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<u>U.S. Corporate Law:
Management, Directors and Shareholders
and the Division of Power</u>

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The Role of U.S. Federal Government in Filling in Blanks Left by State Corporate Law To Support Shareholder Power

This set of materials contains:

- Key provisions of the Delaware General Corporation Law;
- Annotations of these key provisions; i.e., a selected list of court cases that construe the language of the Delaware General Corporation Law.

The Delaware Court system has done an extraordinary job of interpreting the "black letter law," particularly where it comes to focusing on the fiduciary duty directors owe shareholders.

But in other instances, the Delaware General Corporation Law and related Delaware case law fall short. To understand why, ask yourselves the following questions:

- What provision of the Delaware General Corporation Law guarantees that stockholders have the right to elect directors annually?
- Can directors be removed by fellow directors? Can they only be removed by stockholders? What provisions make this clear?
- Can a corporation provide that directors can be removed only for cause? What provision makes this clear?
- As a practical matter, how would stockholders go about seeking to remove directors? Is there any provision in the Delaware General Corporation Law that gives them the express power to call special meetings?
- What power do stockholders have if the corporation fails to hold an annual meeting to elect directors to require that a meeting be held? Is there a provision that addresses this?
- What right do stockholders have to inspect the records of the corporation? Is there a provision that provides for this? How can stockholders learn about a corporation's finances? About its business plans, the identity of its directors and management? The compensation paid directors and management?
- What right do stockholders have to learn the identity of other stockholders? Is there a provision that provides for this?
- What right do stockholders have to require the corporation to:
    a. merge with another corporation?
    b. sell all of its assets?
    c. dissolve?
    d. amend the corporation's certificate of incorporation?

What problems do you see for stockholders who do not believe that the directors are representing their interests?

a. As a practical matter, how would they go about electing a new slate of directors?

b. How would they go about removing directors?

c. How would they be able to easily communicate with each other or know each other's identity?

d. What is the purpose of Section 212 (b) and (c)? Is it an essential procedure when stockholders live far away from corporate headquarters so that they cannot easily vote in person?

e. Is there any requirement under the Delaware General Corporation Law that limits the grant of authority to a proxy by a stockholder to stipulated agenda items? Who typically solicits proxies? Under the Delaware General Corporation Law, must a person seeking a proxy to act on behalf of a stockholder provide the stockholder with any information?

<u>Federal Law</u>

The federal Securities and Exchange Commission, through its direct authority over public companies found in the Securities and Exchange Act of 1934 and through its indirect power over the listing requirements of securities exchanges, such as the New York Stock Exchange, has filled in lapses in state corporate law.

Under the Securities and Exchange Act of 1934, public companies must file annual reports on Form 10-K, with the Securities and Exchange Commission, as well as quarterly reports on Form 10-Q and current reports on Form 8-K.

The annual reports are extremely complete in terms of corporate disclosure. In addition, they must contain audited financial statements. Forms 10-K, 10-Q and 8-K are filed electronically nowadays and are instantly available through the Internet by going to the Securities and Exchange Commission's website at http://www.sec.gov/.

Also under the Securities and Exchange Act, persons that wish to solicit proxies must, in the case of a company, provide stockholders with a very complete proxy statement that accurately explains why the company seeks a favorable vote to:

- elect directors;
- pass major proposals, including mergers, sales of assets, amendments to the certificate of incorporation;

In addition, the proxy cannot grant the proxy holder carte blanche to vote.

Proxy statements are also filed with the Securities and Exchange Commission where they are publicly available on the Securities and Exchange Commission's website.

Who, if anyone, polices the manner in which candidates for election as directors are chosen?

- Is this done by incumbent management? See the *Disney* case where the Chief Executive Officer handpicked most of the Board of Directors. Can directors picked by management truly represent the shareholders?
- See the *ABA Corporate Director's Guidebook*.

Those guidelines state that the majority of U.S. public corporations now require that a nominating committee composed of directors independent of management select the slate of directors.

- Can stockholders run a counterslate? How easy is that when fellow stockholders live throughout the U.S. and outside the U.S.?
- What vote is required to elect directors?
- Should Delaware Corporation Law or U.S. federal law require that directors be elected by at least a majority of the shares outstanding?
- Why do you think the Delaware General Corporation Law has not filled in gaps that would better empower shareholders?
- How are the gaps being filled?

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In general, do you think corporate law norms are subject to evolution and development? What and who drives the current emphasis on shareholder empowerment in the United States?

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KEY PROVISIONS OF DELAWARE STATUTORY CORPORATE LAW

The Delaware General Corporation Law

While we think of U.S. corporate law as case law, it also has a strong statutory component. Some of the statutory provisions are clear on this face. Case law – that is, development of the law through legal decisions interpreting statutory language--plays a very significant role in delineating the role of directors and their fiduciary duties to shareholders. We will examine the *Disney* case to get a very good sense of how judges expand and expound upon statutory law.

This outline is designed to draw your attention to key statutory provisions. It also points out instances in which U.S. federal law, through the federal Securities and Exchange Commission, has stepped in to fill in gaps necessary to better empower shareholders. The sections with the asterisks relate to key corporate governance provisions.

Section 101. A corporation can be formed for any lawful purpose by filing a certificate of incorporation with the State of Delaware.

Note: Unlike early corporate law, there is no need to justify that the corporation will provide essential services. Incorporation is automatic upon filing.

Section 102. The certificate of incorporation must set forth a few basic terms. These include its name, address of a registered office in Delaware, the total number of shares of each class which the corporation is authorized to issue and key terms of each class, such as rights to vote, rights to receive dividends before payment of dividends of another class or rights to receive distributions in liquidation before distribution to other classes and the name and mailing address of the incorporator.

In addition, a certificate of incorporation may also provide for a pre-emptive right of existing stockholders to subscribe for additional shares (little used now), the vote of a larger percentage of stockholders, or a larger number of directors to take action than otherwise specified by the Delaware General Corporation Law, a provision limiting the otherwise perpetual duration of the corporation and a provision limiting the personal liability of directors for money damages if the director acted in good faith.

In this regard, read Section 102(b)(7) with care. It comes up in the *Disney* case and is an important protection for directors.

A certificate of incorporation is a publicly available document. It establishes a bare bones "contract" with stockholders.

Section 109. Unless the certificate of incorporation empowers the directors to amend by-laws relating to the rights and powers of stockholders, directors, officers and employees, only the stockholders can amend the by-laws. By-laws must be consistent with the certificate of incorporation. In practice, certificates of incorporation always empower the board to so act.

Sections 131 and 132. Every corporation incorporated in Delaware must have a registered office in the State, as well as a registered agent who can accept service of process.

Note: A registered office is no more than a mail drop. Fully 50% or more of U.S. corporations are incorporated in Delaware, but have no business office in the State. Similarly, corporations headquartered in Europe, for example, can incorporate under Delaware law. Delaware is picked because of the quality of its corporate code and the quality and experience of its judges.

***Section 141**. This section details the power of the board of directors and provides for board committees, removal of directors, actions by unanimous written consent of directors, etc. It is an essential provision of the Delaware General Corporation Law and a substantial body of case law has developed around it.

Note: The Section opens by stating: “The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of the board of directors…” From this principle, it follows that stockholders do not manage the corporation, and that officers chosen by the board act subject to the board’s oversight.

The idea that directors are fiduciaries with duties of care and loyalty to stockholders derives from this basic precept of Section 141 board management. The *Disney* case is all about the Section 141 power of the board and the legal analysis of Part II of that decision summarizes the development of the business judgment rule. The business judgment rule serves to protect directors from personal liability, even if their decisions seem unwise, if they act in good faith and with reasonable care.

Section 141 and the case law that has developed under it (as summarized in the *Disney* case) is at the heart of Delaware corporate law. Other U.S. states look to the articulation of corporate law provided by the active and knowledgeable Delaware courts.

See also, Section 141(b) amended in 2006 to permit directors to agree to resign, including agreeing to resign if they do not receive a specified affirmative vote of shareholders.

***Section 142**. This section generally provides for the appointment of officers. See the *Disney* case as to whether the Board must have the authority to select and fire all officers or just key officers.

Note: Very little is said about the powers and duties of officers. In practice, the key executive officers have tremendous power and, through the process of influencing the choice of directors, if not absolutely choosing them, can often run corporations with limited challenge from the Board, or, at least, this is the criticism leveled. See the *Disney* case for the chief executive officer as an imperial presence.

***Section 144**. This section provides a mechanism whereby a director who may have a financial interest in a corporate transaction may vote **if** he or she makes their self interest known to other members of the Board.

In practice, case law has expanded on this idea. If, for example, a director is a major shareholder or a member of management of another company that proposes to enter into a material contract with the corporation, Delaware case law essentially requires that the disinterested directors meet separately with their own lawyer and, if necessary, financial experts, to determine whether the proposed transaction is appropriate. A series of separate meetings may prove necessary. This process – one that puts independent directors in control - developed in the 1980's in response to situations in which directors who were members of management put their own interest first in fighting off hostile takeovers.

Section 151. This section broadly establishes the power of a corporation to have more than one series or class of stock with full, limited or no voting powers, with preferences in the payment of dividends or in liquidation, and with provisions permitting or requiring the corporation to redeem a series or class of stock, etc.

However, at least one class or series, must after the redemption of all other classes, have full voting powers.

Note: This section permits corporations to develop either a very simple or very elaborate investor structure. Corporations may choose to issue preferred stock which is preferred over common stock in the payment of dividends or in liquidation. As a result, preferred shares look and feel more like debt because the holders know they will be paid off first. Preferred stock is frequently sold to venture capitalists who take the risk of investing in fledgling companies before they become successful enough to be sold to the public. In this case, the venture capitalists want to be sure that they will recover all or at least some of their investment before the founders do. Also, by insisting that their preferred stock will convert into common stock at a price equal to the lowest price at which common stock is issued after they buy preferred stock, they can be sure that their investment is not diluted.

Section 152. Under this section, directors are charged with the responsibility of ensuring that the corporation gets paid full value for shares it issues. Shares can be issued for property (such as land, other securities, etc.), in addition to cash.

Note: Case law provides that a promise to pay for shares in exchange for the future delivery of services (labor, etc.) is not valid consideration. Similarly, a promise to pay later for the shares, even if it is a good promissory note, is not valid consideration. See Section 153, however, permits a corporation to issue shares if the par value is paid in good consideration, such as cash, and the balance is paid with a note. Par value is, frequently, no more than $0.001 per share. This is because with the advent of audited financial statements, investors, especially those lending money, look to see what the combination of assets represented by the par value, **plus** capital surplus, is. Then they compare this to total liabilities and decide whether the corporation has enough unencumbered assets to provide a solid cushion of net assets. See also Section 154.

For example:

BALANCE SHEET		
ASSETS		**LIABILITIES**
$1,000,000 shares, par value .001 cent	$1,000	
Capital surplus	$25,000,000	$5,000,000
Total assets	$25,001,000	
	(= net assets of $20,001,000)	

Section 170. Dividends. The Delaware General Corporation Law authorized the directors (and no one else) to declare and pay dividends on shares of the corporation's stock. Dividends can only be paid out of capital surplus or net profits for the fiscal year in which the dividend is declared and/or the prior fiscal year. Under Section 174, if directors willfully or negligently declare dividends when there is no capital surplus or net profits to support the dividend, they are personally liable to the corporation and corporate creditors in the event the corporation becomes insolvent or dissolves.

This provision, which has an in terrerom impact, is, in fact, rarely violated. In a modern economy with sophisticated financial controls, directors will not find themselves in a position where they pay shareholders assets needed to support corporate obligations to creditors. See, also, Section 160 which similarly makes directors liable if they repurchase corporate stock using assets that causes the impairment of the capital of the corporation. Again, the thrust of the provision is to provide a level of security to creditors who should be preferred in payment over stockholders.

***Section 211**. Meetings of Stockholders. Section 211(b) states the principle that annual meetings must be held to elect directors. This is a fundamental principle and one that exchanges, such as the New York Stock Exchange, also insist on. In effect, incumbent directors must stand for re-election every year. This section has been updated to provide that stockholders can attend the meeting by "means of remote communication." In practice, this would mean by webcast or by telephonic conference call. Note, also, that Section 211(d) provides that special meetings of stockholders may be called by the board or other specified persons. In practice, corporate by-laws generally provide that a specified percentage of stockholders (i.e., 10% or 25%) can call a special meeting.

Note: Section 211 guarantees that shareholders have a right to assess directors annually because directors must stand for election every year. However, the Delaware General Corporation Law (as is the case with other state codes) does not stipulate the method in which candidates to serve as directors are chosen. And this is a drawback. Until very recently, senior management (i.e., the chief executive officer) handpicked board candidates, some of whom were clearly not independent and others of which, while technically independent, belonged to the same golf club, went to university together, etc. While a large number of corporations now voluntarily provide that directors will be selected by a committee composed of independent directors, this is not universal. See the *Disney* case in which the Court thought many of the directors were "yes men" of the chief executive officer. Also, while it is true that shareholders can suggest candidates or run an expensive counter campaign, this is infrequent. Meanwhile, increasingly, boards do have a majority of independent directors, but even these directors who meet tests of independence established by stock exchanges, may have subtle psychological ties to management.[1]

Note Also: The Delaware General Corporation Law is silent as to the vote required and, typically, corporations provide in the certificate of incorporation or by-laws that directors are elected by a plurality of shares voted. Since, except in the case of a contested election (when there is an anti-management slate pitted against a management slate), only one slate of directors is standing for election, technically, so long as a quorum is present in person or by proxy, and even one share is voted in favor of a director, that director will be elected because plurality simply means receiving one more vote than any other candidate for each slot on the board. Corporate activists in the United States are lobbying to require that directors receive an absolute majority vote of the shares outstanding.

***Section 212**. One Share, One Vote. Unless otherwise specified in a corporation's certificate of incorporation, each stockholder has one vote for each share held. However, a certificate of incorporation can provide, for example, that preferred shareholders have no votes, or limited voting power. On the other hand, it could provide that they have two votes per share. In rare instances, a corporation will have Class A common stock held by the public with one vote per share and Class B common stock, held by corporate founders with ten votes per share. This division is frowned on and is little used.

[1] In the wake of the Enron debacle which many saw as the result of the power of management to hire and fire and thus control the company's independent accountants, the U.S. Congress required the Securities and Exchange Commission to cause stock exchanges to adopt rules that stipulate that independent accountants are hired and fired solely by the audit committee of the board, all of whose members must be independent of management.

This section also validates permitting stockholders to vote by authorizing another person to act for a stockholder at a meeting at which a stockholder vote is taken as the stockholder's proxy. The ability to vote by proxy is crucial from the point of view of stockholders and management where stockholders live throughout the United States (and even, of course, outside the United States) and cannot travel to the site of the shareholder meeting because of the time and expense. Without the power to select a proxy, it would be literally impossible to get sufficient stockholders present in person to constitute a quorum or, of course, to take action in those cases which require a high percentage of the outstanding shares to be voted.

Generally, the management of a corporation requests stockholders to execute a proxy authorizing corporate officers to vote on their behalf.

<u>Note</u>: While Section 212 would, on its face, permit management to seek the authority to vote as it chooses at a stockholder meeting, federal law promulgated by the federal Securities and Exchange Commission requires that stockholders authorize a proxy solicited by management to vote specifically for or against specified proposals; i.e., management is not give carte blanche. And, as discussed later, management must provide stockholders with a comprehensive proxy statement explaining each proposal to be put to a vote and explaining why management believes the vote should be in favor (or against) the proposals.

<u>Section 216</u>. <u>Quorum and Required Vote for Stock Corporation</u>. This section was amended in 2006 to specify that if shareholders adopt a bylaw stipulating that directors must obtain a specified vote of shareholders, that bylaw cannot be amended or repealed by the directors.

<u>*Section 219</u>. <u>Public Availability of Stockholder List</u>. The statute provides that at least ten days before a shareholder meeting the corporation make open for inspection a ledger providing a complete list of stockholders, their address and the number of shares held.

<u>*Section 220</u>. <u>Stockholders and Directors Right of Inspection</u>. Section 220(a) gives a stockholder the right to demand to review during usual hours of business, the list of stockholders. Under Section 220(d), a director has the right to demand to review any corporate book or record, "for a purpose reasonably related to the director's position as director."

<u>Note</u>: Under Delaware General Corporation Law, stockholders have no right to inspect the books and records of a corporation, a serious limitation. However, the federal Securities and Exchange Commission has, in effect, mitigated this limitation by virtue of its regulation of national securities exchanges. Starting in the mid-1960s, it began requiring that exchanges establish basic corporate governance listing standards. It also directly required publicly traded companies to furnish shareholders with a comprehensive written document setting forth all of the relevant information that the Securities and Exchange Commission stipulates a shareholder needs to have in order to (1) vote for or against directors named to stand for election; and (2) any other proposal in which a shareholder vote is required either by state corporate law or by a securities

exchange. In addition, the Securities and Exchange Commission has stipulated that materials in which a corporation seeks to obtain a proxy giving it a right to vote the shares held by the shareholder must be accompanied or proceeded by an annual report to shareholders. That annual report must contain audited financial statements and must provide a wealth of current information about the company. You can get a good sense of the completeness of this material by visiting the Securities and Exchange Commission's website at http://www.sec.gov/.

A major portion of the Securities and Exchange Commission's website reproduces proxy statements and annual reports on Form 10-K. Many corporations now voluntarily place this and other data on their own websites. All of this shareholder disclosure has developed outside of state corporate law codes and case law.

Section 242. Once a corporation has received any payment for any of its stock, its certificate of incorporation can be amended only if (1) the directors first determine that the amendment is advisable and put the amendment to a vote of stockholders. The required stockholder vote is 50% of the shares outstanding (plus, a majority of a class of stock if that class is given such a right or even if not, if the amendment would be material to the class).

Note: Under Section 102(b)(4) of the Delaware General Corporation Law, the certificate of incorporation can require a vote greater than 50% of the shares outstanding.

Sections 251 and 252. These sections provide for the mechanics of a merger of one corporation with another. Generally speaking, if both of the corporations are Delaware corporations, then the boards of both corporations must determine that the merger is advisable and the shareholders of both corporations must approve the merger by a vote of a majority of the stock outstanding (unless a higher vote is stipulated in the certificate of incorporation by Section 102(b)(4) of the Delaware General Corporation Code.

Note: To provide protection against unwanted mergers, certificates of incorporation may stipulate that the requisite vote is 80% of the shares outstanding, unless approved by a supermajority of the Board.

Section 271. A corporation can sell, lease or exchange all or substantially all of its assets if the board of directors of the selling corporation deems this expedient and in the best interest of stockholders and if a majority of the shares outstanding (or a higher percentage as provided by Section 102(b)(4) is required) vote in favor of the transaction.

Note: In practice, this is just an alternative means of merging with another corporation and, for the same reason, a supermajority 80% vote may be required.

Section 275. A corporation can dissolve if the board of directors deems it advisable and a majority of the shares outstanding (or a higher stipulated percentage) vote in favor of this.