" with management proposals. Rule 14a-8(i)(9) (amending previous exclusion of proposals "counter" to management submissions). Otherwise, the rule would create an open forum in which every shareholder could offer a proposal to undermine any management initiative subject to shareholder vote.
- **Duplicative.** Management can exclude proposals that duplicate another shareholder proposal for being included in the management's proxy materials. Rule 14a-8(i)(11).
- **"Recidivist."** Management can exclude "recidivist" proposals that had failed in the past. Rule 14a-8(i)(12). This exclusion covers any proposal dealing "with substantially the same subject matter" as a proposal submitted in the last five years that failed to get 3 percent support on its first try, 6 percent on its second try, or 10 percent after three tries.

(3) Proposals that are illegal, deceptive, or confused. Five of the exclusions are meant to prevent spurious or scandalous proposals:

- **Violation of law.** Management can exclude proposals that would require the company to violate any law, including the SEC's proxy rules and in particular Rule 14a-9's proxy fraud prohibition. Rule 14a-8(i)(2), (i)(3). This allows management to exclude proposals it considers to be materially false or misleading.
- **Personal grievances.** Management can exclude proposals that relate to any personal grievance. Rule 14a-8(i)(4). This category covers the frequent phenomenon of proposals by disgruntled employees who seek to have the body of shareholders recognize their talents and tribulations.
- **Beyond power.** Management can exclude proposals that deal with matters beyond the corporation's power to effectuate. Rule 14a-8(i)(6).
- **Moot.** Management can exclude proposals that are moot because the company is already doing what the shareholder proposes. Rule 14a-8(i)(10).

If a shareholder proposal dances through this minefield of procedural requirements and substantive exclusions, management must include it in the

company's proxy statement and permit shareholders to vote in the proxy card—though management has a chance to recommend that shareholders vote against the proposal and give its reasons. Rule 14a-8(m) (Question 13).

If management fails to include a proposal that is not properly excludable, the proponent can seek an SEC determination that the proxy rules are being violated. Rule 14a-8(k) (Question 11). Alternatively, the shareholder can bring a private action in federal court to compel inclusion or enjoin management's proxy solicitation as a violation of the proxy rules. Shareholders who prevail in court may recover their attorneys' fees on the theory that "the litigation conferred a substantial benefit" on the body of shareholders. *Amalgamated Clothing and Textile Workers v. Wal-Mart Stores*, 54 F.3d 69 (2d Cir. 1995) (finding substantial benefit in proposal's communication to shareholders, even though proposal was defeated).

§9.4.3 Proxy Access

Over the last decade corporate governance has grappled with whether to open the board nomination process in U.S. public companies so shareholders can include their nominees in the company's proxy materials *at company expense*. The history of "proxy access" has been convoluted and interesting. Nearly all the actors in modern corporate governance have played a role: activist and institutional shareholders, corporate management, the SEC, the federal courts, the U.S. Congress, the Delaware legislature, the Delaware courts, and even corporate law professors.

Proxy access began in 2003 when the SEC proposed a new Rule 14a-11 that would have permitted shareholders (or a group of shareholders) holding five percent of a company's voting shares to nominate one to three directors to the company's board—provided a majority of shareholders had authorized such a vote in the previous election cycle or 35 percent had withheld their vote from a particular board nominee. See Exchange Act Rel. No. 48,626 (2003) (proposing release). The proposal met a firestorm of opposition from corporate management. At first the SEC dithered and then eventually decided not to pursue the rulemaking.

In response to the SEC's inaction, activist shareholders (supported by corporate law professors) began a company-by-company movement proposing amendments to company bylaws to create a process for shareholders to use the company's proxy mechanism to nominate a "short

slate" constituting fewer than a majority of directors. Eventually, the SEC took the position that such proposals were excludable as "related to an election" under the then-applicable Rule 14a-8 exclusion, but the Second Circuit held that the exclusion did not cover shareholder proposals seeking to create proxy access. See *AFSCME v. AIG, Inc.*, 462 F.3d 121 (2d. Cir. 2006). In response, the SEC amended Rule 14a-8 to overrule the court's decision, allowing companies to exclude such shareholder proposals. Exchange Act Rel. No. 56,914 (2007).

Without a proxy access rule and faced with a revised Rule 14a-8 that limited shareholder-initiated proxy access, institutional shareholders turned to Congress. In 2010 Congress put proxy access back on the corporate governance agenda when it passed the Dodd-Frank Act and specifically authorized the SEC to promulgate a proxy access rule. Dodd-Frank §971. Within months, the SEC accepted the Dodd-Frank invitation and re-promulgated Rule 14a-11 in even stronger form than before. Exchange Act Rel. No. 62,674 (2010) (permitting nomination of directors constituting at most one-fourth of the board by shareholders, or groups of shareholders, that had held 1, 3, or 5 percent of company's voting shares for at least three years, the percentage varying with company size).

The plot thickened, however, when corporate management (through the Business Roundtable and U.S. Chamber of Commerce) challenged the reincarnated Rule 14a-11 in federal court for failing to adequately consider the costs and benefits of the new governance rights granted to shareholders. The D.C. Circuit agreed and held that the SEC had failed to consider the rule's effect on "efficiency, competition and capital formation." *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (vacating rule). Even though Dodd-Frank seemed to have authorized the SEC to make this cost-benefit determination, the SEC decided not to appeal the decision to the Supreme Court and not to propose the rule again, apparently worried it could not meet the (unusually) high standard of review set by the D.C. Circuit.

Despite the failure of proxy access to become an SEC rule, many shareholder activists decided to take matters into their own hands and returned to the company-by-company approach. The SEC had reopened this door in 2010 when it revised Rule 14a-8 (as part of its Rule 14a-11 rulemaking) to permit shareholders to propose bylaw changes to establish procedures for nominating directors in the company's proxy materials. Shareholder activists were further emboldened by changes to the Delaware

corporate statute, added by the Delaware legislature in 2009, which made clear that shareholders can amend company bylaws to provide for proxy access as well as mandatory reimbursement of proxy expenses incurred by shareholders in director elections. See Del. GCL §§112, 113; see also MBCA §2.06(c).

You might wonder what all the fuss is about. At most, proxy access gives shareholders a chance to use the company's proxy materials to nominate and place a handful, but not a majority, of directors on the board. Why has corporate management fought this? For one, it's been argued that shareholder-nominated directors might make boards less collegial and more antagonistic. For another, proxy access by SEC rule would create a one-size-fits-all approach, away from the flexible private ordering permitted by state law. In the end, proxy access raises in stark relief the question of who defines shareholder voting rights—the SEC or Delaware. For now, it looks like Delaware retains its preeminence, with the SEC providing support on the sidelines.

Examples

1. Two years ago Reba bought $2,000 worth of Video Palace, Inc. (VPI) stock. She recently calculated that VPI's liquidation value exceeds its current stock price. Reba wants to bring this to the attention of other shareholders and to propose the company be liquidated—its assets sold for cash—and the cash distributed to shareholders.
    a. Reba plans to solicit proxies for a resolution she plans to present at the upcoming annual shareholders' meeting. The resolution will ask the board to take steps to liquidate VPI. Will the company reimburse her for her solicitation expenses?
    b. Reba notices that the company bylaws require that she give notice that she plans to submit her proposal at least 120 days before the next annual shareholders' meeting. She gives this notice. Must VPI provide information about the proposal in its proxy statement so the statement is not misleading?
    c. Reba wants management to include her proposal with the company's proxy mailing. When must Reba make this request?
    d. Reba plans to submit a four-page attachment to her resolution that explains the advantage of liquidation and gives financial details. In

her attachment she blames VPI management for “destroying market confidence as reflected in the company’s below-asset market price.” Any problems?

   e. Reba corrects these problems and submits a resolution that calls for the board to liquidate the business, dissolve the corporation, and distribute the proceeds to shareholders. Management objects. On what basis can management exclude this proposal from the company’s proxy materials?

2. Reba’s liquidation proposal is submitted for a shareholder vote and soundly defeated at the shareholders’ annual meeting. Reba is relentless. Anticipating next year’s shareholders’ meeting, she wants to shake up the way VPI does business. Which of the following would be includable under the shareholder proposal rule?
   a. A proposal that shareholders elect Reba to the board.
   b. A resolution stating the shareholders’ desire that management nominate at least two women as directors on the board.
   c. A resolution requiring the VPI board to prepare a report on affirmative action in the company’s management training program.
   d. A proposal to amend the bylaws to permit shareholders holding more than 5 percent of the company’s shares for two years to nominate up to two directors to the company’s nine-person board.
   e. A proposal to amend the bylaws to require the corporation to reimburse the reasonable expenses of any shareholder that successfully nominates fewer than 50 percent of the directors to the board.
3. Management excludes Reba’s proposal against “adult” videos, and the SEC issues a no-action letter accepting the proposal’s exclusion. So Reba contacts some of VPI’s larger individual shareholders, who say they agree with her proposal. She attends the shareholders’ meeting and makes her proposal from the floor. VPI has no advance notice requirements for shareholder proposals.
   a. At the meeting Reba says her proposal is a proper subject for shareholders under the corporation’s constitutive documents and state corporate law. If not, she explains, the shareholders can simply vote it down. Is the proposal proper?

b. Reba's proposal is approved not counting the votes for which management has proxies. Management's proxy card gives management complete authority to vote in its discretion on "any other matters that might arise at the shareholders' meeting." The proxy materials, however, do not mention the possibility of shareholder proposals at the meeting. Does management have discretionary authority to vote its proxies against Reba's floor proposal?

4. VPI's management is tired of shareholder proposals. So are many VPI shareholders, who have never cast more than 20 percent of their votes for any shareholder proposal. The board proposes, and the shareholders approve, an amendment to the company's charter banning all nonmanagement shareholder proposals unless by a shareholder (or group of shareholders) holding more than 20 percent of VPI's voting shares.
   a. At the next shareholders' meeting, Reba proposes a resolution urging that no executive receive a salary greater than $1 million. Her ownership qualifies her to make the proposal under Rule 14a-8, but not the charter provision. Must management include the proposal?
   b. Reba asks management to supply her with a list of shareholders or to send her proxy materials so she can solicit support for her executive pay proposal. Must management comply with her request under Rule 14a-7?
   c. Why don't companies "opt out" of the shareholder proposal rule?

Explanations

1. a. Almost certainly no. Under state law, the board has no obligation to reimburse shareholders' solicitation expenses—and rarely does it happen. Only if a shareholder gains control of the board and gets other shareholders to ratify the reimbursement can the shareholder hope to be repaid. See §8.1.2.

Neither Rule 14a-7 nor Rule 14a-8 of the federal proxy rules change this. Rule 14a-7 merely requires that management provide Reba with a shareholders' list or send her solicitation materials to other shareholders at her expense. Rule 14a-8 does not provide for reimbursement, only inclusion of proper proposals in the company-funded proxy statement by qualifying shareholders who comply with

the rule's procedures.

The only hope for a shareholder who undertakes her own proxy solicitation to be reimbursed is a shareholder-approved bylaw providing for corporate reimbursement of reasonable election-related expenses. See *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008) (finding such a bylaw to be proper under Delaware law, provided it includes a "fiduciary out" that allows the board to fulfill its fiduciary duties) (see §7.1.3).

b. No. A shareholder who announces an intention to make a proposal at an upcoming shareholders' meeting, but does not independently solicit proxies, cannot claim it would be false and misleading under Rule 14a-9 if the company omits mention of the proposal. *Union of Needletrades, Industrial and Textile Employees v. May Department Stores Co.*, 1997 WL 714886 (S.D.N.Y.) (requiring inclusion in the proxy statement would allow shareholders to "back door" their proposals "past the detailed requirements of Rule 14a-8"). This means that shareholders seeking to communicate with other shareholders using the company-financed proxy machinery must use Rule 14a-8.

If Reba were to begin an independent solicitation seeking proxies for her proposal, however, the company would be required to provide shareholders specific disclosure of the proposal and management's intentions on how it would exercise its discretionary authority in voting proxies. See Rule 14a-4(c)(1) (disclosure in company's proxy statement or supplement).

c. Under Rule 14a-8, to qualify for inclusion in management's proxy statement, Reba must mail her proposal so that management receives it at least 120 calendar days before the date on which proxy materials were sent out for last year's annual shareholders' meeting. This assumes this year's meeting is scheduled to fall within 30 days of the date of last year's meeting. Question 5, Rule 14a-8(e).

d. Reba's proposal is in trouble. First, her proposal probably exceeds the word limit for shareholder proposals. The rule limits proposals and supporting statements to 500 words—approximately two double-spaced, typewritten pages. See Question 4, Rule 14a-8(d). If so, management is obligated to point out this deficiency and give her 14 days to reduce the proposal's length. Rule 14a-8(f)(1).

Second, her statement impugning management's integrity may make the proposal excludable. Rule 14a-8(b)(1). Management can exclude proposals that are contrary to SEC rules, including the rule prohibiting proxy fraud. The SEC has said that fraud includes "material which impugns character, integrity or personal reputation." In the no-action process, SEC staff sometimes permits the proponent of an otherwise includable proposal to salvage the proposal by deleting any offending language.

e. A number of exclusions may apply. First, the proposal may not be a "proper subject" for action by shareholders under state law. Rule 14a-8(i)(1). Most state statutes require that sale of substantially all assets and voluntary corporate dissolution be initiated by directors (see §§36.1.2, 36.2.2). Although shareholder approval of the sale and dissolution may be necessary, the board generally has exclusive power to initiate these changes. Second, the proposal would require the company to violate state law regarding the process for approving a sale of all the company's assets and corporate dissolution. Rule 14a-8(i)(2). Third, the proposal may be seen as relating to "specific amounts of cash … dividends." Rule 14a-8(i)(13).

Reba should phrase the resolution to be precatory—a suggestion that the board consider a liquidation or dissolution. The resolution might also call on the board to prepare a report to shareholders on its decision. To make her proposal proper, Reba may have to make it toothless.

2. a. Excludable. The proposal improperly relates to an election to office. Rule 14a-8(i)(8). Although the election of directors is a proper subject for shareholder action, the rule prevents shareholders from interfering with management's orderly operation of the proxy mechanism. If Reba or most other shareholders could propose their own nominees, management's proxy statement and proxy card would become unmanageable, jeopardizing proxy voting.

b. Probably excludable. This resolution is precatory and is a "proper subject" for shareholder action. Under current SEC interpretation, shareholders may make proposals under Rule 14a-8 that urge the board be composed of "outside" directors or "employee" directors. SEC staff has taken the view that such proposals do not relate to a particular

election or nominee and do not “relate to an election” under the Rule 14a-8(i)(8) exclusion.

Nonetheless, the proposal to nominate a specified number of women may be excludable on the ground it urges the company to run afoul of antidiscrimination laws. See Rule 14a-8(i)(2). Reba should have urged the board to consider women nominees to the board, without specifying a quota.

c. Includable. The resolution does not require specific board action, only a report. Further, it deals with a matter of substantial public importance, thus removing it from the “ordinary business” exclusion. Rule 14a-8(i)(7). The SEC once took the position that proposals dealing with a company’s employment practices are within the company’s “ordinary business,” even when they raise “social policy” concerns. *Cracker Barrel Old Country Stores, Inc.*, SEC No-Action Letter (Oct. 13, 1992). The SEC, however, reversed this position in 1998.

d. Includable. Under the current Rule 14a-8, such “proxy access” proposals are permitted. See §9.4.3. The SEC staff once took the position that such proposals were not includable under the prior wording of the Rule 14a-8(i)(8) exclusion for proposals that “relate to an election.” *Walt Disney Co.*, SEC No-Action Letter (Dec. 14, 2004) (reconsideration). But the SEC revised the rule in 2010 to permit such shareholder proposals as part of its rulemaking to create proxy access. As revised, Rule 14a-8(i)(8) now allows exclusion of proposals only if the proposal (i) would disqualify a director standing for election; (ii) remove a director from office; (iii) question the competence, judgment, or character of a director; (iv) seek to exclude a specific individual from being nominated; or (v) otherwise possibly affect the outcome of a board election.

Furthermore, state law (including in Delaware) now permits shareholders to amend the bylaws to provide for a process of shareholder nomination of directors. See Del. GCL §112; see also MBCA §2.06(c).

e. Includable, though it might need to contain a “fiduciary out.” The proposal dealing with a board election is permitted under revised Rule 14a-8(i)(8) (see previous explanation). The only real question is whether it is excludable as invalid under state law. See Rule 14a-8(i)

(1). This question turns on a recent Delaware case and subsequent statute.

In the case—which involved a similar proposal submitted by the SEC to the Delaware Supreme Court for the court's opinion—the Delaware court gave a mixed answer. *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227 (Del. 2008) (see §7.1.3). The court first opined that the proposed bylaw related to the process of director elections and was a proper subject for shareholder action under Delaware law. The court then opined that the bylaw would unlawfully prevent directors from exercising their full management powers if their fiduciary duties required them to deny reimbursement for a dissident slate. The court explained that while bylaws may "define the process and procedures by which those decisions are made," they may not "mandate how the board should decide specific substantive business decisions."

Is a "fiduciary out" necessary so the board could deny reimbursement to a shareholder if required by the directors' fiduciary duties? Although the *CA* case seems to require such a "fiduciary out," a subsequent Delaware statute specifically permits bylaws that provide for reimbursement of shareholder proxy-related expenses without mentioning the need for a "fiduciary out." See Del. GCL §113; see also MBCA §2.06(c). The statute raises the interesting question of whether the legislature can remove the judicial power to decide when director fiduciary duties arise.

3. a. Perhaps. State corporate statutes do not specify what shareholder proposals are proper, which often presents a problem because Rule 14a-8(i)(1) excludes proposals that are "not proper" under the corporate law of the company's state of incorporation. State judicial decisions suggest that shareholders have broad powers to make nonbinding precatory proposals. See *Matter of Auer v. Dressel*, 118 N.E.2d 590 (N.Y. 1954) (see §7.1.3). This broad authority is supported by judicial interpretation in other contexts. For example, courts have permitted shareholders to inspect the shareholders' list (and other corporate documents) if the requesting shareholder articulates a purpose related to the financial interests of the company. See §7.1.4. In this case, the propriety of the proposal depends on what state law and state courts say, not on the independent views of the SEC.

b. Perhaps. It depends on when management knew of Reba’s proposal and how management phrased its proxy materials. In the 1990s many shareholders in public companies, to avoid the strictures of the Rule 14a-8 exclusions, made proposals from the floor of the shareholders’ meeting. These shareholders then asserted that management lacked discretionary authority at the meeting to vote its proxies against the proposal on the theory that management’s proxy card did not create this authority.

In 1998 the SEC amended its proxy rules to permit management to create discretionary authority in the proxy card with respect to shareholder proposals at an annual meeting. The proxy card can create this discretionary authority if the proxy materials state either (1) management had not received timely notice of a shareholder proposal, or (2) management had received notice and stated how it planned to vote. Rule 14a-4(c). In general, notice is timely if received 45 days before the date of the prior year’s proxy mailing. No discretionary authority arises, however, if the shareholder proponent is making his own proxy solicitation (and sending proxy materials to shareholders). The proponent’s solicitation floats or sinks on its own.

In our example, management’s failure to mention the possibility of a shareholder proposal—whether or not Reba’s was received in a timely fashion under the rule—negates any discretionary authority. Although the grant of discretionary authority is valid under state law, the federal proxy rules deny management voting power when shareholders have not been informed how their proxies are likely to be voted.

4. a. Perhaps. It depends on whether the SEC proxy rules can be seen to create federal substantive rights or merely provide procedures to exercise rights under state law. Reba’s proposal on executive compensation is includable under Rule 14a-8, but not under the company’s amended articles.

Many courts have justified Rule 14a-8 on a procedural theory. Without the rule it would be misleading for management not to disclose the shareholder proposals it expects shareholders will raise at an upcoming meeting. The rule provides a procedure for that disclosure. If a shareholder has no right to make a proposal, then presumably the rule

does not require management to disclose it or include it on the proxy card. On the other hand, Rule 14a-8 has over time assumed a life of its own. Many of the exclusion categories—such as for proposals that have failed in the past or are counter to a management proposal or are not significantly related to the company's business—do not find any basis in state law. The SEC, arguably, has created a new substantive right, subject to the agency's list of exclusions. Under this view, companies cannot "opt out" of shareholder access pursuant to Rule 14a-8 any more than they could opt out of the other federal proxy rules.

b. Perhaps not. Even if Reba were willing to pay for the solicitation under Rule 14a-7, management might argue that it need not act as a "common carrier" for proposals that are improper under state law. Unlike Rule 14a-8, however, the "common carrier" requirements of Rule 14a-7 do not offer management any explicit grounds for exclusion or for refusing to provide a shareholders' list. On its face, federal law supersedes state law.

c. Management may not be interested in opting out of the shareholder proposal rule for a number of reasons. First, opting out might be bad for investor confidence (and thus stock prices) if management tried to insulate itself from shareholder input.

Second, shareholder proposals have become an effective way for shareholders to express their views on a broad range of corporate matters (such as majority voting in director elections, shareholder access to the nomination process, and shareholder say on executive pay). Increasingly, management has chosen to adopt shareholder-approved resolutions, even when precatory. Without shareholder proposals, shareholders might turn to other protective devices, such as takeovers and litigation, which could be even more intrusive.

Third, opting out might not be valid under state law. Just as shareholders have a basic right to amend the bylaws, courts could well hold that shareholders have an inviolable right to make proper proposals at shareholders' meetings.

Finally, the shareholder proposal rule may provide a relatively painless way for activist shareholders to express their governance, economic, social, and political views short of seeking governmental intervention through the political process.

CHAPTER 10 Proxy Fraud

Corporate democracy depends on shareholders having full and honest information about the matters on which they vote. The federal proxy rules impose an *ex ante* disclosure regime specifying the information that public shareholders must receive when asked to vote by proxy. Federal courts, and lately state courts, have developed an *ex post* disclosure regime that enforces full and honest disclosure through private litigation. Courts, assuming the role of "reasonable shareholder," review the adequacy of disclosure and infer the likely outcome of a fully informed shareholder vote.

This chapter describes the private causes of action available to shareholders in public corporations to enforce their rights to honest disclosure (§10.1). In particular, it considers the implied proxy fraud action developed by federal courts under §14(a) of the Securities Exchange Act of 1934 (§10.2) and describes how state courts have borrowed elements of the federal action to create disclosure duties under state corporate fiduciary law (§10.3).

Note on Corporate Federalism

This chapter is a study in the interaction of state and federal law. You'll notice that the chapter begins by identifying the weakness of traditional state law in dealing with proxy fraud. It then describes the response by federal courts to create (and later weaken) a federal cause of action.

Finally, it summarizes the emergence of a new state cause of action modeled on the federal one, though subject to some limitations. Today nearly all proxy fraud cases arise in state court in connection with challenges to corporate transactions.

§10.1 PRIVATE ACTIONS

State law traditionally provided limited redress for false or misleading proxy statements. In the 1960s and 1970s, federal courts filled this gap by implying a private federal cause of action.

§10.1.1 Traditional State Remedies

Consider the traditional judicial remedies available to public shareholders unhappy with a corporate transaction procured by false information in a proxy statement. Using the *law of deceit*, the shareholders could sue those who fraudulently misrepresent material facts on which the shareholders relied to their detriment, which reliance was the cause of actual shareholder losses. The shareholders could sue directors who breached their *fiduciary duties* of care or loyalty by misrepresenting information to shareholders.

Each theory of liability had its pitfalls. Traditional state fraud law required that the shareholders prove (1) the proxy statement contained an actual misrepresentation of fact, not just a deceptive opinion or an omission that made the statement misleading; (2) management actually knew of the falsity of the representations; (3) shareholders had actually read the proxy disclosures and justifiably relied on them; and (4) the shareholders had suffered losses because of their reliance, not because of extraneous factors. See *Kerbs v. California Easter Airways, Inc.*, 94 A.2d 217 (Del. Ch. 1953) (commenting that "verbal niceties" not always observed and puffing is permissible in corporate election campaigns).

Traditional corporate fiduciary law was also problematic. If the disappointed shareholders brought a derivative suit on behalf of the corporation, assuming the deceit was viewed as harming the corporation, the suit was subject to procedural obstacles such as demand on the board, security bond for expenses, and potential board dismissal. See §18.3. And if

the deceit was viewed as directly harming the shareholders, a class action to enforce fiduciary duties was not available if shareholder-plaintiffs had to prove they individually relied on the misrepresentations. See §10.3. In addition, shareholder-plaintiffs had to overcome the powerful "business judgment rule" as well as liability exoneration provisions and the exclusivity of the appraisal remedy in control transactions. See §§12.2, 12.5, 37.3.

§10.1.2 Implied Federal Action

Federal securities law does not explicitly provide for private enforcement of its proxy rules. The Securities Exchange Act of 1934 simply prohibits proxy solicitations that do not comply with SEC rules. Exchange Act §14(a). The rules themselves do not mention private actions. The SEC's rule against proxy fraud merely prohibits any proxy solicitation "containing any statement which … is false or misleading with respect to any material fact." Rule 14a-9. Although §21(d) of the Exchange Act authorizes the SEC to enforce its rules in court, there is no explicit authority for a shareholder to seek relief for proxy fraud.

Can a shareholder make a claim under the federal proxy antifraud rule? In a famous (and conclusory) decision, the Supreme Court held that a shareholder has an implied cause of action to challenge a corporate transaction approved by a proxy solicitation that violates the SEC antifraud rule. *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964). The Court used a broad theory that "where there is a wrong the law implies a remedy" and held an action for violations of §14(a) could be inferred under §27 of the Exchange Act. Section 27 is a remarkable source for the Court's implication. By its terms the provision merely gives federal district courts exclusive jurisdiction over actions "to enforce any liability or duty created" under the Exchange Act and prescribes service of process and venue requirements for these actions.

Borak's broad implied-remedy theory has since been rejected by the Supreme Court. Beginning with *Cort v. Ash*, 422 U.S. 66 (1975), a nonsecurities case, and in more recent cases arising under other provisions of the Exchange Act, the test has become whether Congress intended to imply a private action, taking into account the legislative history, the structure of the statute, and the availability of state remedies. See *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1 (1977) (no standing for frustrated bidder that challenges tender offer disclosures under §14(e) of Exchange Act); *Touche*

Ross & Co. v. Redington, 442 U.S. 560 (1979) (no private action for shareholders who claim violations of §17 of the Exchange Act, which requires annual informational filings by stockbrokers with SEC).

Nonetheless, despite its shaky underpinnings, the *Borak* holding that a federal private action exists for proxy fraud is now entrenched. See *Virginia Bankshares, Inc. v. Sandberg,* 501 U.S. 1083 (1991) (reaffirming *Borak* action).

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§10.2 Federal Action for Proxy Fraud

The elements of the federal implied private action for proxy fraud are court-created. In fashioning the scope of action, federal courts have sought to ensure informed shareholder voting and to discipline management through the antiseptic of disclosure. Over the past couple decades, the federal proxy fraud action has fallen into disuse, but its elements and philosophy have formed the bedrock of a state-based duty of disclosure (see §10.3).

§10.2.1 Nature of Action

The proxy fraud action implied in *Borak* is federal. As such, a challenging shareholder can avoid the substantive and procedural impediments of a fiduciary challenge under state law.

Under *Borak* a private proxy fraud action can be brought by a solicited shareholder either in her own name (as an individual or class action) or in a derivative suit on behalf of the corporation. A *federal derivative action* provides a means for shareholder-plaintiffs to recover litigation expenses, including attorney fees, and to avoid state derivative suit procedures. *Borak* justified such an action on the tenuous ground that a federal derivative action would provide relief for damages to the corporation caused by deceptive proxy solicitations.

§10.2.2 Elements of Action

In the three decades following *Borak,* the Supreme Court gave shape to the federal proxy fraud action, opening the federal courthouse door in the 1960s and carefully leaving it ajar in the 1970s and 1980s.

Interestingly, the Court's proxy fraud cases all have the same factual pattern: a shareholder sues after management undertakes a merger or other control transaction accomplished with an allegedly false or misleading proxy statement. The following describes the elements of a federal proxy fraud action. (Notice how these elements both overlap with and are different from those for a securities fraud action under Rule 10b-5; see Chapter 22.)

Misrepresentation or Omission

Rule 14a-9 applies to any statement in a proxy solicitation that is "false or misleading … or which omits to state any material fact necessary in order to make the statements therein not false or misleading." This formulation, which represents an expansion of the traditional common-law view that silence is not actionable, invites disappointed shareholders to point to disclosure falsehoods and half-truths.

Statements of Opinions, Motives, or Reasons

Rule 14a-9 speaks of statements and omissions. Are statements of opinion, motives, or reasons concerning a transaction—though not actionable under the common law of deceit—actionable as proxy fraud? In *Virginia Bankshares, Inc. v. Sandberg,* 501 U.S. 1083 (1991), the Supreme Court held that a board's statement of reasons for approving a merger can be actionable. Shareholders rely on the board's expertise and the directors' fiduciary duties, and the board's opinions and reasons for a transaction "naturally" can be important to shareholders.

Virginia Bankshares, however, was reluctant to make actionable any misleading opinion or statement of reasons. Concerned that shareholder-plaintiffs could fabricate unstated board motives, the Court held that a statement of opinion, motives, or reasons is actionable only if the board both (1) misstates its true beliefs *and* (2) misleads about the subject matter of the statement, such as the value of the shares in a merger.

The *Virginia Bankshares* two-part test seeks to prevent shareholders from using the proxy rules to attack a transaction that, though accompanied by false or misleading information, may nonetheless be fair and thus beyond attack under state law. For example, a proxy statement that fails to explain that the company's majority shareholder was seeking a "quick sale" of the company to obtain cash to pay estate taxes is not materially misleading unless the plaintiffs can also show that the sale price was unfair. See *Mendell v.*

Greenberg, 938 F.2d 1528 (2d Cir. 1991) (remanded in light of *Virginia Bankshares*).

Materiality

Rule 14a-9 requires that the challenged misrepresentation or omission be "with respect to a material fact." The materiality requirement serves to corroborate the complaining party's claim of reliance. Without it, information defects would be an easy pretext to escape bargains gone sour.

In *TSC Industries, Inc. v. Northway, Inc.,* 426 U.S. 438 (1976), the Court defined an omitted material fact as one as to which there is a "substantial likelihood that a reasonable shareholder *would* consider it important in deciding how to vote." The definition balances the Court's concern that trivial misinformation not be actionable and its concern that a complaining shareholder not have to prove with certainty that shareholders would have voted against the transaction had they been fully informed. The Court also stated the information must "significantly alter the total mix" of information available. That is, information is not material if it is redundant or otherwise available to shareholders. (This definition has been widely borrowed for actions alleging fraud under the federal securities laws, in particular fraud in connection with buying or selling securities under Rule 10b-5. See §22.3.1.)

The facts in *TSC v. Northway* illustrate the Court's materiality approach. A TSC shareholder complained that the proxy solicitation for a sale/liquidation of the company had not disclosed that National, the buyer of the assets, controlled the TSC board. The Court held that the omission was not material because the proxy statement had disclosed that National was a 34 percent shareholder and that five of TSC's ten directors were National nominees. Further information about National's control was superfluous; it would not have altered the total mix of information.

Culpability

Rule 14a-9 is silent on the question of whether the defendant must have acted culpably, and the Supreme Court has not resolved the question. Most lower courts have not required a showing that the party making the misrepresentation knew it was false or misleading—that is, scienter is not required.

The Supreme Court has suggested the standard is negligence. *Aaron v. SEC,* 446 U.S. 680 (1980). Lower courts have agreed. See *Gerstle v. Gamble-*

Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973) (contrasting Rule 14a-9 with Rule 10b-5); *Gould v. American Hawaiian Steamship Co.,* 535 F.2d 761 (3d Cir. 1976) (analogizing to the liability in public securities offerings, outside directors' negligence is sufficient for liability under the proxy rules); *Shidler v. All American Life & Financial Corp.,* 775 F.2d 917 (8th Cir. 1985) (no strict liability for incorrectly opining on novel issue of state law).

Reliance

Rule 14a-9 does not address whether a shareholder must have relied on the defendant's misrepresentations—an element of common-law deceit. The issue raises difficult evidentiary questions. Must the complaining shareholders show they each actually read and relied on the alleged misstatements, or that the misstatements had a "decisive effect" on the voting outcome, or that the transaction was unfair and thus the shareholders would likely have voted it down?

In *Mills v. Electric Auto-Lite Co.,* 396 U.S. 375 (1970), the Court rejected these approaches and held it is enough if the alleged misstatements were *material.* In the case, public shareholders of a partially-owned subsidiary challenged disclosures in a proxy statement for the merger between the subsidiary and its parent—specifically that the proxy statement had not mentioned that all the subsidiary's directors were nominees of the parent's controlling shareholder. The Court excused proof of actual reliance, thus eliminating it as an element in a proxy fraud case. The Court said that the materiality test, later refined in *TSC Industries,* embodies a conclusion that the misstatement would have been considered important by a "reasonable shareholder" and weeds out claims based on trivial or unrelated misstatements.

Causation

Rule 14a-9 does not mention whether the shareholders' reliance on the defendant's deception caused her loss—an element of common-law deceit. Like the requirements of materiality and reliance, causation seeks to measure whether the plaintiff's loss is linked to the alleged misinformation.

In proxy fraud cases, federal courts have required that the challenged transaction caused harm to the shareholders—*loss causation.* In a merger, loss causation is relatively easy to show if shareholders of the acquired company claim the merger price was less than what their shares were worth.

If, however, shareholders in a merger receive stock in the surviving company and the stock price falls after the merger, shareholders would have to show that the loss in value happened because of the merger, not extraneous events.

Federal courts have also required that the proxy solicitation be "an essential link to the accomplishment of the transaction"—*transaction causation.* That is, there can be no recovery if the transaction did not depend on the shareholder vote. In *Mills,* for example, the Supreme Court concluded that transaction causation existed because a proxy solicitation of minority shareholders holding 46 percent of the company's stock was essential to getting the necessary two-thirds approval for the merger.

In *Virginia Bankshares,* the Supreme Court considered whether there can be transaction causation when the vote of minority shareholders is not necessary under state law to accomplish a squeeze-out merger. In the case, the board sought the proxies of minority shareholders even though the company's parent corporation held 85 percent of the shares and approval of the merger was assured. The plaintiff argued the board's solicitation of proxies was related to the transaction in two respects: (1) minority approval improved management's reputation among investors, and the omitted information, if revealed, would have shamed the board into acting differently—a "shame facts" theory of causation; and (2) minority approval insulated the merger from review under Virginia's corporate statute on conflict-of-interest transactions, and the omitted information made it less likely shareholders could sue to block the merger under state law—a "sue facts" theory of causation.

On the shame facts theory, the Court held that the board's desire for a cosmetic vote did not provide the essential link between the proxy solicitation and the merger. Otherwise, a judge would have to speculate about the board's timidity or boldness. The Court was unwilling to make presumptions about management behavior as it had about shareholder behavior in *Mills* when it excused proof of individual reliance.

On the sue facts theory, the Court held that even if the board had misled the minority into approving the merger, shareholders could still challenge it in state court, where a shareholder vote obtained through fraud would have no validating effect. The Court left open the possibility that disclosure defects might be actionable if they induced shareholders to forgo dissenters' appraisal rights or if they undermined their ability to challenge the transaction in state court. See *Wilson v. Great American Industries, Inc.,* 979 F.2d 924

(2d Cir. 1992) (finding causation when misstatements may have led shareholders to vote for merger, thus causing them to forgo appraisal remedy).

Prospective or Retrospective Relief

In *Borak* the Supreme Court held that relief for a violation of the proxy rules could be either prospective or retrospective. This gives federal courts a broad remedial arsenal: enjoin the voting of proxies obtained through proxy fraud, enjoin the shareholders' meeting, rescind the transaction, or award damages. In cases of mergers procured through proxy fraud, federal courts typically have awarded damages rather than unwind the merger because it's difficult to "unscramble eggs."

In *Mills* the Supreme Court stated that in fashioning relief the trial court should inquire into the transaction's fairness even though *Mills* purposefully rejected a fairness inquiry in deciding shareholder reliance. In *Mills,* despite a finding that a merger had been procured by fraud, the Seventh Circuit on remand decided the merger price was fair and denied the shareholders any relief.

Attorney Fees

In *Mills* the Supreme Court endorsed the awarding of attorney fees, even before a final remedy, to shareholders who successfully prosecute a proxy fraud case. The Court said attorney fees were available because shareholder-plaintiffs in a proxy fraud action, whether brought as a class action or derivative suit, are producing a benefit for the body of shareholders. This ruling creates an incentive for individual public shareholders with a relatively small stake to vindicate shareholder rights under the proxy rules.

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§10.3 STATE ACTION FOR PROXY FRAUD

Other than the cursory notice required for shareholders' meetings, state corporate statutes do not specify the information that public shareholders are to receive when management solicits their proxies. Nonetheless, state courts (particularly in Delaware) have developed a body of case law that prohibits false and misleading statements in any management communication with public shareholders—whether in a proxy solicitation, tender offer, notice of a

shareholders' meeting even when proxies are not solicited, or a notice of a short-form merger for which no meeting is required.

The seminal Delaware case, *Lynch v. Vickers Energy Corp.*, 383 A.2d 278 (Del. 1977), imposed on management a duty of "complete candor" that explicitly borrows the framework of the federal proxy fraud action. See §10.2.2 above. Liability is premised on false or misleading information that "a reasonable shareholder would consider important in deciding whether to [vote]." As is true of federal proxy fraud litigation, challenging shareholders need not show the alleged misinformation would have changed the outcome of the shareholder vote; it is enough that the challenged disclosure was material.

In Delaware, shareholders have used the duty of "complete candor" (which subsequent courts have labeled a "duty of disclosure") to successfully challenge mergers, reorganizations, and charter amendments. See *Stroud v. Grace*, 606 A.2d 75 (Del. 1992) (in submitting transaction for shareholder vote, directors have duty to exercise "reasonable care to disclose all facts material to stockholders … and that directors can reasonably obtain from their position as directors"). For many shareholder-plaintiffs, Delaware has become preferable to federal court. Delaware's standard for damages is based on rescissory damages (what the shares would have been worth at the time of judgment absent the challenged transaction) rather than the federal out-of-pocket or benefit-of-the-bargain standard (what the shares would have fetched at the time of the transaction absent the misinformation). Thus, shareholders can recover the loss of synergy value in a completed merger. See *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135 (Del. 1997) (failure to disclose can be basis for injunction or rescission of transaction—provided culpability, reliance and damages shown). In addition, attorney fees in Delaware are often computed on the basis of class action results, not the less generous federal "lodestar" method. In a variety of conflict-of-interest transactions involving shareholder voting—parent-subsidiary mergers, tender offers by controlling shareholders, and defensive recapitalizations—disclosure review has served as a substitute for fiduciary review on the merits.

In an expansion of the duty of disclosure, the Delaware Supreme Court extended the duty of disclosure to include all communications to shareholders, not just those seeking shareholder action. *Malone v. Brincat*, 722 A.2d 5 (Del. 1998). The case, brought as a class action, involved

allegation of a corporation's ongoing financial fraud made in SEC filings. The court held that directors who knowingly disseminate false information resulting in corporate or shareholder harm violate their fiduciary duty and should be held accountable. But given the existence of federal securities fraud liability (see §22.2), the court refused to adopt a "fraud on the market" theory —thus making individual shareholder reliance an element of the action. As a result, *Malone* has not been heavily used.

Examples

1. Global Paper, Inc. (GPI) is a multinational paper-products company. Its stock is listed on the New York Stock Exchange. Sara, a GPI shareholder, is upset when she reads a newspaper account of the munificent pay package of GPI's chief executive officer. Sara claims the CEO's pay is a waste of corporate assets and the board failed to disclose fully the CEO's sizeable stock options in the company's most recent proxy statement.
   a. Sara sues in state court claiming federal proxy fraud, state fraudulent misrepresentation, and breach of fiduciary duty. Any problems with the suit?
   b. SEC rules require that executive compensation be fully disclosed in the company's proxy statement. Schedule 14A, Items 8 and 10. Does Sara have standing to sue for violation of the SEC's line-item disclosure requirements?
2. Sara sells her GPI stock after reading in the company's proxy statement for the annual meeting that "management anticipates company earnings will remain flat for the next two years." At the time, GPI management is secretly buying GPI shares at depressed prices on the open market. In fact, earnings soon increase dramatically, a turn of events management was expecting.
   a. Does GPI management violate the proxy rules by making a misleading prediction?
   b. Sara sold her shares before she had a chance to vote. Does she have an implied right of action under the federal proxy rules?
3. GPI management is under investigation by the FBI for bribing environmental regulators with authority over the company's paper-processing operations. Although management is aware of the investigation, the company's proxy statement for the upcoming election

of directors does not mention it.

a. The FBI investigation is ongoing, and no charges have been brought against the company or its officials. Does failure to disclose the investigation violate the proxy rules?
b. Sara sues under the proxy rules to enjoin the shareholders' meeting pending a corrected proxy statement. Assuming the investigation was material, does Sara have to show management intended to deceive?
c. In her suit to enjoin the shareholders' meeting, does Sara have to prove that a majority of shareholders actually read the proxy statement and relied on it?
d. After the election, the FBI concludes its investigation and turns the case over to the Justice Department, which seeks to fine the company for making the bribes. Sara wants the directors to reimburse the company for any fines. Will she succeed if she sues them on behalf of the company under the proxy rules?

4. GPI enters into a merger agreement with New Data Corporation (NDC), under which NDC will acquire GPI for $50 per share. GPI shareholders must approve the merger.
    a. GPI's proxy statement recommending the merger fails to disclose that NDC has been sued for price-fixing and faces potentially staggering civil liability. Sara sues to enjoin the merger under the federal proxy rules. Are NDC's problems material to GPI shareholders?
    b. NDC acquires 51 percent of GPI shares in a tender offer. Assured of the outcome of the shareholder vote, NDC then proceeds with a cash-out merger. After the merger is approved, Sara claims the proxy statement seriously understated GPI's earnings for the last three quarters. Can Sara challenge the merger under the proxy rules?
    c. After the merger, Sara claims that had she known about GPI's true earnings picture, she (and other GPI shareholders) would not have voted for the merger. Instead, she would have exercised her appraisal rights and sought payment of "fair value" for her shares—which she estimates to be $75 per share. Can she recover damages from GPI?

Explanations

1. a. Problems. Federal proxy claims cannot be brought in state court. Federal courts have exclusive jurisdiction over alleged violations of the Exchange Act, including the proxy regulations. Exchange Act §27. Sara must either drop her federal proxy claim from her state complaint or sue in federal court, where the state claims can be asserted under the court's pendent jurisdiction.

   In addition, the state fraud and fiduciary claims may face a number of procedural and substantive obstacles. To prove fraud, Sara will have to show that the board intentionally misrepresented the CEO's compensation, that shareholders collectively relied on the board representations, that the shareholders would have voted differently were it not for misrepresentations, and that the excessive compensation caused shareholders a loss. To maintain a derivative suit challenging the directors' fiduciary breach, Sara may have to make a demand on the board or offer an excuse for not making it and perhaps post a bond for defendants' litigation expenses, if her suit is unsuccessful. (See §18.3.) She will then have to overcome the business judgment rule that presumes disinterested directors act in good faith, with reasonable care, and in the corporation's best interests. (See §12.2.)

   b. Yes. Sara can bring an implied private cause of action to enforce any of the provisions of the SEC proxy rules. See *J.I. Case Co. v. Borak* (§10.1.2). Although most proxy cases are brought to enforce duties under Rule 14a-9, which prohibits proxy fraud, the same logic of protecting shareholder voting animates the other proxy rules and suggests implied causes of action for their violation. See *Haas v. Weibolt Stores Inc.*, 725 F.2d 71 (7th Cir. 1984) (implying action for violation of Rule 14a-7).

2. a. Yes. A prediction, like other forward-looking statements, can be misleading if the source is a speaker on whom shareholders rely. See *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991). Although a prediction's veracity cannot be tested at the time it is made, the sincerity of the speaker and the existence of supporting facts (or the nonexistence of contradictory information) is implicit in a prediction. *Virginia Bankshares*, however, requires both that (1) management not believe that the earnings would be flat, and (2) there was data that

contradicted their view that earnings would be flat. That management was purchasing strongly suggests both. Management's purpose in issuing the misleading prediction seemed to be to manipulate the stock price, believing that earnings would not be flat and having information to support that view.

Nonetheless, the causal relationship between management's undue pessimism and the election of directors at the annual meeting may be lacking. See *Mills v. Electric Auto-Lite Co.* (§10.2.2). Although a company's earnings direction would normally be important to shareholders deciding how to vote, the pessimistic prediction actually hurts the incumbent directors' election chances. If the directors were reelected despite the false "bad news," it is improbable they would not have been reelected had the disclosure been more favorable. (Of course, investors who relied on the overly pessimistic forecast—such as by selling their stock—would have an action for securities fraud under Rule 10b-5. See Chapter 22.)

b. No. Sara lacks standing for two reasons. First, she did not vote and cannot claim that the misleading proxy statement influenced her vote. Although *J.I. Case v. Borak* speaks of shareholders as private attorney generals, the procedures applicable to both derivative suit and class actions require that the shareholder acting on behalf of others be a contemporaneous participant. See *Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981) (denying standing to shareholder who had not himself granted a proxy to defendant).

Second, Sara was not harmed in her capacity as a corporate voter, but rather as a selling shareholder. The proxy rules are meant to preserve the integrity of the voting process, not stock trading. Other rules protect against deception when investors buy or sell stock. Under Rule 10b-5, Sara could claim the deceptive proxy statement was "in connection with the purchase or sale" of her shares. See §22.2. In addition, Sara could claim the proxy statement was a deceptive SEC filing on which she relied in the sale of her shares. Under Exchange Act §18, any person who purchases or sells securities in reliance on false or misleading statements in Exchange Act filings with the SEC, which statements affected the stock price, may sue any person who made the statement subject to a defense of good faith ignorance. It is unlikely the courts would expand the proxy fraud action beyond misinformed

shareholder voting. See *Virginia Bankshares, Inc. v. Sandberg* (§10.2.2).

3. a. Not necessarily. Courts have not favored use of the proxy rules to embarrass management into compliance with other legal norms or to confess corporate *wrongdoing*. It is possible a court would decide the FBI investigation, which had not led to formal charges, was immaterial. See Schedule 14A, Item 7, which refers to Regulation S-K, Item 401(f) (requiring disclosure only if person is actually convicted in criminal proceeding or named the subject of pending criminal proceeding). Nonetheless, some courts have required the disclosure of potential liabilities, particularly related to environmental compliance, under a probability and magnitude test that balances both the likelihood of the company's being liable and the significance of that liability. See *Grossman v. Waste Management, Inc.,* No. 83-C-2167 (N.D. Ill. 1983).

   The investigation's immateriality is buttressed if the underlying bribery activities (even if they occurred) are not material. See *United States v. Mathews,* 787 F.2d 38 (2d Cir. 1986) (corporate officer who had not been charged need not disclose participation in bribery conspiracy because disclosure would be tantamount to admitting guilt to uncharged crime). To require management to disclose wrongdoing that might lead to criminal charges would put corporate insiders in the position of incriminating themselves. Nonetheless, some courts have mandated disclosure when a company engages in widespread criminal behavior even though the dollar amounts were relatively small. See *SEC v. Schlitz Brewing Co.,* 452 F. Supp. 824 (E.D. Wis. 1978) (requiring disclosure of $3 million in illegal kickbacks to beer retailers).

   b. Probably not. Most courts have not treated scienter (or intentional deception) to be an element of proxy fraud. See *Gould v. American-Hawaiian Steamship Co.,* 535 F.2d 761 (3d Cir. 1976) (applying negligence standard on theory proxy rules impose a high standard of care on those responsible for informed shareholder voting). This heightened standard is particularly appropriate when the relief is sought against insiders and involves an injunction, rather than money damages. A scienter requirement in such circumstances would encourage careless disclosure practices, a result at odds with the §14(a) theory of informed shareholder voting.

c. No. The Supreme Court in *Mills* recognized that proof of individual reliance would be too burdensome. It is sufficient that the proxy statement contained omissions of material facts.

d. Probably not. Although *Borak* permits a shareholder to sue derivatively for violations of the proxy rules, Sara will *have* to articulate a theory that the corporation has been injured by the directors' fraud-tainted election. That is, there must be a causal link between the failure to disclose the directors' misdeeds and the bribes themselves. See *Abbey v. Control Data Corp.,* 603 F.2d 729 (8th Cir. 1979). The shareholders were never asked to approve the bribes, but instead to elect directors. If Sara were calling for new elections, a clearer causal link would exist. Instead, Sara is seeking to use a disclosure defect to enforce a duty of honorable management—a matter normally left to corporate fiduciary law. Disclosure that would have "shamed" directors to behave properly has been rejected by the Supreme Court as establishing a causal relationship in a case of proxy fraud. See *Virginia Bankshares, Inc. v. Sandberg* (§10.2.2).

4. a. No. In the cash-out merger GPI's assets and liabilities will be absorbed into NDC, and GPI's shareholders will receive cash. (See §36.2.6.) GPI's shareholders, assuming they have received fair consideration for their shares, will have no continuing financial interest in the surviving company and should be indifferent to any contingent liabilities of the new joint business. NDC's problems are not material to GPI shareholders in this *cash-for-stock* merger.

b. Yes, if the understatement adversely affects Sara's ability to exercise shareholder rights. Normally, shareholders whose vote is unnecessary —as it is in this transaction where NDC *holds* majority voting power— cannot establish the causal link between their vote and the transaction. *Virginia Bankshares* (finding lack of transaction causation when parent squeezed out minority of 85 percent-owned subsidiary) (§10.2.2). Nonetheless, if the deception was material and Sara voted for the merger, she will have lost her state appraisal rights that require her to have not voted for the transaction. See §37.2. In addition, if Sara was deceived into not pursuing state conflict-of-interest remedies, she can also claim a causal link between her vote and accomplishment of the transaction.

c. Not GPI, but the surviving NDC. A damages award in a proxy fraud case involving a merger essentially rewrites the terms of the transaction. In this case, if Sara can show that disclosure of all material information would have led a “reasonable shareholder” to insist on a “fair” price, the court will award this as damages to all members of Sara’s class action—that is, all shareholders who would have voted against the merger and exercised their appraisal rights. The judgment will be against NDC because it assumed the obligations of GPI in the merger. See §36.2.1.

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SECTION 101. SHORT TITLE

This chapter shall be known as the "Business Corporation Law".

SECTION 102. DEFINITIONS

(a) As used in this chapter, unless the context otherwise requires, the term:

(1) "Authorized person" means a person, whether or not a shareholder, officer or director, who is authorized to act on behalf of a corporation or foreign corporation.

(2) "Bonds" includes secured and unsecured bonds, debentures, and notes.

(3) "Certificate of incorporation" includes (A) the original certificate of incorporation or any other instrument filed or issued under any statute to form a domestic or foreign corporation, as amended, supplemented or restated by certificates of amendment, merger or consolidation or other certificates or instruments filed or issued under any statute; or (B) a special act or charter creating a domestic or foreign corporation, as amended, supplemented or restated.

(4) "Corporation" or "domestic corporation" means a corporation for profit formed under this chapter, or existing on its effective date and theretofore formed under any other general statute or by any special act of this state for a purpose or purposes for which a corporation may be formed under this chapter, other than a corporation which may be formed under the cooperative corporations law.

(5) "Director" means any member of the governing board of a corporation, whether designated as director, trustee, manager, governor, or by any other title. The term "board" means "board of directors".

(7) "Foreign corporation" means a corporation for profit formed under laws other than the statutes of this state, which has as its purpose or among its purposes a purpose for which a corporation may be formed under this chapter, other than a corporation which, if it were to be formed currently

under the laws of this state, could not be formed under this chapter.
"Authorized", when used with respect to a foreign corporation, means having authority under article 13 (Foreign corporations) to do business in this state.

(7-a) "Infant" means a person who has not attained the age of eighteen years.

(8) "Insolvent" means being unable to pay debts as they become due in the usual course of the debtor's business.

(9) "Net assets" means the amount by which the total assets exceed the total liabilities. Stated capital and surplus are not liabilities.

(10) "Office of a corporation" means the office the location of which is stated in the certificate of incorporation of a domestic corporation, or in the application for authority of a foreign corporation or an amendment thereof. Such office need not be a place where business activities are conducted by such corporation.

(11) "Process" means judicial process and all orders, demands, notices or other papers required or permitted by law to be personally served on a domestic or foreign corporation, for the purpose of acquiring jurisdiction of such corporation in any action or proceeding, civil or criminal, whether judicial, administrative, arbitrative or otherwise, in this state or in the federal courts sitting in or for this state.

(12) "Stated capital" means the sum of (A) the par value of all shares with par value that have been issued, (B) the amount of the consideration received for all shares without par value that have been issued, except such part of the consideration therefor as may have been allocated to surplus in a manner permitted by law, and (C) such amounts not included in clauses (A) and (B) as have been transferred to stated capital, whether upon the distribution of shares or otherwise, minus all reductions from such sums as have been effected in a manner permitted by law.

(13) "Surplus" means the excess of net assets over stated capital.

(14) "Treasury shares" means shares which have been issued, have been subsequently acquired, and are retained uncancelled by the corporation.

Treasury shares are issued shares, but not outstanding shares, and are not assets.

SECTION 103. APPLICATION

(a) This chapter applies to every domestic corporation and to every foreign corporation which is authorized or does business in this state. This chapter also applies to any other domestic corporation or foreign corporation of any type or kind to the extent, if any, provided under this chapter or any law governing such corporation and, if no such provision for application is made, to the extent, if any, that the stock corporation law applied to such corporation immediately prior to the effective date of this chapter.

This chapter also applies to a corporation of any type or kind, formed for profit under any other chapter of the laws of this state except a chapter of the consolidated laws, to the extent that provisions of this chapter do not conflict with the provisions of such unconsolidated law. If an applicable provision of such unconsolidated law relates to a matter embraced in this chapter but is not in conflict therewith, both provisions shall apply. Any corporation to which this chapter is made applicable by this paragraph shall be treated as a "corporation" or "domestic corporation" as such terms are used in this chapter, except that the purposes of any such corporation formed or formable under such unconsolidated law shall not thereby be extended. For the purpose of this paragraph, the effective date of this chapter as to corporations to which this chapter is made applicable by this paragraph shall be June one, nineteen hundred seventy-three.

This chapter shall not apply to a domestic corporation of any type or kind heretofore or hereafter formed under the banking law, insurance law, railroad law, transportation corporations law or cooperative corporations law, or under any other statute or special act for a purpose or purposes for which a corporation may be formed under any of such laws except to the extent, if any, provided under such law. It shall not apply, except to the extent, if any, provided under the banking law, insurance law, railroad law, transportation corporations law or cooperative corporations law, to a foreign corporation of any type or kind heretofore or hereafter formed which (1) has as its purpose

or among its purposes a purpose for which a corporation may be formed only under the insurance law, banking law, railroad law, transportation corporations law or cooperative corporations law, and (2) is either an authorized insurer as defined in the insurance law or does in this state only the kind of business which can be done lawfully by a corporation formed under the banking law, railroad law, transportation corporations law or cooperative corporations law, as the case may be. After the effective date of this chapter the stock corporation law shall not apply to any corporation of any type or kind. The general corporation law shall not apply to a corporation of any type or kind to which this chapter applies. A reference in any statute of this state, which makes a provision of the stock corporation law applicable to a corporation of any type or kind, shall be deemed and construed to refer to and make applicable the corresponding provision, if any, of this chapter.

(b) This chapter applies to commerce with foreign nations and among the several states, and to corporations formed by or under any act of congress, only to the extent permitted under the constitution and laws of the United States.

(c) The enactment of this chapter shall not affect the duration of a corporation which is existing on the effective date of this chapter. Any such existing corporation, its shareholders, directors and officers shall have the same rights and be subject to the same limitations, restrictions, liabilities and penalties as a corporation formed under this chapter, its shareholders, directors and officers.

(d) This chapter shall not affect any cause of action, liability, penalty or action or special proceeding, which on the effective date of this chapter, is accrued, existing, incurred or pending but the same may be asserted, enforced, prosecuted or defended as if this chapter had not been enacted.

(e) After the effective date of this chapter no corporation shall be formed under the stock corporation law.

SECTION 104. CERTIFICATES; REQUIREMENTS, SIGNING, FILING, EFFECTIVENESS

(a) Every certificate or other instrument relating to a domestic or foreign corporation which is delivered to the department of state for filing under this chapter, other than a certificate of existence under section 1304 (Application for authority; contents), shall be in the English language, except that the corporate name may be in another language if written in English letters or characters.

(c) Whenever such instrument is required to set forth the date when a certificate of incorporation was filed by the department of state, the original certificate of incorporation is meant. This requirement shall be satisfied, in the case of a corporation created by special act, by setting forth the chapter number and year of passage of such act.

(d) Every such certificate required under this chapter to be signed and delivered to the department of state shall, except as otherwise specified in the section providing for such certificate, be signed either by an officer, director, attorney-in-fact or duly authorized person and include the name and the capacity in which such person signs such certificate.

(e) If an instrument which is delivered to the department of state for filing complies as to form with the requirements of law and there has been attached to it the consent or approval of the state official, department, board, agency or other body, if any, whose consent to or approval of such instrument or the filing thereof is required by any statute of this state and the filing fee and tax, if any, required by any statute of this state in connection therewith have been paid, the instrument shall be filed and indexed by the department of state. No certificate of authentication or conformity or other proof shall be required with respect to any verification, oath or acknowledgment of any instrument delivered to the department of state under this chapter, if such verification, oath or acknowledgment purports to have been made before a notary public,

or person performing the equivalent function, of one of the states, or any subdivision thereof, of the United States or the District of Columbia. Without limiting the effect of section four hundred three of this chapter, filing and indexing by the department of state shall not be deemed a finding that a certificate conforms to law, nor shall it be deemed to constitute an approval by the department of state of the name of the corporation or the contents of the certificate, nor shall it be deemed to prevent any person with appropriate standing from contesting the legality thereof in an appropriate forum.

(f) Except as otherwise provided in this chapter, such instrument shall become effective upon the filing thereof by the department of state.

(g) The department shall make, certify and transmit electronically a copy of each such instrument to the clerk of the county in which the office of the domestic or foreign corporation is or is to be located. The county clerk shall file and index such copy.

SECTION 104-A. FEES

Except as otherwise provided, the department of state shall collect the following fees pursuant to this chapter:

(a) For the reservation of a corporate name pursuant to section three hundred three of this chapter, twenty dollars.

(b) For the resignation of a registered agent for service of process pursuant to section three hundred five of this chapter, and for the resignation for receipt for process pursuant to section three hundred six-A of this chapter, sixty dollars.

(c) For service of process on the secretary of state pursuant to section three hundred six, paragraph (e) of section three hundred six-A, or three hundred seven of this chapter, forty dollars. No fee shall be collected for process served on behalf of a county, city, town or village or other political subdivision of the state.

(d) For filing a certificate of incorporation pursuant to section four hundred two of this chapter, one hundred twenty-five dollars.

(e) For filing a certificate of amendment pursuant to section eight hundred five of this chapter, sixty dollars.

(f) For filing a certificate of change pursuant to paragraph (a) of section eight hundred five-A of this chapter, thirty dollars, and for filing a certificate of change pursuant to paragraph (b) of section eight hundred five-A of this chapter, five dollars.

(g) For filing a restated certificate of incorporation pursuant to section eight hundred seven of this chapter, sixty dollars.

(h) For filing a certificate of merger or consolidation pursuant to section nine hundred four of this chapter, or a certificate of exchange pursuant to section nine hundred thirteen (other than paragraph (g) of section nine hundred thirteen) of this chapter, sixty dollars.

(i) For filing a certificate of merger of a subsidiary corporation pursuant to section nine hundred five of this chapter, or a certificate of exchange pursuant to paragraph (g) of section nine hundred thirteen of this chapter, sixty dollars.

(j) For filing a certificate of merger or consolidation pursuant to section nine hundred four-a of this chapter, a certificate of merger or consolidation pursuant to section nine hundred four-b of this chapter, or a certificate of merger or consolidation of domestic and foreign corporations pursuant to section nine hundred seven of this chapter, sixty dollars.

(k) For filing a certificate of dissolution pursuant to section one thousand three of this chapter, sixty dollars.

(l) For filing an application by a foreign corporation for authority to do business in New York state pursuant to section thirteen hundred four of this chapter, two hundred twenty-five dollars.

(m) For filing a certificate of amendment of an application for authority by a foreign corporation pursuant to section thirteen hundred nine of this chapter, sixty dollars.

(n) For filing a certificate of change of application for authority by a foreign corporation pursuant to paragraph (b) of section thirteen hundred nine-A of this chapter, thirty dollars, and for filing a certificate of change pursuant to paragraph (c) of section thirteen hundred nine-A of this chapter, five dollars.

(o) For filing a certificate of surrender of authority pursuant to section thirteen hundred ten of this chapter, sixty dollars.

(p) For filing a statement of the termination of existence of a foreign corporation pursuant to section thirteen hundred eleven of this chapter, sixty dollars. There shall be no fee for the filing by an authorized officer of the jurisdiction of incorporation of a foreign corporation of a certificate that the

foreign corporation has been dissolved or its authority or existence has been otherwise terminated or cancelled in the jurisdiction of its incorporation.

(q) For filing a certificate of incorporation by a professional service corporation pursuant to section fifteen hundred three of this chapter, one hundred twenty-five dollars.

(r) For filing a statement or amendment pursuant to section four hundred eight of this chapter with the department of state, nine dollars. This fee shall not apply to statements submitted through the department of taxation and finance pursuant to paragraph eight of section four hundred eight of this chapter.

(s) For filing any other certificate or instrument, sixty dollars.

SECTION 105. CERTIFICATES; CORRECTIONS

Any certificate or other instrument relating to a domestic or foreign corporation filed by the department of state under this chapter may be corrected with respect to any informality or error apparent on the face, incorrect statement or defect in the execution thereof including the deletion of any matter not permitted to be stated therein. A certificate, entitled "Certificate of correction of............ (correct title of certificate and name of corporation)" shall be signed and delivered to the department of state. It shall set forth the name of the corporation, the date the certificate to be corrected was filed by the department of state, a statement as to the nature of the informality, error, incorrect statement or defect, the provision in the certificate as corrected or eliminated and if the execution was defective, the proper execution. The filing of the certificate by the department of state shall not alter the effective time of the instrument being corrected, which shall remain as its original effective time, and shall not affect any right or liability accrued or incurred before such filing. A corporate name may not be changed or corrected under this section. The provisions of this section shall apply to all instruments and certificates heretofore and hereafter filed with the department of state.

SECTION 106. CERTIFICATES AS EVIDENCE

(a) Any certificate or other instrument filed by the department of state relating to a domestic or foreign corporation and containing statements of fact required or permitted by law to be contained therein, shall be received in all courts, public offices and official bodies as prima facie evidence of such facts and of the execution of such instrument.

(b) Whenever by the laws of any jurisdiction other than this state, any certificate by any officer in such jurisdiction or a copy of any instruments certified or exemplified by any such officer, may be received as prima facie evidence of the incorporation, existence or capacity of any foreign corporation incorporated in such jurisdiction, or claiming so to be, such certificate when exemplified, or such copy of such instrument when exemplified shall be received in all courts, public offices and official bodies of this state, as prima facie evidence with the same force as in such jurisdiction. Such certificate or certified copy of such instrument shall be so received, without being exemplified, if it is certified by the secretary of state, or official performing the equivalent function as to corporate records, of such jurisdiction.

SECTION 107. CORPORATE SEAL AS EVIDENCE

The presence of the corporate seal on a written instrument purporting to be executed by authority of a domestic or foreign corporation shall be prima facie evidence that the instrument was so executed.

SECTION 108. WHEN NOTICE OR LAPSE OF TIME UNNECESSARY; NOTICES DISPENSED WITH WHEN DELIVERY IS PROHIBITED

When notice or lapse of time unnecessary; notices dispensed with

when delivery is prohibited.

(a) Whenever, under this chapter or the certificate of incorporation or by-laws of any corporation or by the terms of any agreement or instrument, a corporation or the board or any committee thereof is authorized to take any action after notice to any person or persons or after the lapse of a prescribed period of time, such action may be taken without notice and without the lapse of such period of time, if at any time before or after such action is completed the person or persons entitled to such notice or entitled to participate in the action to be taken or, in the case of a shareholder, by his attorney-in-fact, submit a signed waiver of notice of such requirements.

(b) Whenever any notice or communication is required to be given to any person by this chapter, the certificate of incorporation or by-laws, or by the terms of any agreement or instrument, or as a condition precedent to taking any corporate action and communication with such person is then unlawful under any statute of this state or of the United States or any regulation, proclamation or order issued under said statutes, then the giving of such notice or communication to such person shall not be required and there shall be no duty to apply for license or other permission to do so. Any affidavit, certificate or other instrument which is required to be made or filed as proof of the giving of any notice or communication required under this chapter shall, if such notice or communication to any person is dispensed with under this paragraph, include a statement that such notice or communication was not given to any person with whom communication is unlawful. Such affidavit, certificate or other instrument shall be as effective for all purposes

as though such notice or communication had been personally given to such person.

(c) Whenever any notice or communication is required or permitted by this chapter to be given by mail, it shall, except as otherwise expressly provided in this chapter, be mailed to the person to whom it is directed at the address designated by him for that purpose or, if none is designated, at his last known address. Such notice or communication is given when deposited, with postage thereon prepaid, in a post office or official depository under the exclusive care and custody of the United States post office department. Such mailing shall be by first class mail except where otherwise required by this chapter.

SECTION 109. ACTIONS OR SPECIAL PROCEEDINGS BY ATTORNEY-GENERAL

(a) The attorney-general may maintain an action or special proceeding:

(1) To annul the corporate existence or dissolve a corporation that has acted beyond its capacity or power or to restrain it from the doing of unauthorized business;

(2) To annul the corporate existence or dissolve any corporation that has not been duly formed;

(3) To restrain any person or persons from acting as a domestic or foreign corporation within this state without being duly incorporated or from exercising in this state any corporate rights, privileges or franchises not granted to them by the law of the state;

(4) To procure a judgment removing a director of a corporation for cause under section 706 (Removal of directors);

(5) To dissolve a corporation under article 11 (Judicial dissolution);

(6) To restrain a foreign corporation or to annul its authority to do business in this state under section 1303 (Violations).

(7) Upon written application, ex parte, for an order to the supreme court at a special term held within the judicial district where the office of the corporation is located, and if the court so orders, to inspect the books and records of the corporation to the extent that such inspection is available to shareholders and directors under the law of this state. Such application shall contain a statement that the inspection is necessary to protect the interests of the people of this state. This paragraph applies to every corporation, no shares of which are listed on a national securities exchange or regularly

quoted in an over-the-counter market by one or more members of a national or an affliated securities association. This paragraph does not apply to a corporation all shares of which are owned either directly or through a wholly owned subsidiary by a corporation or corporations to which this paragraph does not apply.

(8) To collect any fines payable to the department of state pursuant to section four hundred nine of this chapter.

(b) In an action or special proceeding brought by the attorney-general under any of the provisions of this chapter:

(1) If an action, it is triable by jury as a matter of right.

(2) The court may confer immunity in accordance with the provisions of section 50.20 of the criminal procedure law.

(3) A temporary restraining order to restrain the commission or continuance of the unlawful acts which form the basis of the action or special proceeding may be granted upon proof, by affidavit, that the defendant or defendants have committed or are about to commit such acts. Application for such restraining order may be made ex parte or upon such notice as the court may direct.

(4) If the action or special proceeding is against a foreign corporation, the attorney-general may apply to the court at any stage thereof for the appointment of a temporary receiver of the assets in this state of such foreign corporation, whenever it has assets or property of any kind whatsoever, tangible or intangible, within this state.

(5) When final judgment in such action or special proceeding is rendered against the defendant or defendants, the court may direct the costs to be collected by execution against any or all of the defendants or by order of attachment or other process against the person of any director or officer of a corporate defendant.

(6) In connection with any such proposed action or special proceeding, the attorney-general may take proof and issue subpoenas in accordance with the

civil practice law and rules.

(c) In any such action or special proceeding against a foreign corporation which has not designated the secretary of state as its agent for service of process under section 304 (Statutory designation of secretary of state as agent for service of process), any of the following acts in this state by such foreign corporation shall constitute the appointment by it of the secretary of state as its agent upon whom process against such foreign corporation may be served:

(1) As used in this paragraph the term "resident" shall include individuals, domestic corporations and foreign corporations authorized to do business in the state.

(2) Any act done, or representation made as part of a course of the solicitation of orders, or the issuance, or the delivery, of contracts for, or the sale of, property, or the performance of services to residents which involves or promotes a plan or scheme to defraud residents in violation of the laws or the public policy of the state.

(3) Any act done as part of a course of conduct of business in the solicitation of orders from residents for property, goods or services, to be delivered or rendered within this state to, or on their behalf, where the orders or contracts are executed by such residents within this state and where such orders or contracts are accompanied or followed by an earnest money desposit or other down payment or any installment payment thereon or any other form of payment, which payment is either delivered in or transmitted from the state.

(4) Any act done as part of the conduct of a course of business with residents which defrauds such residents or otherwise involves or promotes an attempt by such foreign corporation to circumvent the laws of this state.

(d) Paragraphs (b), (c), (d) and (e) of section 307 (Service of process on unauthorized foreign corporation) shall apply to process served under paragraph (c).

SECTION 110. RESERVATION OF POWER

The legislature reserves the right, at pleasure, to alter, amend, suspend or repeal in whole or in part this chapter, or any certificate of incorporation or any authority to do business in this state, of any domestic or foreign corporation, whether or not existing or authorized on the effective date of this chapter.

SECTION 111. EFFECT OF INVALIDITY OF PART OF CHAPTER; SEVERABILITY

If any provision of this chapter or application thereof to any person or circumstances is held invalid, such invalidity shall not affect other provisions or applications of this chapter which can be given effect without the invalid provision or application, and to this end the provisions of this chapter are declared severable.

SECTION 112. REFERENCES

Unless otherwise stated, all references in this chapter to articles or sections refer to the articles or sections of this chapter, and all references in any section of this chapter to a lettered or numbered paragraph or subparagraph refer to the paragraph or subparagraph so lettered or numbered in such section.

ARTICLE 2. CORPORATE PURPOSES AND POWERS

SECTION 201. PURPOSES

(a) A corporation may be formed under this chapter for any lawful business purpose or purposes except to do in this state any business for which formation is permitted under any other statute of this state unless such statute permits formation under this chapter. If, immediately prior to the effective date of this chapter, a statute of this state permitted the formation of a corporation under the stock corporation law for a purpose or purposes specified in such other statute, such statute shall be deemed and construed to permit formation of such corporation under this chapter, and any conditions, limitations or restrictions in such other statute upon the formation of such corporation under the stock corporation law shall apply to the formation thereof under this chapter.

(b) The approval of the industrial board of appeals is required for the filing with the department of state of any certificate of incorporation, certificate of merger or consolidation or application of a foreign corporation for authority to do business in this state which states as the purpose or one of the purposes of the corporation the formation of an organization of groups of working men or women or wage earners, or the performance, rendition or sale of services as labor consultant or as advisor on labor-management relations or as arbitrator or negotiator in labor-management disputes.

(c) In time of war or other national emergency, a corporation may do any lawful business in aid thereof, notwithstanding the purpose or purposes set forth in its certificate of incorporation, at the request or direction of any competent governmental authority.

(d) A corporation whose statement of purposes specifically includes the establishment or operation of a child day care center, as that term is defined in section three hundred ninety of the social services law, shall provide a certified copy of the certificate of incorporation, each amendment thereto, and any certificate of merger, consolidation or dissolution involving such

corporation to the office of children and family services within thirty days after the filing of such certificate, amendment, merger, consolidation or dissolution with the department of state. This requirement shall also apply to any foreign corporation filing an application for authority under article thirteen of this chapter, any amendments thereto, and any surrender of authority or termination of authority in this state of such corporation.

(e) A corporation may not include as its purpose or among its purposes the establishment or maintenance of a hospital or facility providing health related services, as those terms are defined in article twenty-eight of the public health law unless its certificate of incorporation shall so state and such certificate shall have annexed thereto the approval of the public health and health planning council.

SECTION 202. GENERAL POWERS

(a) Each corporation, subject to any limitations provided in this chapter or any other statute of this state or its certificate of incorporation, shall have power in furtherance of its corporate purposes:

(1) To have perpetual duration.

(2) To sue and be sued in all courts and to participate in actions and proceedings, whether judicial, administrative, arbitrative or otherwise, in like cases as natural persons.

(3) To have a corporate seal, and to alter such seal at pleasure, and to use it by causing it or a facsimile to be affixed or impressed or reproduced in any other manner.

(4) To purchase, receive, take by grant, gift, devise, bequest or otherwise, lease, or otherwise acquire, own, hold, improve, employ, use and otherwise deal in and with, real or personal property, or any interest therein, wherever situated.

(5) To sell, convey, lease, exchange, transfer or otherwise dispose of, or mortgage or pledge, or create a security interest in, all or any of its property, or any interest therein, wherever situated.

(6) To purchase, take, receive, subscribe for, or otherwise acquire, own, hold, vote, employ, sell, lend, lease, exchange, transfer, or otherwise dispose of, mortgage, pledge, use and otherwise deal in and with, bonds and other obligations, shares, or other securities or interests issued by others, whether engaged in similar or different business, governmental, or other activities.

(7) To make contracts, give guarantees and incur liabilities, borrow money at such rates of interest as the corporation may determine, issue its notes, bonds

and other obligations, and secure any of its obligations by mortgage or pledge of all or any of its property or any interest therein, wherever situated.

(8) To lend money, invest and reinvest its funds, and take and hold real and personal property as security for the payment of funds so loaned or invested.

(9) To do business, carry on its operations, and have offices and exercise the powers granted by this chapter in any jurisdiction within or without the United States.

(10) To elect or appoint officers, employees and other agents of the corporation, define their duties, fix their compensation and the compensation of directors, and to indemnify corporate personnel.

(11) To adopt, amend or repeal by-laws, including emergency by-laws made pursuant to subdivision seventeen of section twelve of the state defense emergency act, relating to the business of the corporation, the conduct of its affairs, its rights or powers or the rights or powers of its shareholders, directors or officers.

(12) To make donations, irrespective of corporate benefit, for the public welfare or for community fund, hospital, charitable, educational, scientific, civic or similar purposes, and in time of war or other national emergency in aid thereof.

(13) To pay pensions, establish and carry out pension, profit-sharing, share bonus, share purchase, share option, savings, thrift and other retirement, incentive and benefit plans, trusts and provisions for any or all of its directors, officers and employees.

(14) To purchase, receive, take, or otherwise acquire, own, hold, sell, lend, exchange, transfer or otherwise dispose of, pledge, use and otherwise deal in and with its own shares.

(15) To be a promoter, partner, member, associate or manager of other business enterprises or ventures, or to the extent permitted in any other jurisdiction to be an incorporator of other corporations of any type or kind.

(16) To have and exercise all powers necessary or convenient to effect any or all of the purposes for which the corporation is formed.

(b) No corporation shall do business in New York state under any name, other than that appearing in its certificate of incorporation, without compliance with the filing provisions of section one hundred thirty of the general business law governing the conduct of business under an assumed name.

SECTION 203. DEFENSE OF ULTRA VIRES

(a) No act of a corporation and no transfer of real or personal property to or by a corporation, otherwise lawful, shall be invalid by reason of the fact that the corporation was without capacity or power to do such act or to make or receive such transfer, but such lack of capacity or power may be asserted:

(1) In an action by a shareholder against the corporation to enjoin the doing of any act or the transfer of real or personal property by or to the corporation. If the unauthorized act or transfer sought to be enjoined is being, or is to be, performed or made under any contract to which the corporation is a party, the court may, if all of the parties to the contract are parties to the action and if it deems the same to be equitable, set aside and enjoin the performance of such contract, and in so doing may allow to the corporation or to the other parties to the contract, as the case may be, such compensation as may be equitable for the loss or damage sustained by any of them from the action of the court in setting aside and enjoining the performance of such contract; provided that anticipated profits to be derived from the performance of the contract shall not be awarded by the court as a loss or damage sustained.

(2) In an action by or in the right of the corporation to procure a judgment in its favor against an incumbent or former officer or director of the corporation for loss or damage due to his unauthorized act.

(3) In an action or special proceeding by the attorney-general to annul or dissolve the corporation or to enjoin it from the doing of unauthorized business.

ARTICLE 3. CORPORATE NAME AND SERVICE OF PROCESS

SECTION 301. CORPORATE NAME; GENERAL

(a) Except as otherwise provided in this chapter, the name of a domestic or foreign corporation:

(1) Shall contain the word "corporation", "incorporated" or "limited", or an abbreviation of one of such words; or, in the case of a foreign corporation, it shall, for use in this state, add at the end of its name one of such words or an abbreviation thereof.

(2) (i) Shall be such as to distinguish it from the names of corporations of any type or kind, or a fictitious name of an authorized foreign corporation filed pursuant to article thirteen of this chapter, as such names appear on the index of names of existing domestic and authorized foreign corporations of any type or kind, including fictitious names of authorized foreign corporations filed pursuant to article thirteen of this chapter, in the department of state, division of corporations, or a name the right to which is reserved.

(ii) Shall be such as to distinguish it from (A) the names of domestic limited liability companies, (B) the names of authorized foreign limited liability companies, (C) the fictitious names of authorized foreign limited liability companies, (D) the names of domestic limited partnerships, (E) the names of authorized foreign limited partnerships, or (F) the fictitious names of authorized foreign limited partnerships, in each case, as such names appear on the index of names of existing domestic and authorized foreign limited liability companies, including fictitious names of authorized foreign limited liability companies, in the department of state, or on the index of names of existing domestic or authorized foreign limited partnerships, including fictitious names of authorized foreign limited partnerships, in the department of state, or names the rights to which are reserved; provided, however, that no corporation that was formed prior to the effective date of this clause and no foreign corporation that was qualified to do business in this state prior to such effective date shall be required to change the name or fictitious name it had

on such effective date solely by reason of such name or fictitious name being indistinguishable from the name or fictitious name of any domestic or authorized foreign limited liability company or limited partnership or from any name the right to which is reserved by or on behalf of any domestic or foreign limited liability company or limited partnership.

(3) Shall not contain any word or phrase, or any abbreviation or derivative thereof, the use of which is prohibited or restricted by any other statute of this state, unless in the latter case the restrictions have been complied with.

(4) Shall not contain any word or phrase, or any abbreviation or derivative thereof, in a context which indicates or implies that the corporation, if domestic, is formed or, if foreign, is authorized for any purpose or is possessed in this state of any power other than a purpose for which, or a power with which, the domestic corporation may be and is formed or the foreign corporation is authorized.

(5)(A) Shall not contain any of the following phrases, or any abbreviation or derivative thereof:

board of trade state police urban development

chamber of commerce state trooper urban relocation

community renewal tenant relocation

(B) Shall not contain any of the following words, or any abbreviation or derivative thereof:

acceptance endowment loan

annuity fidelity mortgage

assurance finance savings

bank guaranty surety

benefit indemnity title

bond insurance trust

casualty investment underwriter

doctor lawyer unless the approval of the superintendent of financial services is attached to the certificate of incorporation, or application for authority or amendment thereof; or that the word "doctor" or "lawyer" or an abbreviation or derivation thereof is used in the name of a university faculty practice corporation formed pursuant to section fourteen hundred twelve of the not-for-profit corporation law or a professional service corporation formed pursuant to article fifteen of this chapter, or a foreign professional service corporation authorized to do business in this state pursuant to article fifteen-A of this chapter, the members or shareholders of which are composed exclusively of doctors or lawyers, respectively, or are used in a context which clearly denotes a purpose other than the practice of law or medicine.

(6) Shall not, unless the approval of the state board of standards and appeals is attached to the certificate of incorporation, or application for authority or amendment thereof, contain any of the following words or phrases, or any abbreviation or derivative thereof: union, labor, council, industrial organization, in a context which indicates or implies that the domestic corporation is formed or the foreign corporation authorized as an organization of working men or women or wage earners or for the performance, rendition or sale of services as labor or management consultant, adviser or specialist, or as negotiator or arbitrator in labor-management disputes.

(7) Shall not, unless the approval of the state department of social services is attached to the certificate of incorporation, or application for authority or amendment thereof, contain the word "blind" or "handicapped". Such approval shall be granted by the state department of social services, if in its opinion the word "blind" or "handicapped" as used in the corporate name proposed will not tend to mislead or confuse the public into believing that the corporation is organized for charitable or non-profit purposes related to the blind or the handicapped.

(8) Shall not contain any words or phrases, or any abbreviation or derivation thereof in a context which will tend to mislead the public into believing that

the corporation is an agency or instrumentality of the United States or the state of New York or a subdivision thereof or is a public corporation.

(9) Shall not contain any word or phrase, or any abbreviation or derivation thereof, which, separately, or in context, shall be indecent or obscene, or shall ridicule or degrade any person, group, belief, business or agency of government, or indicate or imply any unlawful activity.

(10) Shall not, unless the approval of the attorney general is attached to the certificate of incorporation, or application for authority or amendment thereof, contain the word "exchange" or any abbreviation or derivative thereof. Such approval shall not be granted by the attorney general, if in his opinion the use of the word "exchange" in the proposed corporate name would falsely imply that the corporation conducts its business at a place where trade is carried on in securities or commodities by brokers, dealers, or merchants.

(11) Shall not, unless the consent of the commissioner of education is endorsed on or annexed to the certificate of incorporation, contain the words "school;" "education;" "elementary;" "secondary;" "kindergarten;" "prekindergarten;" "preschool;" "nursery school;" "museum;" "history;" "historical;" "historical society;" "arboretum;" "library;" "college;" "university" or other term restricted by section two hundred twenty-four of the education law; "conservatory," "academy," or "institute," or any abbreviation or derivative of such terms. Such consent shall not be granted by the commissioner of education, if in the commissioner's opinion, the use of such terms in the corporate name is likely to mislead or confuse the public into believing that the corporation is organized for non-profit educational purposes or for educational business purposes that are not specified in the corporate purposes and powers contained in its certificate of incorporation.

SECTION 302. CORPORATE NAME; EXCEPTIONS

(a) Any reference to a corporation in this section except as otherwise provided herein shall include both domestic and foreign corporations.

(b) The provisions of section 301 (Corporate name; general):

(1) Shall not require any corporation, existing or authorized under any statute on the effective date of this chapter, to add to, modify or otherwise change its corporate name; provided, however, that any corporation organized or qualified to do business in this state under this chapter which contains in its name any of the following words or phrases or any abbreviation or derivation thereof, "community renewal", "tenant relocation", "urban development" or "urban relocation", shall plainly and legibly state immediately following its name in any writing issued or authorized to be issued by it upon which its name appears, including, but not limited to, advertising material letterheads, business cards and building directories and signs, the phrase "not a governmental agency".

(2) Shall not prevent a corporation with which another corporation is merged, or which is formed by the reorganization or consolidation of one or more other corporations or upon a sale, lease, exchange or other disposition to a domestic corporation of all or substantially all the assets of another domestic corporation, including its name, as provided in paragraph (b) of Section 909 (Sale, lease, exchange or other disposition of assets), from having the same name as any of such corporations if at the time such other corporation was authorized or existing under any statute of this state.

(3) Shall not prevent a foreign corporation from being authorized under a name which is similar to the name of a corporation of any type or kind existing or authorized under any statute, if the department of state finds, upon proof by affidavit or otherwise as it may determine, that a difference between such names exists in the terms or abbreviations indicating corporate character

or otherwise, that the applicant has engaged in business as a corporation under its said name for not less than ten consecutive years immediately prior to the date of its application that the business to be conducted in this state is not the same as or similar to the business conducted by the corporation with whose name it may conflict and that the public is not likely to be confused or deceived, and if the applicant shall agree in its application for authority to use with its corporate name, in this state, to be placed immediately under or following such name, the words "a .... (name of jurisdiction of incorporation) corporation".

(4) Shall not prevent a "small business investment corporation" as defined in an act of congress entitled "Small Business Investment Act of 1958" from including the word "investment" as part of its name if such word is coupled with the words "small business".

(5) Shall not prevent an "investment company" as defined in an act of congress entitled "Investment Company Act of 1940" from including the word "finance" or "bond" as part of its name, if the approval of the superintendent of financial services is attached to the certificate of incorporation, application for authority, or amendment thereof.

(6) Shall not prevent a broker or dealer in securities, as defined in an act of congress entitled "Securities Exchange Act of 1934", from including the word "investment" as part of its name if such word is coupled with the words "broker" or "brokers" and if such broker or dealer is registered with the securities and exchange commission under the provisions of section fifteen of the securities exchange act of nineteen hundred thirty-four and is also registered with the attorney general under the provisions of section three hundred fifty-nine-e of the general business law.

(7) Shall not prevent an association of banks or trust companies organized as a non-profit membership corporation for the promotion of the interests of member banks from including the word "bankers" as part of its corporate name.

(8) Shall not prevent a bank holding company, as long as it is required to be registered under article III-A of the banking law or under the federal Bank Holding Company Act, as each may be amended from time to time, from

using the words "bank", "banker" or "trusts" or any abbreviation, derivative or combination thereof as part of its corporate name, if the approval of the superintendent of financial services is attached to the certificate of incorporation, application for authority, or amendment thereof.

SECTION 303. RESERVATION OF NAME

(a) A corporate name may be reserved by:

(1) Any person intending to form a domestic corporation.

(2) Any domestic corporation intending to change its name.

(3) Any foreign corporation intending to apply for authority to do business in this state.

(4) Any authorized foreign corporation intending to change its name.

(5) Any person intending to incorporate a foreign corporation and to have it apply for authority to do business in this state.

(b) A fictitious name for use pursuant to section 1301 of this chapter, may be reserved by:

(1) Any foreign corporation intending to apply for authority to do business in this state, pursuant to paragraph (d) of section 1301 of this chapter.

(2) Any authorized foreign corporation intending to change its fictitious name under which it does business in this state.

(3) Any authorized foreign corporation which has changed its corporate name in its jurisdiction, such new corporate name not being available in this state.

(c) Application to reserve a corporate name shall be delivered to the department of state. It shall set forth the name and address of the applicant, the name to be reserved and a statement of the basis under paragraph (a) or (b) for the application. The secretary of state may require that there be included in the application a statement as to the nature of the business to be conducted by the corporation. If the name is available for corporate use, the

department of state shall reserve the name for the use of the applicant for a period of sixty days and issue a certificate of reservation. The restrictions and qualifications set forth in subparagraphs (a) (3), (4), (5), (6) and (7) of section 301 (Corporate name; general) are not waived by the issuance of a certificate of reservation. The certificate of reservation shall include the name of the applicant, the name reserved and the date of the reservation. The certificate of reservation (or in lieu thereof an affidavit by the applicant or by his agent or attorney that the certificate of reservation has been lost or destroyed) shall accompany the certificate of incorporation or the application for authority when either is delivered to the department of state.

(d) The secretary of state may extend the reservation for additional periods of not more than sixty days each, upon the written request of the applicant, his attorney or agent delivered to the department of state, to be filed before the expiration of the reservation period then in effect. Such request shall have attached to it the certificate of reservation of name. Not more than two such extensions shall be granted.

(e) Upon the request of the applicant, delivered to the department of state before the expiration of the reserved period, the department shall cancel the reservation.

(f) Any application or request under this section shall be signed by the applicant, his attorney or agent.

SECTION 304. STATUTORY DESIGNATION OF SECRETARY OF STATE AS AGENT FOR SERVICE OF PROCESS

Statutory designation of secretary of state as agent for service of process.

(a) The secretary of state shall be the agent of every domestic corporation and every authorized foreign corporation upon whom process against the corporation may be served.

(b) No domestic or foreign corporation may be formed or authorized to do business in this state under this chapter unless in its certificate of incorporation or application for authority it designates the secretary of state as such agent.

(c) Any designation by a domestic or a foreign corporation of the secretary of state as such agent, which designation is in effect on the effective date of this chapter, shall continue. Every domestic or foreign corporation, existing or authorized on the effective date of this chapter, which has not designated the secretary of state as such agent, shall be deemed to have done so. Any designation prior to the effective date of this chapter by a foreign corporation of an agent other than the secretary of state shall terminate on the effective date of this chapter.

(d) Any designated post-office address to which the secretary of state shall mail a copy of process served upon him as agent of a domestic corporation or a foreign corporation, shall continue until the filing of a certificate under this chapter directing the mailing to a different post-office address.

SECTION 305. REGISTERED AGENT FOR SERVICE OF PROCESS

(a) In addition to such designation of the secretary of state, every domestic corporation or authorized foreign corporation may designate a registered agent in this state upon whom process against such corporation may be served. The agent shall be a natural person who is a resident of or has a business address in this state or a domestic corporation or foreign corporation of any type or kind formed, or authorized to do business in this state, under this chapter or under any other statute of this state.

(b) Any such designation of a registered agent may be made, revoked or changed as provided in this chapter.

(c) A registered agent may resign as such agent. A certificate, entitled "Certificate of resignation of registered agent of .... (name of designating corporation) under section 305 of the Business Corporation Law", shall be signed by him and delivered to the department of state. It shall set forth:

(1) That he resigns as registered agent for the designating corporation.

(2) The date the certificate of incorporation or the application for authority of the designating corporation was filed by the department of state.

(3) That he has sent a copy of the certificate of resignation by registered mail to the designating corporation at the post office address on file in the department of state specified for the mailing of process or if such address is the address of the registered agent, then to the office of the designating corporation in the jurisdiction of its formation or incorporation.

(d) The designation of a registered agent shall terminate thirty days after the filing by the department of state of a certificate of resignation or a certificate containing a revocation or change of the designation, whichever is filed

earlier. A certificate designating a new registered agent may be delivered to the department of state by the corporation within the thirty days or thereafter.

SECTION 306. SERVICE OF PROCESS

(a) Service of process on a registered agent may be made in the manner provided by law for the service of a summons, as if the registered agent was a defendant.

(b) (1) Service of process on the secretary of state as agent of a domestic or authorized foreign corporation shall be made by personally delivering to and leaving with the secretary of state or a deputy, or with any person authorized by the secretary of state to receive such service, at the office of the department of state in the city of Albany, duplicate copies of such process together with the statutory fee, which fee shall be a taxable disbursement. Service of process on such corporation shall be complete when the secretary of state is so served. The secretary of state shall promptly send one of such copies by certified mail, return receipt requested, to such corporation, at the post office address, on file in the department of state, specified for the purpose. If a domestic or authorized foreign corporation has no such address on file in the department of state, the secretary of state shall so mail such copy, in the case of a domestic corporation, in care of any director named in its certificate of incorporation at the director's address stated therein or, in the case of an authorized foreign corporation, to such corporation at the address of its office within this state on file in the department.

(2) An additional service of the summons may be made pursuant to paragraph four of subdivision (f) of section thirty-two hundred fifteen of the civil practice law and rules.

(c) If an action or special proceeding is instituted in a court of limited jurisdiction, service of process may be made in the manner provided in this section if the office of the domestic or foreign corporation is within the territorial jurisdiction of the court.

(d) Nothing in this section shall affect the right to serve process in any other

manner permitted by law.

SECTION 306-A. RESIGNATION FOR RECEIPT OF PROCESS

(a) The party (or his/her legal representative) whose post office address has been supplied by a domestic corporation or authorized foreign corporation as its address for process may resign. A certificate entitled "Certificate of Resignation for Receipt of Process under Section 306-A of the Business Corporation Law" shall be signed by such party and delivered to the department of state. It shall set forth:

(1) The name of the corporation and the date that its certificate of incorporation or application of authority was filed by the department of state.

(2) That the address of the party has been designated by the corporation as the post office address to which the secretary of state shall mail a copy of any process served on the secretary of state as agent for such corporation, and that such party wishes to resign.

(3) That sixty days prior to the filing of the certificate of resignation with the department of state the party has sent a copy of the certificate of resignation for receipt of process by registered or certified mail to the address of the registered agent of the designating corporation, if other than the party filing the certificate of resignation, for receipt of process, or if the resigning corporation has no registered agent, then to the last address of the designating corporation known to the party, specifying the address to which the copy was sent. If there is no registered agent and no known address of the designating corporation, the party shall attach an affidavit to the certificate stating that a diligent but unsuccessful search was made by the party to locate the corporation, specifying what efforts were made.

(4) That the designating corporation is required to deliver to the department of state a certificate of amendment or change providing for the designation by the corporation of a new address and that upon its failure to file such certificate, its authority to do business in this state shall be suspended, unless

the corporation has previously filed a biennial statement under section four hundred eight of this chapter, in which case the address of the principal executive office stated in the last filed biennial statement shall constitute the new address for process of the corporation, and no such certificate of amendment or change need be filed.

(b) Upon the failure of the designating corporation to file a certificate of amendment or change providing for the designation by the corporation of the new address after the filing of a certificate of resignation for receipt of process with the secretary of state, its authority to do business in this state shall be suspended unless the corporation has previously filed a statement under section four hundred eight of this chapter, in which case the address of the principal executive office stated in the last filed statement, shall constitute the new address for process of the corporation provided such address is different from the previous address for process, and the corporation shall not be deemed suspended.

(c) The filing by the department of state of a certificate of amendment or change or statement under section four hundred eight of this chapter providing for a new address by a designating corporation shall annul the suspension and its authority to do business in this state shall be restored and continue as if no suspension had occurred.

(d) The resignation for receipt of process shall become effective upon the filing by the department of state of a certificate of resignation for receipt of process.

(e) (1) In any case in which a corporation suspended pursuant to this section would be subject to the personal or other jurisdiction of the courts of this state under article three of the civil practice law and rules, process against such corporation may be served upon the secretary of state as its agent pursuant to this section. Such process may issue in any court in this state having jurisdiction of the subject matter.

(2) Service of such process upon the secretary of state shall be made by personally delivering to and leaving with him or his deputy, or with any person authorized by the secretary of state to receive such service, at the office of the department of state in the city of Albany, a copy of such process

together with the statutory fee, which fee shall be a taxable disbursement. Such service shall be sufficient if notice thereof and a copy of the process are:

(i) delivered personally within or without this state to such corporation by a person and in manner authorized to serve process by law of the jurisdiction in which service is made, or

(ii) sent by or on behalf of the plaintiff to such corporation by registered or certified mail with return receipt requested to the last address of such corporation known to the plaintiff.

(3) (i) Where service of a copy of process was effected by personal service, proof of service shall be by affidavit of compliance with this section filed, together with the process, within thirty days after such service, with the clerk of the court in which the action or special proceeding is pending. Service of process shall complete ten days after such papers are filed with the clerk of the court.

(ii) Where service of a copy of process was effected by mailing in accordance with this section, proof of service shall be by affidavit of compliance with this section filed, together with the process, within thirty days after receipt of the return receipt signed by the corporation, or other official proof of delivery or of the original envelope mailed. If a copy of the process is mailed in accordance with this section, there shall be filed with the affidavit of compliance either the return receipt signed by such corporation or other official proof of delivery, if acceptance was refused by it, the original envelope with a notation by the postal authorities that acceptance was refused. If acceptance was refused, a copy of the notice and process together with notice of the mailing by registered or certified mail and refusal to accept shall be promptly sent to such corporation at the same address by ordinary mail and the affidavit of compliance shall so state. Service of process shall be complete ten days after such papers are filed with the clerk of the court. The refusal to accept delivery of the registered or certified mail or to sign the return receipt shall not affect the validity of the service and such corporation refusing to accept such registered or certified mail shall be charged with knowledge of the contents thereof.

(4) Service made as provided in this section without the state shall have the

same force as personal service made within this state.

(5) Nothing in this section shall affect the right to serve process in any other manner permitted by law.

SECTION 307. SERVICE OF PROCESS ON UNAUTHORIZED FOREIGN CORPORATION

(a) In any case in which a non-domiciliary would be subject to the personal or other jurisdiction of the courts of this state under article three of the civil practice law and rules, a foreign corporation not authorized to do business in this state is subject to a like jurisdiction. In any such case, process against such foreign corporation may be served upon the secretary of state as its agent. Such process may issue in any court in this state having jurisdiction of the subject matter.

(b) Service of such process upon the secretary of state shall be made by personally delivering to and leaving with him or his deputy, or with any person authorized by the secretary of state to receive such service, at the office of the department of state in the city of Albany, a copy of such process together with the statutory fee, which fee shall be a taxable disbursement. Such service shall be sufficient if notice thereof and a copy of the process are:

(1) Delivered personally without this state to such foreign corporation by a person and in the manner authorized to serve process by law of the jurisdiction in which service is made, or

(2) Sent by or on behalf of the plaintiff to such foreign corporation by registered mail with return receipt requested, at the post office address specified for the purpose of mailing process, on file in the department of state, or with any official or body performing the equivalent function, in the jurisdiction of its incorporation, or if no such address is there specified, to its registered or other office there specified, or if no such office is there specified, to the last address of such foreign corporation known to the plaintiff.

(c) 1. Where service of a copy of process was effected by personal service, proof of service shall be by affidavit of compliance with this section filed,

together with the process, within thirty days after such service, with the clerk of the court in which the action or special proceeding is pending. Service of process shall be complete ten days after such papers are filed with the clerk of the court.

2. Where service of a copy of process was effected by mailing in accordance with this section, proof of service shall be by affidavit of compliance with this section filed, together with the process, within thirty days after receipt of the return receipt signed by the foreign corporation, or other official proof of delivery or of the original envelope mailed. If a copy of the process is mailed in accordance with this section, there shall be filed with the affidavit of compliance either the return receipt signed by such foreign corporation or other official proof of delivery or, if acceptance was refused by it, the original envelope with a notation by the postal authorities that acceptance was refused. If acceptance was refused, a copy of the notice and process together with notice of the mailing by registered mail and refusal to accept shall be promptly sent to such foreign corporation at the same address by ordinary mail and the affidavit of compliance shall so state. Service of process shall be complete ten days after such papers are filed with the clerk of the court. The refusal to accept delivery of the registered mail or to sign the return receipt shall not affect the validity of the service and such foreign corporation refusing to accept such registered mail shall be charged with knowledge of the contents thereof.

(d) Service made as provided in this section shall have the same force as personal service made within this state.

(e) Nothing in this section shall affect the right to serve process in any other manner permitted by law.

SECTION 308. RECORDS AND CERTIFICATES OF DEPARTMENT OF STATE

The department of state shall keep a record of each process served upon the secretary of state under this chapter, including the date of service. It shall, upon request made within ten years of such service, issue a certificate under its seal certifying as to the receipt of the process by an authorized person, the date and place of such service and the receipt of the statutory fee. Process served upon the secretary of state under this chapter shall be destroyed by him after a period of ten years from such service.

ARTICLE 4. FORMATION OF CORPORATIONS

SECTION 401. INCORPORATORS

One or more natural persons of the age of eighteen years or over may act as incorporators of a corporation to be formed under this chapter.

SECTION 402. CERTIFICATE OF INCORPORATION; CONTENTS

(a) A certificate, entitled "Certificate of incorporation of ...... (name of corporation) under section 402 of the Business Corporation Law", shall be signed by each incorporator, with his name and address included in such certificate and delivered to the department of state. It shall set forth:

(1) The name of the corporation.

(2) The purpose or purposes for which it is formed, it being sufficient to state, either alone or with other purposes, that the purpose of the corporation is to engage in any lawful act or activity for which corporations may be organized under this chapter, provided that it also state that it is not formed to engage in any act or activity requiring the consent or approval of any state official, department, board, agency or other body without such consent or approval first being obtained. By such statement all lawful acts and activities shall be within the purposes of the corporation, except for express limitations therein or in this chapter, if any.

(3) The county within this state in which the office of the corporation is to be located.

(4) The aggregate number of shares which the corporation shall have the authority to issue; if such shares are to consist of one class only, the par value of the shares or a statement that the shares are without par value; or, if the shares are to be divided into classes, the number of shares of each class and the par value of the shares having par value and a statement as to which shares, if any, are without par value.

(5) If the shares are to be divided into classes, the designation of each class and a statement of the relative rights, preferences and limitations of the shares of each class.

(6) If the shares of any preferred class are to be issued in series, the designation of each series and a statement of the variations in the relative rights, preferences and limitations as between series insofar as the same are to be fixed in the certificate of incorporation, a statement of any authority to be vested in the board to establish and designate series and to fix the variations in the relative rights, preferences and limitations as between series and a statement of any limit on the authority of the board of directors to change the number of shares of any series of preferred shares as provided in paragraph (e) of section 502 (Issue of any class of preferred shares in series).

(7) A designation of the secretary of state as agent of the corporation upon whom process against it may be served and the post office address within or without this state to which the secretary of state shall mail a copy of any process against it served upon him.

(8) If the corporation is to have a registered agent, his name and address within this state and a statement that the registered agent is to be the agent of the corporation upon whom process against it may be served.

(9) The duration of the corporation if other than perpetual.

(b) The certificate of incorporation may set forth a provision eliminating or limiting the personal liability of directors to the corporation or its shareholders for damages for any breach of duty in such capacity, provided that no such provision shall eliminate or limit:

(1) the liability of any director if a judgment or other final adjudication adverse to him establishes that his acts or omissions were in bad faith or involved intentional misconduct or a knowing violation of law or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled or that his acts violated section 719, or

(2) the liability of any director for any act or omission prior to the adoption of a provision authorized by this paragraph.

(c) The certificate of incorporation may set forth any provision, not inconsistent with this chapter or any other statute of this state, relating to the business of the corporation, its affairs, its rights or powers, or the rights or

powers of its shareholders, directors or officers including any provision relating to matters which under this chapter are required or permitted to be set forth in the by-laws. It is not necessary to set forth in the certificate of incorporation any of the powers enumerated in this chapter.

SECTION 403. CERTIFICATE OF INCORPORATION; EFFECT

Upon the filing of the certificate of incorporation by the department of state, the corporate existence shall begin, and such certificate shall be conclusive evidence that all conditions precedent have been fulfilled and that the corporation has been formed under this chapter, except in an action or special proceeding brought by the attorney-general. Notwithstanding the above, a certificate of incorporation may set forth a date subsequent to filing, not to exceed ninety days after filing, upon which date corporate existence shall begin.

SECTION 404. ORGANIZATION MEETING

(a) After the corporate existence has begun, an organization meeting of the incorporator or incorporators shall be held within or without this state, for the purpose of adopting by-laws, electing directors to hold office until the first annual meeting of shareholders, except as authorized under section 704 (Classification of directors), and the transaction of such other business as may come before the meeting. If there are two or more incorporators, the meeting may be held at the call of any incorporator, who shall give at least five days' notice thereof by mail to each other incorporator, which notice shall set forth the time and place of the meeting. Notice need not be given to any incorporator who attends the meeting or submits a signed waiver of notice before or after the meeting. If there are more than two incorporators, a majority shall constitute a quorum and the act of the majority of the incorporators present at a meeting at which a quorum is present shall be the act of the incorporators. An incorporator may act in person or by proxy signed by the incorporator or his attorney-in-fact.

(b) Any action permitted to be taken at the organization meeting may be taken without a meeting if each incorporator or his attorney-in-fact signs an instrument setting forth the action so taken.

(c) If an incorporator dies or is for any reason unable to act, action may be taken as provided in such event in paragraph (c) of section 615 (Written consent of shareholders, subscribers or incorporators without a meeting).

SECTION 405-A. INSTITUTION FOR CHILDREN; APPROVAL OF CERTIFICATE

Every certificate of incorporation which includes among its corporate purposes, the authority to care for children through the establishment or operation of an institution for destitute, delinquent, abandoned, neglected or dependent children shall have endorsed thereon or annexed thereto the approval of the office of children and family services. Provided, however, nothing herein shall authorize such corporation to place out or board out children, as those terms are defined in the social services law, or to care for children in a facility other than an institution possessing an operating certificate issued by the office of children and family services. No certificate of incorporation shall be approved pursuant to this section on or after June first, two thousand seven.

SECTION 406. FILING OF A CERTIFICATE OF INCORPORATION; FACILITY FOR ALCOHOLISM OR ALCOHOL ABUSE, SUBSTANCE ABUSE, SUBSTANCE DEPENDENCE, OR CHEMICAL AB...

Filing of a certificate of incorporation; facility for alcoholism

or alcohol abuse, substance abuse, substance dependence, or

chemical abuse or dependence.

Every certificate of incorporation which includes among its corporate purposes the establishment or operation of a program of services for alcoholism or alcohol abuse, substance abuse, substance dependence, or chemical abuse or dependence shall have endorsed thereon or annexed thereto the approval of the commissioner of the state office of alcoholism and substance abuse services.

SECTION 408. STATEMENT; FILING

1. Except as provided in paragraph eight of this section, each domestic corporation, and each foreign corporation authorized to do business in this state, shall, during the applicable filing period as determined by subdivision three of this section, file a statement setting forth:

(a) The name and business address of its chief executive officer.

(b) The street address of its principal executive office.

(c) The post office address within or without this state to which the secretary of state shall mail a copy of any process against it served upon him or her. Such address shall supersede any previous address on file with the department of state for this purpose.

2. Except as provided in paragraph eight of this section, such statement shall be made on forms prescribed by the secretary of state, and the information therein contained shall be given as of the date of the execution of the statement. Such statement shall only request reporting of information required under paragraph one of this section. It shall be signed and delivered to the department of state.

3. Except as provided in paragraph eight of this section, for the purpose of this section the applicable filing period for a corporation shall be the calendar month during which its original certificate of incorporation or application for authority were filed or the effective date thereof if stated. The applicable filing period shall only occur: (a) annually, during the period starting on April 1, 1992 and ending on March 31, 1994; and (b) biennially, during a period starting on April 1 and ending on March 31 thereafter. Those corporations that filed between April 1, 1992 and June 30, 1994 shall not be required to file such statements again until such time as they would have filed, had this subdivision not been amended.

4. The provisions of paragraph (g) of section one hundred four of this chapter shall not be applicable to filings pursuant to this section.

5. The provisions of this section and section 409 of this article shall not apply to a farm corporation. For the purposes of this subdivision, the term "farm corporation" shall mean any domestic corporation or foreign corporation authorized to do business in this state under this chapter engaged in the production of crops, livestock and livestock products on land used in agricultural production, as defined in section 301 of the agriculture and markets law. However, this exception shall not apply to farm corporations that have filed statements with the department of state which have been submitted through the department of taxation and finance pursuant to paragraph eight of this section.

6. No such statement shall be accepted for filing when a certificate of resignation for receipt of process has been filed under section three hundred six-A of this chapter unless the corporation has stated a different address for process which does not include the name of the party previously designated in the address for process in such certificate.

7. A domestic corporation or foreign corporation may amend its statement to change the information required by subparagraphs (a) and (b) of paragraph one of this section. Such amendment shall be made on forms prescribed by the secretary of state. It shall be signed and delivered to the department of state.

8. (a) The commissioner of taxation and finance and the secretary of state may agree to allow corporations to provide the statement specified in paragraph one of this section on tax reports filed with the department of taxation and finance in lieu of biennial statements. This agreement may apply to tax reports due for tax years starting on or after January first, two thousand sixteen.

(b) If the agreement described in subparagraph (a) of this paragraph is made, each corporation required to file the statement specified in paragraph one of this section that is also subject to tax under article nine or nine-A of the tax law shall include such statement annually on its tax report filed with the department of taxation and finance in lieu of filing a statement under this

section with the department of state and in a manner prescribed by the commissioner of taxation and finance. However, each corporation required to file a statement under this section must continue to file the biennial statement required by this section with the department of state until the corporation in fact has filed a tax report with the department of taxation and finance that includes all required information. After that time, the corporation shall continue to deliver annually the statement specified in paragraph one of this section on its tax report in lieu of the biennial statement required by this section.

(c) If the agreement described in subparagraph (a) of this paragraph is made, the department of taxation and finance shall deliver to the department of state for filing the statement specified in paragraph one of this section for each corporation that files a tax report containing such statement. The department of taxation and finance must, to the extent feasible, also include the current name of the corporation, department of state identification number for such corporation, the name, signature and capacity of the signer of the statement, name and street address of the filer of the statement, and the email address, if any, of the filer of the statement.

SECTION 409. PENALTY FOR FAILURE TO FILE; CURE

1. Each corporation which has failed to file its statement within the time required by this chapter after thirty days shall be shown to be past due on the records of the department of state.

2. Each corporation which has failed to file its statement for two years shall be shown to be delinquent on the records of the department of state sixty days after a notice of delinquency has been mailed to the last known address of such corporation. Such delinquency shall be removed from the records of the department of state upon the filing of the current statement required by section four hundred eight of this article, and the payment of a fine of two hundred fifty dollars.

3. The notice of delinquency shall state the cure and fine for such delinquency as determined by subdivision two of this section and the period during which such delinquency shall be foreborne without the imposition of such fine.

4. This section shall not apply to corporations that have submitted a statement pursuant to paragraph eight of section four hundred eight of this chapter.

ARTICLE 5. CORPORATE FINANCE

SECTION 501. AUTHORIZED SHARES

(a) Every corporation shall have power to create and issue the number of shares stated in its certificate of incorporation. Such shares may be all of one class or may be divided into two or more classes. Each class shall consist of either shares with par value or shares without par value, having such designation and such relative voting, dividend, liquidation and other rights, preferences and limitations, consistent with this chapter, as shall be stated in the certificate of incorporation. The certificate of incorporation may deny, limit or otherwise define the voting rights and may limit or otherwise define the dividend or liquidation rights of shares of any class, but no such denial, limitation or definition of voting rights shall be effective unless at the time one or more classes of outstanding shares or bonds, singly or in the aggregate, are entitled to full voting rights, and no such limitation or definition of dividend or liquidation rights shall be effective unless at the time one or more classes of outstanding shares, singly or in the aggregate, are entitled to unlimited dividend and liquidation rights.

(b) If the shares are divided into two or more classes, the shares of each class shall be designated to distinguish them from the shares of all other classes. Shares which are entitled to preference in the distribution of dividends or assets shall not be designated as common shares. Shares which are not entitled to preference in the distribution of dividends or assets shall be common shares, even if identified by a class or other designation, and shall not be designated as preferred shares.

(c) Subject to the designations, relative rights, preferences and limitations applicable to separate series and except as otherwise permitted by subparagraph two of paragraph (a) of section five hundred five of this article, each share shall be equal to every other share of the same class. With respect to corporations owning or leasing residential premises and operating the same on a cooperative basis, however, provided that (1) liquidation or other distribution rights are substantially equal per share, (2) changes in

maintenance charges and general assessments pursuant to a proprietary lease have been and are hereafter fixed and determined on an equal per-share basis or on an equal per-room basis or as an equal percentage of the maintenance charges, and (3) voting rights are substantially equal per share or the certificate of incorporation provides that the shareholders holding the shares allocated to each apartment or dwelling unit owned by the corporation shall be entitled to one vote in the aggregate regardless of the number of shares allocated to the apartment or dwelling unit or the number of shareholders holding such shares, shares of the same class shall not be considered unequal because of variations in fees or charges payable to the corporation upon sale or transfer of shares and appurtenant proprietary leases that are provided for in proprietary leases, occupancy agreements or offering plans or properly approved amendments to the foregoing instruments.

SECTION 502. ISSUE OF ANY CLASS OF PREFERRED SHARES IN SERIES

(a) If the certificate of incorporation so provides, a corporation may issue any class of preferred shares in series. Shares of each such series when issued, shall be designated to distinguish them from shares of all other series.

(b) The number of shares included in any or all series of any classes of preferred shares and any or all of the designations, relative rights, preferences and limitations of any or all such series may be fixed in the certificate of incorporation, subject to the limitation that, unless the certificate of incorporation provides otherwise, if the stated dividends and amounts payable on liquidation are not paid in full, the shares of all series of the same class shall share ratably in the payment of dividends including accumulations, if any, in accordance with the sums which would be payable on such shares if all dividends were declared and paid in full, and in any distribution of assets other than by way of dividends in accordance with the sums which would be payable on such distribution if all sums payable were discharged in full.

(c) If any such number of shares or any such designation, relative right, preference or limitation of the shares of any series is not fixed in the certificate of incorporation, it may be fixed by the board, to the extent authorized by the certificate of incorporation. Unless otherwise provided in the certificate of incorporation, the number of preferred shares of any series so fixed by the board may be increased (but not above the total number of authorized shares of the class) or decreased (but not below the number of shares thereof then outstanding) by the board. In case the number of such shares shall be decreased, the number of shares by which the series is decreased shall, unless eliminated pursuant to paragraph (e) of this section, resume the status which they had prior to being designated as part of a series of preferred shares.

(d) Before the issue of any shares of a series established by the board, a

certificate of amendment under section 805 (Certificate of amendment; contents) shall be delivered to the department of state. Such certificate shall set forth:

(1) The name of the corporation, and, if it has been changed, the name under which it was formed.

(2) The date the certificate of incorporation was filed by the department of state.

(3) That the certificate of incorporation is thereby amended by the addition of a provision stating the number, designation, relative rights, preferences, and limitations of the shares of the series as fixed by the board, setting forth in full the text of such provision.

(e) Action by the board to increase or decrease the number of preferred shares of any series pursuant to paragraph (c) of this section shall become effective by delivering to the department of state a certificate of amendment under section 805 (Certificate of amendment; contents) which shall set forth:

(1) The name of the corporation, and, if it has been changed, the name under which it was formed.

(2) The date its certificate of incorporation was filed with the department of state.

(3) That the certificate of incorporation is thereby amended to increase or decrease, as the case may be, the number of preferred shares of any series so fixed by the board, setting forth the specific terms of the amendment and the number of shares so authorized following the effectiveness of the amendment.

When no shares of any such series are outstanding, either because none were issued or because no issued shares of any such series remain outstanding, the certificate of amendment under section 805 may also set forth a statement that none of the authorized shares of such series are outstanding and that none will be issued subject to the certificate of incorporation, and, when such certificate becomes accepted for filing, it shall have the effect of eliminating

from the certificate of incorporation all matters set forth therein with respect to such series of preferred shares.

SECTION 503. SUBSCRIPTION FOR SHARES; TIME OF PAYMENT, FORFEITURE FOR DEFAULT

(a) Unless otherwise provided by the terms of the subscription, a subscription for shares of a corporation to be formed shall be irrevocable, except with the consent of all other subscribers or the corporation, for a period of three months from its date.

(b) A subscription, whether made before or after the formation of a corporation, shall not be enforceable unless in writing and signed by the subscriber.

(c) Unless otherwise provided by the terms of the subscription, subscriptions for shares, whether made before or after the formation of a corporation, shall be paid in full at such time, or in such installments and at such times, as shall be determined by the board. Any call made by the board for payment on subscriptions shall be uniform as to all shares of the same class or of the same series. If a receiver of the corporation has been appointed, all unpaid subscriptions shall be paid at such times and in such installments as such receiver or the court may direct.

(d) In the event of default in the payment of any installment or call when due, the corporation may proceed to collect the amount due in the same manner as any debt due the corporation or the board may declare a forfeiture of the subscriptions. The subscription agreement may prescribe other penalties, not amounting to forfeiture, for failure to pay installments or calls that may become due. No forfeiture of the subscription shall be declared as against any subscriber unless the amount due thereon shall remain unpaid for a period of thirty days after written demand has been made therefor. If mailed, such written demand shall be deemed to be made when deposited in the United States mail in a sealed envelope addressed to the subscriber at his last post office address known to the corporation, with postage thereon prepaid. Upon forfeiture of the subscription, if at least fifty percent of the subscription price

has been paid, the shares subscribed for shall be offered for sale for cash or a binding obligation to pay cash at a price at least sufficient to pay the full balance owed by the delinquent subscriber plus the expenses incidental to such sale, and any excess of net proceeds realized over the amount owed on such shares shall be paid to the delinquent subscriber or to his legal representative. If no prospective purchaser offers a cash price or a binding obligation to pay cash sufficient to pay the full balance owed by the delinquent subscriber plus the expenses incidental to such sale, or if less than fifty percent of the subscription price has been paid, the shares subscribed for shall be cancelled and restored to the status of authorized but unissued shares and all previous payments thereon shall be forfeited to the corporation and transferred to surplus.

(e) Notwithstanding the provisions of paragraph (d) of this section, in the event of default in payment or other performance under the instrument evidencing a subscriber's binding obligation to pay a portion of the subscription price or perform services, the corporation may pursue such remedies as are provided in such instrument or a related agreement or under law.

SECTION 504. CONSIDERATION AND PAYMENT FOR SHARES

(a) Consideration for the issue of shares shall consist of money or other property, tangible or intangible; labor or services actually received by or performed for the corporation or for its benefit or in its formation or reorganization; a binding obligation to pay the purchase price or the subscription price in cash or other property; a binding obligation to perform services having an agreed value; or a combination thereof. In the absence of fraud in the transaction, the judgment of the board or shareholders, as the case may be, as to the value of the consideration received for shares shall be conclusive.

(c) Shares with par value may be issued for such consideration, not less than the par value thereof, as is fixed from time to time by the board.

(d) Shares without par value may be issued for such consideration as is fixed from time to time by the board unless the certificate of incorporation reserves to the shareholders the right to fix the consideration. If such right is reserved as to any shares, a vote of the shareholders shall either fix the consideration to be received for the shares or authorize the board to fix such consideration.

(e) Treasury shares may be disposed of by a corporation on such terms and conditions as are fixed from time to time by the board.

(f) Upon distribution of authorized but unissued shares to shareholders, that part of the surplus of a corporation which is concurrently transferred to stated capital shall be the consideration for the issue of such shares.

(g) In the event of a conversion of bonds or shares into shares, or in the event of an exchange of bonds or shares for shares, with or without par value, the consideration for the shares so issued in exchange or conversion shall be the sum of (1) either the principal sum of, and accrued interest on, the bonds so

exchanged or converted, or the stated capital then represented by the shares so exchanged or converted, plus (2) any additional consideration paid to the corporation for the new shares, plus (3) any stated capital not theretofore allocated to any designated class or series which is thereupon allocated to the new shares, plus (4) any surplus thereupon transferred to stated capital and allocated to the new shares.

(h) Certificates for shares may not be issued until the amount of the consideration therefor determined to be stated capital pursuant to section 506 (Determination of stated capital) has been paid in the form of cash, services rendered, personal or real property or a combination thereof and consideration for the balance (if any) complying with paragraph (a) of this section has been provided, except as provided in paragraphs (e) and (f) of section 505 (Rights and options to purchase shares; issue of rights and options to directors, officers and employees).

(i) When the consideration for shares has been provided in compliance with paragraph (h) of this section, the subscriber shall be entitled to all the rights and privileges of a holder of such shares and to a certificate representing his shares, and such shares shall be fully paid and nonassessable.

(j) Notwithstanding that such shares may be fully paid and nonassessable, the corporation may place in escrow shares issued for a binding obligation to pay cash or other property or to perform future services, or make other arrangements to restrict the transfer of the shares, and may credit distributions in respect of the shares against the obligation, until the obligation is performed. If the obligation is not performed in whole or in part, the corporation may pursue such remedies as are provided in the instrument evidencing the obligation or a related agreement or under law.

SECTION 505. RIGHTS AND OPTIONS TO PURCHASE SHARES; ISSUE OF RIGHTS AND OPTIONS TO DIRECTORS, OFFICERS AND EMPLOYEES

Rights and options to purchase shares; issue of rights and

options to directors, officers and employees.

(a) (1) Except as otherwise provided in this section or in the certificate of incorporation, a corporation may create and issue, whether or not in connection with the issue and sale of any of its shares or bonds, rights or options entitling the holders thereof to purchase from the corporation, upon such consideration, terms and conditions as may be fixed by the board, shares of any class or series, whether authorized but unissued shares, treasury shares or shares to be purchased or acquired or assets of the corporation.

(2) (i) In the case of a domestic corporation that has a class of voting stock registered with the Securities and Exchange Commission pursuant to section twelve of the Exchange Act, the terms and conditions of such rights or options may include, without limitation, restrictions or conditions that preclude or limit the exercise, transfer or receipt of such rights or options by an interested shareholder or any transferee of any such interested shareholder or that invalidate or void such rights or options held by any such interested shareholder or any such transferee. For the purpose of this subparagraph, the terms "voting stock", "Exchange Act" and "interested shareholder" shall have the same meanings as set forth in section nine hundred twelve of this chapter;

(ii) Determinations of the board of directors whether to impose, enforce or waive or otherwise render ineffective such limitations or conditions as are permitted by clause (i) of this subparagraph shall be subject to judicial review in an appropriate proceeding in which the courts formulate or apply appropriate standards in order to insure that such limitations or conditions are imposed, enforced or waived in the best long-term interests and short-term

interests of the corporation and its shareholders considering, without limitation, the prospects for potential growth, development, productivity and profitability of the corporation.

(b) The consideration for shares to be purchased under any such right or option shall comply with the requirements of section 504 (Consideration and payment for shares).

(c) The terms and conditions of such rights or options, including the time or times at or within which and the price or prices at which they may be exercised and any limitations upon transferability, shall be set forth or incorporated by reference in the instrument or instruments evidencing such rights or options.

(d) The issue of such rights or options to one or more directors, officers or employees of the corporation or a subsidiary or affiliate thereof, as an incentive to service or continued service with the corporation, a subsidiary or affiliate thereof, or to a trustee on behalf of such directors, officers or employees, shall be authorized as required by the policies of all stock exchanges or automated quotation systems on which the corporation's shares are listed or authorized for trading, or if the corporation's shares are not so listed or authorized, by a majority of the votes cast at a meeting of shareholders by the holders of shares entitled to vote thereon, or authorized by and consistent with a plan adopted by such vote of shareholders. If, under the certificate of incorporation, there are preemptive rights to any of the shares to be thus subject to rights or options to purchase, either such issue or such plan, if any shall also be approved by the vote or written consent of the holders of a majority of the shares entitled to exercise preemptive rights with respect to such shares and such vote or written consent shall operate to release the preemptive rights with respect thereto of the holders of all the shares that were entitled to exercise such preemptive rights.

In the absence of preemptive rights, nothing in this paragraph shall require shareholder approval for the issuance of rights or options to purchase shares of the corporation in substitution for, or upon the assumption of, rights or options issued by another corporation, if such substitution or assumption is in connection with such other corporation's merger or consolidation with, or the acquisition of its shares or all or part of its assets by, the corporation or its

subsidiary.

(e) A plan adopted by the shareholders for the issue of rights or options to directors, officers or employees shall include the material terms and conditions upon which such rights or options are to be issued, such as, but without limitation thereof, any restrictions on the number of shares that eligible individuals may have the right or option to purchase, the method of administering the plan, the terms and conditions of payment for shares in full or in installments, the issue of certificates for shares to be paid for in installments, any limitations upon the transferability of such shares and the voting and dividend rights to which the holders of such shares may be entitled, though the full amount of the consideration therefor has not been paid; provided that under this section no certificate for shares shall be delivered to a shareholder, prior to full payment therefor, unless the fact that the shares are partly paid is noted conspicuously on the face or back of such certificate.

(f) If there is shareholder approval for the issue of rights or options to individual directors, officers or employees, but not under an approved plan under paragraph (e), the terms and conditions of issue set forth in paragraph (e) shall be permissible except that the grantees of such rights or options shall not be granted voting or dividend rights until the consideration for the shares to which they are entitled under such rights or options has been fully paid.

(g) If there is shareholder approval for the issue of rights and options, such approval may provide that the board is authorized by certificate of amendment under section 805 (Certificate of amendment; contents) to increase the authorized shares of any class or series to such number as will be sufficient, when added to the previously authorized but unissued shares of such class or series, to satisfy any such rights or options entitling the holders thereof to purchase from the corporation authorized but unissued shares of such class or series.

(h) In the absence of fraud in the transaction, the judgment of the board shall be conclusive as to the adequacy of the consideration, tangible or intangible, received or to be received by the corporation for the issue of rights or options for the purchase from the corporation of its shares.

(i) The provisions of this section are inapplicable to the rights of the holders of convertible shares or bonds to acquire shares upon the exercise of conversion privileges under section 519 (Convertible shares and bonds).

SECTION 506. DETERMINATION OF STATED CAPITAL

(a) Upon issue by a corporation of shares with a par value, the consideration received therefor shall constitute stated capital to the extent of the par value of such shares.

(b) Upon issue by a corporation of shares without par value, the entire consideration received therefor shall constitute stated capital unless the board within a period of sixty days after issue allocates to surplus a portion, but not all, of the consideration received for such shares. No such allocation shall be made of any portion of the consideration received for shares without par value having a preference in the assets of the corporation upon involuntary liquidation except all or part of the amount, if any, of such consideration in excess of such preference, nor shall such allocation be made of any portion of the consideration for the issue of shares without par value which is fixed by the shareholders pursuant to a right reserved in the certificate of incorporation, unless such allocation is authorized by vote of the shareholders.

(c) The stated capital of a corporation may be increased from time to time by resolution of the board transferring all or part of the surplus of the corporation to stated capital. The board may direct that the amount so transferred shall be stated capital in respect of any designated class or series of shares.

SECTION 507. COMPENSATION FOR FORMATION, REORGANIZATION AND FINANCING

The reasonable charges and expenses of formation or reorganization of a corporation, and the reasonable expenses of and compensation for the sale or underwriting of its shares may be paid or allowed by the corporation out of the consideration received by it in payment for its shares without thereby impairing the fully paid and nonassessable status of such shares.

SECTION 508. CERTIFICATES REPRESENTING SHARES

(a) The shares of a corporation shall be represented by certificates or shall be uncertificated shares. Certificates shall be signed by the chairman or a vice-chairman of the board or the president or a vice-president and the secretary or an assistant secretary or the treasurer or an assistant treasurer of the corporation, and may be sealed with the seal of the corporation or a facsimile thereof. The signatures of the officers upon a certificate may be facsimiles if: (1) the certificate is countersigned by a transfer agent or registered by a registrar other than the corporation itself or its employee, or (2) the shares are listed on a registered national security exchange. In case any officer who has signed or whose facsimile signature has been placed upon a certificate shall have ceased to be such officer before such certificate is issued, it may be issued by the corporation with the same effect as if he were such officer at the date of issue.

(b) Each certificate representing shares issued by a corporation which is authorized to issue shares of more than one class shall set forth upon the face or back of the certificate, or shall state that the corporation will furnish to any shareholder upon request and without charge, a full statement of the designation, relative rights, preferences and limitations of the shares of each class authorized to be issued and, if the corporation is authorized to issue any class of preferred shares in series, the designation, relative rights, preferences and limitations of each such series so far as the same have been fixed and the authority of the board to designate and fix the relative rights, preferences and limitations of other series.

(c) Each certificate representing shares shall state upon the face thereof:

(1) That the corporation is formed under the laws of this state.

(2) The name of the person or persons to whom issued.

(3) The number and class of shares, and the designation of the series, if any, which such certificate represents.

(d) Shares shall be transferable in the manner provided by law and in the by-laws.

(e) The corporation may issue a new certificate for shares in place of any certificate theretofore issued by it, alleged to have been lost or destroyed, and the board may require the owner of the lost or destroyed certificate, or his legal representative, to give the corporation a bond sufficient to indemnify the corporation against any claim that may be made against it on account of the alleged loss or destruction of any such certificate or the issuance of any such new certificate.

(f) Unless otherwise provided by the articles of incorporation or by-laws, the board of directors of a corporation may provide by resolution that some or all of any or all classes and series of its shares shall be uncertificated shares, provided that such resolution shall not apply to shares represented by a certificate until such certificate is surrendered to the corporation. Within a reasonable time after the issuance or transfer of uncertificated shares, the corporation shall send to the registered owner thereof a written notice containing the information required to be set forth or stated on certificates pursuant to paragraphs (b) and (c) of this section. Except as otherwise expressly provided by law, the rights and obligations of the holders of uncertificated shares and the rights and obligations of the holders of certificates representing shares of the same class and series shall be identical.

SECTION 509. FRACTIONS OF A SHARE OR SCRIP AUTHORIZED

(a) A corporation may, but shall not be obliged to, issue fractions of a share either represented by a certificate or uncertificated, which shall entitle the holder, in proportion to his fractional holdings, to exercise voting rights, receive dividends and participate in liquidating distributions.

(b) As an alternative, a corporation may pay in cash the fair value of fractions of a share as of the time when those entitled to receive such fractions are determined.

(c) As an alternative, a corporation may issue scrip in registered or bearer form over the manual or facsimile signature of an officer of the corporation or of its agent, exchangeable as therein provided for full shares, but such scrip shall not entitle the holder to any rights of a shareholder except as therein provided. Such scrip may be issued subject to the condition that it shall become void if not exchanged for certificates representing full shares or uncertificated full shares before a specified date, or subject to the condition that the shares for which such scrip is exchangeable may be sold by the corporation and the proceeds thereof distributed to the holders of such scrip, or subject to any other conditions which the board may determine.

(d) A corporation may provide reasonable opportunity for persons entitled to fractions of a share or scrip to sell such fractions of a share or scrip or to purchase such additional fractions of a share or scrip as may be needed to acquire a full share.

SECTION 510. DIVIDENDS OR OTHER DISTRIBUTIONS IN CASH OR PROPERTY

(a) A corporation may declare and pay dividends or make other distributions in cash or its bonds or its property, including the shares or bonds of other corporations, on its outstanding shares, except when currently the corporation is insolvent or would thereby be made insolvent, or when the declaration, payment or distribution would be contrary to any restrictions contained in the certificate of incorporation.

(b) Dividends may be declared or paid and other distributions may be made either (1) out of surplus, so that the net assets of the corporation remaining after such declaration, payment or distribution shall at least equal the amount of its stated capital, or (2) in case there shall be no such surplus, out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year. If the capital of the corporation shall have been diminished by depreciation in the value of its property or by losses or otherwise to an amount less than the aggregate amount of the stated capital represented by the issued and outstanding shares of all classes having a preference upon the distribution of assets, the directors of such corporation shall not declare and pay out of such net profits any dividends upon any shares until the deficiency in the amount of stated capital represented by the issued and outstanding shares of all classes having a preference upon the distribution of assets shall have been repaired. A corporation engaged in the exploitation of natural resources or other wasting assets, including patents, or formed primarily for the liquidation of specific assets, may declare and pay dividends or make other distributions in excess of its surplus, computed after taking due account of depletion and amortization, to the extent that the cost of the wasting or specific assets has been recovered by depletion reserves, amortization or sale, if the net assets remaining after such dividends or distributions are sufficient to cover the liquidation preferences of shares having such preferences in involuntary liquidation.

SECTION 511. SHARE DISTRIBUTIONS AND CHANGES

(a) A corporation may make pro rata distributions of its authorized but unissued shares to holders of any class or series of its outstanding shares, subject to the following conditions:

(1) If a distribution of shares having a par value is made, such shares shall be issued at not less than the par value thereof and there shall be transferred to stated capital at the time of such distribution an amount of surplus equal to the aggregate par value of such shares.

(2) If a distribution of shares without par value is made, the amount of stated capital to be represented by each such share shall be fixed by the board, unless the certificate of incorporation reserves to the shareholders the right to fix the consideration for the issue of such shares, and there shall be transferred to stated capital at the time of such distribution an amount of surplus equal to the aggregate stated capital represented by such shares.

(3) A distribution of shares of any class or series may be made to holders of the same or any other class or series of shares unless the certificate of incorporation provides otherwise, provided, however, that in the case of a corporation incorporated prior to the effective date of subparagraph (4) of this paragraph, then so long as any shares of such class remain outstanding a distribution of shares of any class or series of shares of such corporation may be made only to holders of the same class or series of shares unless the certificate of incorporation permits distribution to holders of another class or series, or unless such distribution is approved by the affirmative vote or the written consent of the holders of a majority of the outstanding shares of the class or series to be distributed.

(4) A distribution of any class or series of shares shall be subject to the preemptive rights, if any, applicable to such shares pursuant to this chapter.

(b) A corporation making a pro rata distribution of authorized but unissued shares to the holders of any class or series of outstanding shares may at its option make an equivalent distribution upon treasury shares of the same class or series, and any shares so distributed shall be treasury shares.

(c) A change of issued shares of any class which increases the stated capital represented by those shares may be made if the surplus of the corporation is sufficient to permit the transfer, and a transfer is concurrently made, from surplus to stated capital, of an amount equal to such increase.

(d) No transfer from surplus to stated capital need be made by a corporation making a distribution of its treasury shares to holders of any class of outstanding shares; nor upon a split up or division of issued shares of any class into a greater number of shares of the same class, or a combination of issued shares of any class into a lesser number of shares of the same class, if there is no increase in the aggregate stated capital represented by them.

(e) Nothing in this section shall prevent a corporation from making other transfers from surplus to stated capital in connection with share distributions or otherwise.

(f) Every distribution to shareholders of certificates representing a share distribution or a change of shares which affects stated capital or surplus shall be accompanied by a written notice (1) disclosing the amounts by which such distribution or change affects stated capital and surplus, or (2) if such amounts are not determinable at the time of such notice, disclosing the approximate effect of such distribution or change upon stated capital and surplus and stating that such amounts are not yet determinable.

(g) When issued shares are changed in any manner which affects stated capital or surplus, and no distribution to shareholders of certificates representing any shares resulting from such change is made, disclosure of the effect of such change upon the stated capital and surplus shall be made in the next financial statement covering the period in which such change is made that is furnished by the corporation to holders of shares of the class or series so changed or, if practicable, in the first notice of dividend or share distribution or change that is furnished to such shareholders between the date of the change of shares and the next such financial statement, and in any

event within six months of the date of such change.

SECTION 512. REDEEMABLE SHARES

(a) Subject to the restrictions contained in section 513 (Purchase, redemption and certain other transactions by a corporation with respect to its own shares) and paragraph (b) of this section, a corporation may provide in its certificate of incorporation for one or more classes or series of shares which are redeemable, in whole or in part, at the option of the corporation, the holder or another person or upon the happening of a specified event.

(b) No redeemable common shares, other than shares of an open-end investment company, as defined in an act of congress entitled "Investment Company Act of 1940", as amended, or of a member corporation of a national securities exchange registered under a statute of the United States such as the Securities Exchange Act of 1934, as amended, or of a corporation described in this paragraph, shall be issued or redeemed unless the corporation at the time has outstanding a class of common shares that is not subject to redemption. Any common shares of a corporation which directly or through a subsidiary has a license or franchise to conduct its business, which license or franchise is conditioned upon some or all of the holders of such corporation's common shares possessing prescribed qualifications, may be made subject to redemption by the corporation to the extent necessary to prevent the loss of, or to reinstate, such license or franchise.

(c) Shares of any class or series which may be made redeemable under this section may be redeemed for cash, other property, indebtedness or other securities of the same or another corporation, at such time or times, price or prices, or rate or rates, and with such adjustments, as shall be stated in the certificate of incorporation.

(d) Nothing in this section shall prevent a corporation from creating sinking funds for the redemption or purchase of its shares to the extent permitted by section 513 (Purchase, redemption and certain other transactions by a corporation with respect to its own shares).

SECTION 513. PURCHASE, REDEMPTION AND CERTAIN OTHER TRANSACTIONS BY A CORPORATION WITH RESPECT TO ITS OWN SHARES

Purchase, redemption and certain other transactions by a

corporation with respect to its own shares.

(a) Notwithstanding any authority contained in the certificate of incorporation, the shares of a corporation may not be purchased by the corporation, or, if redeemable, convertible or exchangeable shares, may not be redeemed, converted or exchanged, in each case for or into cash, other property, indebtedness or other securities of the corporation (other than shares of the corporation and rights to acquire such shares) if the corporation is then insolvent or would thereby be made insolvent. Shares may be purchased or redeemed only out of surplus.

(b) When its redeemable, convertible or exchangeable shares are purchased by the corporation within the period during which such shares may be redeemed, converted or exchanged at the option of the corporation, the purchase price thereof shall not exceed the applicable redemption, conversion or exchange price stated in the certificate of incorporation. Upon a redemption, conversion or exchange, the amount payable by the corporation for shares having a cumulative preference on dividends may include the stated redemption, conversion or exchange price plus accrued dividends to the next dividend date following the date of redemption, conversion or exchange of such shares.

(c) No domestic corporation which is subject to the provisions of section nine hundred twelve of this chapter shall purchase or agree to purchase more than ten percent of the stock of the corporation from a shareholder for more than the market value thereof unless such purchase or agreement to purchase is approved by the affirmative vote of the board of directors and a majority of

the votes of all outstanding shares entitled to vote thereon at a meeting of shareholders unless the certificate of incorporation requires a greater percentage of the votes of the outstanding shares to approve.

The provisions of this paragraph shall not apply when the corporation offers to purchase shares from all holders of stock or for stock which the holder has been the beneficial owner of for more than two years.

The terms "stock", "beneficial owner", and "market value" shall be as defined in section nine hundred twelve of this chapter.

SECTION 514. AGREEMENTS FOR PURCHASE BY A CORPORATION OF ITS OWN SHARES

(a) An agreement for the purchase by a corporation of its own shares shall be enforceable by the shareholder and the corporation to the extent such purchase is permitted at the time of purchase by section 513 (Purchase or redemption by a corporation of its own shares).

(b) The possibility that a corporation may not be able to purchase its shares under section 513 shall not be a ground for denying to either party specific performance of an agreement for the purchase by a corporation of its own shares, if at the time for performance the corporation can purchase all or part of such shares under section 513.

SECTION 515. REACQUIRED SHARES

(a) Shares that have been issued and have been purchased, redeemed or otherwise reacquired by a corporation shall be cancelled if they are reacquired out of stated capital, or if they are converted shares, or if the certificate of incorporation requires that such shares be cancelled upon reacquisition.

(b) Any shares reacquired by the corporation and not required to be cancelled may be either retained as treasury shares or cancelled by the board at the time of reacquisition or at any time thereafter.

(c) Neither the retention of reacquired shares as treasury shares, nor their subsequent distribution to shareholders or disposition for a consideration shall change the stated capital. When treasury shares are disposed of for a consideration, the surplus shall be increased by the full amount of the consideration received.

(d) Shares cancelled under this section are restored to the status of authorized but unissued shares. However, if the certificate of incorporation prohibits the reissue of any shares required or permitted to be cancelled under this section, the board by certificate of amendment under section 805 (Certificate of amendment; contents) shall reduce the number of authorized shares accordingly.

SECTION 516. REDUCTION OF STATED CAPITAL IN CERTAIN CASES

(a) Except as otherwise provided in the certificate of incorporation, the board may at any time reduce the stated capital of a corporation in any of the following ways:

(1) by eliminating from stated capital any portion of amounts previously transferred by the board from surplus to stated capital and not allocated to any designated class or series of shares;

(2) by reducing or eliminating any amount of stated capital represented by issued shares having a par value which exceeds the aggregate par value of such shares;

(3) by reducing the amount of stated capital represented by issued shares without par value; or

(4) by applying to an otherwise authorized purchase, redemption, conversion or exchange of outstanding shares some or all of the stated capital represented by the shares being purchased, redeemed, converted or exchanged, or some or all of any stated capital that has not been allocated to any particular shares, or both. Notwithstanding the foregoing, if the consideration for the issue of shares without par value was fixed by the shareholders under section 504 (Consideration and payment for shares), the board shall not reduce the stated capital represented by such shares except to the extent, if any, that the board was authorized by the shareholders to allocate any portion of such consideration to surplus.

(b) No reduction of stated capital shall be made under this section unless after such reduction the stated capital exceeds the aggregate preferential amounts payable upon involuntary liquidation upon all issued shares having preferential rights in the assets plus the par value of all other issued shares

with par value.

(c) When a reduction of stated capital has been effected under this section, the amount of such reduction shall be disclosed in the next financial statement covering the period in which such reduction is made that is furnished by the corporation to all its shareholders or, if practicable, in the first notice of dividend or share distribution that is furnished to the holders of each class or series of its shares between the date of such reduction and the next such financial statement, and in any event to all its shareholders within six months of the date of such reduction.

SECTION 518. CORPORATE BONDS

(a) No corporation shall issue bonds except for money or other property, tangible or intangible; labor or services actually received by or performed for the corporation or for its benefit or in its formation or reorganization; a binding obligation to pay the purchase price thereof in cash or other property; a binding obligation to perform services having an agreed value; or a combination thereof. In the absence of fraud in the transaction, the judgment of the board as to the value of the consideration received shall be conclusive.

(b) If a distribution of its own bonds is made by a corporation to holders of any class or series of its outstanding shares, there shall be concurrently transferred to the liabilities of the corporation in respect of such bonds an amount of surplus equal to the principal amount of, and any accrued interest on, such bonds. The amount of the surplus so transferred shall be the consideration for the issue of such bonds.

(c) A corporation may, in its certificate of incorporation, confer upon the holders of any bonds issued or to be issued by the corporation, rights to inspect the corporate books and records and to vote in the election of directors and on any other matters on which shareholders of the corporation may vote.

SECTION 519. CONVERTIBLE OR EXCHANGEABLE SHARES AND BONDS

(a) Unless otherwise provided in the certificate of incorporation, and subject to the restrictions in section 513 (Purchase, redemption and certain other transactions by a corporation with respect to its own shares) and paragraphs (c) and (d) of this section, a corporation may issue shares or bonds convertible into or exchangeable for, at the option of the holder, the corporation or another person, or upon the happening of a specified event, shares of any class or shares of any series of any class or cash, other property, indebtedness or other securities of the same or another corporation.

(b) If there is shareholder approval for the issue of bonds or shares convertible into, or exchangeable for, shares of the corporation, such approval may provide that the board is authorized by certificate of amendment under section 805 (Certificate of amendment; contents) to increase the authorized shares of any class or series to such number as will be sufficient, when added to the previously authorized but unissued shares of such class or series, to satisfy the conversion or exchange privileges of any such bonds or shares convertible into, or exchangeable for, shares of such class or series.

(c) No issue of bonds or shares convertible into, or exchangeable for, shares of the corporation shall be made unless:

(1) A sufficient number of authorized but unissued shares, or treasury shares, of the appropriate class or series are reserved by the board to be issued only in satisfaction of the conversion or exchange privileges of such convertible or exchangeable bonds or shares when issued;

(2) The aggregate conversion or exchange privileges of such convertible or exchangeable bonds or shares when issued do not exceed the aggregate of any shares reserved under subparagraph (1) and any additional shares which

may be authorized by the board under paragraph (b); or

(3) In the case of the conversion or exchange of shares of common stock other than into other shares of common stock, there remains outstanding a class or series of common stock not subject to conversion or exchange other than into other shares of common stock, except in the case of corporations of the type described in the exceptions to the provisions of paragraph (b) of section 512 (Redeemable shares).

(d) No privilege of conversion may be conferred upon, or altered in respect to, any shares or bonds that would result in the receipt by the corporation of less than the minimum consideration required to be received upon the issue of new shares. The consideration for shares issued upon the exercise of a conversion or exchange privilege shall be that provided in paragraph (g) of section 504 (Consideration and payment for shares).

(e) When shares have been converted or exchanged, they shall be cancelled. When bonds have been converted or exchanged, they shall be cancelled and not reissued except upon compliance with the provisions governing the issue of convertible or exchangeable bonds.

SECTION 520. LIABILITY FOR FAILURE TO DISCLOSE REQUIRED INFORMATION

Failure of the corporation to comply in good faith with the notice or disclosure provisions of paragraphs (f) and (g) of section 511 (Share distributions and changes), or paragraph (c) of section 516 (Reduction of stated capital in certain cases), shall make the corporation liable for any damage sustained by any shareholder in consequence thereof.

ARTICLE 6. SHAREHOLDERS

SECTION 601. BY-LAWS

(a) The initial by-laws of a corporation shall be adopted by its incorporator or incorporators at the organization meeting. Thereafter, subject to section 613 (Limitations on right to vote), by-laws may be adopted, amended or repealed by a majority of the votes cast by the shares at the time entitled to vote in the election of any directors. When so provided in the certificate of incorporation or a by-law adopted by the shareholders, by-laws may also be adopted, amended or repealed by the board by such vote as may be therein specified, which may be greater than the vote otherwise prescribed by this chapter, but any by-law adopted by the board may be amended or repealed by the shareholders entitled to vote thereon as herein provided. Any reference in this chapter to a "by-law adopted by the shareholders" shall include a by-law adopted by the incorporator or incorporators.

(b) The by-laws may contain any provision relating to the business of the corporation, the conduct of its affairs, its rights or powers or the rights or powers of its shareholders, directors or officers, not inconsistent with this chapter or any other statute of this state or the certificate of incorporation.

SECTION 602. MEETINGS OF SHAREHOLDERS

(a) Meetings of shareholders may be held at such place, within or without this state, as may be fixed by or under the by-laws, or if not so fixed, at the office of the corporation in this state.

(b) A meeting of shareholders shall be held annually for the election of directors and the transaction of other business on a date fixed by or under the by-laws. A failure to hold the annual meeting on the date so fixed or to elect a sufficient number of directors to conduct the business of the corporation shall not work a forfeiture or give cause for dissolution of the corporation, except as provided in paragraph (c) of section 1104 (Petition in case of deadlock among directors or shareholders).

(c) Special meetings of the shareholders may be called by the board and by such person or persons as may be so authorized by the certificate of incorporation or the by-laws. At any such special meeting only such business may be transacted which is related to the purpose or purposes set forth in the notice required by section 605 (Notice of meetings of shareholders).

(d) Except as otherwise required by this chapter, the by-laws may designate reasonable procedures for the calling and conduct of a meeting of shareholders, including but not limited to specifying: (i) who may call and who may conduct the meeting, (ii) the means by which the order of business to be conducted shall be established, (iii) the procedures and requirements for the nomination of directors, (iv) the procedures with respect to the making of shareholder proposals, and (v) the procedures to be established for the adjournment of any meeting of shareholders. No amendment of the by-laws pertaining to the election of directors or the procedures for the calling and conduct of a meeting of shareholders shall affect the election of directors or the procedures for the calling or conduct in respect of any meeting of shareholders unless adequate notice thereof is given to the shareholders in a manner reasonably calculated to provide shareholders with sufficient time to

respond thereto prior to such meeting.

SECTION 603. SPECIAL MEETING FOR ELECTION OF DIRECTORS

(a) If, for a period of one month after the date fixed by or under the by-laws for the annual meeting of shareholders, or if no date has been so fixed, for a period of thirteen months after the formation of the corporation or the last annual meeting, there is a failure to elect a sufficient number of directors to conduct the business of the corporation, the board shall call a special meeting for the election of directors. If such special meeting is not called by the board within two weeks after the expiration of such period or if it is so called but there is a failure to elect such directors for a period of two months after the expiration of such period, holders of ten percent of the votes of the shares entitled to vote in an election of directors may, in writing, demand the call of a special meeting for the election of directors specifying the date and month thereof, which shall not be less than sixty nor more than ninety days from the date of such written demand. The secretary of the corporation upon receiving the written demand shall promptly give notice of such meeting, or if he fails to do so within five business days thereafter, any shareholder signing such demand may give such notice. The meeting shall be held at the place fixed in the by-laws or, if not so fixed, at the office of the corporation.

(b) At any such special meeting called on demand of shareholders, notwithstanding section 608 (Quorum of shareholders), the shareholders attending, in person or by proxy, and entitled to vote in an election of directors shall constitute a quorum for the purpose of electing directors, but not for the transaction of any other business.

SECTION 604. FIXING RECORD DATE

(a) For the purpose of determining the shareholders entitled to notice of or to vote at any meeting of shareholders or any adjournment thereof, or to express consent to or dissent from any proposal without a meeting, or for the purpose of determining shareholders entitled to receive payment of any dividend or the allotment of any rights, or for the purpose of any other action, the by-laws may provide for fixing or, in the absence of such provision, the board may fix, in advance, a date as the record date for any such determination of shareholders. Such date shall not be more than sixty nor less than ten days before the date of such meeting, nor more than sixty days prior to any other action.

(b) If no record date is fixed:

(1) The record date for the determination of shareholders entitled to notice of or to vote at a meeting of shareholders shall be at the close of business on the day next preceding the day on which notice is given, or, if no notice is given, the day on which the meeting is held.

(2) The record date for determining shareholders for any purpose other than that specified in subparagraph (1) shall be at the close of business on the day on which the resolution of the board relating thereto is adopted.

(c) When a determination of shareholders of record entitled to notice of or to vote at any meeting of shareholders has been made as provided in this section, such determination shall apply to any adjournment thereof, unless the board fixes a new record date under this section for the adjourned meeting.

SECTION 605. NOTICE OF MEETINGS OF SHAREHOLDERS

(a) Whenever under the provisions of this chapter shareholders are required or permitted to take any action at a meeting, notice shall be given stating the place, date and hour of the meeting and, unless it is the annual meeting, indicating that it is being issued by or at the direction of the person or persons calling the meeting. Notice of a special meeting shall also state the purpose or purposes for which the meeting is called. Notice of any meeting of shareholders may be written or electronic. If, at any meeting, action is proposed to be taken which would, if taken, entitle shareholders fulfilling the requirements of section 623 (Procedure to enforce shareholder's right to receive payment for shares) to receive payment for their shares, the notice of such meeting shall include a statement of that purpose and to that effect and shall be accompanied by a copy of section 623 or an outline of its material terms. Notice of any meeting shall be given not fewer than ten nor more than sixty days before the date of the meeting, provided, however, that such notice may be given by third class mail not fewer than twenty-four nor more than sixty days before the date of the meeting, to each shareholder entitled to vote at such meeting. If mailed, such notice is given when deposited in the United States mail, with postage thereon prepaid, directed to the shareholder at the shareholder's address as it appears on the record of shareholders, or, if the shareholder shall have filed with the secretary of the corporation a request that notices to the shareholder be mailed to some other address, then directed to him at such other address. If transmitted electronically, such notice is given when directed to the shareholder's electronic mail address as supplied by the shareholder to the secretary of the corporation or as otherwise directed pursuant to the shareholder's authorization or instructions. An affidavit of the secretary or other person giving the notice or of a transfer agent of the corporation that the notice required by this section has been given shall, in the absence of fraud, be prima facie evidence of the facts therein stated.

(b) When a meeting is adjourned to another time or place, it shall not be necessary, unless the by-laws require otherwise, to give any notice of the

adjourned meeting if the time and place to which the meeting is adjourned are announced at the meeting at which the adjournment is taken, and at the adjourned meeting any business may be transacted that might have been transacted on the original date of the meeting. However, if after the adjournment the board fixes a new record date for the adjourned meeting, a notice of the adjourned meeting shall be given to each shareholder of record on the new record date entitled to notice under paragraph (a).

SECTION 606. WAIVERS OF NOTICE

Notice of meeting need not be given to any shareholder who submits a waiver of notice whether before or after the meeting. Waiver of notice may be written or electronic. If written, the waiver must be executed by the shareholder or the shareholder's authorized officer, director, employee or agent by signing such waiver or causing his or her signature to be affixed to such waiver by any reasonable means, including, but not limited to, facsimile signature. If electronic, the transmission of the waiver must either set forth or be submitted with information from which it can reasonably be determined that the transmission was authorized by the shareholder. The attendance of any shareholder at a meeting, in person or by proxy, without protesting prior to the conclusion of the meeting the lack of notice of such meeting, shall constitute a waiver of notice by such shareholder.

SECTION 607. LIST OF SHAREHOLDERS AT MEETINGS

A list of shareholders as of the record date, certified by the corporate officer responsible for its preparation or by a transfer agent, shall be produced at any meeting of shareholders upon the request thereat or prior thereto of any shareholder. If the right to vote at any meeting is challenged, the inspectors of election, or person presiding thereat, shall require such list of shareholders to be produced as evidence of the right of the persons challenged to vote at such meeting, and all persons who appear from such list to be shareholders entitled to vote thereat may vote at such meeting.

SECTION 608. QUORUM OF SHAREHOLDERS

(a) The holders of a majority of the votes of shares entitled to vote thereat shall constitute a quorum at a meeting of shareholders for the transaction of any business, provided that when a specified item of business is required to be voted on by a particular class or series of shares, voting as a class, the holders of a majority of the votes of shares of such class or series shall constitute a quorum for the transaction of such specified item of business.

(b) The certificate of incorporation or by-laws may provide for any lesser quorum not less than one-third of the votes of shares entitled to vote, and the certificate of incorporation may, under section 616 (Greater requirement as to quorum and vote of shareholders), provide for a greater quorum.

(c) When a quorum is once present to organize a meeting, it is not broken by the subsequent withdrawal of any shareholders.

(d) The shareholders present may adjourn the meeting despite the absence of a quorum.

SECTION 609. PROXIES

(a) Every shareholder entitled to vote at a meeting of shareholders or to express consent or dissent without a meeting may authorize another person or persons to act for him by proxy.

(b) No proxy shall be valid after the expiration of eleven months from the date thereof unless otherwise provided in the proxy. Every proxy shall be revocable at the pleasure of the shareholder executing it, except as otherwise provided in this section.

(c) The authority of the holder of a proxy to act shall not be revoked by the incompetence or death of the shareholder who executed the proxy unless, before the authority is exercised, written notice of an adjudication of such incompetence or of such death is received by the corporate officer responsible for maintaining the list of shareholders.

(d) Except when other provision shall have been made by written agreement between the parties, the record holder of shares which he holds as pledgee or otherwise as security or which belong to another, shall issue to the pledgor or to such owner of such shares, upon demand therefor and payment of necessary expenses thereof, a proxy to vote or take other action thereon.

(e) A shareholder shall not sell his vote or issue a proxy to vote to any person for any sum of money or anything of value, except as authorized in this section and section 620 (Agreements as to voting; provision in certificate of incorporation as to control of directors); provided, however, that this paragraph shall not apply to votes, proxies or consents given by holders of preferred shares in connection with a proxy or consent solicitation made available on identical terms to all holders of shares of the same class or series and remaining open for acceptance for at least twenty business days.

(f) A proxy which is entitled "irrevocable proxy" and which states that it is

irrevocable, is irrevocable when it is held by any of the following or a nominee of any of the following:

(1) A pledgee;

(2) A person who has purchased or agreed to purchase the shares;

(3) A creditor or creditors of the corporation who extend or continue credit to the corporation in consideration of the proxy if the proxy states that it was given in consideration of such extension or continuation of credit, the amount thereof, and the name of the person extending or continuing credit;

(4) A person who has contracted to perform services as an officer of the corporation, if a proxy is required by the contract of employment, if the proxy states that it was given in consideration of such contract of employment, the name of the employee and the period of employment contracted for;

(5) A person designated by or under an agreement under paragraph (a) of section 620.

(g) Notwithstanding a provision in a proxy, stating that it is irrevocable, the proxy becomes revocable after the pledge is redeemed, or the debt of the corporation is paid, or the period of employment provided for in the contract of employment has terminated, or the agreement under paragraph (a) of section 620 has terminated; and, in a case provided for in subparagraphs (f)(3) or (4), becomes revocable three years after the date of the proxy or at the end of the period, if any, specified therein, whichever period is less, unless the period of irrevocability is renewed from time to time by the execution of a new irrevocable proxy as provided in this section. This paragraph does not affect the duration of a proxy under paragraph (b).

(h) A proxy may be revoked, notwithstanding a provision making it irrevocable, by a purchaser of shares without knowledge of the existence of the provision unless the existence of the proxy and its irrevocability is noted conspicuously on the face or back of the certificate representing such shares.

(i) Without limiting the manner in which a shareholder may authorize another person or persons to act for him as proxy pursuant to paragraph (a) of this

section, the following shall constitute a valid means by which a shareholder may grant such authority.

(1) A shareholder may execute a writing authorizing another person or persons to act from him as proxy. Execution may be accomplished by the shareholder or the shareholder's authorized officer, director, employee or agent signing such writing or causing his or her signature to be affixed to such writing by any reasonable means including, but not limited to, by facsimile signature.

(2) A shareholder may authorize another person or persons to act for the shareholder as proxy by transmitting or authorizing the transmission of a telegram, cablegram or other means of electronic transmission to the person who will be the holder of the proxy or to a proxy solicitation firm, proxy support service organization or like agent duly authorized by the person who will be the holder of the proxy to receive such transmission, provided that any such telegram, cablegram or other means of electronic transmission must either set forth or be submitted with information from which it can be reasonably determined that the telegram, cablegram or other electronic transmission was authorized by the shareholder. If it is determined that such telegrams, cablegrams or other electronic transmissions are valid, the inspectors or, if there are no inspectors, such other persons making that determination shall specify the nature of the information upon which they relied.

(j) Any copy, facsimile telecommunication or other reliable reproduction of the writing or transmission created pursuant to paragraph (i) of this section may be substituted or used in lieu of the original writing or transmission for any and all purposes for which the original writing or transmission could be used, provided that such copy, facsimile telecommunication or other reproduction shall be a complete reproduction of the entire original writing or transmission.

SECTION 610. SELECTION OF INSPECTORS AT SHAREHOLDERS' MEETINGS

Selection of inspectors at shareholders' meetings.

(a) The board of directors shall appoint one or more inspectors to act at the meeting or any adjournment thereof and make a written report thereof. The board of directors may designate one or more persons as alternate inspectors to replace any inspector who fails to act. If no inspector or alternate has been appointed, or if such persons are unable to act at a meeting of shareholders, the person presiding at the meeting shall appoint one or more inspectors to act at the meeting. Each inspector, before entering upon the discharge of his duties, shall take and sign an oath faithfully to execute the duties of inspector at such meeting with strict impartiality and according to the best of his ability.

(b) Unless otherwise provided in the certificate of incorporation or by-laws, paragraph (a) of this section shall not apply to a corporation that does not have a class of voting stock that is listed on a national securities exchange or authorized for quotation on an interdealer quotation system of a registered national securities association. Notwithstanding the foregoing, any corporation may take the actions set forth in paragraph (a) of this section.

SECTION 611. DUTIES OF INSPECTORS AT SHAREHOLDERS' MEETINGS

Duties of inspectors at shareholders' meetings.

(a) The inspectors shall determine the number of shares outstanding and the voting power of each, the shares represented at the meeting, the existence of a quorum, the validity and effect of proxies, and shall receive votes, ballots or consents, hear and determine all challenges and questions arising in connection with the right to vote, count and tabulate all votes, ballots or consents, determine the result, and do such acts as are proper to conduct the election or vote with fairness to all shareholders. On request of the person presiding at the meeting or any shareholder entitled to vote thereat, the inspectors shall make a report in writing of any challenge, question or matter determined by them and execute a certificate of any fact found by them. Any report or certificate made by them shall be prima facie evidence of the facts stated and of the vote as certified by them.

(b) In determining the validity and counting of proxies, ballots and consents, the inspectors shall be limited to an examination of the proxies, any envelopes submitted with those proxies and consents, any information provided in accordance with section 609 (Proxies), ballots and the regular books and records of the corporation, except that the inspectors may consider other reliable information for the limited purpose of reconciling proxies, ballots and consents submitted by or on behalf of banks, brokers, their nominees or similar persons which represent more votes than the holder of a proxy is authorized by the record owner to cast or more votes than the stockholder holds of record. If the inspectors consider other reliable information for the limited purpose permitted herein, the inspectors at the time they make their certification pursuant to paragraph (a) of this section shall specify the precise information considered by them including the person or persons from whom they obtained the information, when the information was obtained, the means by which the information was obtained and the basis

for the inspectors' belief that such information is reliable.

(c) The date and time (which need not be a particular time of day) of the opening and the closing of the polls for each matter upon which the shareholders will vote at a meeting shall be announced by the person presiding at the meeting at the beginning of the meeting and, if no date and time is so announced, the polls shall close at the end of the meeting, including any adjournment thereof. No ballot, proxies or consents, nor any revocation thereof or changes thereto, shall be accepted by the inspectors after the closing of polls in accordance with section 605 (Notice of meetings of shareholders) unless the supreme court at a special term held within the judicial district where the office of the corporation is located upon application by a shareholder shall determine otherwise.

(d) Unless otherwise provided in the certificate of incorporation or by-laws, paragraphs (a) and (c) of this section shall not apply to a corporation that does not have a class of voting stock that is listed on a national securities exchange or authorized for quotation on an interdealer quotation system of a registered national securities association. Notwithstanding the foregoing, any corporation may take the actions set forth in paragraphs (a) and (c) of this section.

SECTION 612. QUALIFICATION OF VOTERS

(a) Every shareholder of record shall be entitled at every meeting of shareholders to one vote for every share standing in his name on the record of shareholders, unless otherwise provided in the certificate of incorporation.

(b) Treasury shares and shares held by another domestic or foreign corporation of any type or kind, if a majority of the shares entitled to vote in the election of directors of such other corporation is held by the corporation, shall not be shares entitled to vote or to be counted in determining the total number of outstanding shares.

(c) Shares held by an administrator, executor, guardian, conservator, committee, or other fiduciary, except a trustee, may be voted by him, either in person or by proxy, without transfer of such shares into his name. Shares held by a trustee may be voted by him, either in person or by proxy, only after the shares have been transferred into his name as trustee or into the name of his nominee.

(d) Shares held by or under the control of a receiver may be voted by him without the transfer thereof into his name if authority so to do is contained in an order of the court by which such receiver was appointed.

(e) A shareholder whose shares are pledged shall be entitled to vote such shares until the shares have been transferred into the name of the pledgee, or a nominee of the pledgee.

(f) Redeemable shares which have been called for redemption shall not be deemed to be outstanding shares for the purpose of voting or determining the total number of shares entitled to vote on any matter on and after the date on which written notice of redemption has been sent to holders thereof and a sum sufficient to redeem such shares has been deposited with a bank or trust company with irrevocable instruction and authority to pay the redemption

price to the holders of the shares upon surrender of certificates therefor.

(g) Shares standing in the name of another domestic or foreign corporation of any type or kind may be voted by such officer, agent or proxy as the by-laws of such corporation may provide, or, in the absence of such provision, as the board of such corporation may determine.

(h) If shares are registered on the record of shareholders of a corporation in the name of two or more persons, whether fiduciaries, members of a partnership, joint tenants, tenants in common, tenants by the entirety or otherwise, or if two or more persons have the same fiduciary relationship respecting the same shares, unless the secretary of the corporation is given written notice to the contrary and is furnished with a copy of the instrument or order appointing them or creating the relationship wherein it is so provided, their acts with respect to voting shall have the following effect:

(1) If only one votes, the vote shall be accepted by the corporation as the vote of all;

(2) If more than one vote, the act of the majority so voting shall be accepted by the corporation as the vote of all;

(3) If more than one vote, but the vote is equally divided on any particular matter, the vote shall be accepted by the corporation as a proportionate vote of the shares; unless the corporation has evidence, on the record of shareholders or otherwise, that the shares are held in a fiduciary capacity. Nothing in this paragraph shall alter any requirement that the exercise of fiduciary powers be by act of a majority, contained in any law applicable to such exercise of powers (including section 10-10.7 of the estates, powers and trusts law);

(4) When shares as to which the vote is equally divided are registered on the record of shareholders of a corporation in the name of, or have passed by operation of law or by virtue of any deed of trust or other instrument to two or more fiduciaries, any court having jurisdiction of their accounts, upon petition by any of such fiduciaries or by any party in interest, may direct the voting of such shares for the best interest of the beneficiaries. This subparagraph shall not apply in any case where the instrument or order of the

court appointing fiduciaries shall otherwise direct how such shares shall be voted; and

(5) If the instrument or order furnished to the secretary of a corporation shows that a tenancy is held in unequal interests, a majority or equal division for the purposes of this paragraph shall be a majority or equal division in interest.

(i) Notwithstanding the foregoing paragraphs, a corporation shall be protected in treating the persons in whose names shares stand on the record of shareholders as the owners thereof for all purposes.

SECTION 613. LIMITATIONS ON RIGHT TO VOTE

The certificate of incorporation may provide, except as limited by section 501 (Authorized shares), either absolutely or conditionally, that the holders of any designated class or series of shares shall not be entitled to vote, or it may otherwise limit or define the respective voting powers of the several classes or series of shares, and, except as otherwise provided in this chapter, such provisions of such certificate shall prevail, according to their tenor, in all elections and in all proceedings, over the provisions of this chapter which authorizes any action by the shareholders.

SECTION 614. VOTE OF SHAREHOLDERS

(a) Directors shall, except as otherwise required by this chapter or by the by-laws or certificate of incorporation as permitted by this chapter, be elected by a plurality of the votes cast at a meeting of shareholders by the holders of shares entitled to vote in the election.

(b) Whenever any corporate action, other than the election of directors, is to be taken under this chapter by vote of the shareholders, it shall, except as otherwise required by this chapter or by the certificate of incorporation as permitted by this chapter or by the specific provisions of a by-law adopted by the shareholders, be authorized by a majority of the votes cast in favor of or against such action at a meeting of shareholders by the holders of shares entitled to vote thereon. Except as otherwise provided in the certificate of incorporation or the specific provision of a by-law adopted by the shareholders, an abstention shall not constitute a vote cast.

SECTION 615. WRITTEN CONSENT OF SHAREHOLDERS, SUBSCRIBERS OR INCORPORATORS WITHOUT A MEETING

Written consent of shareholders, subscribers or incorporators

without a meeting.

(a) Whenever under this chapter shareholders are required or permitted to take any action by vote, such action may be taken without a meeting on written consent, setting forth the action so taken, signed by the holders of all outstanding shares entitled to vote thereon or, if the certificate of incorporation so permits, signed by the holders of outstanding shares having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote thereon were present and voted.

In addition, this paragraph shall not be construed to alter or modify the provisions of any section or any provision in a certificate of incorporation not inconsistent with this chapter under which the written consent of the holders of less than all outstanding shares is sufficient for corporate action.

(b) No written consent shall be effective to take the corporate action referred to therein unless, within sixty days of the earliest dated consent delivered in the manner required by this paragraph to the corporation, written consents signed by a sufficient number of holders to take action are delivered to the corporation by delivery to its registered office in this state, its principal place of business, or an officer or agent of the corporation having custody of the book in which proceedings of meetings of shareholders are recorded. Delivery made to a corporation's registered office shall be by hand or by certified or registered mail, return receipt requested.

(c) Prompt notice of the taking of the corporate action without a meeting by

less than unanimous written consent shall be given to those shareholders who have not consented in writing.

(d) Written consent thus given by the holders of such number of shares as is required under paragraph (a) of this section shall have the same effect as a valid vote of holders of such number of shares, and any certificate with respect to the authorization or taking of any such action which is to be delivered to the department of state shall recite that written consent has been given in accordance with this section and that written notice has been given as and to the extent required by this section.

(e) When there are no shareholders of record, such action may be taken on the written consent signed by a majority in interest of the subscribers for shares whose subscriptions have been accepted or their successors in interest or, if no subscription has been accepted, on the written consent signed by the incorporator or a majority of the incorporators. When there are two or more incorporators, if any dies or is for any reason unable to act, the other or others may act. If there is no incorporator able to act, any person for whom an incorporator was acting as agent may act in his stead, or if such other person also dies or is for any reason unable to act, his legal representative may act.

SECTION 616. GREATER REQUIREMENT AS TO QUORUM AND VOTE OF SHAREHOLDERS

(a) The certificate of incorporation may contain provisions specifying either or both of the following:

(1) That the proportion of votes of shares, or the proportion of votes of shares of any class or series thereof, the holders of which shall be present in person or by proxy at any meeting of shareholders, including a special meeting for election of directors under section 603 (Special meeting for election of directors), in order to constitute a quorum for the transaction of any business or of any specified item of business, including amendments to the certificate of incorporation, shall be greater than the proportion prescribed by this chapter in the absence of such provision.

(2) That the proportion of votes of shares, or votes of shares of a particular class or series of shares, that shall be necessary at any meeting of shareholders for the transaction of any business or of any specified item of business, including amendments to the certificate of incorporation, shall be greater than the proportion prescribed by this chapter in the absence of such provision.

(b) An amendment of the certificate of incorporation which changes or strikes out a provision permitted by this section, shall be authorized at a meeting of shareholders by two-thirds of the votes of the shares entitled to vote thereon, or of such greater proportion of votes of shares, or votes of shares of a particular class or series of shares, as may be provided specifically in the certificate of incorporation for changing or striking out a provision permitted by this section.

(c) If the certificate of incorporation of any corporation contains a provision authorized by this section, the existence of such provision shall be noted conspicuously on the face or back of every certificate for shares issued by

such corporation, except that this requirement shall not apply to any corporation having any class of any equity security registered pursuant to Section twelve of the Securities Exchange Act of 1934, as amended.

SECTION 617. VOTING BY CLASS OR CLASSES OF SHARES

(a) The certificate of incorporation may contain provisions specifying that any class or classes of shares or of any series thereof shall vote as a class in connection with the transaction of any business or of any specified item of business at a meeting of shareholders, including amendments to the certificate of incorporation.

(b) Where voting as a class is provided in the certificate of incorporation, it shall be by the proportionate vote so provided or, if no proportionate vote is provided, in the election of directors, by a plurality of the votes cast at such meeting by the holders of shares of such class entitled to vote in the election, or for any other corporate action, by a majority of the votes cast at such meeting by the holders of shares of such class entitled to vote thereon.

(c) Such voting by class shall be in addition to any other vote, including vote by class, required by this chapter and by the certificate of incorporation as permitted by this chapter.

SECTION 618. CUMULATIVE VOTING

The certificate of incorporation of any corporation may provide that in all elections of directors of such corporation each shareholder shall be entitled to as many votes as shall equal the number of votes which, except for such provisions as to cumulative voting, he would be entitled to cast for the election of directors with respect to his shares multiplied by the number of directors to be elected, and that he may cast all of such votes for a single director or may distribute them among the number to be voted for, or any two or more of them, as he may see fit, which right, when exercised, shall be termed cumulative voting.

SECTION 619. POWERS OF SUPREME COURT RESPECTING ELECTIONS

Upon the petition of any shareholder aggrieved by an election, and upon notice to the persons declared elected thereat, the corporation and such other persons as the court may direct, the supreme court at a special term held within the judicial district where the office of the corporation is located shall forthwith hear the proofs and allegations of the parties, and confirm the election, order a new election, or take such other action as justice may require.

SECTION 620. AGREEMENTS AS TO VOTING; PROVISION IN CERTIFICATE OF INCORPORATION AS TO CONTROL OF DIRECTORS

Agreements as to voting; provision in certificate of

incorporation as to control of directors.

(a) An agreement between two or more shareholders, if in writing and signed by the parties thereto, may provide that in exercising any voting rights, the shares held by them shall be voted as therein provided, or as they may agree, or as determined in accordance with a procedure agreed upon by them.

(b) A provision in the certificate of incorporation otherwise prohibited by law because it improperly restricts the board in its management of the business of the corporation, or improperly transfers to one or more shareholders or to one or more persons or corporations to be selected by him or them, all or any part of such management otherwise within the authority of the board under this chapter, shall nevertheless be valid:

(1) If all the incorporators or holders of record of all outstanding shares, whether or not having voting power, have authorized such provision in the certificate of incorporation or an amendment thereof; and

(2) If, subsequent to the adoption of such provision, shares are transferred or issued only to persons who had knowledge or notice thereof or consented in writing to such provision.

(c) A provision authorized by paragraph (b) shall be valid only so long as no shares of the corporation are listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national or affiliated securities association.

(d) (1) Except as provided in paragraph (e), an amendment to strike out a provision authorized by paragraph (b) shall be authorized at a meeting of shareholders by (A) (i) for any corporation in existence on the effective date of subparagraph (2) of this paragraph, two-thirds of the votes of the shares entitled to vote thereon and (ii) for any corporation in existence on the effective date of this clause the certificate of incorporation of which expressly provides such and for any corporation incorporated after the effective date of subparagraph (2) of this paragraph, a majority of the votes of the shares entitled to vote thereon or (B) in either case, by such greater proportion of votes of shares as may be required by the certificate of incorporation for that purpose.

(2) Any corporation may adopt an amendment of the certificate of incorporation in accordance with the applicable clause or subclause of subparagraph (1) of this paragraph to provide that any further amendment of the certificate of incorporation that strikes out a provision authorized by paragraph (b) of this section shall be authorized at a meeting of the shareholders by a specified proportion of votes of the shares, or votes of a particular class or series of shares, entitled to vote thereon, provided that such proportion may not be less than a majority.

(e) Alternatively, if a provision authorized by paragraph (b) shall have ceased to be valid under this section, the board may authorize a certificate of amendment under section 805 (Certificate of amendment; contents) striking out such provision. Such certificate shall set forth the event by reason of which the provision ceased to be valid.

(f) The effect of any such provision authorized by paragraph (b) shall be to relieve the directors and impose upon the shareholders authorizing the same or consenting thereto the liability for managerial acts or omissions that is imposed on directors by this chapter to the extent that and so long as the discretion or powers of the board in its management of corporate affairs is controlled by any such provision.

(g) If the certificate of incorporation of any corporation contains a provision authorized by paragraph (b), the existence of such provision shall be noted conspicuously on the face or back of every certificate for shares issued by such corporation.

SECTION 621. VOTING TRUST AGREEMENTS

(a) Any shareholder or shareholders, under an agreement in writing, may transfer his or their shares to a voting trustee or trustees for the purpose of conferring the right to vote thereon for a period not exceeding ten years upon the terms and conditions therein stated. The certificates for shares so transferred shall be surrendered and cancelled and new certificates therefor issued to such trustee or trustees stating that they are issued under such agreement, and in the entry of such ownership in the record of the corporation that fact shall also be noted, and such trustee or trustees may vote the shares so transferred during the term of such agreement.

(b) The trustee or trustees shall keep available for inspection by holders of voting trust certificates at his or their office or at a place designated in such agreement or of which the holders of voting trust certificates have been notified in writing, correct and complete books and records of account relating to the trust, and a record containing the names and addresses of all persons who are holders of voting trust certificates and the number and class of shares represented by the certificates held by them and the dates when they became the owners thereof. The record may be in written form or any other form capable of being converted into written form within a reasonable time.

(c) A duplicate of every such agreement shall be filed in the office of the corporation and it and the record of voting trust certificate holders shall be subject to the same right of inspection by a shareholder of record or a holder of a voting trust certificate, in person or by agent or attorney, as are the records of the corporation under section 624 (Books and records; right of inspection, prima facie evidence). The shareholder or holder of a voting trust certificate shall be entitled to the remedies provided in that section.

(d) At any time within six months before the expiration of such voting trust agreement as originally fixed or as extended one or more times under this paragraph, one or more holders of voting trust certificates may, by agreement

in writing, extend the duration of such voting trust agreement, nominating the same or substitute trustee or trustees, for an additional period not exceeding ten years. Such extension agreement shall not affect the rights or obligations of persons not parties thereto and shall in every respect comply with and be subject to all the provisions of this section applicable to the original voting trust agreement.

SECTION 622. PREEMPTIVE RIGHTS

(a) As used in this section, the term:

(1) "Unlimited dividend rights" means the right without limitation as to amount either to all or to a share of the balance of current or liquidating dividends after the payment of dividends on any shares entitled to a preference.

(2) "Equity shares" means shares of any class, whether or not preferred as to dividends or assets, which have unlimited dividend rights.

(3) "Voting rights" means the right to vote for the election of one or more directors, excluding a right so to vote which is dependent on the happening of an event specified in the certificate of incorporation which would change the voting rights of any class of shares.

(4) "Voting shares" means shares of any class which have voting rights, but does not include bonds on which voting rights are conferred under section 518 (Corporate bonds).

(5) "Preemptive right" means the right to purchase shares or other securities to be issued or subjected to rights or options to purchase, as such right is defined in this section.

(b) (1) With respect to any corporation incorporated prior to the effective date of subparagraph (2) of this paragraph, except as otherwise provided in the certificate of incorporation, and except as provided in this section, the holders of equity shares of any class, in case of the proposed issuance by the corporation of, or the proposed granting by the corporation of rights or options to purchase, its equity shares of any class or any shares or other securities convertible into or carrying rights or options to purchase its equity shares of any class, shall, if the issuance of the equity shares proposed to be

issued or issuable upon exercise of such rights or options or upon conversion of such other securities would adversely affect the unlimited dividend rights of such holders, have the right during a reasonable time and on reasonable conditions, both to be fixed by the board, to purchase such shares or other securities in such proportions as shall be determined as provided in this section.

(2) With respect to any corporation incorporated on or after the effective date of this subparagraph, the holders of such shares shall not have any preemptive right, except as otherwise expressly provided in the certificate of incorporation.

(c) Except as otherwise provided in the certificate of incorporation, and except as provided in this section, the holders of voting shares of any class having any preemptive right under this paragraph on the date immediately prior to the effective date of subparagraph (2) of paragraph (b) of this section, in case of the proposed issuance by the corporation of, or the proposed granting by the corporation of rights or options to purchase, its voting shares of any class or any shares or other securities convertible into or carrying rights or options to purchase its voting shares of any class, shall, if the issuance of the voting shares proposed to be issued or issuable upon exercise of such rights or options or upon conversion of such other securities would adversely affect the voting rights of such holders, have the right during a reasonable time and on reasonable conditions, both to be fixed by the board, to purchase such shares or other securities in such proportions as shall be determined as provided in this section.

(d) The preemptive right provided for in paragraphs (b) and (c) shall entitle shareholders having such rights to purchase the shares or other securities to be offered or optioned for sale as nearly as practicable in such proportions as would, if such preemptive right were exercised, preserve the relative unlimited dividend rights and voting rights of such holders and at a price or prices not less favorable than the price or prices at which such shares or other securities are proposed to be offered for sale to others, without deduction of such reasonable expenses of and compensation for the sale, underwriting or purchase of such shares or other securities by underwriters or dealers as may lawfully be paid by the corporation. In case each of the shares entitling the

holders thereof to preemptive rights does not confer the same unlimited dividend right or voting right, the board shall apportion the shares or other securities to be offered or optioned for sale among the shareholders having preemptive rights to purchase them in such proportions as in the opinion of the board shall preserve as far as practicable the relative unlimited dividend rights and voting rights of the holders at the time of such offering. The apportionment made by the board shall, in the absence of fraud or bad faith, be binding upon all shareholders.

(e) Unless otherwise provided in the certificate of incorporation, shares or other securities offered for sale or subjected to rights or options to purchase shall not be subject to preemptive rights under paragraph (b) or (c) of this section if they:

(1) Are to be issued by the board to effect a merger or consolidation or offered or subjected to rights or options for consideration other than cash;

(2) Are to be issued or subjected to rights or options under paragraph (d) of section 505 (Rights and options to purchase shares; issue of rights and options to directors, officers and employees);

(3) Are to be issued to satisfy conversion or option rights theretofore granted by the corporation;

(4) Are treasury shares;

(5) Are part of the shares or other securities of the corporation authorized in its original certificate of incorporation and are issued, sold or optioned within two years from the date of filing such certificate; or

(6) Are to be issued under a plan of reorganization approved in a proceeding under any applicable act of congress relating to reorganization of corporations.

(f) Shareholders of record entitled to preemptive rights on the record date fixed by the board under section 604 (Fixing record date), or, if no record date is fixed, then on the record date determined under section 604, and no others shall be entitled to the right defined in this section.

(g) The board shall cause to be given to each shareholder entitled to purchase shares or other securities in accordance with this section, a notice directed to him in the manner provided in section 605 (Notice of meetings of shareholders) setting forth the time within which and the terms and conditions upon which the shareholder may purchase such shares or other securities and also the apportionment made of the right to purchase among the shareholders entitled to preemptive rights. Such notice shall be given personally or by mail at least fifteen days prior to the expiration of the period during which the shareholder shall have the right to purchase. All shareholders entitled to preemptive rights to whom notice shall have been given as aforesaid shall be deemed conclusively to have had a reasonable time in which to exercise their preemptive rights.

(h) Shares or other securities which have been offered to shareholders having preemptive rights to purchase and which have not been purchased by them within the time fixed by the board may thereafter, for a period of not exceeding one year following the expiration of the time during which shareholders might have exercised such preemptive rights, be issued, sold or subjected to rights or options to any other person or persons at a price, without deduction of such reasonable expenses of and compensation for the sale, underwriting or purchase of such shares by underwriters or dealers as may lawfully be paid by the corporation, not less than that at which they were offered to such shareholders. Any such shares or other securities not so issued, sold or subjected to rights or options to others during such one year period shall thereafter again be subject to the preemptive rights of shareholders.

(i) Except as otherwise provided in the certificate of incorporation and except as provided in this section, no holder of any shares of any class shall as such holder have any preemptive right to purchase any other shares or securities of any class which at any time may be sold or offered for sale by the corporation. Unless otherwise provided in the certificate of incorporation, holders of bonds on which voting rights are conferred under section 518 shall have no preemptive rights.

SECTION 623. PROCEDURE TO ENFORCE SHAREHOLDER'S RIGHT TO RECEIVE PAYMENT FOR SHARES

Procedure to enforce shareholder's right to receive payment for

shares.

(a) A shareholder intending to enforce his right under a section of this chapter to receive payment for his shares if the proposed corporate action referred to therein is taken shall file with the corporation, before the meeting of shareholders at which the action is submitted to a vote, or at such meeting but before the vote, written objection to the action. The objection shall include a notice of his election to dissent, his name and residence address, the number and classes of shares as to which he dissents and a demand for payment of the fair value of his shares if the action is taken. Such objection is not required from any shareholder to whom the corporation did not give notice of such meeting in accordance with this chapter or where the proposed action is authorized by written consent of shareholders without a meeting.

(b) Within ten days after the shareholders' authorization date, which term as used in this section means the date on which the shareholders' vote authorizing such action was taken, or the date on which such consent without a meeting was obtained from the requisite shareholders, the corporation shall give written notice of such authorization or consent by registered mail to each shareholder who filed written objection or from whom written objection was not required, excepting any shareholder who voted for or consented in writing to the proposed action and who thereby is deemed to have elected not to enforce his right to receive payment for his shares.

(c) Within twenty days after the giving of notice to him, any shareholder from whom written objection was not required and who elects to dissent shall file with the corporation a written notice of such election, stating his name and residence address, the number and classes of shares as to which he

dissents and a demand for payment of the fair value of his shares. Any shareholder who elects to dissent from a merger under section 905 (Merger of subsidiary corporation) or paragraph (c) of section 907 (Merger or consolidation of domestic and foreign corporations) or from a share exchange under paragraph (g) of section 913 (Share exchanges) shall file a written notice of such election to dissent within twenty days after the giving to him of a copy of the plan of merger or exchange or an outline of the material features thereof under section 905 or 913.

(d) A shareholder may not dissent as to less than all of the shares, as to which he has a right to dissent, held by him of record, that he owns beneficially. A nominee or fiduciary may not dissent on behalf of any beneficial owner as to less than all of the shares of such owner, as to which such nominee or fiduciary has a right to dissent, held of record by such nominee or fiduciary.

(e) Upon consummation of the corporate action, the shareholder shall cease to have any of the rights of a shareholder except the right to be paid the fair value of his shares and any other rights under this section. A notice of election may be withdrawn by the shareholder at any time prior to his acceptance in writing of an offer made by the corporation, as provided in paragraph (g), but in no case later than sixty days from the date of consummation of the corporate action except that if the corporation fails to make a timely offer, as provided in paragraph (g), the time for withdrawing a notice of election shall be extended until sixty days from the date an offer is made. Upon expiration of such time, withdrawal of a notice of election shall require the written consent of the corporation. In order to be effective, withdrawal of a notice of election must be accompanied by the return to the corporation of any advance payment made to the shareholder as provided in paragraph (g). If a notice of election is withdrawn, or the corporate action is rescinded, or a court shall determine that the shareholder is not entitled to receive payment for his shares, or the shareholder shall otherwise lose his dissenters' rights, he shall not have the right to receive payment for his shares and he shall be reinstated to all his rights as a shareholder as of the consummation of the corporate action, including any intervening preemptive rights and the right to payment of any intervening dividend or other distribution or, if any such rights have expired or any such dividend or distribution other than in cash has been completed, in lieu thereof, at the

election of the corporation, the fair value thereof in cash as determined by the board as of the time of such expiration or completion, but without prejudice otherwise to any corporate proceedings that may have been taken in the interim.

(f) At the time of filing the notice of election to dissent or within one month thereafter the shareholder of shares represented by certificates shall submit the certificates representing his shares to the corporation, or to its transfer agent, which shall forthwith note conspicuously thereon that a notice of election has been filed and shall return the certificates to the shareholder or other person who submitted them on his behalf. Any shareholder of shares represented by certificates who fails to submit his certificates for such notation as herein specified shall, at the option of the corporation exercised by written notice to him within forty-five days from the date of filing of such notice of election to dissent, lose his dissenter's rights unless a court, for good cause shown, shall otherwise direct. Upon transfer of a certificate bearing such notation, each new certificate issued therefor shall bear a similar notation together with the name of the original dissenting holder of the shares and a transferee shall acquire no rights in the corporation except those which the original dissenting shareholder had at the time of transfer.

(g) Within fifteen days after the expiration of the period within which shareholders may file their notices of election to dissent, or within fifteen days after the proposed corporate action is consummated, whichever is later (but in no case later than ninety days from the shareholders' authorization date), the corporation or, in the case of a merger or consolidation, the surviving or new corporation, shall make a written offer by registered mail to each shareholder who has filed such notice of election to pay for his shares at a specified price which the corporation considers to be their fair value. Such offer shall be accompanied by a statement setting forth the aggregate number of shares with respect to which notices of election to dissent have been received and the aggregate number of holders of such shares. If the corporate action has been consummated, such offer shall also be accompanied by (1) advance payment to each such shareholder who has submitted the certificates representing his shares to the corporation, as provided in paragraph (f), of an amount equal to eighty percent of the amount of such offer, or (2) as to each shareholder who has not yet submitted his certificates a statement that

advance payment to him of an amount equal to eighty percent of the amount of such offer will be made by the corporation promptly upon submission of his certificates. If the corporate action has not been consummated at the time of the making of the offer, such advance payment or statement as to advance payment shall be sent to each shareholder entitled thereto forthwith upon consummation of the corporate action. Every advance payment or statement as to advance payment shall include advice to the shareholder to the effect that acceptance of such payment does not constitute a waiver of any dissenters' rights. If the corporate action has not been consummated upon the expiration of the ninety day period after the shareholders' authorization date, the offer may be conditioned upon the consummation of such action. Such offer shall be made at the same price per share to all dissenting shareholders of the same class, or if divided into series, of the same series and shall be accompanied by a balance sheet of the corporation whose shares the dissenting shareholder holds as of the latest available date, which shall not be earlier than twelve months before the making of such offer, and a profit and loss statement or statements for not less than a twelve month period ended on the date of such balance sheet or, if the corporation was not in existence throughout such twelve month period, for the portion thereof during which it was in existence. Notwithstanding the foregoing, the corporation shall not be required to furnish a balance sheet or profit and loss statement or statements to any shareholder to whom such balance sheet or profit and loss statement or statements were previously furnished, nor if in connection with obtaining the shareholders' authorization for or consent to the proposed corporate action the shareholders were furnished with a proxy or information statement, which included financial statements, pursuant to Regulation 14A or Regulation 14C of the United States Securities and Exchange Commission. If within thirty days after the making of such offer, the corporation making the offer and any shareholder agree upon the price to be paid for his shares, payment therefor shall be made within sixty days after the making of such offer or the consummation of the proposed corporate action, whichever is later, upon the surrender of the certificates for any such shares represented by certificates.

(h) The following procedure shall apply if the corporation fails to make such offer within such period of fifteen days, or if it makes the offer and any dissenting shareholder or shareholders fail to agree with it within the period of thirty days thereafter upon the price to be paid for their shares:

(1) The corporation shall, within twenty days after the expiration of whichever is applicable of the two periods last mentioned, institute a special proceeding in the supreme court in the judicial district in which the office of the corporation is located to determine the rights of dissenting shareholders and to fix the fair value of their shares. If, in the case of merger or consolidation, the surviving or new corporation is a foreign corporation without an office in this state, such proceeding shall be brought in the county where the office of the domestic corporation, whose shares are to be valued, was located.

(2) If the corporation fails to institute such proceeding within such period of twenty days, any dissenting shareholder may institute such proceeding for the same purpose not later than thirty days after the expiration of such twenty day period. If such proceeding is not instituted within such thirty day period, all dissenter's rights shall be lost unless the supreme court, for good cause shown, shall otherwise direct.

(3) All dissenting shareholders, excepting those who, as provided in paragraph (g), have agreed with the corporation upon the price to be paid for their shares, shall be made parties to such proceeding, which shall have the effect of an action quasi in rem against their shares. The corporation shall serve a copy of the petition in such proceeding upon each dissenting shareholder who is a resident of this state in the manner provided by law for the service of a summons, and upon each nonresident dissenting shareholder either by registered mail and publication, or in such other manner as is permitted by law. The jurisdiction of the court shall be plenary and exclusive.

(4) The court shall determine whether each dissenting shareholder, as to whom the corporation requests the court to make such determination, is entitled to receive payment for his shares. If the corporation does not request any such determination or if the court finds that any dissenting shareholder is so entitled, it shall proceed to fix the value of the shares, which, for the purposes of this section, shall be the fair value as of the close of business on the day prior to the shareholders' authorization date. In fixing the fair value of the shares, the court shall consider the nature of the transaction giving rise to the shareholder's right to receive payment for shares and its effects on the corporation and its shareholders, the concepts and methods then customary in

the relevant securities and financial markets for determining fair value of shares of a corporation engaging in a similar transaction under comparable circumstances and all other relevant factors. The court shall determine the fair value of the shares without a jury and without referral to an appraiser or referee. Upon application by the corporation or by any shareholder who is a party to the proceeding, the court may, in its discretion, permit pretrial disclosure, including, but not limited to, disclosure of any expert's reports relating to the fair value of the shares whether or not intended for use at the trial in the proceeding and notwithstanding subdivision (d) of section 3101 of the civil practice law and rules.

(5) The final order in the proceeding shall be entered against the corporation in favor of each dissenting shareholder who is a party to the proceeding and is entitled thereto for the value of his shares so determined.

(6) The final order shall include an allowance for interest at such rate as the court finds to be equitable, from the date the corporate action was consummated to the date of payment. In determining the rate of interest, the court shall consider all relevant factors, including the rate of interest which the corporation would have had to pay to borrow money during the pendency of the proceeding. If the court finds that the refusal of any shareholder to accept the corporate offer of payment for his shares was arbitrary, vexatious or otherwise not in good faith, no interest shall be allowed to him.

(7) Each party to such proceeding shall bear its own costs and expenses, including the fees and expenses of its counsel and of any experts employed by it. Notwithstanding the foregoing, the court may, in its discretion, apportion and assess all or any part of the costs, expenses and fees incurred by the corporation against any or all of the dissenting shareholders who are parties to the proceeding, including any who have withdrawn their notices of election as provided in paragraph (e), if the court finds that their refusal to accept the corporate offer was arbitrary, vexatious or otherwise not in good faith. The court may, in its discretion, apportion and assess all or any part of the costs, expenses and fees incurred by any or all of the dissenting shareholders who are parties to the proceeding against the corporation if the court finds any of the following: (A) that the fair value of the shares as determined materially exceeds the amount which the corporation offered to

pay; (B) that no offer or required advance payment was made by the corporation; (C) that the corporation failed to institute the special proceeding within the period specified therefor; or (D) that the action of the corporation in complying with its obligations as provided in this section was arbitrary, vexatious or otherwise not in good faith. In making any determination as provided in clause (A), the court may consider the dollar amount or the percentage, or both, by which the fair value of the shares as determined exceeds the corporate offer.

(8) Within sixty days after final determination of the proceeding, the corporation shall pay to each dissenting shareholder the amount found to be due him, upon surrender of the certificates for any such shares represented by certificates.

(i) Shares acquired by the corporation upon the payment of the agreed value therefor or of the amount due under the final order, as provided in this section, shall become treasury shares or be cancelled as provided in section 515 (Reacquired shares), except that, in the case of a merger or consolidation, they may be held and disposed of as the plan of merger or consolidation may otherwise provide.

(j) No payment shall be made to a dissenting shareholder under this section at a time when the corporation is insolvent or when such payment would make it insolvent. In such event, the dissenting shareholder shall, at his option:

(1) Withdraw his notice of election, which shall in such event be deemed withdrawn with the written consent of the corporation; or

(2) Retain his status as a claimant against the corporation and, if it is liquidated, be subordinated to the rights of creditors of the corporation, but have rights superior to the non-dissenting shareholders, and if it is not liquidated, retain his right to be paid for his shares, which right the corporation shall be obliged to satisfy when the restrictions of this paragraph do not apply.

(3) The dissenting shareholder shall exercise such option under subparagraph (1) or (2) by written notice filed with the corporation within thirty days after the corporation has given him written notice that payment for his shares

cannot be made because of the restrictions of this paragraph. If the dissenting shareholder fails to exercise such option as provided, the corporation shall exercise the option by written notice given to him within twenty days after the expiration of such period of thirty days.

(k) The enforcement by a shareholder of his right to receive payment for his shares in the manner provided herein shall exclude the enforcement by such shareholder of any other right to which he might otherwise be entitled by virtue of share ownership, except as provided in paragraph (e), and except that this section shall not exclude the right of such shareholder to bring or maintain an appropriate action to obtain relief on the ground that such corporate action will be or is unlawful or fraudulent as to him.

(l) Except as otherwise expressly provided in this section, any notice to be given by a corporation to a shareholder under this section shall be given in the manner provided in section 605 (Notice of meetings of shareholders).

(m) This section shall not apply to foreign corporations except as provided in subparagraph (e) (2) of section 907 (Merger or consolidation of domestic and foreign corporations).

SECTION 624. BOOKS AND RECORDS; RIGHT OF INSPECTION, PRIMA FACIE EVIDENCE

(a) Each corporation shall keep correct and complete books and records of account and shall keep minutes of the proceedings of its shareholders, board and executive committee, if any, and shall keep at the office of the corporation in this state or at the office of its transfer agent or registrar in this state, a record containing the names and addresses of all shareholders, the number and class of shares held by each and the dates when they respectively became the owners of record thereof. Any of the foregoing books, minutes or records may be in written form or in any other form capable of being converted into written form within a reasonable time.

(b) Any person who shall have been a shareholder of record of a corporation upon at least five days' written demand shall have the right to examine in person or by agent or attorney, during usual business hours, its minutes of the proceedings of its shareholders and record of shareholders and to make extracts therefrom for any purpose reasonably related to such person's interest as a shareholder. Holders of voting trust certificates representing shares of the corporation shall be regarded as shareholders for the purpose of this section. Any such agent or attorney shall be authorized in a writing that satisfies the requirements of a writing under paragraph (b) of section 609 (Proxies). A corporation requested to provide information pursuant to this paragraph shall make available such information in written form and in any other format in which such information is maintained by the corporation and shall not be required to provide such information in any other format. If a request made pursuant to this paragraph includes a request to furnish information regarding beneficial owners, the corporation shall make available such information in its possession regarding beneficial owners as is provided to the corporation by a registered broker or dealer or a bank, association or other entity that exercises fiduciary powers in connection with the forwarding of information to such owners. The corporation shall not be required to obtain information

about beneficial owners not in its possession.

(c) An inspection authorized by paragraph (b) may be denied to such shareholder or other person upon his refusal to furnish to the corporation, its transfer agent or registrar an affidavit that such inspection is not desired for a purpose which is in the interest of a business or object other than the business of the corporation and that he has not within five years sold or offered for sale any list of shareholders of any corporation of any type or kind, whether or not formed under the laws of this state, or aided or abetted any person in procuring any such record of shareholders for any such purpose.

(d) Upon refusal by the corporation or by an officer or agent of the corporation to permit an inspection of the minutes of the proceedings of its shareholders or of the record of shareholders as herein provided, the person making the demand for inspection may apply to the supreme court in the judicial district where the office of the corporation is located, upon such notice as the court may direct, for an order directing the corporation, its officer or agent to show cause why an order should not be granted permitting such inspection by the applicant. Upon the return day of the order to show cause, the court shall hear the parties summarily, by affidavit or otherwise, and if it appears that the applicant is qualified and entitled to such inspection, the court shall grant an order compelling such inspection and awarding such further relief as to the court may seem just and proper.

(e) Upon the written request of any shareholder, the corporation shall give or mail to such shareholder an annual balance sheet and profit and loss statement for the preceding fiscal year, and, if any interim balance sheet or profit and loss statement has been distributed to its shareholders or otherwise made available to the public, the most recent such interim balance sheet or profit and loss statement. The corporation shall be allowed a reasonable time to prepare such annual balance sheet and profit and loss statement.

(f) Nothing herein contained shall impair the power of courts to compel the production for examination of the books and records of a corporation.

(g) The books and records specified in paragraph (a) shall be prima facie evidence of the facts therein stated in favor of the plaintiff in any action or special proceeding against such corporation or any of its officers, directors or

shareholders.

SECTION 625. INFANT SHAREHOLDERS AND BONDHOLDERS

(a) A corporation may treat an infant who holds shares or bonds of such corporation as having capacity to receive and to empower others to receive dividends, interest, principal and other payments and distributions, to vote or express consent or dissent, in person or by proxy, and to make elections and exercise rights relating to such shares or bonds, unless, in the case of shares, the corporate officer responsible for maintaining the list of shareholders or the transfer agent of the corporation or, in the case of bonds, the treasurer or paying officer or agent has received written notice that such holder is an infant.

(b) An infant holder of shares or bonds of a corporation who has received or empowered others to receive payments or distributions, voted or expressed consent or dissent, or made an election or exercised a right relating thereto, shall have no right thereafter to disaffirm or avoid, as against the corporation, any such act on his part, unless prior to such receipt, vote, consent, dissent, election or exercise, as to shares, the corporate officer responsible for maintaining the list of shareholders or its transfer agent or, in the case of bonds, the treasurer or paying officer had received written notice that such holder was an infant.

(c) This section does not limit any other statute which authorizes any corporation to deal with an infant or limits the right of an infant to disaffirm his acts.

SECTION 626. SHAREHOLDERS' DERIVATIVE ACTION BROUGHT IN THE RIGHT OF THE CORPORATION TO PROCURE A JUDGMENT IN ITS FAVOR

Shareholders' derivative action brought in the right of the

corporation to procure a judgment in its favor.

(a) An action may be brought in the right of a domestic or foreign corporation to procure a judgment in its favor, by a holder of shares or of voting trust certificates of the corporation or of a beneficial interest in such shares or certificates.

(b) In any such action, it shall be made to appear that the plaintiff is such a holder at the time of bringing the action and that he was such a holder at the time of the transaction of which he complains, or that his shares or his interest therein devolved upon him by operation of law.

(c) In any such action, the complaint shall set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the board or the reasons for not making such effort.

(d) Such action shall not be discontinued, compromised or settled, without the approval of the court having jurisdiction of the action. If the court shall determine that the interests of the shareholders or any class or classes thereof will be substantially affected by such discontinuance, compromise, or settlement, the court, in its discretion, may direct that notice, by publication or otherwise, shall be given to the shareholders or class or classes thereof whose interests it determines will be so affected; if notice is so directed to be given, the court may determine which one or more of the parties to the action shall bear the expense of giving the same, in such amount as the court shall determine and find to be reasonable in the circumstances, and the amount of such expense shall be awarded as special costs of the action and recoverable

in the same manner as statutory taxable costs.

(e) If the action on behalf of the corporation was successful, in whole or in part, or if anything was received by the plaintiff or plaintiffs or a claimant or claimants as the result of a judgment, compromise or settlement of an action or claim, the court may award the plaintiff or plaintiffs, claimant or claimants, reasonable expenses, including reasonable attorney's fees, and shall direct him or them to account to the corporation for the remainder of the proceeds so received by him or them. This paragraph shall not apply to any judgment rendered for the benefit of injured shareholders only and limited to a recovery of the loss or damage sustained by them.

SECTION 627. SECURITY FOR EXPENSES IN SHAREHOLDERS' DERIVATIVE ACTION BROUGHT IN THE RIGHT OF THE CORPORATION TO PROCURE A JUDGMENT IN ITS FAVOR

Security for expenses in shareholders' derivative action brought

in the right of the corporation to procure a judgment in its

favor.

In any action specified in section 626 (Shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor), unless the plaintiff or plaintiffs hold five percent or more of any class of the outstanding shares or hold voting trust certificates or a beneficial interest in shares representing five percent or more of any class of such shares, or the shares, voting trust certificates and beneficial interest of such plaintiff or plaintiffs have a fair value in excess of fifty thousand dollars, the corporation in whose right such action is brought shall be entitled at any stage of the proceedings before final judgment to require the plaintiff or plaintiffs to give security for the reasonable expenses, including attorney's fees, which may be incurred by it in connection with such action and by the other parties defendant in connection therewith for which the corporation may become liable under this chapter, under any contract or otherwise under law, to which the corporation shall have recourse in such amount as the court having jurisdiction of such action shall determine upon the termination of such action. The amount of such security may thereafter from time to time be increased or decreased in the discretion of the court having jurisdiction of such action upon showing that the security provided has or may become inadequate or excessive.

SECTION 628. LIABILITY OF SUBSCRIBERS AND SHAREHOLDERS

(a) A holder of or subscriber for shares of a corporation shall be under no obligation to the corporation for payment for such shares other than the obligation to pay the unpaid portion of his subscription which in no event shall be less than the amount of the consideration for which such shares could be issued lawfully.

(b) Any person becoming an assignee or transferee of shares or of a subscription for shares in good faith and without knowledge or notice that the full consideration therefor has not been paid shall not be personally liable for any unpaid portion of such consideration, but the transferor shall remain liable therefor.

(c) No person holding shares in any corporation as collateral security shall be personally liable as a shareholder but the person pledging such shares shall be considered the holder thereof and shall be so liable. No executor, administrator, guardian, trustee or other fiduciary shall be personally liable as a shareholder, but the estate and funds in the hands of such executor, administrator, guardian, trustee or other fiduciary shall be liable.

SECTION 629. CERTAIN TRANSFERS OR ASSIGNMENTS BY SHAREHOLDERS OR SUBSCRIBERS; EFFECT

Certain transfers or assignments by shareholders or subscribers;

effect.

Any transfer or assignment by a shareholder of his shares, or by a subscriber for shares of his interest in the corporation, shall not relieve him of any liability as a shareholder or subscriber if at the time of such transfer or assignment the aggregate of the corporation's property, exclusive of any property which it may have conveyed, transferred, concealed, removed, or permitted to be concealed or removed, with intent to defraud, hinder or delay its creditors, is not at a fair valuation sufficient in amount to pay its debts, or if such condition is imminent.

SECTION 630. LIABILITY OF SHAREHOLDERS FOR WAGES DUE TO LABORERS, SERVANTS OR EMPLOYEES

Liability of shareholders for wages due to laborers, servants or

employees.

(a) The ten largest shareholders, as determined by the fair value of their beneficial interest as of the beginning of the period during which the unpaid services referred to in this section are performed, of every domestic corporation or of any foreign corporation, when the unpaid services were performed in the state, no shares of which are listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national or an affiliated securities association, shall jointly and severally be personally liable for all debts, wages or salaries due and owing to any of its laborers, servants or employees other than contractors, for services performed by them for such corporation. Before such laborer, servant or employee shall charge such shareholder for such services, he shall give notice in writing to such shareholder that he intends to hold him liable under this section. Such notice shall be given within one hundred and eighty days after termination of such services, except that if, within such period, the laborer, servant or employee demands an examination of the record of shareholders under paragraph (b) of section 624 (Books and records; right of inspection, prima facie evidence) of this article, such notice may be given within sixty days after he has been given the opportunity to examine the record of shareholders. An action to enforce such liability shall be commenced within ninety days after the return of an execution unsatisfied against the corporation upon a judgment recovered against it for such services. The provisions of this paragraph shall not apply to an investment company registered as such under an act of congress entitled "Investment Company Act of 1940."

(b) For the purposes of this section, wages or salaries shall mean all

compensation and benefits payable by an employer to or for the account of the employee for personal services rendered by such employee. These shall specifically include but not be limited to salaries, overtime, vacation, holiday and severance pay; employer contributions to or payments of insurance or welfare benefits; employer contributions to pension or annuity funds; and any other moneys properly due or payable for services rendered by such employee.

(c) A shareholder who has paid more than his pro rata share under this section shall be entitled to contribution pro rata from the other shareholders liable under this section with respect to the excess so paid, over and above his pro rata share, and may sue them jointly or severally or any number of them to recover the amount due from them. Such recovery may be had in a separate action. As used in this paragraph, "pro rata" means in proportion to beneficial share interest. Before a shareholder may claim contribution from other shareholders under this paragraph, he shall, unless they have been given notice by a laborer, servant or employee under paragraph (a), give them notice in writing that he intends to hold them so liable to him. Such notice shall be given by him within twenty days after the date that notice was given to him by a laborer, servant or employee under paragraph (a).

ARTICLE 7. DIRECTORS AND OFFICERS

SECTION 701. BOARD OF DIRECTORS

Subject to any provision in the certificate of incorporation authorized by paragraph (b) of section 620 (Agreements as to voting; provision in certificate of incorporation as to control of directors) or by paragraph (b) of section 715 (Officers), the business of a corporation shall be managed under the direction of its board of directors, each of whom shall be at least eighteen years of age. The certificate of incorporation or the by-laws may prescribe other qualifications for directors.

SECTION 702. NUMBER OF DIRECTORS

(a) The board of directors shall consist of one or more members. The number of directors constituting the board may be fixed by the by-laws, or by action of the shareholders or of the board under the specific provisions of a by-law adopted by the shareholders. If not otherwise fixed under this paragraph, the number shall be one. As used in this article, "entire board" means the total number of directors which the corporation would have if there were no vacancies.

(b) The number of directors may be increased or decreased by amendment of the by-laws, or by action of the shareholders or of the board under the specific provisions of a by-law adopted by the shareholders, subject to the following limitations:

(1) If the board is authorized by the by-laws to change the number of directors, whether by amending the by-laws or by taking action under the specific provisions of a by-law adopted by the shareholders, such amendment or action shall require the vote of a majority of the entire board.

(2) No decrease shall shorten the term of any incumbent director.

SECTION 703. ELECTION AND TERM OF DIRECTORS

(a) At each annual meeting of shareholders, directors shall be elected to hold office until the next annual meeting except as authorized by section 704 (Classification of directors). The certificate of incorporation may provide for the election of one or more directors by the holders of the shares of any class or series, or by the holders of bonds entitled to vote in the election of directors pursuant to section 518 (Corporate bonds), voting as a class.

(b) Each director shall hold office until the expiration of the term for which he is elected, and until his successor has been elected and qualified.

SECTION 704. CLASSIFICATION OF DIRECTORS

(a) The certificate of incorporation or the specific provisions of a by-law adopted by the shareholders may provide that the directors be divided into either two, three or four classes. All classes shall be as nearly equal in number as possible. The terms of office of the directors initially classified shall be as follows: that of the first class shall expire at the next annual meeting of shareholders, the second class at the second succeeding annual meeting, the third class, if any, at the third succeeding annual meeting, and the fourth class, if any, at the fourth succeeding annual meeting.

(b) At each annual meeting after such initial classification, directors to replace those whose terms expire at such annual meeting shall be elected to hold office until the second succeeding annual meeting if there are two classes, the third succeeding annual meeting if there are three classes, or the fourth succeeding annual meeting if there are four classes.

(c) If directors are classified and the number of directors is thereafter changed:

(1) Any newly created directorships or any decrease in directorships shall be so apportioned among the classes as to make all classes as nearly equal in number as possible.

(2) When the number of directors is increased by the board and any newly created directorships are filled by the board, there shall be no classification of the additional directors until the next annual meeting of shareholders.

SECTION 705. NEWLY CREATED DIRECTORSHIPS AND VACANCIES

(a) Newly created directorships resulting from an increase in the number of directors and vacancies occurring in the board for any reason except the removal of directors without cause may be filled by vote of the board. If the number of the directors then in office is less than a quorum, such newly created directorships and vacancies may be filled by vote of a majority of the directors then in office. Nothing in this paragraph shall affect any provision of the certificate of incorporation or the by-laws which provides that such newly created directorships or vacancies shall be filled by vote of the shareholders, or any provision of the certificate of incorporation specifying greater requirements as permitted under section 709 (Greater requirements as to quorum and vote of directors).

(b) Unless the certificate of incorporation or the specific provisions of a by-law adopted by the shareholders provide that the board may fill vacancies occurring in the board by reason of the removal of directors without cause, such vacancies may be filled only by vote of the shareholders.

(c) A director elected to fill a vacancy, unless elected by the shareholders, shall hold office until the next meeting of shareholders at which the election of directors is in the regular order of business, and until his successor has been elected and qualified.

(d) Unless otherwise provided in the certificate of incorporation or by-laws, notwithstanding the provisions of paragraphs (a) and (b) of this section, whenever the holders of any class or classes of shares or series thereof are entitled to elect one or more directors by the certificate of incorporation, any vacancy that may be filled by the board or a majority of the directors then in office, as the case may be, shall be filled by a majority of the directors elected by such class or classes or series thereof then in office, or, if no such director is in office, then as provided in paragraph (a) or (b) of this section, as the case

may be.

SECTION 706. REMOVAL OF DIRECTORS

(a) Any or all of the directors may be removed for cause by vote of the shareholders. The certificate of incorporation or the specific provisions of a by-law adopted by the shareholders may provide for such removal by action of the board, except in the case of any director elected by cumulative voting, or by the holders of the shares of any class or series, or holders of bonds, voting as a class, when so entitled by the provisions of the certificate of incorporation.

(b) If the certificate of incorporation or the by-laws so provide, any or all of the directors may be removed without cause by vote of the shareholders.

(c) The removal of directors, with or without cause, as provided in paragraphs (a) and (b) is subject to the following:

(1) In the case of a corporation having cumulative voting, no director may be removed when the votes cast against his removal would be sufficient to elect him if voted cumulatively at an election at which the same total number of votes were cast and the entire board, or the entire class of directors of which he is a member, were then being elected; and

(2) When by the provisions of the certificate of incorporation the holders of the shares of any class or series, or holders of bonds, voting as a class, are entitled to elect one or more directors, any director so elected may be removed only by the applicable vote of the holders of the shares of that class or series, or the holders of such bonds, voting as a class.

(d) An action to procure a judgment removing a director for cause may be brought by the attorney-general or by the holders of ten percent of the outstanding shares, whether or not entitled to vote. The court may bar from re-election any director so removed for a period fixed by the court.

SECTION 707. QUORUM OF DIRECTORS

Unless a greater proportion is required by the certificate of incorporation, a majority of the entire board shall constitute a quorum for the transaction of business or of any specified item of business, except that the certificate of incorporation or the by-laws may fix the quorum at less than a majority of the entire board but not less than one-third thereof.

SECTION 708. ACTION BY THE BOARD

(a) Except as otherwise provided in this chapter, any reference in this chapter to corporate action to be taken by the board shall mean such action at a meeting of the board.

(b) Unless otherwise restricted by the certificate of incorporation or the by-laws, any action required or permitted to be taken by the board or any committee thereof may be taken without a meeting if all members of the board or the committee consent in writing to the adoption of a resolution authorizing the action. The resolution and the written consents thereto by the members of the board or committee shall be filed with the minutes of the proceedings of the board or committee.

(c) Unless otherwise restricted by the certificate of incorporation or the by-laws, any one or more members of the board or any committee thereof may participate in a meeting of such board or committee by means of a conference telephone or similar communications equipment allowing all persons participating in the meeting to hear each other at the same time. Participation by such means shall constitute presence in person at a meeting.

(d) Except as otherwise provided in this chapter, the vote of a majority of the directors present at the time of the vote, if a quorum is present at such time, shall be the act of the board.

SECTION 709. GREATER REQUIREMENT AS TO QUORUM AND VOTE OF DIRECTORS

(a) The certificate of incorporation may contain provisions specifying either or both of the following:

(1) That the proportion of directors that shall constitute a quorum for the transaction of business or of any specified item of business shall be greater than the proportion prescribed by this chapter in the absence of such provision.

(2) That the proportion of votes of directors that shall be necessary for the transaction of business or of any specified item of business shall be greater than the proportion prescribed by this chapter in the absence of such provision.

(b) (1) An amendment of the certificate of incorporation which changes or strikes out a provision permitted by this section shall be authorized at a meeting of shareholders by (A) (i) for any corporation in existence on the effective date of subparagraph (2) of this paragraph, two-thirds of the votes of all outstanding shares entitled to vote thereon, and (ii) for any corporation in existence on the effective date of this clause the certificate of incorporation of which expressly provides such and for any corporation incorporated after the effective date of subparagraph (2) of this paragraph, a majority of the votes of all outstanding shares entitled to vote thereon or (B) in either case, such greater proportion of votes of shares, or votes of a class or series of shares, as may be provided specifically in the certificate of incorporation for changing or striking out a provision permitted by this section.

(2) Any corporation may adopt an amendment of the certificate of incorporation in accordance with any applicable clause or subclause of subparagraph (1) of this paragraph to provide that any further amendment of the certificate of incorporation that changes or strikes out a provision

permitted by this section shall be authorized at a meeting of the shareholders by a specified proportion of the votes of the shares, or particular class or series of shares, entitled to vote thereon, provided that such proportion may not be less than a majority.

SECTION 710. PLACE AND TIME OF MEETINGS OF THE BOARD

Meetings of the board, regular or special, may be held at any place within or without this state, unless otherwise provided by the certificate of incorporation or the by-laws. The time and place for holding meetings of the board may be fixed by or under the by-laws, or, if not so fixed, by the board.

SECTION 711. NOTICE OF MEETINGS OF THE BOARD

(a) Unless otherwise provided by the by-laws, regular meetings of the board may be held without notice if the time and place of such meetings are fixed by the by-laws or the board. Special meetings of the board shall be held upon notice to the directors.

(b) The by-laws may prescribe what shall constitute notice of meeting of the board. A notice, or waiver of notice, need not specify the purpose of any regular or special meeting of the board, unless required by the by-laws.

(c) Notice of a meeting need not be given to any director who submits a signed waiver of notice whether before or after the meeting, or who attends the meeting without protesting, prior thereto or at its commencement, the lack of notice to him.

(d) A majority of the directors present, whether or not a quorum is present, may adjourn any meeting to another time and place. If the by-laws so provide, notice of any adjournment of a meeting of the board to another time or place shall be given to the directors who were not present at the time of the adjournment and, unless such time and place are announced at the meeting, to the other directors.

SECTION 712. EXECUTIVE COMMITTEE AND OTHER COMMITTEES

(a) If the certificate of incorporation or the by-laws so provide, the board, by resolution adopted by a majority of the entire board, may designate from among its members an executive committee and other committees, each consisting of one or more directors, and each of which, to the extent provided in the resolution or in the certificate of incorporation or by-laws, shall have all the authority of the board, except that no such committee shall have authority as to the following matters:

(1) The submission to shareholders of any action that needs shareholders' approval under this chapter.

(2) The filling of vacancies in the board of directors or in any committee.

(3) The fixing of compensation of the directors for serving on the board or on any committee.

(4) The amendment or repeal of the by-laws, or the adoption of new by-laws.

(5) The amendment or repeal of any resolution of the board which by its terms shall not be so amendable or repealable.

(b) The board may designate one or more directors as alternate members of any such committee, who may replace any absent or disqualified member or members at any meeting of such committee.

(c) Each such committee shall serve at the pleasure of the board. The designation of any such committee, the delegation thereto of authority, or action by any such committee pursuant to such authority shall not alone constitute performance by any member of the board who is not a member of the committee in question, of his duty to the corporation under section 717

(Duty of directors).

SECTION 713. INTERESTED DIRECTORS

(a) No contract or other transaction between a corporation and one or more of its directors, or between a corporation and any other corporation, firm, association or other entity in which one or more of its directors are directors or officers, or have a substantial financial interest, shall be either void or voidable for this reason alone or by reason alone that such director or directors are present at the meeting of the board, or of a committee thereof, which approves such contract or transaction, or that his or their votes are counted for such purpose:

(1) If the material facts as to such director's interest in such contract or transaction and as to any such common directorship, officership or financial interest are disclosed in good faith or known to the board or committee, and the board or committee approves such contract or transaction by a vote sufficient for such purpose without counting the vote of such interested director or, if the votes of the disinterested directors are insufficient to constitute an act of the board as defined in section 708 (Action by the board), by unanimous vote of the disinterested directors; or

(2) If the material facts as to such director's interest in such contract or transaction and as to any such common directorship, officership or financial interest are disclosed in good faith or known to the shareholders entitled to vote thereon, and such contract or transaction is approved by vote of such shareholders.

(b) If a contract or other transaction between a corporation and one or more of its directors, or between a corporation and any other corporation, firm, association or other entity in which one or more of its directors are directors or officers, or have a substantial financial interest, is not approved in accordance with paragraph (a), the corporation may avoid the contract or transaction unless the party or parties thereto shall establish affirmatively that the contract or transaction was fair and reasonable as to the corporation at the

time it was approved by the board, a committee or the shareholders.

(c) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board or of a committee which approves such contract or transaction.

(d) The certificate of incorporation may contain additional restrictions on contracts or transactions between a corporation and its directors and may provide that contracts or transactions in violation of such restrictions shall be void or voidable by the corporation.

(e) Unless otherwise provided in the certificate of incorporation or the by-laws, the board shall have authority to fix the compensation of directors for services in any capacity.

SECTION 714. LOANS TO DIRECTORS

(a) A corporation may not lend money to or guarantee the obligation of a director of the corporation unless:

(1) the particular loan or guarantee is approved by the shareholders, with the holders of a majority of the votes of the shares entitled to vote thereon constituting a quorum, but shares held of record or beneficially by directors who are benefitted by such loan or guarantee shall not be entitled to vote or to be included in the determination of a quorum; or

(2) with respect to any corporation in existence on the effective date of this subparagraph (2) the certificate of incorporation of which expressly provides such and with respect to any corporation incorporated after the effective date of this subparagraph (2), the board determines that the loan or guarantee benefits the corporation and either approves the specific loan or guarantee or a general plan authorizing loans and guarantees.

(b) The fact that a loan or guarantee is made in violation of this section does not affect the borrower's liability on the loan.

SECTION 715. OFFICERS

(a) The board may elect or appoint a president, one or more vice-presidents, a secretary and a treasurer, and such other officers as it may determine, or as may be provided in the by-laws.

(b) The certificate of incorporation may provide that all officers or that specified officers shall be elected by the shareholders instead of by the board.

(c) Unless otherwise provided in the certificate of incorporation or the by-laws, all officers shall be elected or appointed to hold office until the meeting of the board following the next annual meeting of shareholders or, in the case of officers elected by the shareholders, until the next annual meeting of shareholders.

(d) Each officer shall hold office for the term for which he is elected or appointed, and until his successor has been elected or appointed and qualified.

(e) Any two or more offices may be held by the same person. When all of the issued and outstanding stock of the corporation is owned by one person, such person may hold all or any combination of offices.

(f) The board may require any officer to give security for the faithful performance of his duties.

(g) All officers as between themselves and the corporation shall have such authority and perform such duties in the management of the corporation as may be provided in the by-laws or, to the extent not so provided, by the board.

(h) An officer shall perform his duties as an officer in good faith and with that degree of care which an ordinarily prudent person in a like position

would use under similar circumstances. In performing his duties, an officer shall be entitled to rely on information, opinions, reports or statements including financial statements and other financial data, in each case prepared or presented by:

(1) one or more other officers or employees of the corporation or of any other corporation of which at least fifty percentum of the outstanding shares of stock entitling the holders thereof to vote for the election of directors is owned directly or indirectly by the corporation, whom the officer believes to be reliable and competent in the matters presented, or

(2) counsel, public accountants or other persons as to matters which the officer believes to be within such person's professional or expert competence, so long as in so relying he shall be acting in good faith and with such degree of care, but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties shall have no liability by reason of being or having been an officer of the corporation.

SECTION 716. REMOVAL OF OFFICERS

(a) Any officer elected or appointed by the board may be removed by the board with or without cause. An officer elected by the shareholders may be removed, with or without cause, only by vote of the shareholders, but his authority to act as an officer may be suspended by the board for cause.

(b) The removal of an officer without cause shall be without prejudice to his contract rights, if any. The election or appointment of an officer shall not of itself create contract rights.

(c) An action to procure a judgment removing an officer for cause may be brought by the attorney-general or by ten percent of the votes of the outstanding shares, whether or not entitled to vote. The court may bar from re-election or reappointment any officer so removed for a period fixed by the court.

SECTION 717. DUTY OF DIRECTORS

(a) A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances. In performing his duties, a director shall be entitled to rely on information, opinions, reports or statements including financial statements and other financial data, in each case prepared or presented by:

(1) one or more officers or employees of the corporation or of any other corporation of which at least fifty percentum of the outstanding shares of stock entitling the holders thereof to vote for the election of directors is owned directly or indirectly by the corporation, whom the director believes to be reliable and competent in the matters presented,

(2) counsel, public accountants or other persons as to matters which the director believes to be within such person's professional or expert competence, or

(3) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the certificate of incorporation or the by-laws, as to matters within its designated authority, which committee the director believes to merit confidence, so long as in so relying he shall be acting in good faith and with such degree of care, but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties shall have no liability by reason of being or having been a director of the corporation.

(b) In taking action, including, without limitation, action which may involve or relate to a change or potential change in the control of the corporation, a director shall be entitled to consider, without limitation, (1) both the long-

term and the short-term interests of the corporation and its shareholders and (2) the effects that the corporation's actions may have in the short-term or in the long-term upon any of the following:

(i) the prospects for potential growth, development, productivity and profitability of the corporation;

(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.

Nothing in this paragraph shall create any duties owed by any director to any person or entity to consider or afford any particular weight to any of the foregoing or abrogate any duty of the directors, either statutory or recognized by common law or court decisions.

For purposes of this paragraph, "control" shall mean the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of the corporation, whether through the ownership of voting stock, by contract, or otherwise.

SECTION 718. LIST OF DIRECTORS AND OFFICERS

(a) If a shareholder of a corporation, in person or by his attorney or agent, or a representative of the district attorney or of the secretary of state, the attorney general, or other state official, makes a written demand on a corporation to inspect a current list of its directors and officers, the corporation shall, within two business days after receipt of the demand and for a period of one week thereafter, make the list available for such inspection at its office during usual business hours.

(b) Upon refusal by the corporation to make a current list of its directors and officers available, as provided in paragraph (a), the person making a demand for such list may apply, ex parte, to the supreme court at a special term held within the judicial district where the office of the corporation is located for an order directing the corporation to make such list available. The court may grant such order or take such other action as it may deem just and proper.

SECTION 719. LIABILITY OF DIRECTORS IN CERTAIN CASES

(a) Directors of a corporation who vote for or concur in any of the following corporate actions shall be jointly and severally liable to the corporation for the benefit of its creditors or shareholders, to the extent of any injury suffered by such persons, respectively, as a result of such action:

(1) The declaration of any dividend or other distribution to the extent that it is contrary to the provisions of paragraphs (a) and (b) of section 510 (Dividends or other distributions in cash or property).

(2) The purchase of the shares of the corporation to the extent that it is contrary to the provisions of section 513 (Purchase or redemption by a corporation of its own shares).

(3) The distribution of assets to shareholders after dissolution of the corporation without paying or adequately providing for all known liabilities of the corporation, excluding any claims not filed by creditors within the time limit set in a notice given to creditors under articles 10 (Non-judicial dissolution) or 11 (Judicial dissolution).

(4) The making of any loan contrary to section 714 (Loans to directors).

(b) A director who is present at a meeting of the board, or any committee thereof, when action specified in paragraph (a) is taken shall be presumed to have concurred in the action unless his dissent thereto shall be entered in the minutes of the meeting, or unless he shall submit his written dissent to the person acting as the secretary of the meeting before the adjournment thereof, or shall deliver or send by registered mail such dissent to the secretary of the corporation promptly after the adjournment of the meeting. Such right to dissent shall not apply to a director who voted in favor of such action. A director who is absent from a meeting of the board, or any committee thereof,

when such action is taken shall be presumed to have concurred in the action unless he shall deliver or send by registered mail his dissent thereto to the secretary of the corporation or shall cause such dissent to be filed with the minutes of the proceedings of the board or committee within a reasonable time after learning of such action.

(c) Any director against whom a claim is successfully asserted under this section shall be entitled to contribution from the other directors who voted for or concurred in the action upon which the claim is asserted.

(d) Directors against whom a claim is successfully asserted under this section shall be entitled, to the extent of the amounts paid by them to the corporation as a result of such claims:

(1) Upon payment to the corporation of any amount of an improper dividend or distribution, to be subrogated to the rights of the corporation against shareholders who received such dividend or distribution with knowledge of facts indicating that it was not authorized by section 510, in proportion to the amounts received by them respectively.

(2) Upon payment to the corporation of any amount of the purchase price of an improper purchase of shares, to have the corporation rescind such purchase of shares and recover for their benefit, but at their expense, the amount of such purchase price from any seller who sold such shares with knowledge of facts indicating that such purchase of shares by the corporation was not authorized by section 513.

(3) Upon payment to the corporation of the claim of any creditor by reason of a violation of subparagraph (a) (3), to be subrogated to the rights of the corporation against shareholders who received an improper distribution of assets.

(4) Upon payment to the corporation of the amount of any loan made contrary to section 714, to be subrogated to the rights of the corporation against a director who received the improper loan.

(e) A director shall not be liable under this section if, in the circumstances, he performed his duty to the corporation under paragraph (a) of section 717.

(f) This section shall not affect any liability otherwise imposed by law upon any director.

SECTION 720. ACTION AGAINST DIRECTORS AND OFFICERS FOR MISCONDUCT

(a) An action may be brought against one or more directors or officers of a corporation to procure a judgment for the following relief:

(1) Subject to any provision of the certificate of incorporation authorized pursuant to paragraph (b) of section 402, to compel the defendant to account for his official conduct in the following cases:

(A) The neglect of, or failure to perform, or other violation of his duties in the management and disposition of corporate assets committed to his charge.

(B) The acquisition by himself, transfer to others, loss or waste of corporate assets due to any neglect of, or failure to perform, or other violation of his duties.

(C) In the case of directors or officers of a benefit corporation organized under article seventeen of this chapter: (i) the failure to pursue the general public benefit purpose of a benefit corporation or any specific public benefit set forth in its certificate of incorporation; (ii) the failure by a benefit corporation to deliver or post an annual report as required by section seventeen hundred eight of article seventeen of this chapter; or (iii) the neglect of, or failure to perform, or other violation of his or her duties or standard of conduct under article seventeen of this chapter.

(2) To set aside an unlawful conveyance, assignment or transfer of corporate assets, where the transferee knew of its unlawfulness.

(3) To enjoin a proposed unlawful conveyance, assignment or transfer of corporate assets, where there is sufficient evidence that it will be made.

(b) An action may be brought for the relief provided in this section, and in

paragraph (a) of section 719 (Liability of directors in certain cases) by a corporation, or a receiver, trustee in bankruptcy, officer, director or judgment creditor thereof, or, under section 626 (Shareholders' derivative action brought in the right of the corporation to procure a judgment in its favor), by a shareholder, voting trust certificate holder, or the owner of a beneficial interest in shares thereof.

(c) This section shall not affect any liability otherwise imposed by law upon any director or officer.

SECTION 721. NONEXCLUSIVITY OF STATUTORY PROVISIONS FOR INDEMNIFICATION OF DIRECTORS AND OFFICERS

Nonexclusivity of statutory provisions for indemnification of

directors and officers.

The indemnification and advancement of expenses granted pursuant to, or provided by, this article shall not be deemed exclusive of any other rights to which a director or officer seeking indemnification or advancement of expenses may be entitled, whether contained in the certificate of incorporation or the by-laws or, when authorized by such certificate of incorporation or by-laws, (i) a resolution of shareholders, (ii) a resolution of directors, or (iii) an agreement providing for such indemnification, provided that no indemnification may be made to or on behalf of any director or officer if a judgment or other final adjudication adverse to the director or officer establishes that his acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated, or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled. Nothing contained in this article shall affect any rights to indemnification to which corporate personnel other than directors and officers may be entitled by contract or otherwise under law.

SECTION 722. AUTHORIZATION FOR INDEMNIFICATION OF DIRECTORS AND OFFICERS

(a) A corporation may indemnify any person made, or threatened to be made, a party to an action or proceeding (other than one by or in the right of the corporation to procure a judgment in its favor), whether civil or criminal, including an action by or in the right of any other corporation of any type or kind, domestic or foreign, or any partnership, joint venture, trust, employee benefit plan or other enterprise, which any director or officer of the corporation served in any capacity at the request of the corporation, by reason of the fact that he, his testator or intestate, was a director or officer of the corporation, or served such other corporation, partnership, joint venture, trust, employee benefit plan or other enterprise in any capacity, against judgments, fines, amounts paid in settlement and reasonable expenses, including attorneys' fees actually and necessarily incurred as a result of such action or proceeding, or any appeal therein, if such director or officer acted, in good faith, for a purpose which he reasonably believed to be in, or, in the case of service for any other corporation or any partnership, joint venture, trust, employee benefit plan or other enterprise, not opposed to, the best interests of the corporation and, in criminal actions or proceedings, in addition, had no reasonable cause to believe that his conduct was unlawful.

(b) The termination of any such civil or criminal action or proceeding by judgment, settlement, conviction or upon a plea of nolo contendere, or its equivalent, shall not in itself create a presumption that any such director or officer did not act, in good faith, for a purpose which he reasonably believed to be in, or, in the case of service for any other corporation or any partnership, joint venture, trust, employee benefit plan or other enterprise, not opposed to, the best interests of the corporation or that he had reasonable cause to believe that his conduct was unlawful.

(c) A corporation may indemnify any person made, or threatened to be made, a party to an action by or in the right of the corporation to procure a judgment

in its favor by reason of the fact that he, his testator or intestate, is or was a director or officer of the corporation, or is or was serving at the request of the corporation as a director or officer of any other corporation of any type or kind, domestic or foreign, of any partnership, joint venture, trust, employee benefit plan or other enterprise, against amounts paid in settlement and reasonable expenses, including attorneys' fees, actually and necessarily incurred by him in connection with the defense or settlement of such action, or in connection with an appeal therein, if such director or officer acted, in good faith, for a purpose which he reasonably believed to be in, or, in the case of service for any other corporation or any partnership, joint venture, trust, employee benefit plan or other enterprise, not opposed to, the best interests of the corporation, except that no indemnification under this paragraph shall be made in respect of (1) a threatened action, or a pending action which is settled or otherwise disposed of, or (2) any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation, unless and only to the extent that the court in which the action was brought, or, if no action was brought, any court of competent jurisdiction, determines upon application that, in view of all the circumstances of the case, the person is fairly and reasonably entitled to indemnity for such portion of the settlement amount and expenses as the court deems proper.

(d) For the purpose of this section, a corporation shall be deemed to have requested a person to serve an employee benefit plan where the performance by such person of his duties to the corporation also imposes duties on, or otherwise involves services by, such person to the plan or participants or beneficiaries of the plan; excise taxes assessed on a person with respect to an employee benefit plan pursuant to applicable law shall be considered fines; and action taken or omitted by a person with respect to an employee benefit plan in the performance of such person's duties for a purpose reasonably believed by such person to be in the interest of the participants and beneficiaries of the plan shall be deemed to be for a purpose which is not opposed to the best interests of the corporation.

SECTION 723. PAYMENT OF INDEMNIFICATION OTHER THAN BY COURT AWARD

(a) A person who has been successful, on the merits or otherwise, in the defense of a civil or criminal action or proceeding of the character described in section 722 shall be entitled to indemnification as authorized in such section.

(b) Except as provided in paragraph (a), any indemnification under section 722 or otherwise permitted by section 721, unless ordered by a court under section 724 (Indemnification of directors and officers by a court), shall be made by the corporation, only if authorized in the specific case:

(1) By the board acting by a quorum consisting of directors who are not parties to such action or proceeding upon a finding that the director or officer has met the standard of conduct set forth in section 722 or established pursuant to section 721, as the case may be, or,

(2) If a quorum under subparagraph (1) is not obtainable or, even if obtainable, a quorum of disinterested directors so directs;

(A) By the board upon the opinion in writing of independent legal counsel that indemnification is proper in the circumstances because the applicable standard of conduct set forth in such sections has been met by such director or officer, or

(B) By the shareholders upon a finding that the director or officer has met the applicable standard of conduct set forth in such sections.

(c) Expenses incurred in defending a civil or criminal action or proceeding may be paid by the corporation in advance of the final disposition of such action or proceeding upon receipt of an undertaking by or on behalf of such director or officer to repay such amount as, and to the extent, required by

paragraph (a) of section 725.

SECTION 724. INDEMNIFICATION OF DIRECTORS AND OFFICERS BY A COURT

(a) Notwithstanding the failure of a corporation to provide indemnification, and despite any contrary resolution of the board or of the shareholders in the specific case under section 723 (Payment of indemnification other than by court award), indemnification shall be awarded by a court to the extent authorized under section 722 (Authorization for indemnification of directors and officers), and paragraph (a) of section 723. Application therefor may be made, in every case, either:

(1) In the civil action or proceeding in which the expenses were incurred or other amounts were paid, or

(2) To the supreme court in a separate proceeding, in which case the application shall set forth the disposition of any previous application made to any court for the same or similar relief and also reasonable cause for the failure to make application for such relief in the action or proceeding in which the expenses were incurred or other amounts were paid.

(b) The application shall be made in such manner and form as may be required by the applicable rules of court or, in the absence thereof, by direction of a court to which it is made. Such application shall be upon notice to the corporation. The court may also direct that notice be given at the expense of the corporation to the shareholders and such other persons as it may designate in such manner as it may require.

(c) Where indemnification is sought by judicial action, the court may allow a person such reasonable expenses, including attorneys' fees, during the pendency of the litigation as are necessary in connection with his defense therein, if the court shall find that the defendant has by his pleadings or during the course of the litigation raised genuine issues of fact or law.

SECTION 725. OTHER PROVISIONS AFFECTING INDEMNIFICATION OF DIRECTORS AND OFFICERS

Other provisions affecting indemnification of directors and

officers.

(a) All expenses incurred in defending a civil or criminal action or proceeding which are advanced by the corporation under paragraph (c) of section 723 (Payment of indemnification other than by court award) or allowed by a court under paragraph (c) of section 724 (Indemnification of directors and officers by a court) shall be repaid in case the person receiving such advancement or allowance is ultimately found, under the procedure set forth in this article, not to be entitled to indemnification or, where indemnification is granted, to the extent the expenses so advanced by the corporation or allowed by the court exceed the indemnification to which he is entitled.

(b) No indemnification, advancement or allowance shall be made under this article in any circumstance where it appears:

(1) That the indemnification would be inconsistent with the law of the jurisdiction of incorporation of a foreign corporation which prohibits or otherwise limits such indemnification;

(2) That the indemnification would be inconsistent with a provision of the certificate of incorporation, a by-law, a resolution of the board or of the shareholders, an agreement or other proper corporate action, in effect at the time of the accrual of the alleged cause of action asserted in the threatened or pending action or proceeding in which the expenses were incurred or other amounts were paid, which prohibits or otherwise limits indemnification; or

(3) If there has been a settlement approved by the court, that the indemnification would be inconsistent with any condition with respect to

indemnification expressly imposed by the court in approving the settlement.

(c) If any expenses or other amounts are paid by way of indemnification, otherwise than by court order or action by the shareholders, the corporation shall, not later than the next annual meeting of shareholders unless such meeting is held within three months from the date of such payment, and, in any event, within fifteen months from the date of such payment, mail to its shareholders of record at the time entitled to vote for the election of directors a statement specifying the persons paid, the amounts paid, and the nature and status at the time of such payment of the litigation or threatened litigation.

(d) If any action with respect to indemnification of directors and officers is taken by way of amendment of the by-laws, resolution of directors, or by agreement, then the corporation shall, not later than the next annual meeting of shareholders, unless such meeting is held within three months from the date of such action, and, in any event, within fifteen months from the date of such action, mail to its shareholders of record at the time entitled to vote for the election of directors a statement specifying the action taken.

(e) Any notification required to be made pursuant to the foregoing paragraph (c) or (d) of this section by any domestic mutual insurer shall be satisfied by compliance with the corresponding provisions of section one thousand two hundred sixteen of the insurance law.

(f) The provisions of this article relating to indemnification of directors and officers and insurance therefor shall apply to domestic corporations and foreign corporations doing business in this state, except as provided in section 1320 (Exemption from certain provisions).

SECTION 726. INSURANCE FOR INDEMNIFICATION OF DIRECTORS AND OFFICERS

(a) Subject to paragraph (b), a corporation shall have power to purchase and maintain insurance:

(1) To indemnify the corporation for any obligation which it incurs as a result of the indemnification of directors and officers under the provisions of this article, and

(2) To indemnify directors and officers in instances in which they may be indemnified by the corporation under the provisions of this article, and

(3) To indemnify directors and officers in instances in which they may not otherwise be indemnified by the corporation under the provisions of this article provided the contract of insurance covering such directors and officers provides, in a manner acceptable to the superintendent of financial services, for a retention amount and for co-insurance.

(b) No insurance under paragraph (a) may provide for any payment, other than cost of defense, to or on behalf of any director or officer:

(1) if a judgment or other final adjudication adverse to the insured director or officer establishes that his acts of active and deliberate dishonesty were material to the cause of action so adjudicated, or that he personally gained in fact a financial profit or other advantage to which he was not legally entitled, or

(2) in relation to any risk the insurance of which is prohibited under the insurance law of this state.

(c) Insurance under any or all subparagraphs of paragraph (a) may be included in a single contract or supplement thereto. Retrospective rated

contracts are prohibited.

(d) The corporation shall, within the time and to the persons provided in paragraph (c) of section 725 (Other provisions affecting indemnification of directors or officers), mail a statement in respect of any insurance it has purchased or renewed under this section, specifying the insurance carrier, date of the contract, cost of the insurance, corporate positions insured, and a statement explaining all sums, not previously reported in a statement to shareholders, paid under any indemnification insurance contract.

(e) This section is the public policy of this state to spread the risk of corporate management, notwithstanding any other general or special law of this state or of any other jurisdiction including the federal government.

SECTION 727. ANNUAL REPORTS FOR CERTAIN TRANSACTIONS REQUIRED

(a) A condominium created pursuant to the real property law or a cooperative housing corporation created pursuant to this chapter, shall, at least once each year:

(1) require that each director, as defined in paragraph five of subdivision (a) of section one hundred two of this chapter, receive a copy of section seven hundred thirteen of this chapter; and

(2) submit an annual report to the shareholders, which shall be signed by each such director, containing information on any contracts made, entered into, or otherwise voted on by the board of directors where one or more of the directors was an interested director, pursuant to section seven hundred thirteen of this chapter.

(b) The annual report required by subdivision (a) of this section shall include, but not be limited to, the following:

(1) a list of all contracts voted on by the board of directors, including information on the contract recipient, contract amount, and the purpose of entering into the contract;

(2) the record of each meeting including director attendance, voting records for contracts, and how each director voted on such contracts; and

(3) the date of each vote on each contract, and the date the contract would be and remain valid.

(c) If the annual report required by subdivision (a) of this section would, notwithstanding the requirements of this section, contain no information because of the absence of any actions taken by the board that would

otherwise qualify for inclusion in such annual report, then the board shall instead submit to the shareholders a document, signed by each director, indicating: "No actions taken by the board were subject to the annual report required pursuant to section 727 of the Business Corporation Law".

ARTICLE 8. AMENDMENTS AND CHANGES