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<u>Annexes to Report</u>

A Note on Citations

Citations to other corporation statutes has been done on a selective basis to avoid needless dusplication. References to the Model Act are useful, since it has been the basis for most corporation law revisions, and a Model Act provision is likely to be found in the statutes of about 20 states, usually with little or no modification. New York, Connecticut, North Carolina, and South Carolina are cited for their deliberate deviations from the Model Act. New York and the Carolinas are rich in close corporation provisions. Virginia offers significant provisions not found elsewhere. New York represents the most comprehensive corporation law study ever undertaken in the United States. Occasional references are made to other states, and to foreign countries.

It should be noted that any Model Act section can be compared with the corresponding provision (if any) in all other states, through the Model Business Corporation Act Annotated, published by West in 1960, with supplements.

Additions and Corrections

Page 191: After the citation to the Florida Attorney General's opinion, at the next to the last line, add the following:

> A strong dictum in Braasch v. Goldschmidt, 199 A 2d 760, 763-764 (Ch. 1964) indicates that the Delaware statute would be similarly construed, although it was held that this construction of Section 253 would not preclude a merger with a wholly-owned-Delaware-incorporated subsidiary of a Netherlands corporation.

Page 208: After the citation to Stiles v. Aluminum Products, add the following:

> See also Philadelphia Nat. Bank v. B.S.F. Co., 199 A.2d 557 (Ch. 1964) (similar construction of indenture clause referring to sale of "all or substantially all of (the corporation's) property).

A Uniform Procedure for Executing and Filing Instruments

The best of the recent corporation statutes have provided for a standard, uniform procedure for executing corporate instruments which must be filed with the Secretary of State. These formal requirements for execution and filing do not, of course, apply to other corporate documents which will continue to be executed as before. There are several merits to this procedure. First, the procedure is assuredly uniform for all instruments required by the statute (except as otherwise provided). Secondly, much repetitive matter is eliminated, since the substantive sections will merely be cross-referenced to the execution-filing provisions. Thirdly, the execution-filing requirements can be more detailed than would be appropriate in each individual substantive section. Finally, the recommended provisions merely expand an idea already inherent in the Delaware statute, since Section 102 (c) makes various filing and recording sections, e.g., Section 103, applicable to other instruments and enumerated by section references in Section 102 (c). Accordingly, it is believed that the uniform execution-filing provisions will effect a marked simplification and utility in the statutory revision.

Besides elaborating the concept of a uniform execution-filing provision, a significant change in the present procedure is recommended for Committee consideration. That is the abolition of local recordation requirements as provided in several recent corporation law revisions, e.g., Conn. Gen. Stat. § 33-285 (1961); S.C. Code § 12-11.6 (Supp. 1963), and recommended by ABA Model Act Section 49. Several advantages accrue from this procedure. Most important, it simplifies incorporation procedures by eliminating a step of doubtful utility. The traditional recordation requirement, has been probably the chief occasion for cases invoking the de facto corporation concept to save the limited liability of a defectively incorporated enterprise. Happily, the Delaware approach has been liberal. See In re Mitchell's Restaurant, Inc. 31 Del. Ch. 121, 67 A.2d 64 (Ch. 1949) (corporation held de facto, despite non-filing and non-recordation of incorporation papers, at least for purposes of appointing a receiver). It is sometimes suggested that local recordation aids real estate title searching. First, it is a simple matter to find out from the Secretary of State whether a relevant corporate document is on file. Secondly, even if local recording is required a vital document may not in fact be recorded, and complete safety would dictate recourse to the Secretary of State's office to determine what documents have been filed there. Third, not all corporate - documents will be recorded in each county in which the corporation has real property, and indeed any such requirement would be unthinkable. Finally, it should be noted that local recordation, if required, applies to every major corporated instrument-- not merely to the certificate of incorporation. This Report unhesitatingly takes the view that the local requirement should not be included in a modern corporation stature, and that Delaware's abolition of the requirement would be an attractive feature to enterprises looking for an advantageous "home".

It is recognized that local recordation may have to be continued for reasons not related to the advantage and convenience of corporations. If so, it is suggested that the matter be handled by a requirement that two copies of each instrument be delivered to the Secretary of State, that he collect both his and the recorder's fees and taxes for filing and recording, that the second copy of the document be duly forwarded to the appropriate recorder, and that the local fees and taxes be remitted or otherwise disposed of in some appropriate manner. Compare Section 136 (b). In short, a single act of filing with the Secretary of State would take care of both central and local filing. If this procedure is considered, two points should be noted: (1) the extra work in the Secretary of State's office should be considered in terms of present work-load and appropriations, and (2) appropriate procedures should be considered for transmitting documents and fees and taxes to the recorders' offices, including (a) the frequency of transmission, and (b) the question of diversity or uniformity as to recording fees in the three counties.

This Report considers the second alternative--local recordation effected through the Secretary of State's office--a useful prodedure, although inferior to the outright elimination of local recordation. But if recordation must be retained, it should be simplified, as suggested. There are precedents in other states for this procedure, e.g. N.Y.Bus.Corp. Law § 104(g); Iowa Code Ann. § 496A.53(3) (Supp. 1963); Va. Code § 13.1-51 (1956); Minn.Stat.Ann. § 301.06,-07 (Supp. 1963).

The following three draft provisions would achieve a uniform filing-execution procedure. They are not identical with any single provision in any other jurisdication, but include the best provisions from New York (N.Y.Bus.Corp.Law § 104), Connecticut (Conn.Gen. Stat. § 33-285), North Carolina (N.C.Gen.Stats. § 55-4), and South Carolina (S.C.Code §§ 12-11.4, 11.5, 11.6 (Supp. 1963), as well as the Reporter's study of scattered provisions of other statutes. Comments on each draft section follow the text thereof.

Section Execution of Instruments.

Whenever any provision of this Chapter requires any instrument to be executed in accordance with this section, unless otherwise specifically stated in this Chapter and subject to any additional provisions of this Chapter, such requirement means that:

(a) There shall be ~~one~~ original executed and one conformed copy of the instrument.

(b) The title of the instrument shall be set forth at its head.

(c) The original executed instrument shall be signed:

(1) By the incorporator or incorporators, in the case of a certificate of incorporation or any other instrument executed before election of the initial board of directors, as provided by Section 108.

(2) In the case of other instruments:

(A) By the president or a vice-president, and by the secretary or an assistant secretary; or

(B) If there are no such officers, then by a majority of the directors, or by such directors as may be designated by a majority of directors, then in office.

(C) If there are no such officers or directors, then by the holders, or such of them as may be designated by the holders, of record of a majority of all outstanding shares entitled to vote thereon.

(D) In any event, by the holders of all of the outstanding shares of the corporation.

(d) Any person signing an instrument shall, either opposite or beneath his signature, legibly state his name, the capacity in which he signs, and his address.

(e) The instrument shall also set forth the current address of the corporations's principal office or place of business in this State, and the name of its registered agent and also his address if different from the address of the principal office or place of business. Any address shall include street and number and/or post office box number, town or city and hundred.

Reporter's Note

This proposed provision would state, for all documents required by statute to be filed with the Secretary of State, a uniform procedure for execution. Subsection (c) distinguishes between documents to be signed before election of the first board of directors (see subparagraph (c) (1)) and documents signed thereafter (see subparagraphs (c)(2)(A)-(D)). Subparagraph (c)(2)(D) would be useful only to close corporations.

The preamble reference to "additional provisions" would preserve a requirement, such as Section 251 (c)'s requirement that the proper officers of all merging corporations execute the instrument.

The "conformed copy" referred to under subsection (a) is necessary only if local recordation is continued. See the alternative provisions in the draft section entitled "Filing of Instruments", and compare both with present Section 103(b) requiring the Secretary of State to "furnish a certified copy of (the certificate of incorporation) under his hand and seal of office" for local recordation.

If a provision such as the draft section on "Execution of Instruments" is approved, a number of subsections and sentences in the present statute will automatically be deleted and replaced with a cross-reference to this section. See, e.g., Section 103; Section 102(a) (2), second sentence.

Section Acknowledgment of Instruments.

Whenever any provision of this Act requires any instrument to be acknowledged in accordance with this section, unless otherwise specifically stated in this Chapter and subject to any additional provisions of this Chapter, such requirement means that:

(a) The person signing the instrument, as provided by subsection (c) of Section (Execution of Instruments), acknowledges that the instrument he signs is his act and deed, and that the facts therein stated are truly set forth.

(b) The instrument shall be acknowledged before any officer authorized by the laws of this State to take acknowledgments of deeds.

Reporter's Note

This draft provision would retain the established Delaware acknowledgment requirements, in substantially the same form as it is stated in Section 103(a).

Section Filing of Instruments

Alternative 1: No Recordation Requirement.

(a) Whenever any provision of this Chapter requires any instrument to be filed in accordance with this section, unless otherwise specifically stated in this Chapter and subject to any additional provisions of this Act, such requirement means that:

(1) The original executed instrument, together with the conformed copy, shall be delivered to the office of the Secretary of State.

(2) All fees and taxes required for filing the instrument shall be tendered to the Secretary of State.

(3) Upon delivery of the instrument, and upon tender of the required fees and taxes, the Secretary of State shall certify that the original has been filed in his office by endorsing upon the original the word "Filed", and the hour, day, month and year thereof. This endorsement is the "filing date" of the instrument, and is conclusive of the date of filing in the absence of actual fraud. The Secretary of State shall thereupon file and index the original.

(4) The Secretary of State shall compare the conformed copy with the original, and if he finds that they are identical, he shall certify the

conformed copy by making upon it the same endorsement which is required to appear upon the original, together with a further endorsement that the conformed copy is a true copy of the original.

(5) The conformed copy, so certified, shall be returned to the person delivering the instruments to the Secretary of State, and it shall be retained as a part of the permanent records of the corporation.

(b) Unless otherwise provided or permitted by this chapter, any instrument filed as provided by this section shall be effective as of its filing date, notwithstanding any failure or defect in recording the instrument as required by subsections (a)(5) and (a)(6).

Alternative 2: Recordation Required

(The preceding draft section would be used except for the following:)

(a)(1) The original executed instrument, together with the conformed copy, shall be delivered to the office of the Secretary of State.

(2) All fees and taxes, including any fees and taxes which may be lawfully assessed for recording the instrument with the recorder of the county in which the principal office of the corporation is to be located, shall be tendered to the Secretary of State.

* * * * *

(5) The certified conformed copy shall be transmitted by the Secretary of State to the recorder of the county where the principal office or place of business of the corporation is to be located in this State.

(6) The recorder of the county shall, upon receipt of the instrument, record and index it in a book kept for that purpose.

Reporter's Note

Alternative 1 assumes that local recordation is abolished. The concept of the "filing date" is introduced in subsection (a)(3), and conclusively and precisely designates the effective date of the instrument, e.g., the date when corporate existence commences, or an amendment to the certificate or incorporation is effected, etc. It would not, however, interfere with the privilege of postponing an affective date, e.g., as to a merger, See Section 251(c), last sentence, in which a different provision is "otherwise specifically stated."

Alternative 2 is a substitute provision if recordation is retained and the Secretary of State transmits the filed instrument to the appropriate recorder. It substantially follows present Section 103(b).

Whichever alternative is adopted, Section 362 becomes superfluous, because of the broader coverage of subsection (b) of the draft. Section 362's limited function is retroactively to validate acts of a corporation which records in County A an instrument which should have been recorded in County B, provided the corporation corrects the error. It does not apply when all recording is omitted, since, presumably, the judicial *de facto* corporation doctrine would come into play.

Certificates and Other Instruments as Evidence

Delaware Section 105 currently provides that a copy of a certificate of incorporation, certified by the Secretary of State and the local recorder, "shall be evidence in all courts" of Delaware. Section 102(c) would presumably make this provision applicable to other instruments filed with the Secretary of State.

It is recommended that this section be revised to make its scope more definite, both as to the types of instruments covered by it, the effect of the instrument, and the tribunals in which it is effective. Newer statutes normally make the contents of the instrument "prima facie evidence" of all facts stated therein, and of the due execution of the instrument, e.g., N.Y.Bus.Corp.Law § 106 (a) and make it effective in administrative agencies as well as courts. Moreover, the revised provision should reflect any elimination of local recordation; even if local recording is continued, the evidentiary effect of filed instruments should depend only on filing with the Secretary of State. The following draft provision should achieve these objectives:

> Unless otherwise provided in this Chapter, all copies of instruments relating to a domestic or foreign corporation, which have been filed in the office of the Secretary of State as required by any provision of this Chapter shall, when certified by him, be received in all courts, public offices, and official bodies as prima facie evidence of
>
> (a) due execution, acknowledgment, and filing of the instrument;
>
> (b) observance and performance of all acts and conditions necessary to have been observed and performed; and of
>
> (c) any other facts required or permitted by law to be stated in the instrument.

Subsections (a) and (c) reflect Model Act Section 134 (and state statutes based thereon) and N.Y.Bus.Corp.Law § 106(a). Subsection (b) adapts for general use the language now applicable to mergers in Delaware Section 251 (c)._/ The introductory clause ("unless otherwise provided") insures priority to a suggested revision of present Section 105 by which due filing of the certificate of incorporation would be conclusive evidence of performance of all conditions for incorporation (except when the Attorney General initiates a proceeding to revoke the charter under Section 283).

_/ N.Y.Bus.Corp.Law § 106 (b) accords a similar, though more limited, effectiveness to documents filed in any other jurisdication if certified by an appropriate officer.

Corporate Purposes

Section 101's statement of permissible corporate purposes seems adequate. Of course, it assumes that a single general statute should govern all types of corporations, both business and non-profit. This is not necessarily undesirable, although today most states, following the lead of the ABA Model Acts, adopt separate statutes. There are certain advantages. Because the objectives and operations of business and non-profit corporations often diverge, separate statutory treatment is neater and simpler, and avoids cluttering a statute predominantly oriented to business corporations with special provisions and exceptions for non-business undertakings. Although separate statutes would be advisable if the matter were _tabula rasa_, the Delaware treatment seems generally to have worked well, and this Report will assume that the general statute will apply to all corporations, unless the Committee determines otherwise.

It would be useful, in dealing with Section 101's involved sentences, to separate the provisions relating to the purposes of incorporation, and the number and qualifications of incorporators. The purpose is not substantive change, but clarity. In the interest of completeness, Section 101 should enumerate the types of corporations constitutionally excluded from coverage under the General Corporation Law, rather than by a cross-reference to Article IX, Section 1 of the Constitution. If Section 101 is so organized, it would read substantially as follows (with some language simplification):

(a) A corporation may be organized under this Chapter to transact any lawful business, or to promote or conduct any legitimate objects or purposes.

(b) Subsection (a) shall not apply to municipal corporations, banks, or corporations for charitable penal, reformatory, or educational purposes sustained in whole or in part by this State. Corporations for constructing, maintaining and operating public utilities outside of this State, may be formed under the general provisions of this Chapter, but corporations for constructing, maintaining and operating public utilities with this State shall be subject to the special provisions and requirements of Title 26 applicable to such corporations.

Incorporation Procedure in General

The procedure for incorporation under existing Delaware law is needlessly cumbersome, and, although professional familiarity minimizes the problems the procedure should be simplified. A simple, unencumbered incorporation process is a marked characteristic of all new and revised corporation statutes. Notable examples are Connecticut, New York, South Carolina, and the many jurisdications following the Model Act. The guiding principle should, therefore, be the maximum of simplicity in forming a corporation, since a proliferation of participants, document filings, etc. serve no substantive purpose.

This report suggests, in broad outline, a simplified procedure, the details of which appear in the section-by-section analysis below. First, a single person should be sufficient as an incorporator of any corporations, thereby eliminating the present Delaware requirement of at least three persons. Secondly, Section 108's requirement of newspaper notice of the first meeting should be eliminated completely, rather than conditionally, as at present. Thirdly, it would be appropriate to eliminate entirely the existing (Section 103(b)) mandate for local recordation of the certificate of incorporation, requiring only central filing with the Secretary of State. If outright abolition of recordation is not feasible, alternative procedures are available to expedite dual filing. Finally it is doubtful whether any substantive purpose is served by present requirements of a minimum initial capital of

$1000 (see Section 102(a)(4)); whatever protection this supposedly provides can be better achieved by other types of statutory provisions.

This streamlined incorporation procedure, while not identical in its totality to the requirements of any other single state, represents the maximum of simplicity and convenience in forming corporations, and is based upon provisions currently found in the corporation statutes of many states. Although the suggested procedure is less complex than existing methods, it is not so drastic a departure as to disrupt established procedures.

Number and Qualifications of Incorporators.

Section 101 presently provides that "any number of persons, not less than three" may act as incorporators of a Delaware corporations. It is suggested that a single person be authorized to incorporate a Delaware enterprise. This accords with statutory provisions in a number of states, notably N.Y. Bus.Corp.Law § 401; Iowa Corp. Law § 48 (carrying forward prior Iowa practice); S.C.Code § 12-14.2 (Supp. 1963); Mich.Comp.Laws § 450.2; Wisc.Stat.Ann. § 180.44; and Ky.Rev.Stat.Ann. § 271. The ABA-ALI Model Act has revised its Section 47 to provide that "one or more persons, or a domestic or foreign corporation, may act as incorporator or incorporators or a corporation," etc. No substantive purpose is served by requiring multiple incorporators. It does not significantly guard against fraud, nor insure commitment of more funds to the corporation, since incorporators are normally "dummy" officials in the enterprise. Permitting a single incorporator also accords with the general acceptance of the "one-man" corporation--a concept which itself was specifically recognized by the recent amendment of Section 141(b) in effect permitting a single director for a one-man corporation.

The use of the unmodified term "person" presumably means that the incorporator can be a legal person, such as a corporation, although obviously such a "person" would act through human agents. Some statutes in other states specifically recognize the corporate incorporator _/ *e.g.*, Iowa Corp.Law § 48; S.C.Code § 12-14.2 coupled with the definition of person in S.C.Code 12-11.2(a), although N.Y.Bus.Corp.Law § 401 calls for "one or more natural persons of the age of twenty-one years or over" to act as incorporators. Although apparently no Delaware cases have construed the term "person" in Section 101, presumably its meaning is broader than natural persons, both under generally accepted interpretation, and Delaware decisions construing the term in other statutory contexts. See *State v. Delaware Saengerbund, Inc.*, 5 Boyce 162, 91 Atl. 290 (1914); *In re Lynch Co.*, 1 Boyce 104, 75 Atl. 41 (1909).

The following language, derived in part from Model Action Section 47, would achieve this purpose:

> One or more natural persons whether or nor residents of this State, or a domestic or foreign corporation, may act as incorporator or incorporators or a corporation, by executing, acknowledging and filing a certificate of incorporation in writing.

Contents of the Certificate of Incorporation

(Section 102)

Section 102, setting forth the required and permissible provisions in the certificate of incorporation, substantially accords with modern

_/ Under English practice, a corporation may be a director.

corporation law statues, although some of its provisions could be simplified or shifted to other more appropriate parts of the statute. The provisions of Section 102 will be examined separately, although on several items a final recommendation will be postponed pending a through study of the substantive point, e.g., pre-emtive rights.

Subsection (a) (1): Corporate Name

The Delaware statutory requirements concerning corporate names are few and simple, in marked contrast to the increasingly complex statutory provisions in the newer corporation statates. Delaware Section 102(a)(1) requires only (1) some term or abbreviation indicating the corporate character, and (2) some basis for distinguishing the proposed corporation's name from existing domestic corporations. Case law indicates that the common law of unfair competition governs outside these limited statutory requirements. See Standard Oilshares, Inc. v. Standard Oil Group, Inc., 17 Del. Ch. 113, 124-125, 150 Atl. 174 (Ch.1930).

The new New York statute requires two full pages of complex provisions to state its legal requirements for the corporate name. See N.Y.Bus.Corp. Law Sections 301-302. Model Act Section 7, besides requiring words or abbreviations indicating corporateness, specifies that the corporate name must not indicate some purpose other than a purpose stated in the certificate of incorporation, __/ (Section 7(b)), and also states that the name "shall not be the same as, or deceptively similar to" the name of domestic or foreign corporations or any reserved or registered name (Section 7 (C)). __/

__/ This provision probably does no more than preserve the law of unfair competition, and thus merely restates the ~~doctrine~~ Delaware doctrine of the Standard Oilshares case.

__/ This is meaningless, since the certificate of incorporation may state any and all purposes desired, whether or not the corporation actually intends to engage in all of them. No state apparently goes so far as to require that the name reflect the type of business, or the principal type of business, in which the corporation is or will be actually engaged.

Moreover, as a practical matter, statutory changes in requirements for the corporate name usually produce more dislocation and uncertainly then they are worth, and also require extensive provisions to protect existing corporations from doubt as to the legal validity of their names. Since, therefore, changes in the legal requirements of corporate names should be avoided except where absolutely necessary, the requirements of Delaware's Section 102 (a) (1) should remain intact. Indeed, the very simplicity and flexibility of the Delaware provision may make Delaware incorporation attractive to enterprises which would otherwise encounter complex and sometimes burdensome restrictions elsewhere.

A few minor changes should be made in Section 102 (a) (1), as follows:

(1) The test of distinguishing corporate names upon the records of the Secretary of State, now limited to "names of other corporations organized under the Laws of" Delaware, should be extended to include (a) the names of foreign corporations authorized to do business in Delaware, and (b) corporate names duly reserved or registered under the statutory procedures suggested below, pp. 23-26. These would be housekeeping changes, not impairing the simplicity of the Delaware test.

(2) The Committee, and especially the office of the Secretary of State, may wish to consider the need for a statutory provision to prevent a corporation from using terminology falsely suggesting that it is engaged in banking, insurance, transportation, brokerage, or like businesses or in professional activities. Possibly such misleading usage is barred by existing procedures in the office of the Secretary of State, or by specific prohibitions elsewhere in the Delaware Code. However, some remedial action has been necessary, since Del.Corp.Law Section 365 specifically forbids improper use of the work "trust" in a corporate name. If additional provisions

are necessary, these can be readily drafted from precedents in other states. E.g., N.Y.Bus.Corp.Law Sections 301 (a)(3), (5), and (6) and 302 (b)(4) and (5); for more general prohibition, see S.C.Code § 12-13.1 (a)(3).

Subsection (a)(2): Registered Agent and Office

It is suggested that this provision be simplified by retaining the first sentence, viz.,

> (2) The name of the county and the city, town and place within the county in which its principal office or place of business/ is to be located in this State, and the name of its registered agent,

and striking the remainder of subsection (a)(2). The phrase "which agent may be either an individual or a corporation" duplicates the fuller statement in Section 131. The next two sectences of (a)(2) should also be deleted, if, as this Report recommends, there be uniform statutory provisions for executing, acknowledging, and filing all instruments. The draft section "Execution of Instruments" sets forth in its subsection (e) the requirements for the address of the corporation's office and resident agent, and would automatically apply to the certificate of incorporation.

Subsection (a)(3): Business and Purposes

This report recommends no change in this provision.

Subsection (a)(4): Authorized Stock and Minimum Capital.

This subsection is substantially in accord with the Model Act Section

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/ In newer corporation statutes, e.g., Model Act, New York, etc. it is customary to use the more inclusive term "registered office" which may or may not be the "principal office or place of business" and indeed may and often is the office of an attorney or service company. This is a matter of terminology only.

48 (d)-(f) and its progeny. See also N.Y.Bus.Corp.Law Section 402(a)(4)-(6).

This report questions whether the existing $1,000 minimum initial capital requirement serves any substantive purpose. Conceivably, the compulsion to make a minimum initial contribution in lawful consideration (See Section 152) deters some dubious enterprises. But apart from the ease of raising $1,000, once contributed it can readily be taken out of the corporation which then has no assets, thereby defeating the statutory requirement. Out of $1,000, a minimum sum can be allocated to capital (say $1.00 for 100 shares of 1 cent par, or for 100 shares of no par) and the remainder ($999.00) to capital surplus, which is a part of "net assets in excess of capital" (see Section 170 (a)) and therefore a legal dividend source. Thus, the $1,000 minimum capital requirement is illusory protection, wholly apart from the fact that this sum is rarely enough to protect anyone except the most insignificant creditor. Hence, the interests supposedly aided by the requirement will usually protect themselves in other ways, e.g., by a comprehensive examination of the financial resources of the enterprise and its promoters or by demanding shareholders' or directors' personal liability on loans. Nor is the minimum capital requirement protection to equity investors. If the corporation "goes public", the currently fashionable protection is through disclosure under federal and state statutes regulating sale of securities or controlling broker-dealers and underwriters -- a function obviously alien to minimum capital requirements on incorporation.

Corporation statutes provide no satisfactory alternative devices to achieve the objective of the minimum capitalization requirement. It would be a step backward to compel subscription to large amounts of money or property before incorporating or beginning business. Indeed, some recent statutes entirely abandon an initial capital requirement. Thus, even North Carolina--the strictest statute on statutory control of corporate finance and shareholder protection--requires no fixed minimum capital, but provides only for receipt of an unspecified "minimum amount of consideration . . . before commencing business," N.C.Gen.Stats. §§ 55-7 (5), -9, a requirement apparently satisfied by a nominal amount.__/

Accordingly, this Report views the minimum capital requirement as essentially a relic of an earlier and unsuccessful effort at governmental control through a device not well geared to that purpose. Accordingly, it is suggested that the minimum initial capital requirement be deleted.

Subsection (a)(5): Names and Addresses of Incorporators.

This Report recommends deletion of the present requirement of names and addresses of incorporators. If the recommended uniform provision for execution of instruments is adopted, incorporators' names and addresses would be stated in the certificate, immediately after the signatures. See draft section "Filing of Instruments," subsection (d). N.Y.Bus.Corp.Law § 402 similarly deletes this requirement.

__/ Apart from statute, and even with payment of a minimum capital, an inadequately capitalized corporation may lose its limited liability and shareholders become liable. This remedy, however, comes into play only in instances of grossest inadequacy, e.g., a merchandizing enterprise capitalized at $1.00, Weisser v. Mursam Shoe Corp., 127 F.2d 344 (2d Cir. 1942), or a steamship company capitalized at $10,000 but leasing vessels worth several million dollars and entering into large contracts, Luckenbach S.S.Co. v. W.R.Grace & Co., 267 Fed. 676 (4th Cir. 1920). It cannot be assumed that in every instance an initial $1000 capitalization would be sufficient to prevent operation to this doctrine--an aspect of judicial disregard of the corporate entity.

Subsection (a)(6): Duration of Corporation.

The present provision is satisfactory, although it would be simpler to assume perpetual existence and require a statement of duration only if a limited time span is contemplaed, as in New York, the Model Act, and statutes following the Model Act, e.g., "The duration of the corporation if other than perpetual."

Subsection (a)(7): Negating Shareholder Liability.

It is questionable whether this provision should appear at all, since (1) it will invariably be negated by language in the certificate, and (2) personal shareholder liability is simply alien to the concept of the corporation. There is no reason to suppose that a charter clause such as subsection (a)(7) precludes normal court jurisdiction to "pierce the corporate veil" in cases of fraud, misuse of corporate powers, illegality, or the other circumstances where courts will "disregard the corporate entity;" and presumably no jurisdiction would thus insulate shareholders from liability for breach of fiduciary duty, whether by directors, officers, or dominant shareholders. In short, the present provision merely requires the charter to state a legal consequence which would in every jurisdication, be achieved without such a provision.

Subsection (b): Other Provisions in Certificate of Incorporation.

Subsection (b) (1): Permissive Provisions.

In general, this provision seems satisfactory and in accord with like clause in other new statutes. However, it should specify that any provision which by statute is required or permitted to appear in the by-laws may instead be stated in the certificate of incorporation. This codifes a

Chancery ruling in Lippmann v. Kehoe Stenograph Co., 11 Del. Ch. 80, 91-92, Atc. 895 (Ch.1915). In some cases the principals may prefer the protection from ready amendment afforded to charter provisions, and recent statutes usually affirmatively recognize this.

Subsection (b) (2): Creditor Readjustments.

It is suggested that this provision be retained, but not in its present form and location. Rather it should be restated as a rule of law and included with Section 124. If a corporation does not wish to avail itself of this procedure, it could negate it in the certificate of incorporation.

Section (b) (3): Pre-emptive Rights.

This Report presently expresses no view on pre-emptive rights, pending a full study of the question. The existing provision assumes continuance of the common-law pre-emptive right, absent negation or limitation thereof. Alternatively, the statute could abolish the pre-emptive right, subject to its preservation in the certificate of incorporation. In all events, certain useful statutory rules can be formulated without disturbing the established Delaware view of pre-emptive rights.

Subsection (b) (4): Super-statutory vote requirements.

The permission granted by this subsection is probably implied in the broader language of subsection (b)(1). Because (b)(4) does specifically authorize greater-than-majority voting by shareholders, without a comparable provision for director voting, arguably the specificity of (b)(4) excludes the latter, even it if were deemed authorized under the general language of (b)(1). Because close corporations usually desire greater-than-majority voting both for director and shareholder action, this should be clarified here, or elsewhere in the statute, e.g., under Subchapter 7 ("Meetings").

Subsection (c): Definition of "certificate of incorporation."

If the proposed uniform provisions for executing, acknowledging, and filing instruments in approved, subsection (c)--which achieves the same result in a roundabout way--should be deleted.

Beginning of Corporate Existence

Under Section 106 corporate existence begins when the certificate has been filed with the Secretary of State, recorded, and all taxes have been paid. Although in accord with modern corporation law provisions, Section 106's language could be sharpened. First, whether or not the certificate of incorporation must be recorded, corporate existence should begin when it is filed by the Secretary of State, i.e., at most recordation should be a condition subsequent not affecting corporate existence.__/ The corporation's precise natal date may conveniently be specified by reference to the "filing date" which, under proposed Section   (Filing of Instruments), is endorsed by the Secretary of State on the filed instrument.

Second, the fact of filing should be conclusive, not merely presumptive, evidence of due performance of all conditions. See Model Act Section 50 and N.Y.Bus. Corp.Law § 402. Probably a majority of states similarly provide. See 2 Model Bus.Corp.Act Ann. 175 (1960) for a listing. This is

__/ This is particularly true if the Committee prefers Alternative 2 of the section entitled "Filing of Instruments" by which the Secretary of State transmits a copy of the certificate of incorporation to the appropriate recorder.

appropriate since the Secretary of State will be unlikely to file a document not in proper form or if fees and taxes are unpaid.

Third, making corporate existence conclusively date from filing virtually eliminates all possibility of defective incorporation requiring resort to the _de facto_ doctrine.

Fourth, if filing is conclusive evidence of due performance of conditions, an exception should be made for the infrequent case when the Attorney General institutes a Section 283 Chancery proceeding "to revoke or forfeit charters . . . for abuse, mis-use, or non-use of their corporate powers, privileges, or franchises" as required by Art. IX, Sec. 1 of the Constitution.

The following provision, in lieu of Section 106, would achieve these objectives:

Section 106. Beginning of Corporate Existence.

(a) The existence of the corporation shall begin as of the filing date of the certificate of incorporation, that is to say, as of the date endorsed by the Secretary of State upon the original filed copy of the certificate as provided by Section (Filing of Instruments).

(b) The certificate of incorporation as filed by the Secretary of State shall be conclusive evidence that all conditions required by this Chapter to be performed by the incorporators have been complied with and that the corporate existence has begun, except in a proceeding instituted by the Attorney General under Section 283 (Revocation or Forfeiture of Chapter; Proceedings).

Reserving and Registering Corporate Name

At present, Delaware has no statutory procedure for reserving and registering a corporate name, although this has been available "on an informal non-statutory basis... for many years." Israels, Corporate Practice 114 (1963). This valuable procedure should be definitively codified by statute, and the Model Act provisions, with some slight word changes, appropriately serve this purpose. Reserving and registering corporate names are matters on which uniformity among states is desirable, and for this reason the Model Act terminology is widely adopted. Under this procedure, a domestic or foreign corporation "reserves" its name for a brief period of time (usually no more than 3 months) when it is preparing to incorporate or seek authority for doing business in the State. A foreign corporation "registers" its name, typically for a much longer time period, (Usually up to ten years) pending its decision to come into a State to transact business. In both instances, the purpose is to prevent appropriation of the name before the legitimate user of the name has time to act.

(a) Reserving Corporate Name

The following provision is suggested for Subchapter 1:

Section . Reservation of Corporate Name

(a) The exclusive right to the use of a corporate name which is not prohibited by Section 102 (a)(1) may be reserved by:

(1) Any person intending to organize a corporation under this Chapter;

(2) Any domestic corporation intending to change its name;

(3) Any foreign corporation intending to apply for a certificate of authority to do business in this State;

(4) Any foreign corporation authorized to do business in this State and intending to change its name;

(5) Any person intending to organize a foreign corporation and intending to have such corporation apply for a certificate of authority to do business in this State.

(b) The reservation shall be made by filing with the Secretary of State an application to reserve a specified corporate name, signed by the applicant, and by paying to the Secretary of State the required fees. If the Secretary of State finds that the name is available for corporate use, he shall reserve the requested name for the applicant's exclusive use for a period of sixty days. The Secretary of State may extend the reservation for periods of not more than sixty days, for good cause shown in an application received before the expiration of the reserved period. Not more than two such extensions shall be granted.

(c) The right to the exclusive use of a reserved corporate name may be transferred to any other person or corporation by filing with the Secretary of State a notice of transfer signed by the applicant for whom the name was reserved and specifying the name and address of the transferee.

(d) The Secretary of State may revoke any reservation if, after hearing, he finds that the application therefor or any transfer thereof was not made in good faith.

Reporter's Note

Subsections (a), (b) and (c) are substantially in accord with Model Act Section 8, and the corresponding provision in N.Y.Bus.Corp.Law Section 303. It seems unnecessary, however, to specify in detail, as in N.Y.Bus. Corp.Law § 303(b), the detailed contents of the application. Subsection (d) of the proposed Delaware provision is derived from Va.Code § 13.1-7.

(b) Registration of Corporate Name

The following provision for registering corporate names is suggested for inclusion in Subchapter 1:

(a) Any corporation organized under the laws of any jurisdiction other than this State may register its corporate name under this Act, if such name is not prohibited by Section 102 (a)(1).

(b) The applicant may register its name by

(1) Filing with the Secretary of State of Delaware (A) an application for registration executed by the corporation by an officer thereof setting forth the corporate name to be registered, the date of incorporation, its jurisdiction of incorporation, and a brief statement of the business in which it is engaged; and (B) a certificate that the applicant corporation is in good standing under the laws of its jurisdication of incorporation, executed by the Secretary of State or equivalentofficer or agency of that jurisdiction; and

(2) Paying to the Secretary of State of Delaware the required registration fee.

(c) Registration shall be effective until the close of the calendar year in which the application is filed.

(d) A corporation whose name has been registered may renew registration from year to year (not to exceed ten years) by annually filing with the Secretary of State of Delaware the application, certificate and fee required by subsection (b) for an original registration. The renewal application shall be filed between October 1 and December 31 in each year, and such filing shall extend the registration for the next succeeding calendar year.

Reporter's Note

This provision accords with Model Act Sections 9 and 10. It is chiefly useful for already existing non-Delaware corporations seeking to save the exclusive user of its name in Delaware before actually entering the State to do business.

If one or both of the proposed provisions for statutory reservation or registration of a corporate name are accepted, Section 102 (a)(1) should be amended by adding at the end of that subparagraph the following language: "or reserved or registered as provided by Sections and ."

Organization of the Corporation

The present Delaware incorporation procedure envisions two sets of management officials, and two meetings, of these officials, before the corporation is duly organized to do business. The incorporators, designated in the certificate of incorporation (Section 102(a)(5)), "direct the affairs and organization of the corporation" (Section 107) until they meet and elect the directors (Section 108). The directors then meet and take other necessary or appropriate corporate action.

The marked trend of recent corporation law revisions derived from ABA Model Act Sections 48(H) and 52, is to designate in the certificate of incorporation the members of the initial board of directors. Hence, the corporation comes into existence with a board of directors ready to handle all matters within the purview of directors' powers. Incidental advantages are (1) to reduce the role of incorporators to signatories of the certificate of incorporation, (2) to eliminate the necessity for two meetings, viz., of the incorporators and of the directors elected at the incorporators' meeting, and (3) to avoid having to divide corporate management, even temporarily between two types of officials, viz., incorporators and directors. Under this procedure, the directors designated by the certificate of incorporation would hold office until the first shareholders' meeting or until successor directors are elected and qualify. If adopted in Delaware, this procedure would not disturb the established Delaware practice of fixing the number of directors in the by-laws and amendments thereto (see Section 141(b)).__/

In any state other than Delaware, this Report would unqualifiedly recommend the newer procedure by which the "management" role of incorporators is eliminated, directors are designated by the articles, and a single organizational meeting is held. In most cases principals do not hesitate to reveal themselves when the incorporation papers are filed. But in some situations, anonymity is a substantive interest to be protected, and the present procedure in Delaware well serves that interest. Moreover, incorporators may be completely "controlled" in a manner raising serious doubts in case of directors. Again, corporation service companies might be reluctant affirmatively to assume the role of "directors," even temporarily.

Accordingly, it is suggested that, despite the strong contrary trend in the United States, the present Delaware procedure employing incorporators

__/ This procedure does not entail amending the certificate of incorporation when new directors are elected or the number of directors are changed. The effect of the procedure is that the certificate of incorporation contains an item of only temporary concern completed organization of the corporation.

be retained. It is significant that New York also has the same provision. N.Y.Bus.Corp.Law Section 404. Although the substance of Sections 107 and 108 should be retained, the existing provisions are incomplete, and should be clarified and supplemented, The following provisions, derived from the Model Act and the New York statute, together with original Delaware language, are suggested:

§ 107. Powers of incorporators; management prior to election of directors.

Until the directors are elected, the incorporator or incorporators shall manage the affairs of the corporation and may take such steps as are necessary and proper to perfect the organization of the corporation.

Reporter's Note

This provision condenses the language of present Section 107. The phrase "manage the affairs" is substituted for "direct the affairs" to harmonize with Section 141(a). The reference to obtaining stock subscriptions is deleted as no longer necessary, since it is a power encompassed by the grant of management authority to the incorporators.

§ 108. First meeting; organization of corporation.

(a) At any time after the filing date of the certificate of incorporation, an organizational meeting of the incorporator or incorporators shall be held, either within or without this State, to adopt by-laws, to elect directors to hold office until the first annual meeting of shareholders, to do any other or further acts to complete the organization of the incorporation, and to transact such other business as may come before the meeting.

(b) If there are two or more incorporators, the organizational meeting may be called by a majority of the incorporators who shall give each other incorporator at least two days notice by any usual means of communication. The notice shall set forth the time, place and purpose of the meeting. Notice of the meeting need not be given to any incorporator who attends the meeting or who signs a waiver of notice either before or after the meeting.

(c) Any action permitted to be taken at the organizational meeting of the incorporators may be taken without a meeting if each incorporator signs an instrument setting forth the action so taken.

Reporter's Note

Subsection (a) retains the concept of the organizational meeting but spells out the appropriate action to be taken at that time; it is based largely on N.Y.Bus.Corp.Law § 404(a). Subsection (b) retains the substance of present Section 108, but is more specific on the notice requirement, expands the waiver-of-notice concept to dispense with notice to one actually attending the meeting, and completely abolishes newspaper notice which is at present conditionally eliminated under Section 108. Subsection (c) based on N.Y.Bus.Corp.Law § 404(b) definitively validates action without a meeting. All portions of the suggested section reflect the recommendation to eliminate multiple incorporators._/

_/ It is possible to proliferate detail and specify the consequences of death or incapacity of one or more incorporators, or of dissolution of a corporation functioning as incorporator. Thus N.Y.Bus.Corp.Law § 615(c) provides: "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 person also dies or is for any reason unable to act, his legal representative may act." Analogous provisions could be worked out for dissolution of a corporation or loss of Delaware authority of a foreign corporation acting as incorporator. This Report questions the necessity for such fine detail and would suggest that the problems, if they arise at all, may best be resolved on a case-by-case basis, in the unlikely event that they cannot be adjusted by the parties involved.

By-Laws

Sections 109(a) and 122(6) generally authorize corporate by-laws, although numerous other sections deal with substantive points which may or must be covered in the by-laws.

1. The major substantive question at this point is the locus of the by-law power. Under Section 109(a), given the initial by-laws adopted by incorporators, the by-law power reposes in the stockholders unless delegated to the directors by the certificate of incorporation. This long standing Delaware doctrine apparently accommodates most corporations, large and small. However, the effect of shareholder delegation to directors of the by-law power is not clear. In principle, it could either give the directors and shareholders merely concurrent power over the by-laws, see Rogers v. Hill, 289 U.S. 582, 588-589 (1933)(New Jersey statute), or wholly extinguish shareholder by-law power unless subsequently restored to them by amending the certificate of incorporation. Delaware decisions seem not to have resolved the question if, indeed, it has been squarely presented. Moreover, many charter provisions expressly reserve by-law power to shareholders. See e.g., Moon v. Moon Motor Car Co., 17 Del.Ch. 176, 186, 151 Alt. 298 (Ch. 1930)("the by-laws in this case were subject to amendment by the stockholders" to increase the number of directors); Campbell v. Loew's Inc., 36 Del.Ch. 563, 567, 134 A2d 852 (Ch. 1957)(shareholders called to amend by-laws to increase number of directors); Gow. v. Consolidated Coppermines, Corp., 19 Del.Ch. 172, 175, 165 Atl. 136 (1933)(Same); SEC. v. Transamerica Corp., 163 F2d 511.

__/ In Rogers v. Hill, The Supreme Court of the United States construed a New Jersey statute substantially identical with Delaware's Section 109(a) to authorize delegation and concurrent by-law power, but not an abdiction of the shareholders power over the by-laws, i.e., the shareholders have an inherent power with respect to by-laws. However, the New Jersey statute contains the phrase lacking in Delaware: "by-laws made by the directors under power so conferred may be altered or repealed by the stockholders.

Some statutes resolve the question by specifically providing that, despite delegation to directors of by-law power, the shareholders retain a continuing concurrent by-law power. See, e.g., Calif. Corp. Code § 500; N.C.Gen.Stats. § 55-16; S.C.Code § 12-16.1; compare Conn.Gen.Stats.§ 33-306; N.Y.Bus.Corp. Law § 601(a). In other jurisdictions, the question is by-passed by vesting the by-law power in the directors unless and to the extent that the certificate of incorporation reserves it to the shareholders. See e.g., Model Act Section § 25; Iowa Bus. Corp.Act § 26. Even so some states add a provision reserving a shareholder power to amend or repeal by-laws made by directors. See e.g., Va.Code Ann. § 13.1-24 (1956); Ala.Bus. Corp.Act § 59. And no state, apparently, has gone so far as to vest by-law power in the directors and forbid its exercise by the shareholders--a procedure objectionable on the ground, inter alia, of destroying an important interest of the closely held corporation. Even if the by-law power is vested in the directors unless specifically reserved to shareholders, courts would still determine whether the by-law is "unreasonable," see, e.g., State ex rel. Brumley v. Jessup and Moore Paper Co., 24 Del. (1 Boyce) 379, 389, 77 Atl. 16 (1910) (by law held "unreasonable and unlawful"); In the Matter of the Osteopathic Hosp.Ass'n of Delaware, 195 A 2d 759,, 764-765 (Del.S.Ct. 1963) ("legally unreasonable". . . "patently unreasonable as a matter of law". . ."out of context with the basic organizational structure of this organization"), or whether it violates some term of the charter of statute, Brooks v. State, 26 Del. (3 Boyce) 1, 49, 79 Atl. 790 (1911) (contrary to charter); Gaskill v. Gladys Bell Oil Co., 16 Del.Ch.289, 146 Atl. 337 (1929). However the formula is framed, litigation will likely continue, whether over the by-laws' "reasonableness: or the shareholder"power" to act on them. Finally, a reversal of the rule would likely be unsettling to existing corporations and would probably require special provisions to adjust the new rule to outstanding charter and by-law provisions._/

2. Section 122 (6)'s authorization of the contents of the by-laws, could be stated in broader language. Also it might be well to codify fully the doctrine of Gaskill v. Gladys Bell Oil Co., 16 Del.Ch. 289, 146 Atl. 337 (Ch.1929) that by-laws are subordinate to the certificate of incorporation. The following provision might be considered:

> The by-laws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, or officers.

Section 122(6)'s reference to altering the number of directors can be deleted as it merely duplicates Section 141(b); the provision regarding stock transfer and penalties should be inserted elsewhere than in the general powers of the corporation.

3. It is also suggested that the by-law provisions, now divided between Section 109(a) and 122(6), appear in a single section; and that Section 122(6) merely state the power to adopt and amend the by laws.

4. For the closely held corporation, the following points should be made explicit either here or elsewhere in the statute: (a) that any provision required or permitted to be stated in the by-laws may instead

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_/ An appendix to this section discusses the Delaware provision in relation to the SEC proxy rules.

appear in the certificate of incorporation;—/ (b) that the certificate of incorporation may confer exclusive power on the shareholders with respect to the by-laws;—/ and (c) that whoever has the by-law power, whether shareholders or directors, may be required, by appropriate provision of the certificate of incorporation or the by-laws, to act by a greater-than-majority vote.—/ These provisions are permissive, and would have no effect on any corporation unless affirmatively implemented by the certificate of incorporation or the by-laws themselves.

5. Finally, subsections (b) and (c), providing for emergency by-laws, require no change. They accord with the procedures authorised in many new corporation statutes.

__/ See the proposed additional language to Section 105 (b) (1), and compare Conn.Gen.Stats. § 33-306(e): "Any lawful provisions of the by-laws may be included in the certificate of incorporation and, wherever in this Chapter reference is made to any provision of the by-laws, such reference includeds any similar provision contained in the certificate of incorporation."

__/ See S.C.Code § 12-16.1(d): "The articles of incorporation may exclusively vest in the shareholders the power to amend, adopt or repeal the by-laws generally or a particular by-law or class of by-laws."

__/ Many states specifically so authorise. To protect a greater-than-majority voting requirement from being eliminated by a majority vote, some statues, e.g., Conn.Gen.Stats. § 33-306(d) specify: "No by-law provision prescribing the vote required to amend the by-laws or any provision thereof shall be amended by lesser vote"

Appendix.

By-Law Power and Proxy Rules

The question may be raised whether vesting exclusive by-law power in the directors as in the Model Act, would affect the number of shareholder proposals which under the SEC's proxy rules may be inserted, together with a supporting statement, in management proxy material. With limitations immaterial here, Rule 14a-8 requires this if the proposal is "under the laws of the issuer's domicile . . . a proper subject for action by security holders." SEC v. Transamerica Corp., 163 F.2d 511 (3d Cir. 1947) involved a shareholder's proposed amendments to the by-laws of a Delaware corporation whose certificate of incorporation specifically permitted shareholders to alter or repeal director-made by-laws, Id. at 516, n.9. The Third Circuit held that both under Section 109(a) and Transamerica's charter, the shareholders could act on by-law amendment proposals, Id. at 517, and that each proposal was a "proper subject" for shareholder action under Delaware law, Id. at 518.

It is probable that if the by-law power were vested in the directors, no by-law amendment would be a "proper subject" for a shareholder proposal. See Loss, Securities Regulation 903, n. 183. (2d ed.1961). Even this result would probably prove to have limited utility from a management viewpoint since Rule 14a-8 is not limited to action with respect to by-laws, but in the SEC view, encompasses shareholder resolutions not in the form of by-law amendments, and even proposals not mandatory but merely advisory in form. And Transamerica itself indicated that it is immaterial, at least on one "proper subject" matter (appointing auditors) whether the proposal "be considered as a proposal to amend the by-laws" or as "a mandate from the stockholders to the directors to be carried into execution by following its terms." 163 F. 2d at 517.

Thus, even if the Delaware statute exclusively vested the by-law power in the directors, unless reserved it is unlikely that Rule 14a-8 shareholder proposals would be sharply reduced; since they would probably take a different form, viz., a shareholder's resolution._/ And even though SEC Rule 14a-8 keys "proper subject" to the law of the issuer's domicile, this is only the SEC's self-imposed limitation. Indeed, the Third Circuit alternatively held (semble) that even if a matter is not a "proper subject" under Delaware law, it may be under federal law, and in the proposals involved in Transamerica were so regarded. Id. at 518. Thus, it would appear that permissive withdrawal of all shareholder by-law power would be unlikely to affect substantially the frequency and number of shareholder proposals under Rule 14a-8.

_/ One of the shareholder proposals was identified as "a straight resolution" rather than a by-law amendment. 163 F.2d at 513.

Subchapter II. CORPORATE POWERS

General Powers

Although somewhat verbose in its present form and not duplicated by more recent statutes, Section 121's traditional language, with needed clarifications, should be retained. It affords a firm base for Section 122's specific powers, and it might, in some instances, support the exercise of some power not explicitly stated in Section 122. Section 121 also embodies the concept that all corporate powers are subordinated to the purposes stated in the certificate, although this is usually no practical limitation since purposes normally are broadly stated.—/

Section 121 presently contains some awkward or ambiguous features. (1) In the first sentence, the adverb "expressly" seems needlessly to restrict the phrase "powers expressly given in its charter," and even suggests a rule of narrower contruction for charter than for statutory powers. (2) Although the intent of the second sentence can be deduced, its wording could imply that charter terms can vary statutory terms, although under Delaware decisions the statute clearly prevails over inconsistent charter terms. Gaskill v. Gladys Bell Oil Co., 16 Del.Ch. 289, 146 Atl.337 (1929).

__/ There is some variance in statutory language on this point, although the differences seem chiefly verbal, not substantive. (1) All corporate powers are expressly subordinated to corporate purposes. E.g., N.Y.Bus. Corp.Law § 202. (2) None of the corporate powers are subordinated to corporate purposes, e.g., Model Act Section 4, although presumably a Model Act state would impose such a limitation if the issue were presented in court. (3) A few states grant some powers unsubordinated to charter purposes, e.g., the powers to appoint officers and agents, make by-laws, contribute to charities, invest funds, and pay compensation, but expressly subordinate all other powers to purposes. E.g., N.C.Gen.Stats. § 55-17; Conn.Gen.Stats. § 291.

Presumably this clause means simply that statutory provisions may be varied by the charter so far as the statute permits the charter to do so, but not otherwise. This would accord with the wording of Section 102(b)(1). (3)Section 121's final sentence is uncertain in effect. At best, it seems to state a truism: powers not granted may not be exercised. If its purpose is to grant powers incidental to other powers, it is probably an unnecessary holdover from the time when corporate powers were rigidly construed and "incidental" powers grudingly conceded, if at all. Although probably embraced by the general grant of powers "necessary or convenient" to corporate purposes, it could be retained, although in a somewhat different form.

The following restatement of Section 121, retaining as much traditional language as possible, might be considered:

(a) In addition to the powers enumerated in Section 122 of this title, every corporation, its officers, directors, and stockholders shall possess and may exercise all the powers and privileges granted by this chapter or by any other law ~~and~~ or by the certificate or incorporation_/ together with any powers incidental thereto, so far as such powers and privileges are necessary or convenient to the attainment of the objects set forth in its certificate of incorporation.

(b) Every corporation shall be governed by the provisions and be subject to the restrictions and liabilities contained in this chapter, unless otherwise provided by the certificate of incorporation as permitted by this chapter.

_/ It would be useful to collect together various terms for general definition in a section at the beginning of the chapter. For example, "certificate of incorporation" could be defined to include, both the original and an amended certificate, besides the ordinary certificate, or charter, or special legislative act conferring a charter or granting powers. From time to time, footnotes will refer to terms which could be given a general definition. See Model Act Section 2; N.Y.Bus.Corp.Law §102.

Powers Enumerated in Section 122

In general, the powers enumerated in Section 122 are sufficient so far as they go, but (1) in some respects those granted may be expanded, and (2) other powers, not presently specified in Section 122, should also be granted. Section 122 will be analyzed by subsections.

(1) Succession in Corporate Name: This provision calls for no change, and properly assumes perpetual life unless otherwise stated.

(2) Capacity to sue and be sued: This provision should also authorize participation in non-judicial trubunals:

> To sue and be sued, in all courts, and otherwise to participate in any judicial, administrative, arbitrative, or other proceeding.

Compare N.Y.Bus.Corp.Law § 202(a)(2); Model Act § 4(b).

(3) Corporate Seal: No change suggested.

(4) Powers over Realty and Personalty: Probably no courts would today view this power restrictively, although Delaware's rather limited statement could invite question. For instance, New York (N.Y.Bus.Corp.Law § 202(a)(5)-(6)): empowers a corporation

> 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 (and) To sell, convey, lease, exchange, transfer or otherwise dispose of, or mortgage or pledge, all or any of its property, or any interest therein, wherever situated.

(5) Appointing and Compensating Agents: In general this is adequate.

(6) By-Laws-: See the discussion of this topic, *supra*. If the provisions regarding the by-law power are stated in a single section, subsection (6) should merely state the power:

To adopt, amend, and repeal by-laws.

(7) Dissolution: This provision needs no change.

(8) Out-of-state Business: This provision seems adequate. If the provision for corporate powers with respect to property is expanded, as suggest, the final clause of present subsection (8) can be eliminated (". . . and to hold, purchase, mortgage, and convey real and personal property, both within and without this State").

(9) Charitable Donations: This provision seems adequate. An occasional statute, *e.g.*, N.Y.Bus.Corp.Law § 202(a)(12), adds: "irrespective of corporate benefit" in order to sidetrack any contention that remote or non-existent corporate benefit does not invalidate the contribution as a "waste" of corporate assets. Although most decisions in other states interpret their statutes to find "corporate benefit," see, *e.g.*, *A.P.Smith Mfg.Co. v. Barlow* 13 N.J. 145, 98 A.2d 581 (1953), the phrase might discourage litigation on the question. Delaware might also wish to consider a phrase, now usual in new statutes, authorizing donations "in time of war or other national emergency in aid thereof." N.Y.Bus.Corp.Law § 203(a)(12), modifying Model Act Section 4(m) which has been adopted in many states.

(10) Indemnification: This will be separately considered in the section of the Report dealing with officers and directors.

Powers not Now Enumerated in the Statute

A number of other corporate powers, not now specifically recognized by Delaware statutes, should be enumerated in Section 122. Although some of these may have been recognized in judicial rulings, and many of them are inserted in charters, it is desirable to eliminate any doubt as to a Delaware corporartion's plenitude of power, especially since the Model Ac and all recent corporation law revisions explictly provide these powers. Each type of power will be separately considered, and draft statutory language suggested.

(a) Wartime or Emergency Business: Many statutes e.g., Model Act § 4(n); N.Y.Bus.Corp.Law §§ 201(b), specifically authorize a corporation, irrespective of the purposes stated in the certificate of incorporation, to do any lawful business in time of war or other national emergency. Its effect is to eliminate the necessity for a formal amendment of the certificate, by shareholder action; and in war or emergency times, especially in a nuclear age, this may be important. Accordingly, Delaware should, of all states, make this power clear and unmistakeable, and protect its corporations in the exercise thereof. Delaware's recognition of emergency situations is reflected by its 1961 enactment of the emergency by-laws provision of Section 109(b). Accordingly, language such as the following would seem indispensable:

> 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.

This provision is taken from N.Y.Bus.Corp.Law § 201(b), and is superior to the more amorphous language of Model Act Section 4(n) and states following that Act.

(b) Contracts; Guaranties; Borrowing, etc.: Many states now specifically set forth powers to contract, guaranty, etc., rather than leave it to implication or as an incidental power. The following provisions would achieve this in Delaware:

> To make contracts and incur liabilities, borrow money, issue its notes and bonds and other obligations, and secure any of its obligations by mortgage, pledge or other encumbrance of any of its property, wherever situated. (and)
>
> To enter into contracts of guaranty or suretyship.

These provisions are taken form Model Act Section 4(h); N.Y.Bus.Corp.Law § 202(a)(7); S.C.Code §§ 12-2.2(a)(10)-(11); and are found in many other states as well.__/

(c) Investing Funds: Although this power has been recognized in Delaware, once again it should be specifically set forth, in terms such as the following:

> To lend money, invest and reinvest its funds from time to time, and take, hold, and deal with real and personal property as secruity for the payment of funds so invested or loaned.

See Model Act Section 4(i); N.Y.Bus.Corp.Law § 202(a)(8), etc.

(d) Power to be Incorporator or Promoter: If a Delaware corporation may act as an incorporator, as recommended previously, it should be expressly empowered to do so, and to act in other related capacities, as follows:

> To be an incorporator, promoter, or manager of other corporations of any type or kind.

This is based in part, on N.Y.Bus.Corp.Law § 202(a)(15). Management contracts are important in the field of investment companies and (to a lesser extent today) in public utitilities, as well as in other areas of business; and

__/ Explicit recognition of this power should facilitate borrowing. Isreals, Corporate Practice 125 notes that lenders' counsel advise clients not to lend to Delaware corporation whose certificate does not specifically empower it to borrow.

capacity to act as manager should be expressly recognized.

(e) Power to be Partner: Unlike many other states, Delaware does not specifically recognize corporate power to enter into a partnership or joint venture. Although the Uniform Partnership Act does not preclude corporate partners,_/ corporation law concepts make it uncertain whether a corporation may delegate or share with others the control of its affairs which, under the corporate norm concept, is vested in its own directors. To permit this useful procedure, and allay doubts, a corporation should have power:

> To participate with others in any corporation, partnership, limited partnership, joint venture, or other association of any kind, or in any transaction, undertaking or arrangement which the participating corporation would have power to conduct by itself, whether or not such participation involves sharing or delegation of control with or to others.

This language is taken primarily from Conn.Gen.Stat. § 33-291 (3)(4); N.C. Gen.Stat. § 55-17(b)(6), and S.C.Code § 12-12.2(a)(16), and is recommended for its breadth and for its specific negation of the "corporate norm" concept in this particular area. N.Y.Bus.Corp.Law § 202(a)(15) is insufficient to avoid possible problems, for it merely empowers a corporation "to be a promoter, partner, member, associate or manage of any other business enterprises or ventures.

(f) Compensation: Although this would chiefly codify results reached

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_/ Partnership is defined (in pertinent part) as "an association of two or more persons" (U.P.A. § 6(1)) and "person" is defined to "include . . . corporations" (U.P.A. § 2). Del. Code Ann. §§ 1506(a) and 1502, respectively.

under decisional law, it would be desirable for Delaware to follow other new statutes and broadly sanction all sorts of compensation devices:

> To pay pensions, and to establish and carry out pension, profit sharing, stock option, stock purchase, stock bonus, retirement, benefit, incentive and compensation plans, trusts and provisions for its directors, officers, and employees, and for directors, officers and employees of its subsidiaries.

This provision is based on N.Y.Bus.Corp.Law § 202(a)(13) and Model Act Section 4(p). The final clause should benefit corporate "families" especially when the subsidiaries' stock is not publicly marketed. A comparable provision was added to the Virginia statute, by Va.Laws 1964, Ch. 352; see also S.C. Code § 12-15.8(c) (parent may option its stock to personnel of subsidiaries).

(g) <u>Power to Insure Directors, Officers, and Other Employees:</u> Some states usefully recognize corporate power to take out insurance n officers, directors and shareholders. This need not function as compensation, and may benefit the corporation in some other way. For example, close corporations constantly use "key-man" insurance to reacquire stock at the owner's death. Thus, S.C. Code § 12-12.2(a)(17) empowers a corporation:

> To provide for its benefit insurance on the life of any of its directors, officers, or employees, or on the life of any shareholder for the purpose of reacquiring at his death shares owned by such shareholders.

Comparable, though somewhat narrower, provisions appear in the North

Carolina __/ and Virginia __/ statutes.

Powers Respecting Other Securities

Section 123 is fundamentally sound; although a close inspection reveals deficiencies in the power conferred, this can be readily corrected.

(1) Section 123 should not be limited, as at present, to acquiring securities of other corporations, since this impliedly excludes power to acquire securities issued by non-corporate issuers, including governments. For example, under what authority could a Delaware corporation purchase, solely for investment, limited partnership i terests which are occasionally sold publicly. Both the Model Act and New York confer much broader power than Delaware's Section 123, and the Model Act provision has been widely adopted.

(2) Section 123 should also confer somewhat broader powers of acquiring and using securities. Unless it it certain that "purchase" includes any mode of acquisition, it would be well to add additional words such as: "take, receive, subscribe for, or otherwise acquire."

__/ N.C.Gen.Stats. § 55-17(b)(4): "To procure for its benefit insurance on the life of any employee, including any officer, whose death might cause financial loss to the corporation, and to this end the corporation is deemed to have an insurable interest in its employees and officers."

__/ Va.Code § 13.1-3(p): "To insure the life of any director, officer, agent or employee, and to continue such insurance after the relationship terminates, and no such director, officer, agent or employee shall be deemed disqualified by interest from acting in respect thereof." The last clause of the Virginia section will be covered by a provision which this Report will suggest for recognizing transactions involving interested directors and officers.

Without disturbing settled case-law, especially Hariton v. Arco Electronics, Inc., 188 A.2d 123 (Del.S.Ct. 1963) and Orzeck v. Englehart, 195 A2d 375 (Del.S.Ct. 1963), Section 123 should be expanded and clarified as follows:

> Any corporation organized under the laws of this State, whether created by this chapter or by special act of the legislature or general law,_/ may guarentee,_/ purchase, take, receive, subscribe for or otherwise acquire; own, hold, use or otherwise employ; sell, lease, exchange, transfer, or otherwise dispose of; mortgage, lend, pledge or otherwise deal in and with, bonds and other obligations of, or shares or other securities or interest in, or issued by, any other domestic or foreign corporations, partnership, associations, or individuals, or by any government or agency or instrumentality thereof. A corporation while owner of any such securities may exercise all the rights, powers and privileges of ownership, including the right to vote thereon._/

This first sentence of this reformulation of Section 123 is primarily derived from Model Act Section 4(h), while the second sentence is taken from present Section 123 (substituting the broader term "securities" for "such stock").

_/ The use of the term "corporation" or "domestic corporation," defined to include a Delaware corporation however created, would simplify this and other sections, by eliminating lengthy and repetitious language.

_/ If a specific power of guaranty is inserted in Section 122, as suggested on p. , it could be deleted from Section 123.

_/ N.Y.Bus.Corp.Law § 202(a)(6) states the power somewhat more generally: "To purchase . . . bonds and other obligations, shares or other securities or interests issued by others, whether engaged in similar or different business, governmental, or other activities." N.Y.Bus.Corp.Law § 102(a)(1) defines 'bonds" to include "secured and unsecured bonds, debentures, and notes."

One letter_/ suggests that Delaware statute, besides granting all necessary corporate powers (as the Report recommends, supra pp 36-46), should contain "a provision permitting the Certificate of Incorporation to refer to and incorporate such powers merely by reference to the provisions of the statute without setting them out at length." Since it is apparently customary practice to recite fully the powers in the charter, this Report concurs, and suggests that this is best accomplished by a simple provision at the end of Section 102 as follows:

> It shall not be necessary to set forth in the certificate of incorporation any of the powers enumerated in this Title.

Cf. N.Y.Bus.Corp.Law § 402(b) (last sentence); Model Act Section 48 (last sentence) and all states following the Model Act. This would not preclude a corporation, if it so desired, from including charter clauses limiting or restricting the powers granted by the statute--a privilege sometimes desired by closely held enterprises.

__/ Letter of Bradford S. Magill, of Naylon Aronson Huber & Magill, to Hon. Clarence A. Southerland, dated August 27, 1964, at p.1.

Corporate Powers: Miscellaneous Provisions

Creditor Readjustments: This Report suggested, *supra* p. 20, that instead of keying Section 124's procedures to an express recital in the certificate of incorporation, Section 102(b)(2), it would be simpler to confer the power and authorize the certificate to negative it, if desired. This can be accomplished by eliminating Section 102(b)(2), and rewording Section 124, and inserting in either place authority to negative a Section 124 readjustment. Beyond that, no changes are suggested.

Conferring Academic Degrees: This Report makes no recommendation as to Section 125, except possibly to include it at the end of the chapter with miscellaneous provisions, or in another code title.

Banking Powers: This Report makes one minor recommendation as to Section 126. To avoid confusion with general corporate power to invest and reinvest funds, recommended previously,_/ Section 126(b) should make clear that it refers to corporations organized for the *purpose* of dealing in notes and other debt:

> Corporations created . . . for the purpose of buying, selling and otherwise dealing in notes, open accounts and other similar evidences of debt, or for lending money and taking notes, open accounts . . . "

_/ See p. 41 *supra*.

Ultra Vires Doctrine

The ultra vires doctrine, once a focal point of litigation over corporations, has played a decreasingly significant role in American law. In all of the recent corporation law revisions, the ultra vires defense has been abolished except in limited circumstances. Actually, this reflects the growing body of case-law which has severely restricted ultra vires; and Model Act Section 6, widely adopted, merely codified the prevailing American rules.

The somewhat spotty Delaware case-law accords with the prevailing trend. An early Superior Court decision, Standard Sewing-Machine Co. v. Frame, 2 Penne. 430, 431, 48 Atl. 188 (Del.Super.1900) articulated a broad ground for limiting ultra vires by stating that one who has contracted with a corporation "is estopped from denying that the corporation was not authorized by the charter to make the contract since "any one dealing with the corporation is bound to know the limitations put on it by the statute under which it was created," In the Matter of Int'l Radiator Co., 10 Del.Ch. 358, 360, 95 Atl. 255 (Ch. 1914), and therefore assumes the risk of no corporate power. A further limitation was stated in terms of standing, since "he only can invoke the doctrine of ultra vires who can show the violation of some duty owing to himself," Graham v. Young, 5 W.W.Harr. 484, 167 Atl. 906, 908 (Del.Super. 1933). Again, Delaware does not allow the ultra vires defense to suit on a fully executed contract, Delmarva Poultry Corp. v. Showell Poultry Corp., 179 A.2d 796, 799 (Del.S.Ct. 1962). However, "the right to question the validity of corporate acts beyond the powers of the corporation could, of course, be exercised by the sovereignity by whom the corporation was created." Graham v. Young, supra.

The Model Act provision leaves ultra vires effective only in three situations: (1) a strictly limited class of shareholders' suits to enjoin a contract not yet executed, (2) a suit by, or in the right of, the corporation against directors or officers (for their unauthorized acts), and (3) an Attorney General's suit. At least thirty states have similar provisions limiting ultra vires, and a majority of these employ the Model Act language, including N.Y.Bus.Corp. § 203. This provision accomplishes at least as much as Delaware "estoppel" concept by extinguishing any right of the contracting parties to plead ultra vires. At least one state further restricts the shareholder's right to invoke ultra vires requiring him to plead and prove "That he has not any time prior thereto (i.e., the suit) assented to the act or transfer in question, and that in bringing the action he is not acting in collusion with officials of the corporation." N.C.Gen.Stats. § 55-18(a)(1).[/]

The following provision is recommended to the Committee:

SECTION 127. DEFENSE OF ULTRA VIRES (Draft)

No act of a corporation and no conveyance or transfer of real or personal property to or by a corporation shall be invalid solely by reason of the fact that the corporation was without capacity or power to do such act or to make or receive such conveyance or transfer, but such lack of capacity or power may be asserted:

(a) In a proceeding by a shareholder against the corporation to enjoin the doing of any act or acts or the transfer of real or personal property by

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/ Cf. a dictum in John W. Cooney Co. v. Arlington Hotel Co., 11 Del.Ch. 430, 441, 106 Atl. 39 (S.Ct. 1918) for a limited application of the same idea: "Certainly a stockholder cannot escape such assessment if he has held himself out, or permitted himself to be held out, as the owner of the stock; and much less could he escape if he participated in the unlawful issue or acquiesced therein."

or to the corporation. If the unauthorized acts or transfer sought to be enjoined are being, or are to be, performed or made persuant to any contract to which the corporation is a party, the court may, if all of the parties to the contract are parties to the proceeding 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 which may result from the action of the court in setting aside and enjoining the performance of such contract, but anticipated profits to be derived from the performance of the contract shall not be awarded by the court as a loss or damage sustained.

(b) In a proceeding by the corporation, whether acting directly or through a receiver, trustee, or other legal representative, or through shareholders in a representative suit, against an incumbent or former officer or director of the corporation, for loss or damage due to his unauthorized act.

(c) In a proceeding by the Attorney General to dissolve the corporation, or to enjoin the corporation from the transaction of unauthorized business.

Subchapter III. Principal Office and Resident Agent

(Sections 131-136)

This Report recommends no substantive changes in Subchapter III. Many recent corporation statutes contain many of the same provisions, but the differences are chiefly terminological. If the Committee approves certain recommendations of this Report, the following language changes should be made in Sections 131-136:

(1) Elimination of Local Recording: Sections 132-136 call for local recordation of documents dealing with the principal office or resident agent. If local recordation is abolished or, alternatively, if the documents are transmitted by the Secretary of State, some reworking of these sections will be necessary. But cf. Section 136(b) requiring the Secretary of State to "notify" the local recorder of the filing of a resident's certificate of resignation without appointing a successor.

(2) Uniform Execution-Acknowledgment-Filing Provisions: If the Committee endorses the sections, *supra* pp. 1-8, providing a uniform procedure for executing, acknowledging, and filing corporate documents, a cross reference to those sections can be substituted for some of the detail in Sections 132-136.

Subchapter 4. Directors and Officers

Unlike most recent corporation codes, the Delaware statute covers only a few basic points concerning directors and officers, leaving most questions to case-law or charter or by-law provisions. It is clearly a policy matter whether the statutory provisions should be amplified, but this policy judgment, it is believed, can only be made against the background of the extensive developments inother states and an assessment of their relevance or advantage to Delaware. Most of the provisions here recommended appear in all or most of the newly revised statutes, including those adopted after the most thorough study, e.g., New York, Connecticut, Virginia, North Carolina, South Carolina, and Texas; and other notable statutes of slightly older vintage, e.g., Ohio, Illlinois, Pennsylvania, and California.

While not conclusive, several factors favor expanded statutory coverage. (1) Corporation law is increasingly statute law. Thus, it may be relatively disadvantageous to leave important questions solely to case-law statement or development when other states expressly resolve issues on the face of the statutes, or--what it more frequent and helpful--expressly state a rule subject to charter or by-law variance. (2) Allowing for unforeseeable constructional problems, codification usually makes for greater certainty, both for business counsel and courts. Statutory statement may forestall complex and unsettling litigation, expecially on unresolved issues. (3) Explicit statutory statement, which might otherwise not be necessary, may be essential to discriminate adequately between rules applicable to close and public corporations--a matter of increasing interest and concern today.

With this as background, the Report points up major differences between Delaware and other statutes, and suggests at least one possible approach to the problem. In addition, some ambiguities in the existing statute need to be cleared up. Throughout, draft provisions are supplied for implementing the recommendations.

A. The Board of Directors

1. Management by Directors

Section 141(a)'s general grant of management authority to directors accords with like provisions in all other statutes and requires no change.__/

2. Number of Directors

The first sentence of Section 141(b) requires three directors with exceptions for close corporations, and adequately authorizes increase and decrease in the number of directors. Certain additional provisions should be considered:

(1) The less-than-three exception should be inserted in the yet-to-be drafted close corporations chapter.

(2) Under Gow v. Consolidated Coppermines Corp., 19 Del. Ch. 172, 177-187, 165 Atl. 136 (Ch. 1933) the by-laws control the number of directors, despite a contrary charter provision. Generally, this is satisfactory, but since the greater protection of a charter provision may be desired, it should be permitted, as in many states.__/ Va.code § 13.1-36 follows the Delaware provision (slightly reworded) "unless the articles (certificate) of incorporation provides that a change in the number of directors shall be made only by amendment of the" certificate. A similar provision for Delaware would affect only the exclusiveness of the Gow reading of Section 141(b).

__/ If the close corporation provisions, yet to be drafted, also modify Section 141(b), a specific cross-reference should be made.

__/ Some states permit changing the number of directors only by amending the charter or by a by-law adopted by the stockholders, see N.C.Gen.Stats. § 55-25(b), and N.Y.Bus.Corp.Law § 702(b) which is almost as inflexible and considerably more complex.

(3) Many states add a useful clarifying provision that no decrease in the number of directors shall shorten the term of any incumbent, see N.Y. Bus.Corp.Law § 702(b)(2), or effect his removal, Calif.Corp.Code § 809, par. 2.

(4) The unique Delaware language, "fixed by, <u>or in the manner provided</u> in, the by-laws," should certainly be retained for its extra flexibility so well illustrated by <u>Ellin</u> v. <u>Consolidated Caribou Silver Mines, Inc.</u>, 31 Del.Ch. 149, 156-157, 67 A.2d 416 (Ch.1949). Delaware may wish to codify this doctrine, as a few states have done, and if so, the following language, based in part on Conn.Gen.Stats. §§ 33-314(b), could be used:

> If the by-laws of the certificate of incorporation authorize a maximum and minimum number of directors, the number of directors at any time, within the maximum and minimum, shall be the number determined by resolution or other action of the shareholders or directors.

This less restrictive version of the Connecticut provision would preserve the <u>Ellin</u> holding and would not limit the generality of Section 141(b).

3. Qualifications of Directors

Delaware's only reference to director qualifications is to exclude any shareholder status requirement. Other states expressly negative any residence requirement, <u>e.g.</u>, Model Act Section 33. More importantly, statutes customarily codify the common understanding that the certificate or the by-laws may stipulate other qualifications for directors. See, <u>e. g.</u>, Model Act Section 33; Va.Code § 13.1-35, N.Y.Bus.Corp.Law § 701:

> Directors need not be residents of this State or stockholders of the corporation unless required by the certificate of incorporation of by-laws which may specify other qualifications of directors.

4. Resignation of Directors

It is suggested that the Delaware provisions relating to director resignations could be conveniently inserted in a single section (or Subsection), and included either in the chapter on directors or meetings. See Section 222 (last sentence) (resignation on written notice) and Section 223 (last sentence) (deferred effectiveness of resignation). In view of the early judicial requirement of acceptance of resignations, now negatived by Section 222,_/ Section 141(b) should at least be cross-referenced to the statutory rule, or should specify that a director holds office until his successor's election and qualification, or until his own earlier resignation.

5. Classification (Staggering) of Directors

Staggered boards, authorized by Section 141(d), are an exception to the annual election concept. Unlike Model Act Section 35 and many state statutes, requiring a minimum of nine directors for valid classification, Delaware presumably intends not to subject staggering to a minimum number of directors (other than generally specified in 141(b)), and it is not recommended that this be changed. A few states, however, do use a numbers requirement to protect cumulative voting from undue dilution, *e.g.*, Va. Code § 13.1-37 (last sentence), but a flat rule would seemingly handicap a close corporation which wants classification of directors but not a large board (usually nine directors, as in Virginia). Hence, even considering the need to protect cumulative voting, the Delaware statute should leave the matter to intra-corporate agreement, as it does now. However, certain technical points should be noted:

/ *Query*, whether the old rule continues to apply to resignation of *officers*, since Section 222 refers only to directors.

(1) It would be less confusing to collect all statutory provisions on classification into a single section, including Section 141(d) and parts of Section 223.

(2) It is unclear whether Delaware, by omitting the standard requirement that each class of directors "be as nearly equal in number as possible" (Model Act Section 35) intends to allow unequal classes. No cases seem to resolve this, although unequal classes are not necessarily unfair or otherwise objectionable. New York, which does require approximate equality of classes, N.Y.Bus.Corp.Law § 704(a), also requires like apportionment when the number of directors is increased or decreased, § 704(c)(1).

6. Vacancies

Section 223's authorization for directors to fill vacancies and newly created directorships is followed by the Model Act and most commercial jurisdictions. There appears to be no reason to change its substance, but a few technical amendments should be considered:

(1) A number of states which adopt Delaware's Section 223 add, after the phrase "though less than a quorum", the explanatory phrase "or by a sole remaining director" to explicity cover a situation which can readily arise with a very few directors, see Conn.Gen. Stats. 33-317(d)(1); N.C.GenStats. 55-27(c); Calif.Corp.Code 808. Since Delaware will presumably wish to accommodate closecorporations, with small boards, express coverage of this point is helpful.

(2) It is not clear from Section 223 whether the clause "unless it is otherwise provided," etc. modifies (a) only the phrase "though less than a quorum", or (b) all of the preceding sentence. Presumably, the latter is intended. If so the ambiquity should be corrected by placing the "unless" clause at the beginning of the sentecne. Whatever the position of the

clause, it is apparent that it does not exclusively empower the directors to fill vacancies and newly created directorships. The 1949 amendment of Section 223 only displaced the former rule that directors cannot fill newly created directorships, Automatic Steel Products, Inc. v. Johnston, 31 Del Ch. 469, 64 A2d 416(S.Ct. 1949), by giving directors that power while reserving concurrent power to the shareholders, Campbell v. Loews, Inc., 36 DelCh. 563, 571, 134 A.2d 852 (Ch. 1957), although Loew's hints that "strong by-law language" might wholly preempt shareholder power, Ibid. If this accurately states the law, it could be clarified by providing that the power to fill is vested in the directors, unless otherwise provided by the certificate of incorporation or by-laws, and subject to the jurisdiction of Chancery to order an election.

(3) The needless complexitiy of Section 223 could be avoided by breaking down the first sentence into separate sentences or subsections dealing with (a) the general rule on vacancies and newly created directorships, (b) the special rule for staggered boards, and (c) Chancery jurisdiction to order an election.

7. Removal of Directors

A slight majority of all state statutues, including almost all newly revised corporation laws, deal expressly with removal of directors. Because few decisions, either in Delaware or elsewhere, have treated the problem, there is substantial uncertainty as to the subject and as to the validity of by-laws or certificate provisions dealing with it. Although the Committee may prefer, as a matter of policy, to continue Delaware's statutory silence on the point it is thoughtappropriate to indicate the type of provisions which have been adopted in other states and which could be considered in

Delaware to codify the sparse case-law and deal with some problems not so far litigated.

(1) The statute should recognize the right of shareholders to remove for cause, even when voting is cumulative. Campbell v. Loew's Inc., 36 Del.Ch. 563, 572-573, 134 A.2d 852 (Ch.1957). Some statutes so recognize, although N.Y.Bus.Corp.Law § 706(c)(1) forbids any removal where there is cumulative voting. Chancellor Seitz's reasoning in support of the Loew's result is indisputedly correct. See 71 Harv. L.Rev.1154-1157 (1958).

(2) Removal of directors is a dangerous power, as Chancellor Wolcott explained in Bruch v. National Guarantee Credit Corp., 13 Del.Ch. 180, 186-190, 116 Atl. 738 (Ch.1922)(removal for cause). A few states permit it in such cases as a felony conviction, declared insanity, adjudicated bankruptcy or failure to fulfill requirements or qualifications stated in the by-laws. Calif.Corp.Code § 807; N.C.Gen.Stats. § 55-27 (b); and a few others. Sometimes a court order is necessary. Conn. Gen.Stats. § 33-317 (b)(4). New York authorizes directors to remove directors for cause if so provided in the certificate or in by-laws adopted by the shareholders; but absolutely precludes it if cumulative voting exists. N.Y.Bus.Corp.Law § 706(a), (c)(1). Chancellor Seitz left undecided the question whether shareholders could "deprive themselves" of the right to remove directors. Campbell v. Loew's Inc., supra at 573. Whether removed by shareholder or director action, the director to be removed for cause is entitled to minimum due process. Campbell v. Loew's Inc., supra at 577-579.__/

(3) Shareholders should be able to remove directors without cause,

__/ The result in Bruch could be sustained on the ground of no "due process" 13 Del. Ch. at 186.

not, however, by statutory right, e.g., Va.Code 13.1-42, but only if the certificate or by-laws permit it, N.Y.Bus.Corp.Law § 706(b). No state authorizes directors to remove directors without cause. Cumulative voting, however, should be protected from removal-without-cause, see In the Matter of Rogers Imports, Inc. 202 Misc. 761, 116 N.Y.S. 2d 106(S.Ct.1952), although not from removal-for-cause, Campbell v. Loew's Inc., supra at 573; N.Y.Bus.Corp.Law § 706(c)(1). Similarly, the doctrine of Essential Enterprises Corp. v. Automatic Steel Products. Inc., 39 Del.Ch. 93, 159 A.2d 288 (Ch. 1960), that staggered directors cannot be removed without cause, could readily be codified.

(4) Finally, directors elected by one class should not be removable except by shareholders of that class. See discussion infra at pp. 69

The following provision, based on statutes from a number of states, is suggested for consideration:

(a) Any or all of the directors may be removed for cause by vote of the shareholders entitled to vote to elect directors. The certificate of incorporation may provide for removal for cause by action of the directors, but such provision shall not exclude the power of the shareholders to remove directors for cause.

(b) If the certificate of incorporation so provides, any or all directors may be removed without cause by vote of the shareholders entitled to vote to elect directors.

(c) The removal of directors shall be subject to the following limitations:

(1) Except for cause, no director who has been elected by cumulative voting may be removed by (A) the directors, or (B) by the shareholders, if the votes cast against his removal would be

sufficient to elect him if then cumulatively voted at an election of the entire board of directors, or, if there be classes of directors, at an election of the class of directors of which he is a part.

(2) If a class of shares is entitled to elect one or more directors, no director may be removed, with or without cause, except by action of the directors of that class, or by vote of the holders of the outstanding shares of that class voting as a class, unless the certificate of incorporation shall otherwise provide.

(3) Whenever the board of directors is classified as to term of office, no director who has been so elected may be removed except for cause.

8. Classification of Directors other than Staggering

Many new statutory revisions state special rules on the division of powers among multiple stock classes, especially when each class has the right to choose a specified number of directors. It would seem appropriate for Delaware to consider some such provisions, especially if the statute is to take acoount of the interests of close corporations which most frequently use stock classes to allocate control and profits. The general language of Section 151(a) sufficiently authorizes classes varying as to voting rights. The Committee may wish to consider the following provisions which could either be included in a single section or distributed among sections dealing with the specific subject matter.

(1) Increase or decrease of number of directors: If, for example, Class A and Class B common may each elect a stated number of directors, the number should be varied only by the affected class. This could be guaranteed by providing that:

If the certificate of incorporation provides that directors shall be elected by the votes of a specified class of shares, the number of directors to be elected by that class shall be increased or decreased only by vote of the shareholders of that class voting as a class, unless the certificate specifically provides otherwise.

(2) Vacancies: A similar rule can be codified for filling vacancies among special classes of directors. At least three states specifically so provide: Conn.Gen.Stats. § 33-317(d)(1); N.C.Gen.Stats. § 55-27(c); S.C.Code §12-18.6(a). The fol owing language, based on all three, is suggested:

If a vacancy occurs with respect to a director elected by a specified class of shares, and if the class is still entit d to fill the directorship, this vacancy may be filled by a majority of the directors of that class then in office, though less than a quorum, or by the sole remaining director of that class, or if there be no director of that class, then by the vote of a majority of all directors then in office, though less than a quorum. A newly created directorship entitled to be filled in the same manner as if it were a vacancy. The certificate of incorporation or the by-laws may provide otherwise for filling vacancies or newly created directorships.

(3) Removal of Directors Elected by Class: Directors elected by a class of shares should similarly be protected from removal except by that class; and many new statutes so provide. See subsection (c)(2) of the suggested statutory provision under "Removal of Directors," *supra* p. 58. See, *e.g.*, N.Y.Bus.Corp.Law § 706(c)(2); Conn.Gen.Stats. 55-317 (b)(3) and 317 (d)(1); N.C.Gen.Stats. 55-27(f); S.C.12-18.7(b)(2); Calif.Corp.Code § 810, par.2.

9. Action without Meeting:

Section 141(g) authorizes board or committee action without a meeting, and properly extends this provision to all corporations, and not merely to closely held enterprises.

Several letters to the Committee, transmitted to the Reporter, suggest meritorious changes.

(1) The Pennsylvania Bar Association Report, p. 11, recommends revision of the corresponding statute to negative an implication that all consents must appear on the same document. Since Delaware's Section 141(g) is susceptible to such a construction, it, too, should be clarified. Often consents will come in through letters or telegrams from individual directors; and a requirement that they appear on the same document is at best formalistic, and at worst seriously inconvenient.

(2) Two letters _/ point out that the wording of Section 141(g), validates advance authorization, but may preclude effective ratification, through written consents. Obviously, this is needlessly restrictive, for the practical reasons indicated by the Cummings & Lockwood letter.

The following rewording of Section 141(g) would implement both of these recommendations: _/

_/ Letter from Cahill Gordon Reindel & Ohl, New York City, dated August 31, 1964 (recommendation no. 3); letter from Cummings & Lockwood, Stamford, Connecticut, dated August 7, 1964.

_/ It is occasionally suggested that non-unanimous written consents should be as effective as unanimous consents. On this theory, a written consent by a majority of directors would be as effective as majority action taken at a duly called meeting. This could, however, raise serious questions as to whether the non-consenting directors had received notice, whereas unanimous written consent *ipso facto* proves notice actually received. Besides raising more questions than it would solve permitting non-unanimous written consents would make serious inroads upon the concept of meetings as forums in which ideas are exchanged ad (hopefully) a consensus reached.

> Unless otherwise restricted by the certificate of incorporation or by-laws, any action required or permitted to be taken at any meeting of the board of directors, or governing body, or of any committee thereof may be taken without a meeting if all members of the board or governing body or committee, as the case may be, consent thereto in writing, and the writing or writings are filed with the minutes of proceedings of the board, governing body, or committee.

The use of the phrase "writing or writings" should reinforce the implication that no single document is required.

(The next page is Page 61B)

(The preceding page is page 61A)

10. Quorum

Generally Section 141(b) is satisfactory on the quorum requirements. The only recommendations would be to codify case-law as in many other states, including New York Bus.Corp.Law § 707, and states adopting Model Act Section 37.

(1) Since Bruch v. National Guarantee Credit Corp, 13 Del.Ch. 180, 116 Atl. 738 (Ch. 1922) long ago determined quorum by the entire (authorized) number of directors, it would be clearer to replace the vague phrase "a majority of them" with "a majority of the total number of directors", a phrase used later in the same sentence._/

(2) Although statutory authorization of "a different number" presumably embraces greater-than-majority quorum requirements, most statutes now explicitly authorize super-statutory (and even unanimous) quorum requirements to accommodate close corporations. Statutes vary in requiring these provisions to appear in the certificate, see N.Y.Bus.Corp.Law § 709, or, more typically, in the certificate or by-laws, Model Act Section 37. The advantage of the latter is greater flexibility, although mandatory inclusion in the

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_/ See Model Act Section 37, a quorum is "a majority of the number of directors fixed by the by-laws. Under N.Y.Bus.Corp.Law § 707 a quorum is "a majority of the entire board" which is defined (§ 702(a)) as "the total number of directors which the corporation would have if there were no vacancies." Accord, Bruch case, 13 Del. Ch. 180 at 184. Presumably, newly created directorships are still not vacancies for this purpose, Belle Island v. MacBean, 30 Del.Ch.373, 378-379, 61 A.2d 699 (Ch. 1948), despite the 1949 amendment to Section 223.

certificate assures constructive notice of a variance from the statutory norm. _/

(3) This Report also recommends reversal of the Delaware case-law doctrine that interested directors should not be counted in making up a quorum. See <u>infra</u> p. "Transaction with Directors."

Preserving as much existing language as possible, the following statutory provision is suggested:

> A majority of the total number of directors shall constitute a quorum for the transaction of business, unless the certificate of incorporation (or by-laws) requires a greater number. Unless so required, _/ the by-laws may provide that a number less than a majority shall constitute a quorum, which in no case shall be less than one-third of the total number of directors nor less than two directors. When a board of one director is authorized under the provisions of this Section, then one diretor shall constitute a quorum.

11. <u>Vote</u>

The state should expressly validate super-statutory voting requirements in the charter or by-laws. See the discussion at pp. 20-21, <u>supra</u>.

_/ Wherever appearing, all super-statutory vote and quorum requirements should be protected <u>by the statute</u> from being amended out by the lesser statutory vote. Cf. <u>N.Y. Bus.Corp.law</u> § 709(b); a number of other states give similar protection. See the chapter on close corporations for further discussion and draft statutory provisions.

_/ The "unless" clause is necessary to preclude by-law changes of a certificate provision for a greater-than-majority quorum under the rule of <u>Gow v. Consolidated Coppermines Corp.</u>, 19 Del.Ch. 172, 177-187, 165 Atl. 136 (Ch. 1933).

The following language, closely tracking Model Act Section 37, would accomplish this:

> The vote of the majority of the directors present at a meeting at which a quorum is present/ shall be the act of the board of directors, unless the vote of a greater number is required by the certificate of incorporation (or the by-laws).

A majority of states have a provision of this sort. See tabulation in 1 Model Bus.Corp.Act.Ann. 627 (1960); N.Y.Bus.Corp.Law §§ 708-709; Conn. Gen.Stats. 33-316(b); Va.Code § 13.1-39; Calif.Corp.Code § 817.

12. Notice of Meetings

Delaware presently has no statutory rules on notice of directors meetings, although some cases invalidate director action absent notice or waived notice. Today, all revised corporation statutes explicity guarantee maximum flexibility on this point and thereby confirm the legality of existing corporate practice. Many states adopt Model Act Section 39 verbatim, while others slightly alter it.

SECTION 39. PLACE AND NOTICE OF DIRECTORS' MEETINGS

(a) Meetings of the board of directors, regular or special, may be held either within or without this State.

(b) Regular meetings of the board of directors may be held with or without notice as prescribed in the by-laws. Special meetings of the board of directors shall be held upon such notice as is prescribed in the by-laws. Attendance of a director at a meeting shall constitute a waiver of notice

/ Under N.Y.Bus.Corp.Law § 708, a quorum must be present "at the time of the vote," see also Conn.Gen.Stats. § 33-316(b).

of such meeting, except where a director attends a meeting for the express purpose of objecting to the transaction of any business because the meeting is not lawfully called or convened. Neither the business to be transacted at, nor the purpose of, any regular or special meeting of the board of directors need be specified in the notice or waiver of notice of such meeting unless required by the by-laws.

Expecially useful is the provision that attendance at a meeting automatically waives notice, except for the director who makes a threshold objection to transacting any business at the meeting. New York excuses notice to the director "who attends the meeting without protesting, prior thereto or at its commencement, the lack of notice to him." N.Y.Bus.Corp. Law § 711(c). Though narrower than its Model Act counterpart, it is more specific and is to be preferred. Whether or not the other notice provisions are adopted, Section 229 should be amended to provide for automatic waiver of notice.

B. Committees

Section 141(c) is basically sound. It apparently contemplates possible delegation of the directors' full power unlike the Model Act and other statutes, including N.Y.Bus.Corp.Law § 712, which reserve some points of policy to the full board. Needless to say, non-committee directors do not necessarily gain immunity from liability for misconduct of committee directors, and "common law" decisions (outside Delaware) and at least a dozen statutes so state.[/]

Section 141(c) should authorize the board to appoint alternate committee members when the committee is established, thereby supplementing present statutory authority for committee members themselves to substitute another director for a disqualified committee member. Based on N.Y.Bus.Corp.Law § 712(b), the following is suggested:

> The board may designate one or more directors as alternate members of any committee, who may replace any absent or disqualified member at any meeting of the committee.

See Ohio Rev.Code Ann. § 1701.63(B) and Wisc. Stat.Ann. § 180.36 for like provisions.

The last sentence of Delaware's Section 141(c) (names of committees) seems too trivial to appear in the statute.

[/] "The designation of such committee and the delegation thereto of authority shall not operate to relieve the board of directors, or any member thereof, of any responsibility imposed upon it or him by law." Model Act Section 38; N.Y.Bus.Corp.Law § 712(c).

C. Officers

In general, Section 142 is adequate, except for some points of detail, as follows:

(1) Despite its complexity, Section 142(b) fails to achieve its simple purpose which is to validate multiple office-holding and keep the posts of president and secretary separate. This provision is suggested instead:

> Any two or more offices may be held by the same person, except the offices of president and secretary.

See Model Act Section 44, followed by many other states (including N.Y.Bus. Corp.Law § 715(e). The chapter on closecorporations should expressly relieve the one-man corporation of any statutory requirement concerning offices-- a provision which, incidentally,would be an advance over any existing close corporation statute, including Florida.

(2) To cover shareholder-elected officers, permitted by Section 142(a), the following clause should be added at the end of Section 142(e):

> or by the stockholders in the case of officers elected by them.

(3) Many statutes now harmonize the directors' removal power with employment contracts, by a provision such as the following:

> Removal from office shall not prejudice the contract rights, if any, of the officer removed. / Election or appointment of an officer or agent shall not of itself create contract rights. /

This language is adopted from Model Act Section 45(followed in many other states) and N.Y.Bus.Corp.Law § 716(b). Absent statute, cases normally, but not inevitably, reach this result. See especially United Producers and Consumers Corp. v. Held, 225 F.2d 615 (9th Cir. 1955). See also Companies Act, 1948, 11 and 12 Geo. VI, c. 38, §§ 184(b).

/ The 1962 Amendment of N.Y.Bus.Corp.Law § 716(b), applies this rule only to removal "without cause". Since this apparently assumes or implies that removal for any "cause" (itself a concept of uncertain scope) necessarily "prejudices" contract rights the New York version is not recommended.

/ Conn.Gen.Stats § 33-319(b) is even more specific: The appointment or election of an officer for a given term, or a general provision in the by-laws or certificate of incorporation with respect to the term of the office, shall not of itself create contract rights.

Interested Director Transactions

It is suggested that Delaware adopt a useful statutory provision expressly validating transactions between a corporation and one or more of its directors or officers, or between corporations having common directors. Comparable provisions appear in the corporation laws of New York, California, Connecticut, North Carolina, South Carolina, and, in somewhat cruder form, in the Michigan, Rhode Island, and West Virginia statutes. A Delaware statute would in part codify decisional law, in part replace by-law and charter provisions, and would answer some questions not so far resolved by the courts.

The need for loosening the traditional common law restrictions on interested director transactions, see Keenan v. Eshleman, 23 Del.Ch. 234, 243, 2 A. 2d 904(S.Ct. 1938); Lofland v. Cahall, 13 Del.Ch. 384, 118 Atl. 1 (S.Ct. 1922), has been recognized in decisions validating by-laws varying the common law rules, e. g., Sterling v. Mayflower Hotel Corp., 33 Del.Ch. 293, 93 A.2d 107(S.Ct. 1952); Kaufman v. Schoenberg, 33 Del.Ch. 211, 220, 91 A.2d 786(Ch.1952); cf. Martin Foundation v. North American Rayon Corp., 31 Del.Ch. 195, 202, 68 A.2d 313(Ch. 1949). These more flexible procedures clearly "fill a legitimate need in the efficient functioning of the corporate enterprise," Sterling v. Mayflower Hotel Corp., supra at 314-315. Although useful to all corporations, they are absolutely essential to the close corporation, many of whose transactions necessarily involve conflicting interests/ parent-subsidiary transactions similarly benefit form such a statute. Moreover, the certainty of a clear statutory rule should deter many unwarranted challenges to bona fide interested director tranactions.__/

__/ ". . . In our experience the most fertile breeding ground of potential derivative actions is the affilated (interested director) transaction." The procedures outlined in N.Y.Bus.Corp.Law § 713, "if intelligently followed should provide substantial protection if not insulation" from such suits. Israels, Corporate Practice 259 (1963).

This report recommends that Delaware adopt at least the following provisions, which are based upon the statutes of the states already mentioned.

(a) No contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee thereof which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if the circumstances specified in any one of the following paragraphs exist:

(1) The material facts as to his interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, _/ and the board of committee in good faith authorizes the contract or transaction by a vote sufficient for such purpose without counting the vote of the interested director or directors; _/

(2) The material facts as to his interest and as to the transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders.

_/ This formulation is to be preferred to New York's required disclosure only of "the fact of such common directorship, officership, or financial interest," but nothing as to the transaction itself, Section 713(a)(1). Such grudging disclosure requirement is so minimal as to invite judicial requirements for further disclosure, and thus leave uncertainty promoting litigation on the adequacy of the directors' or shareholders' knowledge when adopting or approving the transaction.

_/ An alternative wording for this clause is: (1) ...the board or committee in good faith authorizes, the contract or transaction by a majority of the votes of the disinterested directors even though less than a quorum." Cf. N.C.Gen. Stats. § 55-30(b)(1).

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee thereof, or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.

1. Persons Affected by Statute: The typical statutory provision validates two related classes of transactions: (1) between a director or officer and his corporation, and (2) between corporations with common directors or officers or where a director has a financial interest in the other corporation. See N.Y.Bus.Corp.Law §§ 713(a); ConnGen.Stats. § 33-323(a); S.C.Code §§ 12-18.18(b); cf. N.C.Gen.Stats. § 55-30 (b) (indefinite coverage). At this stage of legal development, this is as far as the statutory provision should go. Consequently, it is not recommended that the statute attempt to cover transactions (1) between a corporation and a shareholder not a director or officer, including even a controlling shareholder, or (2) between a corporation and a member of a director's immediate family, as in Conn.Gen.Stats. § 33-323(a), (d)(1), or a corporation and a nominee of one of its directors.

2. Tranactions Affected by Statute: Unless otherwise specifically provided, a statute of this character is all inclusive, and covers sales and purchases of property of all kinds, compensation of directors or officers, loans to directors, and officers, etc.

3. The Statutory Tests for Validating Transactions: An interested director transaction should be sustained if it meets any one (not all three)

of the following statutory tests:

(a) The relevant facts as to the transactions are disclosed or known to the directors, and the tranaction is approved by a majority of the disinterested directors. E.g., N.Y.Bus.Corp.Law § 713(a)(1); S.C.Code § 12-18.18(a)(1); Several other states use the same language but also require that the action taken be "in good faith," Calif.Corps.Code § 820(a); N.C. Gen.Stats. § 55-30(b)(1), or "not manifestly unfair as to the corporation," Conn.Gen.Stats. § 33-323(a)(1). This Report recommends that some such language be included. Otherwise, inevitably the question will arise whether literal and technical compliance with the statute is sufficient, and courts will be asked to gloss the statute with a "good faith" or "fairness" test which, indeed, they are likely to do.__/ The language choice here is not an easy one. Johnston v. Green, 33 Del.Ch. 479, 492, 121 A2d 919 (S.Ct. 1956) delcared that "the test applicable to transactions between the dominating director and his corporation (is) the test of fairness." On the other hand, the concept of "good faith" can never be wholly isolated from elements of fairness and reasonableness; and it seems sufficient to specify only "good faith" in conjuction with the requirement of disinterested approval. Finally, the third validating procedure, infra, specifically refers to 'fairness.'

__/ Judicial inclination to read additional "equitable limitations" into such a statute as Calif.Corp.Code § 820, is illustrated by Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal.App. 2d 405, 241 P.2d 66 (1952), holding that despite literal compliance with the requirement of disclosure to and ratification by shareholders, "transactions that are unfair and unreasonable to the corporation may be avoided." This result is correct, but should have rested on the fact that the shareholders did not act "in good faith" in ratifying the grossly unfair contract.

(b) The relevant facts are disclosed to the shareholders, and they approve or ratify the transaction. N.Y.Bus.Corp.Law § 713(a)(2); Conn.Gen. Stats. § 33-323(a)(2). Some states require that the shareholders also act "in good faith," Calif.Corps.Code § 820(b), or, more strictly, that the transaction be approved by a majority of the disinterested shares, viz., those not owned or controlled by the interested person, e.g., N.C.Gen.Stats. §§ 55-30(b)(2); S.C.Code §§ 12-18.16(a)(2). Cf. Chancellor Seitz's statement that the complaining shareholder must prove bad faith when a transaction is approved by a majority of shareholders "who were not, on the record, controlled by the directors." Kaufman v. Schoenberg, 33 Del.Ch. 211, 218, 91 A.2d 786(Ch. 1952). It is doubtful whether a disinterested shareholder requirement, would be worth the administrative difficulties it would entail. Once again, the 'good faith' requirement should sufficiently guard against abuse.

(c) The transaction is fair as to the corporation as of the time it is made. This alternative is a catchall for contracts, especially in close corporations where it is impossible to obtain a disinterested board of directors, or in public enterprises where shareholder approval is not desired or feasible if desired. Also this would preserve the traditional Delaware jurisdiction to "scrutinize" the transaction for "fairness". Johnston v. Greene, 35 Del.Ch. 479, 492, 121 A.2d 919 (S.Ct. 1956); Sterling v. Mayflower Hotel Corp., 33 Del.Ch. 293, 298, 93, A.2d 107(S.Ct. 1952). A court could also invoke this provision to uphold a "fair" transaction which attempted but failed to meet the specifics of the other two tests.

It is again stressed that the tests are alternative, any one of which validates the transaction, and the draft has made this clear to avoid any argument that, for example, the stricter "fairness" test is read into the disinterested director or shareholder ratification tests. See Calif. Corps.Code § 820, preamble; S.C.Code § 12-18.16 (a)(1)-(3).

4. Quorum: The draft statute specifically validates the practice, often authorized by by-laws with judicial sanction, of permitting interested directors to count towards a quorum. See, *e.g.*, N.Y.Bus.Corp.Law § 713(b). Equally applicable to a statutory provision are the observations in *Sterling v. Mayflower Hotel Corp.*, 33 Del.Ch. 293, 314-315, 93 A.2d 107 (S.Ct. 1952), *affirming*, 33 Del.Ch. 20, 25-27, 89 A.2d 862 (Ch. 1952), that "questions of alleged unfairness or inequity" are for the courts and remain "untouched" by the quorum-counting provision.

This is the basic statutory provision adopted by several carefully considered corporation law revisions. There are, however, further problems which should be considered in Delaware, and also, possibly, additional provisions which would be useful in connection with an "interested transaction" statute.

5. Burden of Proof: The proposed statute does not treat burden of proof which may be significant, sometimes decisive, on questions of "good faith" or "fairness". Several alternatives are available. The proposed statute could be adopted without referring to burden of proof, on the assumption (a rational one) that the rules of *Gottlieb v. Hayden Chem.Corp.*, 33 Del.Ch. 177, 178-179, 91 A.2d 57 (S.Ct. 1952) continue applicable. On the other hand, since a statute of this sort will likely invite litigation on burden of proof, it may be well to be specific at the outset. One possibility is to rest the burden of proof on the complainant when the tranaction has been approved by a disinterested board, or by the shareholders (as in *Gottlieb*), but on the interested parties when "fairness"

alone can sustain the transaction, Johnston v. Greene, supra, since insiders are better positioned to show fairness than the outsider to prove unfairness.___/ At least two statute specifically require the insider to prove fairness. N.C.Gen.Stats. § 55-30(b)(3); S.C.Code §§ 12-18.16(a)(3).

6. Common Directors: The typical statute applies the general rule to all tranactions involving any dual interest, and does not distinguish transactions between a corporation and its director, and between corporations with common directors. New York cases, at least prior to its new statute, recognized a more lenient standard on common directors ("fairness" of the transaction) and dispensed with any requirement of a disinterested majority. A few states do this today. As an exception to its general rule, Conn. Gen.Stats. § 33-323(b) sustains a common director transaction if it is "not manifestly unfair" or has been approved by the shareholders; S.C.Code § 12-18.16(c) protects every "fair and aquitable" contract between parent, subsidiary, and affilated corporations, or between any corporation with common directors; and requires the party asserting unfairness of such a contract to prove it. If Delaware wishes a special rule for common director situations, the following is suggested:

> No contract or transaction by a corporation with any of its subsidiary, parent, or affiliated corporations, or with another corporation in which there is a common director, shall be void or voidable solely for this reason, if the contract or other transaction is fair as to

___/ This is easily accomplished by adding at the end of draft subsection (a)(3) such words as: "the party asserting fairness of the transaction establishes fairness," or by prefacing subsection (a)(3), with such words as: "The director or officer establishes that . . ."

the corporation as of the date it is authorized, or if it is approved by a vote of the shareholders entitled to vote thereon.

7. Director's Liability: Since the draft statute gives directors and officers a privilege of dealing with their corporation, they are unlikely to be held liable if the transactions are not voidable. Conn. Gen.Stats. § 33-323(a) specifically so provides in its preamble that "such director," viz., one participating in a transaction with his corporation, "shall not incur any liability therefor."__/ The only problem here is a lurking implication that a director is personally liable if the transaction is voidable, and this may not necessarily be so. In fact, a leading New York decision held a director not liable although the transaction was properly voided by the court.

8. Financial Interest: All statutes of this character make the rule applicable to transactions where a director of Corporation A is "financially interested in" Corporation B (N.Y.Bus.Corp.Law § 712(a)), has a "substantial interest" (Conn.Gen.Stats. § 33-323(a), (d)(1)), or has "a financial interest, direct or indirect" (S.C.Code § 12-18.16(b)(2)).__/ All but one statute leaves the term undefined, apparently assuming that the courts will disregard a de minimis interest. In Connecticut, the "interest" must be at least 10% of the total debt or 10% of the total

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__/ If desired in Delaware, the underlined words should be added to Subsection (a) of the draft:

(a) No contract . . . . or solely because his or their votes are counted for such purpose, and such director or officer shall not incur any liability solely by reason thereof, if the circumstances specified in any one of the following paragraphs exist."

__/ The "interest" is never limited to an interest in another corporation, but includes an interest in a partnership, firm, other association or entity, etc.

equity of the other corporation, partnership, etc. It is not clear that this is really helpful. These statutes are devised as to give relief from the uncertain impact of the general fiduciary duty. The holder of a small interest and his corporation are best protected by justifying the transaction on any of the three specific statutory grounds rather than standing outside the protective ambit of the statute; disclosure even of "small interests is surely to be encouraged, notexcused, by statute. Since the consequences of non-coverage by the statute are uncertain, it is not recommended that the statute limit its coverage by a Connectitut-type definition or even by a phrase such as "substantial financial interest."

9. Although no state so far has done this, Delaware might break new ground by providing that a board of directors or shareholders act in"good faith," if they act upon findings by one or more of the following "independent"persons:

(a) Independent appraisers of value. See Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 296, 93 A.2d 107(S.Ct. 1952). Statutory recognition of this would be particularly helpful in sustaining, for instance, a sale by director A to his corporation of items whose value necessarily involves estimates.

(B) Independent certified public accountants.

(c) Independent committee of directors, *e.g.*, in making a determination of value on compensation, etc.

(d) an opinion by independent counsel *e.g.*, as to circumstances entitling a person to indemnification, or a loan, etc.

Section 141(f), already "fully protects" directors from liability in like circumstances/and the above provision would similarly help sustain a contract or other transaction when challenged. Draft language will be prepared and submitted, if desired.

Indemnification of Directors and Officers

A. Introduction

Despite its apparent, and presumably intended, breadth, the Delaware indemnification statue (Section 122(10)) is uncertain in scope and application; the Court of Chancery has urged its clarification, Essential Enterprises II, 182 A.2d at 655-656,_/ and proposals have been submitted for extending coverage on some points. This Report recommends that the statute, in fact, be expanded and clarif ,d, and that many points be explicitly resolved in the statute. The statute should also recognize and act upon the distinction between indemnifying derivative and non-derivative suits. Also, since in some instances an executive should have a right to indemnfication, as against a reluctant corporation, the statute should not only empower idemnification but also recognize a judicially enforceable right .

While indemnifying executives for many risks of office is, in the judgment of this Report, to be favored, this objective is not satisfactorily achieved by wording the indemnification statute so broadly that its language authorizes indemnification in obviously inequitable situations. Such, indeed, is a possible contruction of present Section 122(10) whose second sentence purportedly makes non-exclusive the indemnification power granted by the first sentence but limited to situations where there is no adjudication of misconduct. For example, the open-ended wording of the second sentence seemingly would allow indemnity to a director who had been "adjudged liable" of breach of duty, for which he paid a money judgment to the corporation. So, too, the statute arguably permits almost

_/ Essential Enterprises II cited to Atlantic Reporter pages, refers to Essential Enterprises Corp. v. Dorsey Corp., 182 A.2d 647 (Del.Ch. 1962). Essential Enterprises Corp. v. Automatic Steel Products, Inc., 39 Del.Ch. 371, 164 A2d 437 (Del.Ch. 1960) is referred to as Essential Enterprises I and is cited only to Delaware Chancery Reports.

uncontrolled discretion to indemnify settlements of derivative actions, since by hypothesis no one has been "adjudged liable" for wrongful acts.

A statute too broadly permitting indemnification creates more uncertainty than a more limited provision. If the statutory language potentially covers inequitable situations, courts are apt to read unsettling "equitable limitations" into the statute. Thus, Essential Enterprises II already exhibits judicial restiveness with overly generous indemnification procedures or interpretations, and this shadows the validity of by-law provisions as well. Excessive indemnification powers, moreover, will often not be used by management which prudently fears the consequences; and by-law provisions may themselves be too limited, perhaps out of uncertainty, as in the by-law construed in Essential Enterprises II, 182 A.2d at 656. Finally, too easy indemnification may not only undercut fiduciary duties, but also encourage settlements and thereby create an atmosphere conducive to strike suits (which thrive on easy settlements) and secret expenditures therefor.

Besides being too broad (and vague) on some topics, Section 122(10) is needlessly restrictive in other important situations. Accordingly, this Report recommends wider coverage of the statute, by carefully drafted language, and at the same time, a clearer indication of the permissible limits of indemnification than is now afforded by the sole standard, whether one has been "adjudged liable" of misconduct. Especially in view of the judicial call for "study" and "clarification" of Section 122(10), Essential Enterprises II, 182 A.2d at 656, specific suggestions will be made on (1) indemnifying settlements of actions, (2) indemnifying the partially vindicated executive, and (3) recognizing in appropriate circumstances a specifically enforceable right to indemnification.

B. Types of Proceedings in Which Indemnification Should be Available

Section 122(10), despite its seeming breadth, is so indefinite as to coverage that by-laws and other intra-corporate indemnification procedures must suffer from the uncertainty. Accordingly, this Report recommends additional language making unmistakeably clear that the power to indemnify extends to all types of proceedings. The appropriate safeguards for exercise of this power will be considered later.

(a) From the operative language, "action, suit, or proceeding," it is not clear whether indemnification applies only to actions by or in the right of the corporation (including derivative actions) or also to third-party actions, such as civil antitrust suits, either by the United States or less frequently by private parties, naming corporation executives, or suits under federal securities statutes. Indeed, the need for indemnfication in such third-party actions is often more pressing then in derivative suits. The Delaware statute does not clearly cover indemnity in such actions, when it could so easily do so.

(b) Section 122(10) also fails to cover indemnification in at least some criminal suits. Indeed, the New York Court of Appeals construed "action, suit or proceeding" in its former statute to exclude criminal proceedings, Schwartz v. General Aniline & Film Corp., 305 N.Y.395, 113 N.E. 2d 533 (1953). Since that case highlighted the issue, most new, and many amended, indemnification provision expressly cover criminal actions. See Model Act Section 4(o) ("action, suit, or proceeding, civil or criminal").

Clearly, indemnification in a criminal action is proper, when an executive successfully defends a criminal antitrust action on the merits since not only has he vindicated corporate action but fairness dictates reimbursement.__/ Less clear is an indemnfication for success not on the merits, e.g., a statute of limitations defense, or for expenses and fines paid on a nolo contendere plea to an antitrust indictment, Koster v. Warren, 297 F.2d 418 (9th Cir.1961) (expenses and fines indemnified; "corporate benefit" found for nolo pleas).__/ And indeed, despite a conviction, it may be appropriate to award indemnification. Simon v. Socony-Vacuum Oil Co., 179 Misc. 202, 38 N.Y.S2d, 270, (S.Ct. 1942), aff'd mem. 267 App.Div. 890, 47 N.Y.S.2d 589 (Dept. 1944).__/ That executive action may even violate specific statutory prohibitions and yet, vis-a-vis the corporation, not violate duty is recognized in some statutes today. Thus Model Act Section 4(o) blockS indemnification only for a adjuciated "negligence or misconduct in the performance of duty to the corporation," the underscored clause being absent from the otherwise identical Delaware statute. More complex is the statutory provision in New York permitting indemnification of the fines and

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__/ In England"every director, managing director, agent, auditor, secretary and other officer for the time being of the company shall be indemnified out of the assets of the company against any liability incurred by him in defending any proceedings, whether civil or criminal, in which judgment is given in his favour or in which he is acquitted. . ." Companies Act, 1948, 11 & 12 Geo. VI, c. 38, Sch. I, Table A, S 136. (emphasis supplied).

__/ This arose under California law, a federal court dismissing the diversity-based action on finding no reasonable probability of success on the merits or benefit to the corporation, the conditions upon which plaintiff's bond could be waived.

__/ Corporate executives' convictions were sustained in United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940) for a type of price-fixing which arguably had been validated by United States v. Appalachian Coals, 288 U.S. 344 (1933) and even encouraged by early New Deal programs. The indemnifying state court concluded that despite the antitrust convictions, the executives did not violate any duty to the corporation and had acted "honestly and reasonably" for what they believed to be the best interests of the company," 38 N.Y.S2d at 273.

expenses even of convicted executives if approved by disinterested directors or shareholders, N.Y.Bus.Corp.Law § 724(b) or by a court, Id. § 725(a), provided he acted in "good faith" reasonably believing his action to be in the best corporate interests, and without "reasonable cause to believe" that his conduct was illegal. Id. § 723(a). At the very least, then, Delaware should expressly include criminal actions within the statutory coverage, although a Model Act type amendment will not deal with all possible situations fairly deserving indemnity.

(C) Finally, statutory coverage should be expressly extended to administrative actions to which an executive is a party, although presumably the term "proceeding" in Sectinn 122(10) could be read to include this. See Rhode Island Gen.Laws § 7-9-12 ("any legal or administrative proceedings"); Wisc.Stats. Ann. § 180.04(14) (1964 Supp.). Cf. Blish v. Thompson Automatic Arms Corp., 30 Del. Ch. 538, 589-590, 64 A.2d 581 (S.Ct. 1948) sustaining indemnity for expenses incurred by officer in SEC investigation of his possible criminal violations, where the investigation was "ultimately closed to the satisfaction of the corporation." __/ Since Section 122 (10) refers to expenses connected with "defense", a legally meaningless concept in the context of an investigation, it should be amended to make clear that indemnification may extend to investigations.

Section 122(10) should, at the least, add the underscored words to give the coverage recommended in this part of the Report:

> . . . any action, suit, or proceeding, civil, criminal, administrative, or investigative . . . __/

__/ Apparently, the court did not consider Section 122(10) in Blish.

__/ No statute so far has purposted to indemnity proper expenses in an arbitratune proceeding, despite the rapid growth of arbitration, expecially in areas of the Northeast.

2. The present statute confines indemnification to expenses growing out of the "defense" of an action, suit or proceeding. Although this will usually be the situation, it is possible that a corporate executive may fairly be entitled to indemnification when he is plaintiff, or otherwise the intiating party, but will be barred by a rather formalistic limitation in the statute. Whereas Essential Enterprises I allowed indemnification of executives whose title to office was challenged, it is at least questionable whether indemnification would be appropriate had the executives themselves (as shareholders) initiated a Section 225 proceeding to establish their title to office. However, in Essential Enterprises I, the board chairman filed a cross-claim for salary, and presumably indemnification of his expenses included that items. This should be clarified either by deleting the reference to "defense" of an action, or alternatively, substituting a neutral word like "participation" for "defense".

C. Persons Entitled to Indemnification

1. The Delaware statute should extend indemnification to the personal representatives of any persons entitled in their own right to indemnity. This suggestion, previously offered to the Committee, accords with several new statutes including N.Y.Bus. Corp.Law §§ 722(a), 723(a) (indemnification extends to "any person . . . his testator or intestate"). This terminology is recommended.

2. Indemnification of employees, other than officers and directors, should be explicitly recognized. Secion 122(10)'s reference to "officers" would apparently cover only those designated as "officers" by the by-laws or a board resolution, under Section 142(c). Many persons properly entitled to indemnification are not technically officers, and, at least

in antitrust proceedings, often sub-officer personnel such as sales executives are parties. Aside from statutes which are silent (as in the Model Act), some states specifically mention employees, e.g., Calif.Corp.Code § 830(a) Conn.Gen.Stats. 33-320; R.I.Gen.Laws § 7-9-12; Wisc.Stats.Ann. § 180.407. (indemnification mandatory). Many by-laws also indemnify non-officer employees. The Delaware statute should specifically mention "employees" so as to avoid any doubt as to corporate power to take such action.

3. The Delaware statute authorizes indemnification of an officer or director of another corporation in which the indemnifying corporation owns stock (e.g., subsidiaries) or is a creditor. This probably sufficiently covers the categories desired, although some statutes now simply/ empower a corporate to indemnify one serving "at its request" as director, etc, of another corporation. Conn. Gen.Stats. § 33-320(d); N.Y.Bus.Corp.Law § 722(a). Cf. N.J.Stat.Ann. § 14.3-14 (person serving "at the request of the (indemnifying) corporation because of the corporation's interest in such other corporation"). In all events, simpler language ("another corporation of which it is a creditor or shareholders") could well replace the present cumbersome phrase ("another corporation in which it owns shares of capital stock or of which it is a creditor").

/ "Employee" includes any person who is engaged to perform service for the corporation, whether as independent contractor or otherwise." Conn.Gen.Stats. § 33-320(a).

D. Indemnification in "Third-Party" Actions

As to "third party" suits (other than those by or in the right of the corporation), the Delaware phrase "expenses actually and necessarily incurred" in connection with defense is too rigid. Despite a conviction in a criminal action, or a judgment in a civil action, it may still be equitable for the corporation to indemnify the amount of the judgment or fine. Not only would this be barred under the test of "expenses actually and necessarily incurred," but also because the person has been "adjudged . . . liable." __/ The statutory validity of settlements of third party actions is even more uncertain; arguably they are indemnifiable because the person was not "adjudged" liable, but arguably they are not indemnifiable because the amounts were not "actually and <u>necessarily</u>" expended, since the party chose to settle rather than go to trial and possibly win on the merits. __/

A number of statutes, including some of the strictest, specifically include these items. See, <u>e. g.</u>, Conn.Gen.Stats. § 33-320(b); N.C. Gen.Stats. § 55-20; Calif.Corps.Code § 830(f) (Supp. 1963). In some instances indemnification is a matter of right. As earlier indicated, some cases have allowed "common law" indemnification for fines on nolo pleas, <u>Koster</u> v. <u>Warren</u>. <u>supra</u>, and even on actual convictions, <u>Simon</u> v. <u>Socony-Vacuum Oil Corp.</u>, <u>supra</u>.

__/ Whether the additional language "negligence or misconduct in the performance of duty" refers to duty "to the corporation" or duties generally is so uncertain that late statutes based on Delaware's have specified the former so as to include indemnification of third party actions in the somewhat backhanded way of forbidding it only on adjudicated breach of duty <u>to the corporation</u>.

__/ <u>Essential Enterprises II</u> did not have to decide these questions in the even more delicate context of settlements of derivative actions. 182 A.2d at 652.

Statutes vary in the types of control which they impose on indemnification of fines, penalties, settlements, ect., in third party suits. Conn.Gen.Stats. § 33-320 (b) requires a shareholder-authorized by-law or resolution for the directors to indemnify these items. N.C. Gen.Stats. § 55-20 indemnifies as of right one who is "wholly successful on the merits"; the directors may indemnify as they choose when he is "wholly successful otherwise than on the merits"; and a disinterested majority of shareholders can alone indemnify one who is unsuccessful in the action. Calif. Corps.Code § 830 (f) authorizes broad indemnification, whether or not the person is successful, if the "board of directors determines in good faith that such director, officer or employee was acting in good faith within what he reasonably believed to be the scope of his employment or authority and for a purpose which he reasonably believed to be in the best interests of the corporation of its shareholders." N.Y.Bus.Corp.Law § 723(a) is similar to California, but also requires a finding that the person indemnified after a criminal conviction had "no reasonable cause" to believe his conduct was unlawful, and also requires the findings to be made by disinterested directors, absent a quorum of which the matter must go to the shareholders, Id. § 724(b)

It is suggested that the Delaware statute may usefully be amended along the lines of the California statute, vesting the directors, acting in good faith, with discretion to indemnify, and letting them determine whether he acted in the best interests of the corporation. This formulation is simple, clear, and fair, and also accords with the sparse, although rather clear, "common law" developments.

The present statutory phrase "expenses actually and necessarily incurred" is too rigid and should be changed, as in the newer statutes, to "expenses actually and reasonably incurred" in an action. See, *e.g.*, Conn.Gen.Stats. § 33-320(b) ("expenses . . . directors deem reasonable, actually incurred by him"); Model Act Section 4(c). Some statutes also specifically include attorney fees, N.Y. Bus.Corp.Law § 723(a) ("including attorneys' fees actually and necessarily incurred"); Conn.Gen.Stats. § 33-320(b); etc.

E. Indemnification in Derivative Actions: Adjudications

Indemnification of suits by or in the right of the corporation present more complex problems as indemnity of less-than-honorable directors sharply conflicts with the policy of promoting ethical standards. The present statutory standard, which bars indemnity if the executive has been "adjudged liable for negligence or misconduct in the performance of duty," is inadequate for the problems with which it purportedly deals. It is too narrow in barring all indemnity where, despite adjudicated liability, indemnity may be fair; it is too broad if, in conjunction with Section 122(10)'s second sentence, it permits indemnity where there is adjudicated liability for some inexcusable negligence or misconduct. Although undeniably complicating the statute, this Report recommends the following methods of dealing with the quite disparate problems involved.

(a) If the individual is successful in his defense, the corporation clearly has power to indemnify, under the present "adjudged liable" test. The only suggestion would be to recognize that the vindicated director has a specifically enforceable <u>right</u> to indemnity from a possibly reluctant corporation, *e.g.*, a proxy fight has installed a new board of directors unwilling to indemnify a former director.

For example, Calif. Corps. Code § 830(a) gives the successful director a court-enforceable indemnity right on judicially finding that "his conduct fairly and equitably merits such indemnity." While California makes the judicial procedure exclusive, it is suggested that Delaware, at most, need only recognize it as a right available to the vindicated executive who is unable to secure indemnity voluntarily from his corporation.

(b) If the individual is unsuccessful on the merits, the corporation cannot indemnify him under the first sentence of Section 122(10). The argument that such indemnification could be made under the second sentence may be illusory for several reasons. (1) Since the action produced a corporate recovery for breach of duty, a repayment to the faithless person of all his expenses plus the judgment against him would defeat the purpose of the original action and its subversion of fiduciary duty enforcement would probably be against public policy. Thus a court could readily hold such indemnification to be a waste of corporate assets and itself a breach of duty by the concurring directors. (2) It is questionable how and whether a specific statutory bar to indemnifying a director "adjudged" liable can be avoided by a mere by-law, resolution, or agreement, even if the statute seemingly authorizes it.

It does not follow, however, that indemnification should be culpable in every type of derivative action which goes against the director. Despite easy statement of the general fiduciary duty, its application to specific situations is not so clear that any director subsequently "adjudged liable" for breach of duty is necessarily to be barred from all indemnification. Examples in recent years in Delaware include (1) the development of the law on stock options, an issue which occupied the courts for many years; (2) purchase of a corporation's own stock to prevent shifts of control; and (3) other corporate expenditures in connection with proxy fights. Thus, "in litigation involving corporate policies, where the chief issue is one of law, without any allegation of bad faith on the part of the directors, the corporation should bear the expense" even if the action goes against the directors.__/ Washington & Bishop, Indemnifying the Corporate Executive 82 (1963).

It is suggested that the general rule continue to be no indemnity for the executive "adjudged liable" of breach of duty, as it now is under the present language. However, it would be desirable to add that the unsuccessful individual should be able to apply to Chancery, in the main case or a separate proceeding, for indemnification of expenses so far as such indemnity would, under the circumstances of the case, be fair and equitable. This would recognize the fairness to an individual of paying his expenses in an action which he loses because the court determines a new point on fiduciary duty or some new application of

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__/ English practice is instructive here. Companies Act Section 448(1) provides that although an "officer or person" is liable for "negligence, default, breach of duty or breach of trust," the court may relieve him from personal liability "on such terms as the court may think fit," upon finding that he "acted honestly and reasonably, and that, having regard to all the circumstances of the case . . . he ought fairly to be excused" from liability. Of immediate importance here is that any person so relieved from liability "shall be indemnified out of the assets of the company." Companies Act Sch.I, Table A, § 136. Thus, apparently the English court can recognize indemnity for one who is guilty of breach of duty but who personally "acted honestly and reasonably". This certainly seems sound precedent for the suggestion made above.

the fiduciary concept not reasonably to be foreseen at the time the individual acted. Such a procedure would be in harmony with customary Chancery determinations, and its fairness would certainly give directors and officers a greater confidence in their actions. Finally, it seems proper for the corporate treasury to bear at least some of these risks.

(c) Chancellor Seitz urged "clarification in the area of partial liability," particularly "whether the statute permits an allocation of expenses when directors have been adjudged liable as to some but not all of the claims asserted against them." Essential Enterprises II, 182 A.2d at 655. No statutory provision seems so far to have dealt with this rather refined problem, which may be avoided, however, by rewording the "except" clause in the first sentence somewhat as follows:

> . . . except in relation to any claim, issue, or matter as to which such director or officer . . . shall be adjudged. . .

Although this alone may be helpful, it would also be well to indicate specifically that Chancery does have the clear jurisdiction to allocate expenses in these "partial liability" situations. If the Committee agrees with the recommendation, supra p.3 , to confer a right to indemnity for the successful executive, and to empower Chancery to entertain and act on an indemnity application by the unsuccessful executive, supra p.87 , it could easily be provided further that the court may also allocate indemnifiable expenses and items when a director is adjudicated liable as to some but not all claims to the extent that the court deems fair and equitable.

The upshot of these recommendations on indemnity in adjudicated derivative actions is that (1) the corporation (through the board of directors) may indemnify the vindicated executive, but (2) may not indemnify the unsuccessful litigant. Either the vindicated executive who is refused indemnity, or the unsuccessful litigant who is not generally entitled to it, may turn to Chancery for allowance of indemnity. It is believed that this procedure confers a measurable degree of certainty in this confused area, reconciles conflicting policies (enforcement of fiduciary duty and indemnity for executives), and works fairness both to executive and corporation.

F. Indemnification in Derivative Actions; Settlements

Quite different policy considerations govern indemnity for expenses of settling actions by or in the right of the corporation. Directors should be encouraged to litigate groundless claims against them and vindicate both themselves and their corporation. See *Essential Enterprises I*, 39 Del.Ch. at 379; see also *Solomine* v. *Hollander*, 129 N.J.Eq. 264, 19 A.2d 344, 347-348 (Ch. 1941). Indemnification liberally granted after judicial vindication but withheld after settlement encourages that policy. Uncontrolled indemnification of settlement derivative suits presents other problems. By promoting settlement of claims which cannot be successfully defended, it undercuts enforcement of fiduciary duties. Secondly, it encourages strike suits: if directors can readily settle at corporate expense, their disincentive to contest charges invites disreputable shareholders to sue and force a costly settlement. As *Essential Enterprises II*, 182 A.2d at 652, stated, it is "unhealthy" to "place a director in the position where he would be assured of indemnification if he settled but would run the risk of paying his own attorney if he unsuccessfully resisted the action."

The present statute does not deal with settled derivative actions, except obliquely. Arguably, expenses (and conceivably the settlement sum) comprise indemnifiable "expenses," and are not barred by statute since the individuals have not been "adjudged liable" for misconduct. On the other hand, Essential Enterprises II, 182 A.2d at 652, left undecided the question whether a settlement, containing a consent injunction by the court, has "adjudged" the issue within the meaning of Section 122(10) so as to bar indemnification. Another counter-argument is that settlement expenses are not "necessarily incurred" since there is no legal compulsion to settle and incur "expenses" incident thereto. Again, the literal language in the second sentence arguably permits voluntary indemnification of settlement expenses, but once again it is questionable whether this provision authorizes a corporation to violate the limitations stated in the first sentence, particularly in view of the policy considerations previously indicated. Essential Enterprises II, 182 A.2d at 656, has urged a study of the statute "to consider whether it should deal with compromise situations." Certainly, the serious policy problems here involved should not be left in the present uncertainty.

Some states flatly exclude indemnity of settled derivative suits. E.g., Conn.Gen.Stats. § 33-320(c); N.C.Gen.Stats. § 55-21(a); Calif.Corps.Code § 830 (Supp. 1963).__/ This simplistic and inflexible

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__/ New York apparently forbids any indemnification in connection with settled derivative suits, N.Y.Bus.Corp.Law § 722(b). Cf. the by-law in Ackerman v. Stemerman, 201 A.2d 173, 174 (Del.S.Ct. 1964), requiring approval of a proposed settlement by independent legal counsel. Since Chancery Rule 23(e) is mandatory in terms, and assuming that it is not evaded by other techniques, judicially approved indemnification on settlement should suffice, and indemnification contrary to the judicial determination would seem as objectionable as further undisclosed terms in the main compromise.

view assumes all settlements to be void of corporate benefit, although, more charitably, it merely recognizes the ill effects of secret indemnification of secret settlements. Since Chancery Rule 23(c) requires court approval of a "dismissed or compromised" derivative action, it would be appropriate to specify, in the draft statute or by petition for amendment of the Rules, that indemnification of individuals may be determined by the Court of Chancery on application of any interested party, perhaps also specifying a "fair and equitable" standard. Clearly this is the most flexible and fairest procedure. It enables an objective tribunal to consider the merits of indemnification in the immediate factual context and to award some, all or none of the expenses. As Essential Enterprises II, 182 A.2d at 652-653 indicates, "a compromise does not necessarily connote 'liability' /but/ may do so" (653), and "some compromises . . . do not involve any personal contribution by the defendant directors" (652). Compare the new South Carolina statute authorizing the court to order indemnification of "any amount paid by the person sued in a settlement approved by the court, if the court finds that indemnification of such amounts would be fair and equitable." S.C.Code § 12-18.18(b)(2).

G. Indemnification of Right

It has been suggested in this Report that in some situations the statute should give directors the right to indemnification as well as grant the corporation power to do so -- a feature by which the Delaware statute would gain added attractiveness. The right may be desirable, even necessary, if a change of management refuses to indemnify old management personnel in situations where indemnification would be proper; or if a by-law is unduly and needlessly restrictive on indemnity (a rare case, though apparently this was present in Essential Enterprises II); or where management hesitates to indemnify voluntarily for some or no reason. In all events, even if the actual situations are few, Delaware corporations will be well served if their managements have indemnity rights which cannot be overriden by abrupt changes of corporate policy or personnel.

Indemnity should be available as of right whenever a suit is won, on the merits or otherwise, by corporate executives. N.Y.Bus.Corp. Law § 724(a) so provides; N.C. Gen.Stats. § 55-20(1) (director must be "wholly successful . . . on the merits"; limited to third-party suits). Other statutes condition indemnity as of right on court approval. See Calif.Corps.Code § 830(a) and 830(f).

Indemnity should be available, if Chancery approves an application therefor, in those limited situations where a derivative suit is adjudicated adversely to the director or is settled by him; but only if Chancery so provides.

H. The Non-Exclusive Clause

This Report's view is that the "non-exclusive" provision in Section 122(10) (second sentence) should be eliminated, if indemnification is expanded along the lines previously suggested. Its chief purposes presumably has been to allow corporations to indemnify outside the limits of the existing statute. But with these limits substantially expanded and clarified, the "non-exclusive" clause is apt only to create uncertainty.

(1) Given the broad coverage of the proposed revision, courts are likely to treat its provisions as exclusive, even though the non-exclusive clause stands unchanged. For this reason, it would be unwise to rely on it for indemnity beyond that sanctioned by the revised statute.__/

(2) Because the proposed revision covers all situations fairly deserving indemnity, the non-exclusive clause would likely be used in highly questionable situations, e.g., repayment of expenses and settlement amounts in a secret settlement not approved by Chancery; or where an executive has been "adjudged liable" of breach of duty and indemnification judicially denied. Thus, preserving the non-exclusive clause invites misuse of corporate powers for improper indemnification to the detriment of the shareholders who will normally remain ignorant.__/

(3) When statutes have sought to cover all items reasonably to be indemnified, they have either deleted non-exclusive clauses e.g., Conn.Gen.Stats. § 33-320, or they have made the statutory provision exclusive, e.g., N.Y.Bus.Corp.Law § 721.

It is believed that Delaware corporations and their managements are best served by recognizing adequate indemnification through a statute which is clear, certain, and exclusive in its terms.

__/ Reluctance to rely on non-exclusive clauses has been expressed by more than one attorney. Israels, Corporate Practice 266 ("In our experience careful corporate lawyers have often been reluctant to rely on the 'non-exclusivity' provision in the prior New York Law (Gen.Corp.Law § 63) to sanction indemnification for any amount paid in settlement or incident to a case settled without court approval," especially absent a disinterested board majority); Washington & Bishop, Indemnifying the Corporate Executive 122-123, 199-200 (1963).

__/ New York requires that indemnification, other than by court or shareholder action, must be promptly disclosed to shareholders with specifics as to "the persons paid, the amounts paid, and the nature and final disposition of the litigation or threatened litigation." N.Y.Bus.Corp.Law § 726(c).

Draft Section on Indemnification

The following provision incorporates all recommendations made in the foregoing discussion. It is based upon a detailed analysis of the specific language in the most important indemnification statutes (New York, California, Connecticut, Wisconsin, the Model Act, North Carolina, and South Carolina). Although lengthy, the subject itself is complex and requires discrimination among the various problems presented, but even so it is more concise than the New York or Connecticut statutes. Footnotes refer to statutes and to the text of the report on indemnification.

(a)[1] A corporation shall have power to indemnify any person who is a party or is threatened to be made a party,[2] to any action, suit, or proceeding, whether civil, criminal, administrative, or investigative[3] (other than an action by or in the right of the corporation), by reason of the fact that he, his testator or intestate,[4] is or was[5] a director or officer or employee[6] of the corporation, against reasonable expenses (including attorney's fees), judgments, fines, and amounts paid in settlement[7] actually and reasonably[8] incurred by him in connection with such action, suit or proceeding, if the director or officer acted in good faith for a purpuse which he reasonably believed to be in the best interests of the corporation.[9]

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1 Subsection (a) applies only to non-derivative suits. See Report, Part D.

2 See Wisc. Stats. Ann. §§ 180.04 (14) and 180.407(Supp. 1964) for coverage of "threatened" litigation; this language reinforces statutory coverage of investigations. See N.Y. Bus. Corp. Law 723 (a).

3 See Report, Part B.

4 This coverage of rights of deceased executives is based on New York and Connecticut statutes. See Report, Part C (1).

5 This covers incumbent and former directors, etc., and is in lieu of the repetitious Delaware references to "directors or officers or former directors or officers.

6 Employees other than directors and officers are covered. See Report, Part C (2).

7 Specific coverage for fines, etc. on nolo pleas or convictions, as well as litigation expenses.

8 "Actually and reasonably" for "actually and necessarily." See Report, Part D.

9 Originating as the California test, this had been adopted by N.Y. and others.

The termination of any criminal, civil or administrative action by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent shall not of itself create a presumption that the director or officer, did not act in good faith for a purpose which he reasonably believed to be in the best interests of the corporation.[10]

(b) A corporation shall have power to indemnify any person made a party to any action or suit by or in the right of the corporation to procure a judgment in its favor,[11] by reason of the fact that he, his testator, or intestate, is or was a director or officer or employee of the corporation, against the reasonable expenses, including attorneys' fees, actually and reasonably incurred by him in connection with such action, or suit, except that

(1) No indemnification shall be made in any case in relation to any claim, issue or matter[12] as to which person shall have been adjudged to be liable for negligence or misconductin the performance of duty to the corporation, unless, and only to the extent, that, the Court of Chancery shall determine, in the pending suit or upon application, that despite the adjucication of liability but in view of all the circumstances of the case, the person is fairly and reasonably entitled to indemnity for such expenses as the Court of Chancery shall deem proper.[13]

(2) No indemnification shall be made of expenses incurred in compromising an action by or in the right of the corporation unless, and only to the extent that, the Court of Chancery shall approve any

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[10] Based on N.Y.Bus.Corp.Law § 723 (b).

[11] Applies only to suits by the corporation or shareholder derivative suits. See Report, Parts E and F.

[12] Permits the corporation or court to segregate claims as to which he was vindicated, from those which he was adjudged liable. See Report, Part E (c).

[13] Authorizes Chancery to indemnify a director despite his being "adjudged liable". See Report, Part E (b).

such provision therefor.

(c) A director or officer or employee who has been wholly successful, on the merits or otherwise, in defense of any action, suit, or proceeding, or in defense of any claim, issue or matter therein, shall be entitled to indemnification as provided by subsections (a) and (b) of this section.[15]

(d) Notwithstanding the failure of a corporation to provide indemnification as permitted by this section, or despite any contrary resolution of directors or shareholders in a particular case, the Court of Chancery may authorize indemnification as provided in this section.[16]

(e) The provisions of this section shall apply to any person, his testator or intestate who may have served at the request of the indemnifying corporation as a director, officer or employee of another corporation of which it is a creditor or a shareholder.[17]

If the Committee wishes to add to the draft section a provision stating the intra-corporate procedure for indemnifying executives, as permitted by subsections (a) and (b), the following language, based on the California and New York statutes, is suggested for consideration:

A corporation may pay the expenses which subsections (a) and (b) of this section permit to be indemnified if such payment is authorized with respect to a specific action, suit or proceeding by a resolution (1) of the board of directors consisting of a quorum of directors who are not parties to the action, suit or proceeding, or (2) of a committee of directors who are not parties to the action, suit or proceeding, or (3) of the shareholders.

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[15] Gives the vindicated director a specifically enforceable right to indemnity. See N.Y.Bus.Corp.Law § 724(a). Report Part G.

[16] Strengthens the hand of an executive who has unfairly been denied indemnification. See N.Y.Bus.Corp.Law § 725(a).

[17] This is in lieu of the present phrase in Section 122(10), but does not expand or contract present coverage.

Shareholder Derivative Suits

State statutes on shareholder derivative suits are invariably enacted to restrict or impede such actions; no statute (or rule of court) has ever been adopted to facilitate these equity-based actions in the right of the corporation. Whether or nor statutory restrictions are in order depends not only upon the type of provision proposed and the existing judicial controls but also upon the individual state's overall experience with such actions. Thus, statutory restrictions should be adopted only in terms of a particular evil to be remedied, and any restriction should be balanced against the value, however irritating at times and to some managements, of private, as distinguished from governmental, enforcement of fiduciary duties—the basic justification for such actions.

The view of this Report is that the existing Delaware controls are adequate to bar abuse of the derivative action, unless the premise (rejected by this Report) is that all shareholder suits are undesirable and should be discouraged. The existing controls are the requirements of contemporaneous stock ownership, demand upon directors and (where necessary) upon stockholders, and mandatory court approval for settling or dismissing stockholder actions. Together these procedures bar the purchased suit, require reasonable exhaustion of intra-corporate remedies, and bar secret settlements and pay-offs. Of these, court approval for dismissed or settled actions is the most important and effective device, and at the same time the fairest method for balancing the corporate interest in immunity from groundless or 'strike' actions and the policy favoring private enforcement of fiduciary duties. Accordingly, the recommendation of this Report is that the present system of controls be retained intact (with one or two minor changes) and that no additional restrictions be imposed, at least absent a "clear and present danger" of abuses with which existing procedures are patently unable to cope with.

A. Existing Controls

1. Contemporaneous Ownership Requirement: This requirement in Section 327 and Chancery Rule 23(b), precluding the evil of purchased rights to bring derivative actions, Rosenthal v. Burry Biscuit Corp., 30 Del.Ch. 299, 60 A.2d 106(Ch.1948), is unquestionably sound,___/ and its language is adequate for the purpose.

(a) It would however, be desirable to codify case-law permitting beneficial, equitable owners to bring actions, e. g., Rosenthal v. Burry Biscuit Corp., supra (stock in broker's street name at time of transaction); Gamble-Skogmo, Inc. v. Saks, 35 Del.Ch. 503, 122 A.2d 120 (S.Ct. 1956) (same); McClary v. Pleasant Hills, Inc., 35 Del.Ch. 39, 109 A.2d 830 (Ch. 1954) (certificatenot issued at time of transaction); Brown v. Dolese, 38 Ch. 471, 479-480, 154 A.2d 233 (Ch. 1959) (beneficiary of trust owning shares of record). See N.Y.Bus.Corp.Law § 626(a) (action may be brought "by a holder . . . of a beneficial interest in such shares"). If also a holder of a voting trust certificate has standing to sue derivatively, the statute could also refer to this, as in New York (action may be brought "by a holder . . . of voting trust certificates of the corporation"). If this precise issue has not been determined (as seems to be the case),

___/ Some writers view the contemporaneous ownership requirement as inconsistent with the concept of the suing shareholder as a guardian ad litem of the corporate interest suing for a corporate reqovery. E.g., Hornstein, New Aspects of Stockholder Derivate Suits, 47 Colum.L.Rev. 1, 7 (1947). Even though this is so, abolishing the Section 327 requirement does not follow, since clearly the policy of eliminating the purchased suit can outweigh the policy of effective private enforcement of fiduciary obligations. In all events, this Report does not regard repeal of Section 327 as an open question.

it would be well to codify the point one way or another as it is likely to arise in Delaware as it has elsewhere.

(b) The statute could also codify the "continuing wrong" theory, a judicial gloss on the literal wording of Section 329. See, e. g. Newkirk v. W. J. Rainey, Inc., 31 Del.Ch. 433, 436, 76 A.2d 121(Ch. 1950); see also Maclary v. Pleasant Hills, Inc., 35 Del.Ch. 39, 42-44, 109 A.2d 830 (Ch. 1954). Several states have done so by adding to their "contemporaneous ownership" statutes the phrase "or any part thereof" after the term "transaction" or its equivalent. E.g., Calif.Corp.Code §§ 834(a)(1).__/ Wisc. Stat.Ann. §§ 180.405(1)(a); Ohio Rev.Code Ann. § 2307.311(Supp. 1963).

2. Demand on Directors: The present Chancery Rule 23(b) is sound, accords with provisions in many other states, and should not be changed.

3. Demand on Shareholders: The Chancery rule requiring shareholder action "if necessary," and its interpretation by Mayer v. Adams, 37 Del.Ch. 298, 141 A.2d 458 (S.Ct. 1958), is adequate. The distinction drawn in the Mayer case between unratifiable conduct such as fraud or waste and "irregualarity or lack of authority in directorate action" (141 A.2d at 465) is not susceptible to statutory statement, and no statutes appear to have attempted it. Although it does call for a case-by-case application, this judicial doctrine seems preferable to statutes which excuse a shareholder demand in all cases, e. g., Calif.Corp.Code § 834(a)(2); Ohio Rev.Code Ann. § 2307.311(Supp. 1963); Wisc. Stat. Ann.

__/ He was a holder "at the time of the transaction or any part thereof of which he complains..."

§ 180.405 (1)(b), and certainly to any provision, at the opposite extreme, for a shareholder demand in all instances. See Note, Demand on Directors and Shareholders as a Prerequisite to Derivative Suit, 73 Harv.L.Rev. 746, 754-759, 760-762 (1960).

4. Court-approved Dismissal or Compromise: Beyond question, Chancery Rule 23(c)'s requirement is the most effective and fairest method of discouraging groundless suits and barring secret settlements._/ Since it is an accurate and a sufficient weapon agains this evil, it is in the judgment of this Report and of commentators, that a supplemental provision such as a security-for-expense statute is not needed. A number of states have adopted this rule by statute, and, of course, it prevails in federal courts. No changes are recommended with respect to the present Chancery Rule.

Some states supplement the statute or rule of court with a provision such as Wisc.Stat.Ann § 180.405(3):

> If anything is recovered or obtained as the result of the action, whether by means of a compromise and settlement, or by a judgment, the court may, out of the proceeds of the action, award the plaintiff the reasonable expenses of maintaining the action, including reasonable attorneys' fees and may direct the plaintiff to account to the corporation for the remainder of such proceeds.

Such a statute is declaratory of established equity doctine. See, e.g., Aaron v. Parson, 37 Del.Ch. 407, 413-414, 144 A.2d 155 (S.Ct. 1958).

_/ This rule does not, of course, reach settlement of threatened actions, but neither do other statutory restrictions on derivative suits such as a security-for-expenses requirement.

N.Y.Bus.Corp.Act § 626(e) is similar but specially provides for the type of case represented in Delaware by Keenan v. Eshleman, 21 Del.Ch. 234, 2 A.2d 904(S.Ct. 1938).

B. Security-for Expenses Statutes

Although no changes in the present Delaware law on derivative actions, are recommended, this Report considers it appropriate to point out to the Committee several types of derivative suit restrictions in other states.

1. Posting Security: By far the most popular recent device restraining derivative suits is the procedure, varying in detail, for compelling the shareholder to post security for the corporation's "reasonable expenses" in connection with the action. Depending upon the state, the rule is applicable if the shareholder owns less than 5% of the outstanding shares of any class or if the market value of his shares is less than $25,000 (Model Act Section 43A); The percentage requirement may range as low as , 3% (Wisconsin) but not above 5%. Excepting Pennsylvania and Wisconsin which have no alternative dollar figure (Pa.Stat.Ann. tit. 12 § 1322; Wisc. Stat. Ann. § 180.405(4)), the usual range of market value is from $25,000 to $50,000 (New York). This, of course, seems to assume that the small shareholder will, but the large one will not, bring groundless suits. Accordingly, California makes security-for- expenses available without reference to the size of the holding. Calif.Corp.Code § 834.

Apparently under all statutes except California security-for-expenses where available, may be demanded as of right by the corporation, and naturally the demand in invariably made. The corporation may apply for,

and the court after hearing may order, security posted on a showing of "no reasonable possibility" that the suit "will benefit the corporation or its security holders," with mandatory dismissal if the security is not posted within the time determined by the court.—/
The California procedure is to be preferred over its New York counterpart. It directly relates posting security to probability of success rather than to size of shareholdings which is not a rational criterion.—/

It is to be noted that both the New York and California type statutes authorize security-for-expenses to include not only the corporation's expenses but also amounts which the corporation must or may lawfully indemnify other defendants in the action.—/ "Expenses" usually include attorney fees (as under the Model Act and the New York statute), although Colorado and Maryland specifically exclude them.

A compromise between the two statutes is possible, although apparently not previously considered. A statute could provide that if the plaintiff shareholder owns less than 5% of any class of shares or if his shares

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__/ Under all provisions, the amount of security if ordered, may be increased or decreased if the security "has or may become inadequate or excessive."

__/Courts have susteined the constitutionality of both forms of statute. Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1949) (New Jersey statute, similar to New York); Beyerbach v. Juno Oil Co., 42 Cal. 2d 11, 265 P.2d 1, (1954), appeal dismissed 347 U.S. 985 (1955) (California statute).

__/ Cal.Corp. Code § 834 even has a provision by which security for the expenses of defendants other than the corporation's executive personnel can be required, e.g., by a third-party defendent under an allegedly unfair contract with the corporation. Thus security-for-expenses may be required by an outsider who would not be entitled to reimbursement under any circumstances if sued by the corporation itself. See Beyerbach v. Juno Oil Co., supra. This seems clearly at variance with the asserted purpose of security-for-expense requirements, viz., to avoid 'strike' suits.

have a market value of less than $25,000, the corporation may seek a court order for security-for-expenses, absent a showing of "no reasonable probability" of corporate benefit (as in California). Such a statute would almost certainly be constitutional under the <u>Cohen</u> decision, <u>supra</u>. If it is thought that small shareholdings are highly correlated with groundless suits--an unproved assumption--it at least provides threshold court supervision to avoid this.

2. <u>Mandatory Reimbursement by Plaintiff:</u> The Model Act Section 43A (par. 2), also provides that, whether or not security is required to be posted, the court may compel the plaintiff to reimburse all parties defendant for all expenses (including attorney fees), on a "finding that the action was brought without reasonable cause." This procedure, the Model Act's "unique contribution" to this branch of the law (2 Model Act Ann. 70), has commended itself to only two states, N.Dak.Rev. Code § 10-19-48 and Colo.Rev.Stat. § 31-30-21(2) (Perm.Supp. 1960) and has been rejected by all other states including those requiring security to be posted. Moreover, a California-type procedure deals with the problem supposedly redressed by the Model Act provision, by dismissing the groundless suit at the outset if no bond is posted.__/

3. <u>Policy Considerations:</u> Because of its importance, the policy aspects of security-for-expenses statutes will be fully considered.

(a) It is submitted that a security-for expenses statute is not needed in a jurisdiction such as Delaware which has effective methods to control abuses of the deriviative suit. The asserted basis for

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__/ Arguably, it fills a gap under a New York type provision, since it operates agains a large shareholder who cannot be compelled to post security for expenses, but whose suit is in fact brought "without reasonable cause."

security-for-expenses is control of the "strike" suit.__/ But, in fact, the most effective method is mandatory court approval of settled or dismissed actions, since New York experience demonstrated that 'strike' suits flourish in secrecy. It is significant that during the period when New York was most troubled with 'strike' suits, it did not require court approval to dismiss or settle an action.__/ Thus, adoption of a security-for-expenses statute would needlessly subordinate the basic equitable function of the derivative action to the policy of curbing its abuse.

(b) Even if further statutory regulation be essential to curb "strike" suits, the security-for-expenses is an excessively blunt weapon for its asserted purpose.

Unique to American law, it imposes litigation costs of both sides on the plaintiff, including potentially large attorney fees,__/ even though the litigation is defeated not on the merits but on one of the many technical grounds with which the derivative action is replete. The bond cost is likely to deter stockholders unable to muster the statutory percentage or market value of stock. Even though the court may stay the

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__/ Governor Dewey's memorandum approving the prototype New York statutes asserted that they were need to "cleanse (the) law" of "secret settlements--really pay-offs for silence." Memorandum filed with Senate Bills No. 1314 and 1315, dated April 9, 1944.

__/ N.Y.Bus.Corp.Law §§ 626(e) now requires court approval.

__/ Truncale v. Universal Pictures Co., 76 F. Supp. 465 (S.D. N.Y. 1948) (bond for $150,000 required); Cohen v. Beneficial Ind. Loan Corp., 337 U.S. 541 (1949) ($125,000). As these cases indicate, security-for-expensos statutes are "substantive" law for purposes of applying the Erie doctrine in the federal courts.

action while the individual plaintiff seeks co-plaintiffs with sufficient shares of stock,__/ this will likely entail expense and delay in discovering and persuading other stockholders to join an action which carries such potential liabilities to a plaintiff.

The fact that the typical statute discriminates against the 'small' plaintiff, although not unconstitutional for this reason, is relevant to making the basic policy decision. Indeed, the actual result-- and sometimes the covert purpose--of security-for-expenses statutes is to approximate abolition of the derivative action.__/

(c) The ultimate justification for derivate actions both actual and threatened, is their deterrent effect upon insiders tempted to misuse their positions of trust. Severe restrictions upon effective suits cut down the incentive they afford. Such a result, it is believe, is contrary to the long-standing "policy of our courts . . . to hold the directors and the majority stockholders to strict accountability for any breach of good faith in the exercise" of their powers and "to permit any minority stockholder to seek redress in equity on behalf of the corporation for wrongs committed by the directors or by the majority stockholders." Mayer v. Adams, 37 Del.Ch. 298, 304, 141 A.2d 458 (S.Ct. 1958). Security-for-expenses, like a mandatory demand on shareholders in all cases, would

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__/ New York construedits statute to permit the court to stay the action while a "small shareholder seeks others to join him in the suit to meet the statutory percentage or market-value figures, and for this purpose he may inspect the stockholder records. Baker v. Macfadden Publications, Inc., 300 N.Y. 325, 90 N.E. 2d 876 (1950)

__/ See the statistics in Hornstein, New Aspects of Stockholders' Derivative Suits, 47 Colum.L.Rev. 1, 5 (1947).

"import into our law a procedure that would inevitably have the effect of seriously impairing the minority stockholder's now existing right to seek redress for frauds committed by directors of the corporation." Ibid. _/ Like restrictions would be indefensible in the case of a beneficiary's right of action against an erring trustee of an express trust, or a labor union member's effort to hold accountable a faithless union leader.

(d) Taking a longer view, alternative sanctions for enforcing fiduciary duties are uncertain. Since the shareholder as an investor alone has sufficient interest or incentive to sue, _/ no other satisfactory private action has been devised. Hence, proposed substitutes usually involve government inquisitorial and enforcement procedures (typically federal) --by no means an impossible development. Thus, England's impotent form of derivative suit _/ was followed by procedures, long antedating any "socialist" government, by which the Board of Trade may, on application make plenary investigations of corporation, make reports, and invoke judical aid. See Companies Act, 1948, §§ 164-175. A pertinent American analogy is the enactment of the federal Trust Indenture Act of 1939 dealing with a form of fiduciary misconduct as to which state law had

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_/ Unlike the judicial doctrine in Mayer v. Adams, the typical security-for expense statute disables a court from discriminating between potentially meriotorious and groundless suits, or between fraud and mere "irregularity or lack of authority in directorate action", 37 Del.Ch. at 312.

_/ That is, apart from infrequent derivative suits by directors or officers, or by creditors (in some states).

_/ This is said to be "because of the general English rule that the loser pays the costs, including the winner's advocate's fee, and because it is unprofessional for a lawyer to take a case on a contingent fee." Gower, Some Contrast Between British and American Corporation Law, 69 Harv.L.Rev. 1369, 1385 (1956).

been wholly ineffective.__/ Restriction of the derivative action, seemingly beneficial in the short-run, may have adverse long-run consequences.

(3) Prudential consideration do not dictate an oppostie view. It is unlikely that a security-for expenses statute would be a significant factor in attracting new corporations or in inducing others to leave Delaware, in the light of overall Delware advantages for all corporations. For example, New York's extreme pro-management provisions on derivative actions are more than offset by a plethora of other restrictions not found in Delaware, many of them replete with complexity and uncertainty.

4. If security-for-expenses is desired, the California procedure, on balance, is to be preferred. Besides relating security to probability of success, rather than size of holdings, it is fairer both to the corporation and to the honest shareholder seeking to redress a likely corporate wrong, while at the same time barring, at the threshold, an action which is groundless or frivilous or designed for improper purposes. The issue is one which the Court of Chancery should be able to determine without particular delay or difficulty. A possible form of statute, based primarily on California,__/ is as follows:

> In any suit in the right of the corporation, the corporation or any other defendant who is or was a director or officer of the corporation, may, at any time before final judgment,__/ petition

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__/ Another analogy is the extent to which private federal actions under SEC Rule 10b-5 (formerly X-10B-5) have filled the vacuum left by ineffective state law on rights of "defrauded" sellers and purchasers of securities.

__/ For a full discussion, see Ballantine's article, 37 Calif. L.Rev. 399 (1949).

__/ This is the usual provision. Calif.Corp.Code § 834(b) requires application to be made within 30 days after summons is served on the corporation or other defendant.

the court for an order requiring the plaintiff to furnish security for the reasonable expenses (including attorney's fees) which may be incurred by the moving party or by the corporation in connection with the action, including in the case of the corporation expenses for which the corporation may become liable for indemnifcation under Section . If the court determines, after notice and hearing, that there is no reasonable probability that the prosecution of the suit will benefit the corporation or the holders of its securities, or that a party defendant other than the corporation did not participate in the transaction complained of, the Court shall fix the character and amount of security to be furnished by the plaintiff. The amount of the security may thereafter be increased or decreased in the discretion of the court upon showing that the security provided has or may become inadequate or excessive. The corporation shall have recourse to the security in such amount as the court shall upon termination of the suit find to be just and reasonable. A determination by the court that security shall or shall not be furnished shall not be deemed a determination of any issue in the suit or of the merits thereof.

APPENDIX

I. The following states have enacted a security-for-expenses statute which, except for California, is similar to Model Act Section 43A and to the New York statute:

1. California
2. Colorado
3. Florida
4. Maryland
5. Nebraska
6. New Jersey
7. New York
8. North Dakota
9. Pennsylvania
10. Wisconsin

II. The following states, like Delaware, require court approval of a settled or dismissed derivative suit (either by statute or by rule of court):

1. Arizona
2. Colorado
3. Florida
4. Iowa
5. Minnesota
6. Missouri
7. Nevada
8. New Jersey
9. New Mexico
10. New York
11. North Dakota
12. Texas
13. Utah
14. Washington
15. Wisconsin
16. Wyoming
17. District of Columbia
18. Puerto Rico

(Source: 2 Model Business Corporation Act Annotated, Section 43A: 1960 text and 1964 supplement.)

Subchapter 7. MEETINGS, ELECTIONS,

VOTING AND NOTICE

I. Shareholder Meetings, Notice, Reocrd Dabe, and Voting

This Report, after careful consideration, recommends substantial restructuring of the Delaware provisions on the requirement of meetings, notice, record dates, and voting. Compared to the corporate law revisions of other states, the existing Delaware provisions are spotty; some are archaic; and various important legal rules are left to case-law statement when all other statutes expressly codify them. In view of the clarity and specificity of the most important corporation statutes elsewhere, it is believed that comprehensive provisions in the Delaware law would better serve the interests of corporations, including enterprises which will choose between Delaware and another jurisdiction. The increase in the number and complexity of statutory provisions is perhaps inevitable, considering that revision has been undertaken during the many years when corporation law has so greatly expanded. Even so, the substance of these proposals should work no drastic change in sound corporate practice; and in fact greater flexibility and certainty will result from many of the suggested provisions. In all events, the Committee has before it the most significant statutory provisions of other leading states, and, an analysis of their relation to other parts of the Delaware statute and the case law.

A. Requirement of Meetings; Time and Place

1. Place of Meetings: Section 211 requires no substantive changes or additions. It is assumed that "outside of this State" is broad enough to authorize meetings outside of the United States. Although the present language is satisfactory, greater flexibility is possible with the suggested wording in draft subsection (a), infra p.113, which is based on N.Y.Bus.Corp.Law § 602(a), and also borrows for use here the phrase "by or in the manner provided in the by-laws" which appears in Section 141(b) concerning directors' meetings. This facilitates such practices as rotating the place of meetings without formally amending the by-laws.__/

It is suggested that the present statutory permission for directors to hold their meetings in or outside Delaware be transferred to Section 141(b).

2. Annual or Other Regular Meetings: Although the legal requirement of annual meetings to elect directors is ingrained in Delaware cases,__/ the statute should specifically say so, as in all new corporate law revisions.__/ E.g., Model Act § 26(par. b); Conn. 33-326(b); N.Y. 602(b); Calif. § 2200; Penna. 2852-501(B)(Supp.1963)

Section 224 properly protects corporations from dissolution because

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__/ This accords with recommendations, supra pp. 54, 55-56, to transfer provisions on directors' resignations and vacancies to Subchapter II.

__/ E.g., Standard Power and Light Corp. v. Investment Associates, Inc., 29 Del. Ch. 593, 601-602, A.2d (S.Ct. 1947), quoting Duffy v. Loft.

__/ A few statutes state a time for annual meetings subject to by-law variation. Calif. § 2200, Conn. § 33-326(b).

they omit annual meetings, but it would also be desirable to provide that otherwise valid corporate actions are not invalidated or impaired thereby.

3. Special Meetings: Many states specify in greater or less detail who may call special stockholder meetings. It is suggested that the common understanding be codified by providing that special meetings may be called by the board of directors or by any other person authorized by the by-laws or the certificate or incorporation. N.Y.§ 602(c); Conn. § 33-326(c). Beyond this it is unnecessary (and for Delaware, undesirable) to vest named offieers, or specified percentages of shareholders (usually 10%), with statutory, as distinguished from by-law, authority to call special meetings, although this too is done in many states. Model Act §§ 26 (Par.3); Ohio § 1701.40(A).

4. Changing Time and Place of Regular Meetings: This Report recommends deletion of Section 222's rule against changing the stated place and time of meetings. Its protective purpose is better achieved by a different sort of notice procedure explained infra p.116, while at the same time giving Delaware corporations greater flexibility.

5. Court-ordered Meeting to Elect Directors: Section 224 is sound in principle and has been widely imitated in various forms. Some states, e.g., N.Y. § 603; refer to a "substitute annual meeting" or "special meeting for election of directors," to be called by the directors or a fixed percentage of shareholders (usually 10%) without court action; but the complexities that any such provision necessitate outweigh the supposed advantage of leaving it to intra-corporate remedies,

especially since, in many such situations, the court will sooner or later have to step in. Accordingly, the existing Delaware procedure should be continued as the exclusive method for dealing with refusals to summon annual meetings.

Two minor additions to Section 224 may well commend themselves to the Committee:

(a) Since the failure to hold a meeting may be due to causes other than recalcitrance or self-perpetuation in office, the statute could well defer for a fixed though brief time period the right of "any stockholder" to apply for a court-ordered election. See Texas Act. 2.24; S.C. 12-16.3(c). It is suggested that this period last for thirty-days after the date designated therefor;__/ absent any designated date, application could be made after expiration of thirteen months after the last annual meeting. Cf. N.Y. § 603(a).

(b) The final sentence of the suggested re-draft would specifically recognize Chancery's plenary jurisdiction.

Section . <u>Meetings of Stockholders</u>

(a) Meetings of stockholders may be held at such place, either within or without this state, as may be designated by or in the manner provided in" the by-laws, or if not so designated at the principal office of the corporation in this State.

__/ A possible attempted abuse might be to continue to amend the by-laws to defer the date in the hope that this would start a new 30-day period running each time. However, a court would certainly disregard any such obviously bad-faith maneuver.

(b) An annual meeting of stockholders shall be held for the election of directors and for the transation of other business on a date designated by or in the manner provided in the by-laws. A failure to hold the annual meeting at the designated time or to elect a sufficient number of directors to conduct the business of the corporation shall not affect otherwise valid corporate acts or work a forfeiture or dissolution of the coporation except as may be otherwise specifically provided in this Title.

(c) /If the annual meeting for election of directors is not held on the date designated therefor, the directors shall cause the meeting to be held as soon thereafter as convenient. If there be a failure to hold the annual meeting for a period of thirty days after the date designated therefor, or if no date has been designated, for a period of thirteen months after the organisation of the corporation or after its last annual meeting, the Court of Chancery may summarily order a meeting to be held upon the application of any stockholder, or in the case of a corporation without shares of stock upon the application of any member of the corporation, At such meeting, the shares of stock, or in the case of a corporation without shares of stock the members, represented at such meeting, either in person or by proxy, and entitled to vote thereat, shall constitute a quorum for the purpose of such meeting, notwithstanding any provision of the certificate of incorporation or by-laws to the contrary. The Court of Chancery may issue such orders as may be appropriate, including, without limitation, orders designating the time and place of such meeting, the record date for determination of stockholders entitled to vote, and the form of notice of such meeting.

/ Draft subsection (c) closely follows Section 224, whose content is transferred to the draft provision.

(d) Special meetings of the stockholders may be called by the board of directors and by such person or persons as may be authorized by the certificate of incorporation or by the by-laws.

B. Notice of Meetings

The Delaware statute should codify notice requirements. This appears in the Model Act, in all statutes based on it, and in most of the older statutes._/ A general notice requirement will not hamper corporate activity or flexibility, and in some respects actually liberalizes Delaware practice besides making it definite and precise on the face of the statute.

1. Notice Requirement: This Report recommends that the statute require notice of every meeting, annual, other regular, or special. Contrary to first appearances, this allows greater flexibility. Among other things, this permits elimination of Section 222's elaborate provisions, several times litigated, which in fact compel notice when the stated time and place of meetings are changed. Besides being the better practice-and often required in by-laws--listed corporations are, for practical purposes, compelled to notice all meetings. As the law now stands in Delaware, special meetings must always be noticed, *e.g.*, *Bryan v. Western Pac. R.R.*, 28 Del.Ch. 13, 23, 35 A.2d 909 (Ch. 1944); see *American*

_/ As of March 1964, all jurisdictions except Arizona, Hawaii, Kansas, Maine, New Hampshire, New Mexico, Rhode Island, Vermont, and Puerto Rico had provisions for notice of shareholder meetings. Montana, New Jersey and South Dakota have notice requirements applicable only in specified situations. See tabulation in 1 Model Bus. Corp. Act Ann. 447, and Id. 143 (Supp. 1964). None of the named states have undertaken substantial corporation law revisions and presumably have not considered the issues involved.

Hardware Corp. v. Savage Arms Corp., 37 Del.Ch. 10, 135 A.2d 725 (1957). And although annual meetings whose place and time remain unchanged apparently need not be noticed, existing law does impose notice requirements (including a 20 day notice) for changing stated time and place. It is likely, then, that mandatory notice for all meetings is probably no very drastic change in current practice.

2. Changing Stated Place and Time of Meeting: Section 222's rigid (and probably inconvenient) limitations on changing stated dated and place supposedly insure that shareholders will know where to meet and when; on the assumption that, absent such change, they will remember the date and place, without reminder. This beneficent policy is not thwarted by eliminating the 60/20 day requirements, if, in all cases, notice of regular meetings must be given a reasonable time (usually 10 days) in advance. If notice is mandatory, then the directors can readily adjust meeting dates and locations as seems best_/ (assuming good-faith action), and shareholders will be assured of notice. With notice always required, directors' power to change meeting dates is less apt to be abused. See In the Matter of Seminole Oil & Gas Corp., 38 Del.Ch. 549, 552, 155 A.2d 887 (Ch. 1959). Although directors may always possibly abuse this power, the threat does not seem sufficient to vest shareholders with exclusive power to alter meeting dates, as Seminole indirectly suggested._/

_/ Use of the phrase "by or in the matter provided in the by-laws", suggested in the redraft, supra p.113-4 facilitates the selection of date or place.

_/ See also letter from John Mulford, Esquire (of Drinker Biddle & Reath, Philadelphia) to Hon.Clarence A. Southerland, July 28, 1964 p.2.

3. Notice of Regular Meetings: In a few states notice of regular meetings may be dispensed if the by-laws designate the time and place of meeting, and no change of time or place has been made. This is not recommended for several reasons. First, it would reinvolve the statute in the problem of changingdate and place, contrary to the recommendation above. Second, assuming that the original shareholders knew of the requirement, transferees are unlikely to know or seek out the by-law provision. The result is, in practice, to disfranchise many shareholders for lack of knowledge; shareholder inaction assuredly needs no encouragement. Third, it assumes that shareholders, even if they once knew of the meeting date, will remember it from year to year. Finally, a general notice requirement without special exceptions has the merit of simplicity and definiteness, besides being in accord with normal statutory practice in this country.

4. Notice of Special Meetings: It is recommended that Delaware follow the great majority of states in requiring by statute a statement of the purpose of any special meeting, thus codifying the results of Bryan v. Western Pac. R.R., supra, and American Hardware Corp. v. Savage Arms Corp., supra. All statutes based on the Model Act do so, as New York do and Connecticut. A few states including Ohio, Virginia and Nevada (surprisingly enough) go furthur and require stating the purpose of all, including annual meetings. While this Report regards this as the preferable statutory provision, it is not indispensable to fairness; proxy statements, in effect, compel this for listed corporations.

5. Mechanics of Notice Giving: The draft statute adopte useful provisions from the Model Act, New York, and other states. See draft subsection (b).

6. Adjourned Meetings: Several states now specifically dispense with notice when a meeting is adjourned and then resumed, although some require it if the meeting is resumed more than 30 days later, or if a new record date is fixed, e. g., New York § 605(c). The latter certainly is essential, and the former is fairer to shareholders especially if any business can be transacted at the resumed meeting which was allowable at the adjourned meeting, as statutes usually allow.

Section . Notice of Meetings

(a) Whenever under the provisions of this Title shareholders are required or permitted to take any action at a meeting, written or printed notice shall state the place, date, and hour of the meeting, and in the case of a special meeting shall state the purpose or purposes for which the meeting is called.

(b) A copy of the notice of any meeting of the stockholder shall be given, personally or by mail, not less than ten nor more than fifty days before the date of the meeting, to each stockholder entitled to voted at such meeting. If mailed, notice is given when deposited in the United State mail, postage prepaid, directed to the stockholder at his address as it appears in the record of stockholders. ___/ An affidavit of the secretary or of the transfer agent of the corporation that the notice has been given shall, in the absence of fraud, be prima facie evidence of the facts stated therein.

___/ New York Section 605(a) also provides that notice is to be given at any address which the shareholder requests in writing. This seems a needless refinement, but if adopted, the statute should, unlike New York, provide that the corporation or transfer agent has assented to the extra burden of observing dual addresses.

(c) When a meeting is adjourned to another time or place, unless the by-laws otherwise require, notice need not be given of the adjourned meeting if the time and place thereof are announced at the meeting at which the adjournment is taken, and at the adjourned meeting the corporation may transact any business which might have been transacted on the original date of the meeting. If the adjournment is for more than thirty days, or if after the adjournment a new record date is fixed for the adjourned meeting, a notice of the adjourned meeting shall be given to each shareholder of record entitled to vote at the meetings.

C. Record Date

The several procedures authorized by Section 212 and 213 permit corporations to fix a deadline for determining the shareholders entitled to vote, receive notices or dividends, etc. Of these three devices, the record date procedure is most used, so that stock transfers may be continuously recorded after the record date instead of piling them up while the books are "closed". Either practice makes inapplicable Section 212's disfranchisement of stock transferred within 20 days before an election of directors.

It is not clear what substantive purpose is now served by Section 212's disfranchisement proviso, unique to Delaware law, especially since equity can compel a record owner to give a proxy to a subsequent purchaser. In re Giant Portland Cement Co., 26 Del.Ch. 32, 41-43 21 A.2d 697 (1941). Even if the "evident purpose" is to facilitate determining shareholders entitled to vote, etc., Standard Scale & Supply Corp. v. Chappel, 16 Del.Ch. 331, 336-337, 141 Atl. 191(1928), this purpose is just as well effectuated by Section 213's record-date and book-closing procedures.

Absent some other specific reason for retaining the disfranchisement provision, it should be struck as obsolete.

Not only is the record-date procedure customary today, but N.Y.Bus. Corp. Law § 604 makes it the exclusive method, and abolishes the older book-closing technique. S.C.Code § 12-16.6(a)-(b) makes it applicable unless the by-laws authorize closing the books; most other states authorize book-closing unless the by-laws provide for fixing a record date. It is suggested that, like New York, Delaware make the record-date procedure exclusive, but that if book-closing is retained, it be treated as an alternative to be authorized by the by-laws.

The 50-day maximum limit is customary everywhere, but most states now also specify a 10-day minimum limit (in the case of meetings.) Model Act Section 28, N.Y.Bus.Corp. Law § 604(a). It is also customary for statutes to specify a record date when a by-law or resolution fails to do so.

The following draft would accomplsih these purposes and also fits in with New York Stock Exchange requirements:

Section . Record Date

(a) In order that the corporation may determine the shareholders entitled to notice of or to vote at any meeting of shareholders or any adjournment therof, or entitled to receive payment of any dividend or other distribution or allotment of any rights, or entitled to exercise any rights in respect of any change, conversion or exchange of shares or to give consent thereto, or for the purpose of any other lawful action, the board of directors may fix, in advance, a record date, which shall not be more than fifty nor less than ten days before the date of such meeting, nor more than fifty days prior to any other action.

(b) If no record date is fixed:

(1) The record date for determin ng 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, at the close of business on the day next preceding the day on which the meeintg is held.

(2) The record date for determining shareholders for any other purpose shall be at the close of business on the day on which the board of directors adopts the resolution relating thereto.

(c) A determination of shareholders of record entitled to notice of or to vote at a meeting of shareholders shall apply to any adjournment of the meeting, unless a new record date is fixed for the adjourned meeting.

The foregoing provision, based on the Model Act and especially New York, eliminates disfranchisement and book-clesing and makes the record date procedure exclusive. Subsection (b) specifies the record date when none is set. The draft provision directly empowers the directors to set the record date, without further by-law authorization, unlike present Section 213. A "catchall clause" is added ("for the purpose of any other lawful action"). Like Section 213, draft Subsection (c) applies the record date to adjourned meetings, but authorizes a new record date if desired. Section 213's final clause (beginning "only such stockholders as shall be stockholders of record. . .) is deleted as redundant; the deletion reinforces, rather than weakens, Chancery jurisdiction to determine the shareholders equiably entitled to vote, as does subsection (a)'s introductory clause ("In order that <u>the corporation</u> may determine the shareholders entitled,"etc.)

D. Other Provisions on Notice

1. Waiver of Notice: In connection with notice of directors' meetings, Report supra at 63-64, it has been suggested that attendance at a meeting automatically effect a notice waiver, without requiring signatures to written waivers. As with directors, an exception should be made for a "special appearance" of a shareholder to protest the meeting because not lawfully called or convened. Accordingly, Section 229 should read as follows; with some simplification of present language:

> Whenever any notice is required to be given under the provisions of this Chapter or of the certificate of incorporation or by-laws, a written waiver thereof, signed by the person entitled to notice, whether before or after the time stated therein, shall be deemed equivalent to notice._/ Attendance of a person at a meeting of shareholders shall constitute a waiver of notice of such meeting, except when the shareholder attends a meeting for the express purpose of objecting at the beginning of the meeting, to the transaction of any business because the meeting is not lawfully called or convened. Neither the business to be transacted at, nor the purpose of, any regular or special meeting of the shareholders need be specified in any written waiver of notice unless so required by the by-laws.

_/ This sentence closly tracks Section 229's language (with redundant omissions), but a more precise expression of the same idea is as follows: "Notice of a meeting of shareholders need not be given to any shareholder who signs a waiver of notice, in person or by proxy, either before or after the meeting." See N.Y.§ 606 (first sentence).

A shareholder should, ofcourse, be allowed a 'jurisdictional' objection, but he must make it, as the above provision specifies, at the beginning of the meeting, rather than wait around to see how the meeting progresses and then object when things go against his wishes. The last sentence states a rule of convenience. Adoption of this section does not affect the doctrine of In the Matter of Seminole Oil & Gas Corp., 38 Del.Ch. 549, 155 A.2d 887 (Ch.1959) (waiver of notice cannot be used to defeat a prior judgment of Chancery).

The draft provision has been worded in terms of shareholder meetings, on the assumption that a like provision will be inserted in the provision on directors' meetings, as suggested supra p. 64. With some language changes (which will be submitted, if desired) a single provision, applicable to all meetings, can be drafted; but this should go along with definitions and other general provisions, in a new subchapter at the beginning of the statute. Cf. the organization of the new New York statute.

2. Prohibited Notice: Section 230 requires no changes in its wording. A similar provision has been adopted in New York (Section 108(b)) and in a few other states. However, the section title could be better stated as: "Notice Dispensed with When Delivery Prohibited." It, too, should appear in the new subchapter containing provisions of general application.

E. Proxies

Section 212 contains all indispensable rules relating to proxies. It should be made clear, however, that the right of proxy voting applies not only at meetings but to shareholder action without a meeting authorized by Section 229. For example N.Y.Bus.Corp.Law § 609(a) states that:

> Every shareholder entitled to vote at a meeting of shareholders or to express consnet or dissent without a meeting may authorize another person or persons to act for him by proxy.

Section 212 gives proxies a three-year life unless a longer period is stipulated. Since the longer period may be required, the choice of three years, or eleven months,(as in N.Y.Bus.Corp.Law § 609(b), is arbitrary; moreover, for listed corporations, eleven months fromdate is the limit, thereby preventing continued use of proxies at annual meetings without resolicitation. No change on this point is needed.

A scattering of states have, after careful study of their laws, adopted statutory rules codifying much agency law applicable to proxies. Although not essential, this practice has the usual advantages of codificatinn, and dispenses with case-law research for many situations. The utility of such rules should be considered not alone from the lawyer's standpoint, but that of the lay businessmen (including proxy-holders) in the heat of a meeting. Some of these provisions from various states, are set forth, with brief comments on their relative desirability and attractiveness:

1. "Definition" of Proxy: Model Act Section 31 (par.3) and a large number of states specifically requires the proxy to be "executed in writing by the shareholder or by his duly appointed attorney-in-fact." Four states go further and, with minor variations, add that a telegram or cablegram "appearing to have been transmitted by a shareholder" is an effective proxy, e.g., Ohio §1701.48; S.C. § 12-16.14, N.C. § 55-68, and Conn.Gen.Stats. § 33-336(a) which also includes

"a photographic or similar reproduction of a proxy." This would reinforce the judicial rule that "whatever reasonably appears to be a proxy of a shareholder entitled to vote at an election is entitled to a prima facie presumption of validity." Standard Power & Light Corp. v. Investment Associates, Inc. 29 Del.Ch. 593, 607, 51 A.2d 572 (S.Ct. 1947).

2. Revocation of Proxy: The ordinary proxy's revocability is expressly stated in many states, including New York, Connecticut, Pennsylvania, and others. E.g., "every proxy shall be revocable at the pleasure of the shareholder executing it," N.Y.§ 609(b).

Of special usefulness, and recommended here, are provisions which protect the corporation from revocation by death, supervening incapacity, or shareholder's presence at the meeting, absent specific and timely notice to an appropriate person. For example, New York § 609(c) specifically deals with a shareholder's death, and South Carolina § 12-16.14(c) states a simlar rule for supervening incapacity or appearance of a shareholder at the meeting. The following language is suggested:

> The authority of the holder of a proxy to act for a shareholder shall not be revoked by the death, supervening incapacity, or presence at the shareholders' meeting of the shareholder who executed the proxy unless before the authority is exercised, written notice of such death, incapacity, or presense at the meeting is received by the corporate officer responsible for

maintaining the list of shareholders. _/

3. Miscellaneous Provisions: Under Conn.Gen.Stats. 33-336 unless the proxy otherwise provides, (1) it covers all voting shares owned by the person executing it; and (2) the proxy-holder may appoint substitutes to act for him; (3) The statute also states a special rule, susceptible to variation in the proxy, for voting by multiple proxy-holders. _/ Cf. voting of shares owned by several fiduciaries.

F. Stockholder List

Section 219 is sound in substance, but several refinements are worth considering in view of the use of computers and other business machines by large corporations.

1. Specific reference should be made to the transfer agent _/ who normally maintains a large corporation's stockholder list, e.g., New York Section 607 ("A list of shareholders . . . certified by the corporate officer responsible for its preparation or by a transfer agent. . ."); Several states also provide that the shareholder list

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_/ Compare Conn.Gen.Stats. § 33-336(d) concisely summarizing this (and other rules) by providing that: "A proxy shall be revocable at will . . . but revocation shall not affect any vote or other action theretofore taken. The corporation may treat any duly executed proxy as not revoked and in full force and effect until it receives a duly executed instrument revoking it, or duly executed proxy bearing a later date or, in the case of death or incapacity of the person executing the same, written notice thereof."

_/ "Unless the proxy otherwise provides . . . (2) if authority with respect to the same shares is conferred upon two or more agents, a majority of those present at the meeting may exercise all powers conferred by the proxy or, if only one is present, then that one may do so. If the agents present are divided as to the manner of voting or taking action in any particular case and there is no majority, the voting of such shares or other action shall be prorated."

_/ Section 219's limitation to "officer who has charge of the stock ledger" is too restrictive, and should at least refer to the "officer or agent," as in Model Act Section 29.

may be kept at the office of the transfer agent or registrar, e.g., Va. Code § 13.1-30; S.C.Code § 12-16.7(a), or at the principal place of business or at the place of meeting, at the corporation's option--a distinct convenience. Again, at least one state has a specific provision to the effect that a stockholder list need not be prepared if the stock books themselves clearly give the necessary information regarding the stockholders entitled to vote (including addresses, number and class of shares), S.C.Code §§ 12-16.7(a). This provision is especially useful to the small corporation, but it may well be adaptable to the large enterprise as well.

2. The rule of Moon v. Moon Motor Car Co., 17 Del.Ch. 176, 184, 151 Atl. 298 (Ch. 1930), may be conveniently codified as it is in Model Act Section 29. The existing sanction for non-compliance (disqualification from office of directors wilfully refusing to comply) is of minimal importance and, of necessity, does not apply to a transfer agent, and should be deleted. In the event of a sharply contested election, very probably any default will be corrected as an incident to any litigation under state law or under the SEC proxy rules. Aside from a few other jurisdictions disqualifying defaulting officers, other state statutes provide a sanction either in the form of damages to the injured stockholde, see Model Act Section 29 and its progeny, or a statutory penalty in a fixed amount, e.g., N.J.Stat.Ann. § 14:10-5, or by requiring adjournment of the meeting pending compliance, e.g., Va.Code § 13.1-30. Certainly the latter is most effective for compelling complaince, since the threat of a postponed meeting will likely induce maximum care in advance; but it does confer an undue degree of disruptive power on a shareholder contesting possibly insubstantial defects. The suggested

redraft contains no sanction and deletes the disqualification of officers.

3. Under the suggested redraft of Section 219, the list speaks as of the record date. See Report, supra at pp. 119-121. The list must be available for ten days (as at present) or for whatever period of time after notice of the meeting is given, see Report supra at 118 .

4. The redraft makes the voting list requirement applicable to all meetings, and not merely to election of directors as in present Section 219. Besides Delaware, only Indiana, Kansas, Michigan, New Jersey, and Puerto Rico so limit it; and these statutes have not been recently revised or studies.

5. The first sentence of Section 220 is transferred to the redraft of Section 219 to which it is chiefly relevant. The phrase "only evidence" is changed to "prima facie" evidence which, it is submitted, more accurately reflects decisional law that Chancery is not bound by the stock transfer books. Also, the now customary phrase "stock transfer books" is employed in lieu of "stock ledger." See Model Act Section 29.

6. New York Section 607, and Model Act Section 29 (revised as of 1964), do not require the list to be available before the meeting, but only at the meeting, relying on the stockholder's ordinary inspection rights if he seeks or needs information in advance of the meeting. However, if the list must be prepared and available at the meeting, it seems no hardship to make it available a reasonable time before the meeting, as it is now in Delaware.

Section 219 <u>Voting List</u> (redraft)

The officer or transfer agent having charge of the stock transfer books of a corporation shall in advance of any meeting of stockholders prepare a complete list of stockholders as of the record date who are entitled to vote at the meeting. Such list shall be arranged in alphabetical order and shall show the address of and number of shares registered in the name of each stockholder. For a period beginning upon the date when notice of the meeting is given, and in no event less than ten days prior to the date of the meeting, such list shall be kept on file at the corporation's principal place of business within this State or at the place where the meeting is to be held or at the office of its transfer agent or registrar, and shall be available for inspection by any stockholder at any time during ordinary business hours. Such list shall also be produced and kept open at the time and place of the meeting and shall be available for inspection by any stockholder during the whole time of the meeting.

(b) A list of stockholders need not be prepared as required by subsection (a) if the stock transfer books readily show the information required to appear in the list of stockholders entitled to vote at the meeting.

(c) Failure to comply with the requirements of this section shall not affect the validity of any action taken at the meeting.

(d) The original or duplicate stock transfer books shall be prima facie evidence of the stockholders entitled to examine the list required by subsection (a) or the stock transfer books or to vote in person or by proxy at the meeting.

G. Quorum

1. Under Section 216, the certificate of incorporation or the by-laws determines a quorum. This is presumably sufficient to authorize a greater-than-majority or even unanimous quorum requirement (as may be desired in close corporations). Presumably it also permits any lesser number as a quorum, in accord with the common law rule that any number of shareholders comprise a quorum at any lawfully convened meeting. Some states, fearing abuse, follow Model Act Section 30 (first sentence) in forbidding a quorum of less than one-third of the shares entitled to vote at the meeting, E.g., New York § 608(b); Virginia § 13.1-31; and about thirteen others. A number of states are stricter and forbid a quorum of less than a majority of shares entitled to vote at the meeting, e.g., California, Maryland, Pennsylvania; and a number of others. This Report regards a floor as desirable, and recommends setting it at one-third of the shares entitled to vote at the particular meeting. This allows all needed flexibility, since quorum can vary from one-third to unanimous; and, at the same time, protects shareholders against corporate action by a very small number of shares, especially considering that, absent contrary provision, a majority of a quorum can act. __/ In all events, the smaller the quorum, the greater the need for notice of all meetings, as recommended supra p.115-119. If the one-third limitation is desired, the following should be added:

> In no event shall a quorum consist of less than one-third of the shares entitled to vote at the meeting.

__/ Thus, even if the statute required 1/3 of the shares to constitute a quorum, 1/6 of the shares plus one could still lawfully take action.

2. At least fourteen jurisdictions (including New York, Connecticut, California, and Pennsylvania) explicitly codify the doctrine, represented by several Delaware decisions, that once quorum is established withdrawal of shareholders does not break it, and the meeting may continue to act. In Delaware, see Atterbury v. Consolidated Coppermines Corp., 26 Del.Ch. 1, 15, 20 A.2d 743 (Ch. 1941); Duffy v. Loft, Inc., 17 Del.Ch. 140, 149-150, 151 Atl. 223 (Ch. 1930); Hexter v. Columbia Baking Co., 16 Del. Ch. 263, 268, 145 Atl. 115 (Ch. 1929). The following language is suggested for consideration:

> When a quorum is once present to organize a meeting of stockholders, the meeting may continue to do business notwithstanding that the withdrawal of stockholders leaves less than a quorum present unless the by-laws specifically provide otherwise.

3. At least eighteen states (including California, Pennsylvania, Michigan, New York, and Virginia) expressly state, with language variations: "The shareholders present may adjourn the meeting despite the absence of a quorum." N.Y. § 608(d).

4. Section 216's quorum rule for non-stock corporations could conveniently be transferred to Section 215. See *infra* at .

H. Vote of Shareholders

As in the case of quorum, Section 216 permits the certificate or by-laws to fix the necessary shareholder vote, unless the statute otherwise specifies, *e.g.*, for merger, dissolution, etc. Today statutes usually state the vote necessary for shareholder action, absent contrary provision in the statute, certificate, or by-laws.

Cf. Investment Associates Inc. v. Standard Power & Light Corp., 29 Del. Ch. 225, 234, 48 A.2d 501 (Ch. 1946), aff'd 29 Del.Ch. 593, 51 A.2d 572 (S.Ct. 1947) (majority of votes cast absent express contrary provision).

The Committee may wish to consider specifically providing for the necessary vote, both for election of directors and at other meetings.

1. Shareholder Action Generally: Leaving aside elections of directors, statutes either require merely a "majority" without further specification, Tenn.Code Ann. § 48.312, or a "majority of the shares represented at the meeting and entitled to vote," Model Act Section 30 (second sentence), or a majority of the quorum present at a meeting, Conn.Gen.Stats. § 33-329(b), or "a majority of the votes cast at a meeting", e.g., N.Y. § 614(b). The last rule is preferable, certainly if the statute requires a minimum quorum present; and it accords with Delaware case law.

2. Election of Directors: It is, of course, accepted that in corporate meetings, directors need not receive an absolute majority of votes to be elected, but only a plurality. Four states have expressly stated this rule in their statutes: N.Y. § 614(a); Va.Code 13.1-31; S.C.Code § 12-16.10(a) (2); and D.C.Code Ann. § 29-915.

If desired, these rules can be readily codified, subject to permissible variations by certificate or by-laws and saving statutory provisions for a different vote:

> Unless the vote of a greater number of shares or voting by classes of shares is required by this Act or by the certificate of incorporation, at any meeting of shareholders:

(a.) Any action taken by the shareholders shall be authorized by a majority of the votes cast at the meeting by the holders of shares entitled to vote on such action, except that

(b.) In any election of directors, those candidates who receive the greatest number of votes cast at the meeting by the holders of shares entitled to vote to elect directors, even though not receiving a majority of the votes cast, shall be deemed elected.

It will be noted that the wording of the suggested provision applies not only to common stock but to any other securities which by charter or otherwise have a right to vote, e.g., preferred stock or bonds following some default specified in the indenture. This provision does not affect class voting required by statute since this is in addition to the ordinary vote. Finally, where classes of stock may elect classes of directors, the general rule of the proposed provision would apply.

I. Cumulative Voting

Section 214's provision for cumulative voting is sound in policy and statutory language. Several states (including North Carolina and South Carolina) require shareholders to give notice of intention to cumulate their votes, either before the meeting or at the meeting just prior to voting. In the latter situation, these statutes permit a brief recess so that all shareholders may most effectively cumulate their votes. The latter is appropriate since it is often difficult to calculate the largest number of directors which may be chosen by any block of shares voting cumulatively. Moreover, there have been occasions when majority shareholders have miscalculated their voting power, and a minority has been able to elect a majority or all of the directors. It is not infrequent that, despite a charter requirement of cumulative voting during an "era of good feeling" all shareholders (particularly in a small corporation) will vote straight, only to discover that in a dispute the unused or miscalculated cumulative voting rights decide the outcome of a contested election. Accordingly, it is proper to require notice of intended cumulative voting, either before or at the meeting, and in the latter situation to grant a short recess. The following is suggested as an addition to Section 214:

> If the certificate of incorporation provides for cumulative voting a shareholder who intends to exercise his right of cumulative voting, shall either (1) give written notice of his intention to the secretary of the corporation not less than 48 hours before the time fixed for the meeting, or (2) announce his intention in the meeting before the voting for directors

begins; and all shareholders entitled to vote at such meeting shall, without further notice, be entitled to cumulate their votes. If a shareholder intending to cumulate his votes, gives notice only at the meeting, the person presiding may, or if requested by any shareholder shall, recess the meeting for a period not to exceed two hours.

J. Quorum and Voting in Non-Profit Corporations

The only recommendation regarding Section 215 is the simplification of its language, and the transfer to Section 215 of the quorum provision for non-stock corporations now found in Section 216. The following re-wording is suggested:

(a) The provisions of Sections 212-214 of this title shall not apply to non-profit corporations without shares of stock.

(b) Unless otherwise provided in the original or amended certificate of incorporation of a corporation without shares of stock, each member shall be entitled at every meeting of members to one vote in person or by proxy, but no proxy shall be voted on after three years from its date, unless the proxy provides for a longer period.

(c) Unless otherwise provided by this title, the certificate of incorporation or by-laws of a corporation without shares of stock may specify the number of members having voting power who shall be present or represented by proxy at any meeting in order to constitute a quorum for, and the votes that shall be necessary for, the transaction of any business.__/

K. Qualification of Voters

A number of recent statutes specify the persons entitled to vote shares when held by persons other than individuals. The Delaware statute already does so as to fiduciaries and pledgors (Section 217) and corporate owners of stock (Section 160), and case-law covers others more or less adequately. The following discussion is long and technical; the subject matter may be infrequently presented; and the provisions considered would, if adopted, be lengthy. Weighted against this is the utility of definite and explicit rules for the convenience of corporations and non-lawyer officers faced with shares held in various tenancies or by various entities.

If any of these rules are adopted, the statute should specify, by specifically defining the term "vote," that they apply both to actual voting and to giving proxies. The following definition is recommended (based on Conn.Gen.Stats. § 33-311a(a)(3):

> The term "vote," as used herein, means to vote in person or by proxy, or to execute proxies, to express consent or dissent without a meeting whether in person or by proxy, or otherwise to represent shares for the purpose of ascertaining a quorum or otherwise.

__/ Like present Section 215, the redraft makes Sections 212-214 inapplicable to non-stock non-profit corporations; by implication, they would apply to all stock corporations (profit and non-profit) and (if such ever existed) a non-stock corporation for profit. Again like present Section 215, the redraft, in subsections (b) and (c), states rules applicable to all non-stock corporations which will, in practice, mean only non-profit enterprises.

1. Fiduciaries: Section 217 broadly covers "persons holding stock in a fiduciary capacity." [/] A number of other states enumerate the fiduciaries, and slightly vary their rules for particular types. For example, N.Y. § 602(c) permits administrators, executors, guardians, conservators, committees, or fiduciaries other than trustees to vote (and give proxies) whether or not shares are held in the fiduciary's name; but requires a trustee to effect transfer into his or a nominee's name. Receivers need not secure transfer into his name if the receivership court authorizes him to vote. N.Y. § 602(d). From a corporate law standpoint the Delaware provision is preferable to its New York counterparts; also the open-ended Delaware phrase avoids possible omissions from a list of fiduciaries. The desirability of the rule from a trust law standpoint is not considered. However, to relate Section 217's coverage more precisely to case-law, this Report suggests adding the clause beginning with the word "without" at the end of the first sentence:

> Persons holding stock in a fiduciary capacity shall be entitled to vote the stock so held without registering transfer of the stock into the fiduciary's name, unless an order of court or other controlling instrument shall so direct and a copy thereof has been filed with the

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[/] See Gow v. Consolidated Coppermines Corp., 19 Del.Ch. 172 202-205, 165 Atl. 136 (Ch. 1933) (applying Section 217 to stock voted by unregistered executors, administrators, guardians, and trustees); Gans v. Delaware Terminal Corp., 23 Del.Ch. 69, 72-73, 2 A.2d 154 (Ch. 1938) (unregistered trustees).

officer of the corporation or transfer agent responsible for maintaining records of shareholders.__/

2. Pledgor/Pledgee: Delaware's Section 217 accords with the usual statutory rule, except for requiring express authorization for a pledgee of record to vote shares. See Italo Pet. Corp. v. Producers' Oil Corp., 20 Del.Ch. 283, 294, 174 Atl. 276 (Ch. 1934). New York permits the pledgee of record to vote the shares (Section 612(a))but the pledgor may demand a proxy from the pledgee (Section 309(d)). The matter is not important enough to demand any change.

3. Partnerships: The following provision from Virginia (Va. Code § 13.1-32) and South Carolina (S.C.Code § 12-16.12(1) is recommended:

> Shares standing in the name of a partnership may be voted by any partner, and shares standing in the name of a limited partnership may be voted by any general partner.

See Gow v. Consolidated Coppermines Corp., 19 Del.Ch. 172, 200-202, 165 Atl. 136 (Ch. 1933). See also Atterbury v. Consolidated Coppermines Corp., 26 Del.Ch. 1, 12-13, 20 A.2d 743 (Ch. 1941).

4. Corporations: Many states now follow Model Act Section 31 (par. 5) in prescribing a rule for voting of shares owned by a corporation (other than its own), as follows:

> Shares standing in the name of another corporation, domestic or foreign, may be voted by such officer, agent, or proxy as the by-laws of such corporation may prescribe,

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__/ This phraseology reflects the language of Article 8 of the Uniform Commercial Code ("Investment Securities") which probably will eventually be considered in Delaware as it has already in a majority of states, including New York, Pennsylvania, New Jersey, Virginia, and most other commercial jurisdictions.

or, in the absence of such provision, as the board of directors of such corporation may determine.

A few states go further and state that, absent any such determination by the corporate shareholder, various officers of the corporate shareholder are presumed to have authority to vote the shares; and that the corporation whose shares are being voted may rely upon that presumption as a rule of convenience.__/

It is recommended that, at least, the Model Act provision should be adopted in Delaware (where the problem is most likely to arise). Compare Gow. v. Consolidated Copperines Corp., supra at 202.

5. Shares Owned by Corporation: The relevant provisions of Section 160 should be included with these draft provisions. Section 160's disfranshisement of a corporation's self-held stock is sound policy and routinely adopted elsewhere. The rule of Atterbury v. Consolidated Coppermines Corp., 26 Del.Ch. 1, 8-9, 20 A.2d 743 (Ch. 1941) should be codified, by adding at the end of the second sentence the clause: "nor counted towards a quorum." Section 160 bars a corporation from "directly or indirectly" voting its shares, thereby disfranchising shares in itself owned by its subsidiary. See Italo Pet.Corp. v. Producers' Oil Corp., 20 Del.Ch. 283, 288-293, 174 Atl. 276 (Ch. 1934) (99% owned subsidiary). Because the scope of the term "indirectly" is indefinite, a number of states follow Model Act Section 31 (par 2) by providing, in the language of N.Y. § 612(b):

__/ See Ohio § 1701.47 (A); N.C.Gen.Stats. § 55-69 (a); S.C. Code § 12-16.12(b).

> Treasury shares, __/ and shares held by another domestic or foreign corporation of any type of 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. __/

This does have the merit of definiteness and does not run the risk of shadowing all intra-corporate voting merely because of some small stock tie.

Finally, Section 160's rule should be liberalized to authorize a corporation to vote its own shares when held in a fiduciary capacity, since the potential evils are substantially lessened in view of its trust obligations. A typical provision is Wisc.Stat.Ann. § 180.25(2):

> . . . Shares of its own stock held by it in a fiduciary capacity may be voted and shall be counted in determining the total number of outstanding shares at any given time.

Illinois, Maryland, Michigan, and several other states similarly provide; Va.Code § 13.1-32 follows this rule only if there is a second fiduciary independent of the corporation. This Report recommends adoption of a all-or-none rule, along the lines of the Wisconsin provision.

__/ This is another term which should be defined at the beginning of the statute. See Model Act Section 2 .

__/ Italo Petroleum would, of course, be decided the same way under this provision.

6. Redeemed Shares: Statutes now normally expressly disfranchise shares called for redemption, N.Y.Bus.Corp.Law § 612(f) best expresses the rule first developed by Model Act Section 31 (par. 9) and widely adopted:

> 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.

7. Multiple Interests and Tenancies: Various Delaware cases have dealt with voting and proxy rights when shares are held of record by tenants in the entirety or by co-fiduciaries. __/ A proposal (based on N.J.Stat. Ann. § 14:10-7 (Supp. 1963)) has been made to amend Section 217 to deal with an equal split as to voting shares held of record by co-fiduciaries. __/ This Report suggests that the problem be treated, as in several states, __/ as part of the broader problem of multiple interests in shares, and that a general rule be declared by statute for guidance of all corporations.

__/ See letter of Richard F. Corroon Esq. to Hon. Clarence A. Southerland, dated March 19, 1964, p. 1, par. 2

__/ Conn. § 33-311a(f); Ohio Stat.Ann. § 1701.46 (E); N.C. Gen.Stats. § 55-70(f); S.C.Code § 12-16.13.

At least four states--Ohio, Connecticut, North Carolina, and South Carolina --provide by statute the following rules for voting jointly held shares of record

(1) If only one person votes, his vote binds all. Accord, Sellers v. Joseph Bancroft & Sons Co., 25 Del. Ch. 268, 278-280, 17 A.2d 831 (Ch. 1941) (co-executors); Standard Power & Light Co. v. Investment Associates, Inc., 29 Del.Ch. 593, 608-609, 51 A.2d 572 (S.Ct. 1947) (tenants by the entirety).

(2) If more than one votes, the majority vote binds all, e.g., a 2-1 split among trustees or tenants in common.

(3) If there is an even split, e.g., 2-2 or 1-1, each faction may vote the shares proportionally. Under this rule, given a 1 to 1 split of co-fiduciaries holding 1000 shares in trust for X, 500 shares would be voted for, and 500 shares against, a given proposal. _/ The Delaware rule is apparently contra and results in disfranchising the stock altogether, see In re Giant Portland Cement Co., 26 Del.Ch. 32, 44-46, 21 A.2d 697 (Ch. 1941) (tenants by the entirety); Sellers v. Joseph Bancroft & Sons Co., supra at 278-280 (co-executors). _/

_/ These states also provide that if the multiple interests are unequal, a majority of even split would refer, not to persons but to the interest.

_/ If this rule had been in force in 1941, under the facts in Sellers, Wilmington Trust Co. and Mrs. Bancroft would each have voted 578 shres (with one share left over).

Cf. the result under a pooling agreement in Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del.Ch. 610, 53 A.2d 441 (S.Ct. 1947). Such a result is at war with Delaware's asserted desire to avoid disfranchising shares, particularly noticeable in decisions sustaining proxies.

These statutory rules would apply, unless a court order or any other controlling instrument otherwise provided, and a duly authenticated copy of the instrument was given to the secretary of the corporation. Thus, flexibility for estate planners, etc. is preserved, but at the same time the corporation's interest is protected by requiring filing of any instrument which varies the statutory rule.

In the case of even-splits, an easily applied rule is stated, and the expense and delay of seeking a court-appointed *ad hoc* fiduciary is averted, although a controlling instrument could so provide. If the vote-splitting result is not desired as the exclusive remedy, the statute could provide dual remedies: either split the vote, or permit any fiduciary to seek a court order for a third deadlock-breaking fiduciary.

Statutes of this character cover all multiple interests, normally specifying, *inter alia*, fiduciaries, joint tenants, tenants in common, or fiduciaries having the same fiduciary relationship respecting the same securities. No statute specifically covers tenants by the entirety, but no reason appears not to do so whenever, as in Delaware, this tenancy exists.

Since this is a general revision of the Corporation Law, it is suggested that a broad remedial provision be considered at this time rather than one limited solely to equally-divided fiduciaries. The well-drafted Connecticut provision __/ is the basis for the following:

" If shares stand of record in the names of two or more persons, whether fiduciaries, joint 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, his act binds all;

(2) If more than one vote, the act of the majority so voting binds all;

(3) If more than one vote, but the vote is evenly split on any particular matter, each faction may vote the securities in question proportionally. If the instrument so filed shows that any such tenancy is held in unequal interests, a majority or even-split for the purpose of this provision shall be a majority or even-split in interest."

If the Committee wishes to provide, alternatively, for appointing an ad hoc fiduciary in an even-split, the following language should be added in draft subparagraph (3) after the word "proportionally":

__/ Connecticut makes its rule applicable to all securities, e.g., bonds entitled to vote. The same result can be reached under Delaware law by a cross-reference to Section 221. Connecticut also applies its rule to shares owned by partnerships.

. . . or any person voting the shares, or a beneficiary, if any, may apply to the Court of Chancery or Orphans' Court having jurisdiction to appoint an additional person to act with the persons so voting the shares, which shall then be voted as determined by a majority of such persons and the person appointed by the court.

8. Survivors' Rights: Related to the rights of co-owners is the right of a survivor to vote shares. Connecticut (Conn.Gen.Stats. § 33-311a(g) has a specific rule which is recommended for consideration:

"If securities stand of record in the names of two or more persons with the words 'with the right of survivorship,' 'as joint tenants,' 'as joint tenants with the right of survivorship and not as tenants in common,' or words of substantially similar import following their names, the corporation may, upon the death of one or more of such persons treat as the absolute owner or owners the surviving person or persons so named."

9. Miscellaneous Provisions: Several states, permit a minor to vote his stock and either preclude disaffirmance, Conn.Gen.Stats. § 33-311a(k); S.C.Code § 12-16.12(e), or permit it only if the corporation has been formally notified of his infancy, N.Y.Bus. Corp. Law § 625(b). Two or three states permit life tenants to vote stock. E.g., Conn.Gen.Stats. § 33-311a(e); N.C. Gen.Stats. § 55-69(c).__/

L. Voting Inspectors (Election Judges)

Delaware does not give statutory recognition to voting inspectors except in the case of "election judges" for voting on amendments of the certificate (Section 242(d)(1)) and on dissolution (Section 275).

__/ See the Appendix to this section of the Report for a comment on an important Connecticut statute.

When voting inspectors have been appointed for other shareholder meetings and have made findings, their functions are said to be merely "ministerial" and not "quasi-judicial," e.g., Standard Power & Light Corp. v. Investment Associates, Inc., 29 Del.Ch. 225, 245-246, 48 A.2d 501 (Ch. 1946), affirmed, 29 Del.Ch. 593, 606, 51 A.2d 572 (S. Ct. 1947). The asserted reason is the possibly inordinate time consumed by more extensive duties, which are said to be peculiarly "judicial" and thus for courts, not inspectors. 29 Del.Ch. at 246. When election judges are required by statute, their functions apparently are more than ministerial, since they must "decide upon the qualifications of voters," "count and ascertain the number of shares voted" for and against the proposed action, and furnish a certificate as to their findings. Section 242(d)(1).

Several commercial states, including New York and Ohio, and some others, __/ in effect, require "election judges" for all meetings, since (to take New York's Section 610) any stockholder at a meeting may demand appointment of inspectors if the directors have not done so prior to the meeting. Such inspectors (in New York at least) act "quasi-judicially," and by statute (Section 611) their "report or certificate" is "prima facie evidence of the facts stated and of the vote as certified by them." They must take an oath of fidelity to duty and "strict impartiality." Section 610. Absence of objection to non-compliance with a by-law requirement of inspectors is treated as a waiver. Section 610 (as amended in 1964).

__/ The following state statutes require voting inspectors for all meetings: Cal.Corp.Code § 2232; Mich.Stat.Ann. § 21.41; New York supra; Missouri Ann.Stat. § 351.235; Ohio Rev. Code Ann. § 1701.50 (Supp. 1958); Penna.Stat.Ann. tit. 15, § 2852-512; N.C.Gen.Stats. § 55-70; S.C.Code § 12-16.17.

It is obviously a policy issue whether Delaware wishes to require by statute voting inspectors for all meetings. Assuming that inspectors are normally desirable--and noting frequent by-law provisions for their routine appointment--it does not follow that they should be mandatory. Statutes which "require" voting inspectors do not compel this in the sense that courts will void elections held without inspectors. However, in effect, such statutes are often mandatory, since the prospect of a recalcitrant shareholder's demand at the meeting often prompts an advance appointment of inspectors to avoid possible trouble from the floor. Inspectors are also apt to be a needless formality in some instances, e.g., uncontested election or other vote, and may prove costly for small corporations.

The main advantage of voting inspectors stems from the typical modern statutory provision that their reports are prima facie evidence of the facts stated therein, thus making an objector's challenge to a vote or election more difficult. If, as in New York, voting inspectors are to perform such a clearly "judicial" function, the statute must insure their fidelity and impartiality, at least by oath and preferably by statutory provisions stating minimum qualifications insuring these virtues. E.g., N.J.Stat.Ann. 14:10-14 (directors, officers, and candidates disqualified); Pa. Stat.Ann. tit.15, § 2852-512 (A) (non-shareholders may be inspectors). Otherwise, it would be most undersirable for the Court of Chancery to be even partially bound by their findings, even though, presumably, it could determine bias or partiality, let alone fraud. Moreover, since the findings are only presumptively correct, facts so found can be questioned. Hence, it cannot be flatly asserted that voting inspectors will make litigation less likely.

Since there is no compelling reason for requiring voting inspectors nor any strong trend towards this, it is recommended that Delaware not insert such a requirement, but leave the matter, as at present, to intra

It may be questioned whether "election judges" are needed for charter amendments (Section 242) and dissolutions (Section 275).__/ After all, these votes are no more significant to intra-corporate determination (or to the State as its creator) than a vote on merging or selling assets, or, for that matter, a major proxy fight, where "election judges" are not statutorily required. It is suggested, therefore, that the statute adopt a consistent approach and either require impartial qualified inspectors for all meetings or leave the issue to by-law determination in all instances. The safeguards are, as usual, the shareholder's right to contest a vote or election in the Court of Chancery, certainly the fairest and most impartial of all tribunals.

2. Consistently with making voting inspectors ("election judges") permissive, the statute could, however, require that when inspectors are authorized and act, they shall at least take a New York-type oath of impartiality and fidelity to duty, or specifically disqualify certain obviously interested parties. Once again, however, the disputing parties are likely to protect their respective factional interests from partial or biased voting inspectors, as in the Montgomery

__/ On a quick survey of statutes, the Reporter finds none which, as presently in Delaware, have election judge requirements for some, but not all, shareholder meetings.

Ward and New York Central Proxy Fights. See Stephan, Highlights of the Montgomery Ward Proxy Contest from a Lawyer's Viewpoint, 11 Bus. Law. 86, 95 (1955); Sprowl, The Work of the Inspectors of Election in the Montgomery Ward Proxy Contest, 11 Bus.Law. 98 (1955).

For the Committee's convenience, the New York Sections 610 and 611 (amended through 1964) appear in the footnote./

M. Rights of Bondholders

No changes are suggested in Section 221 regarding voting, inspection, and other rights of bondholders or debentureholders, except that, to achieve widest possible coverage, the statute should add the phrase "or

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/ § 610. Selection of inspectors at shareholders' meetings; If the by-laws require inspectors at any shareholders' meeting, such requirement may be waived unless compliance therewith is requested by a shareholder present in person or by proxy and entitled to vote at such meeting. Unless otherwise provided in the by-laws, the board, in advance of any shareholders' meeting, may appoint one or more inspectors to act at the meeting or any adjournment thereof. If inspectors are not so appointed, the person presiding at a shareholders' meeting may, and on the request of any shareholder entitled to vote thereat shall, appoint one or more inspectors. In case any person appointed fails to appear or act, the vacancy may be filled by appointment made by the board in advance of the meeting or at the meeting by the person presiding thereat. 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.

§ 611. Duties of inspectors at shareholders' meetings. 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 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.

other obligations issued or to be issued by the corporation" after the words "bonds or debentures." The quoted language is from California's Section 306; accord N.Y.Section 518(c) and Section 102 (a)(1) defining bonds to include "secured and unsecured bonds, debentures, and notes." In at least two states, California and Virginia, once the certificate confers any rights on bondholders, as authorized by statute, these rights may not be terminated except by amending the articles by a vote of at least a majority in principal amount (California Section 306) or by a two-third vote (Va.Code § 13.1-32, last par.) This Report does not regard such a provision as necessary, but would leave the matter to determination under the indenture.

N. Review of Elections

Section 225 and its related Section 227, are sound in principle and in the language is adequate. Under Section 225, a stockholder (or member of a non-stock corporation) alone has standing to invoke judicial review of an election. See In re Chelsea Exchange Corp., 18 Del.Ch. 287, 297, 159 Atl. 432 (1932)(cross-petition by corporation dismissed). A few states enlarge the category of persons with standing to seek review to include directors, e.g., N.C.Gen.Stats. § 55-71(a). Arguably, the corporation itself should have standing since it has an evident interest in a conclusive determination of a disputed election, and since its interests may now be indirectly represented by a shareholder who can, in effect, secure what amounts to a declaratory judgment of the validity of an election, see Tomlinson v. Loew's, Inc., 36 Del.Ch. 516, 134 A.2d 518*Ch.), aff'd per curiam, 37 Del.Ch. 8, 135 A.2d 156 (S.Ct. 1957). Considering the possible difficulty of saying which faction really speaks for "the corporation," it is b to leave the matter as it is now under Section 225. In all events, either faction can usually find shareholders willing to seek review. _/

O. Court-ordered Election to Fill Vacancies in Board of Directors

No change is suggested in the portion of Section 223 empowering 10% of the voting shares to seek a Chancery-ordered election of directors to fill vacancies (including new directorships) when "the directors then in office shall constitute less than a majority of the whole board." The other portions of Section 223, dealing generally with vacancies and new directorships, with staggered boards, and with directors' resignations, have already been considered. See Report, supra at pp. 55-56.

P. Shareholder Action Without Meeting

Appropriately, Section 228 permits unanimous shareholder consent in lieu of a meeting, and a like provision has been widely adopted elsewhere. One letter reads Section 228 as permitting shareholders to authorize but not to ratify by unanimous consent. _/

Although Section 141(g) does so restrict directors' written consent, this is due to a phrase ("prior to such action") not repeated in Section 228. Accordingly, this Report sees no need to change the language to avoid a possible, although highly strained, construction of Section 228.

_/ Two states specifically empower the reviewing court to issue, at its discretion, an interlocutory order restraining directors or officers whose election or appointment is contested from acting in office. N.C. Gen. Stats. S 55-71(f); S.C. Code S 12-16.19 (c).

_/ Cummings & Lockwood, Stamford, Connecticut, letter dated August 7, 1964.

It is suggested that Section 228's second sentence be broadened, so that instead of referring solely to Section 271 (sale of assets with written consent of stockholder majority), it apply generally, like New York Section 615(a), to any lawful consent by less than all shareholders, viz:

> This section shall not be construed to alter or modify the provision 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 action by the corporation.

Otherwise no change is recommended in Section 228.

Q. Miscellaneous

1. Section 226 (Equally Divided Vote for Directors) will be considered in connection with close corporation provisions.

2. Inspection rights of shareholders, briefly touched on by Section 220, and voting trusts and other control devices are considered in the immediately following part of this Report.

Connecticut General Statutes Section 33-311a

Note: The committee's attention is directed to the following provisions in Connecticut which give maximum protection to all corporations by clearly defining their duties and rights with respect to shareholders. These provisions also accord with the developments in the Uniform Commercial Code, Article 8--Investment Securities which similarly protects corporations in registering transfer of securities. The omitted subsections in the Connecticut statute deal with voting by fiduciaries, joint owners, corporations, etc. and have been omitted, since many of them are referred to, and some are fully set forth in, the part of this Report entitled "Qualifications of Voters."

(a) As used in this section: (1) "Recordholder" means the person or persons in whose name a security is registered form is registered at the time in question, or at the applicable record date or applicable date on which share transfer books were closed pursuant to section 33-310; (a) "security" means a security as defined in section 42a-8-102 issued by a corporation; (3) "vote" means to vote a security in person or by proxy, or execute proxies, whether special or general or discretionary waivers, consents or objections in respect thereof, or otherwise to represent a security, for the purpose of ascertaining a quorum or otherwise.

(b) Subject to the further provisions of this section (1) a corporation may treat the recordholder of a security as the absolute owner thereof, as if such recordholder had full competency, capacity and authority to exercise all rights of ownership, irrespective of any knowledge or notice to the contrary, or any description appearing upon its records or upon the security indicating a representative, pledge, or fiduciary relation or referring to any other instrument or to the rights of any other person; (2) a corporation shall not be obligated to inquire into existence of, or see to the performance or observance of, any duty or obligation to a third person by a recordholder or by any one who exercises any rights in respect of a security as permitted or required by this section. * * * * *

(j) When more than one person claims to be entitled to the same rights with respect to particular securities, the corporation may, in good faith, refuse to treat any of them as entitled to such rights.

(k) A corporation shall incur no liability to any person by the exercise of any privilege to which it is entitled by this section, nor shall any of its rights be thereby impaired nor shall any of its acts or any corporate meeting be thereby invalidated. * * * *

(l) Nothing herein shall relieve a corporation from any liability which it otherwise would have for breach by it of a contract to which it is a party or for violation of lawful provisions in its certificate of incorporation or bylaws or for participating in bad faith with a fiduciary in breach of trust.

(m) Nothing in this section shall relieve a corporation from the duty of abiding by or complying with any valid judgment, decree or court order, terminating, restricting, establishing or declaring the competency, capacity, authority, rights or obligations or any person wtih respect to securities, if and afer a certified copy of such judgment, decree or court order is filed with the secretary of the corporation, or if such judgment, decree or court order is rendered in a proceeding to which the corporation is a party.

(n) The rights, privileges and immunity afforded to the corporation in this section shall extend also to each transfer agent and to each registrar of its securities, to its voting inspectors and to all agents of the corporation concerned with the exercise of any rights by any of its security holders.

(o) Excepting subsection (c) and the first sentence of subsection (d) of this section, nothing in this section and no action taken in accordance therewith shall enlarge the competency, capacity, authority or rights of any recordholder, or any person who exercises any rights in respect of securities as permitted or required by this section, with respect other than the corporation and its representatives referred to in subsection (n) of this section.

This statute gives maximum protection to the corporation with respect to voting by its shareholders, especially as to shares held in representative or fiduciary capacities. (Subsection (b)) Liability arises only from actual participation in a breach of trust, or other breach of a contract to which the corporation is a party. (Subsection (l)). A transfer agent or registrar is similarly protected. (Subsection (n)) Subsection (j) may be useful, as a last resort, in permitting a corporation to be neutral when conflict in rights are asserted. Presumably, if the outcome of a vote depends upon this, it would be resolved in a Section 225 Chancery proceeding, but, assuming the corporation acts in good faith, it is not liable for non-recognition of the asserted rights.

As indicated in the introductory note, this provision closely follows the treatment given by the Uniform Commercial Code to the rights and liabilities of corporations, transfer agents, and registrars, when transfer of securities is registered. The theory of the Code -- which goes far beyond the Uniform Stock Transfer Act -- is to protect the corporation or transfer agent from liability for any registration of transfer, even though the transfer is wrongful, except in narrowly defined circumstances when actual notice is given (usually in the form of a stop-transfer notice).

This Report does not now make a specific recommendation that Delaware adopt these Connecticut-type provisions, but it suggests consideration of this type of statute, particularly in the light of the rapid adoption of the Commercial Code.

If the Committee wishes to consider this type of statute more fully, it will be necessary to redraft it in parts in order to fit its language into the organization of the Delaware statute and the other amendments already recommended.

II. VOTING CONTROL DEVICES

Speaking generally, the Delaware statute explicitly provides for voting trusts; case-law recognizes pooling agreements, but hampers use of ancillary devices, such as irrevocable proxies, to deal with voting deadlocks. Necessarily, the safest procedure is the voting trust, and in many instances it is the most desirable. However, Delaware corporations and shareholders should have a wider choice of devices to implement legitimate corporate or shareholder interests. In affording this choice, Delaware is far less accomodating than other states which have, either by statute or favorable "common law" rulings, sustained a wide spectrum of devices each useful for particular (although often overlapping) purposes and each independent of the requirements or formalities imposed on the others. Accordingly, this Report recommends new and amended statutory provisions to insure added flexibility.

A. Voting Trusts

Delaware's Section 218 is sound, __/ but one or two additional provisions would make it even more attractive. Perhaps the most serious handicap to using voting trusts in Delaware has been the unusually strict construction of the statute.

1. Time for Extension: Under Section 218(b) any extension of a voting trust must take place within one year before its expiration date. Elsewhere, it varies from six months (New York § 621(d)) to

__/ Ten years duration is now typical in most states.

two years (Conn.Gen.Stats. § 33-338(d)), or is uncertain because the statute is silent. It is suggested that the Delaware statute be liberalized, with at least two years allowed for extending the trust.__/ In all events, it should be specified whether the new period runs from the date when the extension is made or from the expiration date of the original instrument, so as to avoid ambiguity. The underscored language is suggested for inclusion in Section 218(b):

> (b) At any time within <u>two</u> years prior to the time of expiration of any such voting trust agreement as originally fixed or as extended as herein provided, one or more beneficiaries of the trust under such voting trust agreement may, by agreement in writing and with the written consent of such voting trustees, extend the duration of such voting trust agreement for an additional period not exceeding ten years <u>from the expiration date of the trust as originally fixed or as extended as herein provided</u>.

2. <u>Voting Trusts Exceeding Ten Years</u>: Delaware has, unfortunately, invalidated an entire trust because its duration could exceed ten years. <u>Perry</u> v. <u>Missouri-Kansas Pipe Line Co.</u>, 22 Del.Ch. 33, 37-42, 191 Atl. 823 (Ch. 1937).__/ This overly restrictive result should be

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__/ Opening the trust for renewals for a brief period such as one year or six months does not significantly protect certificate holders since, in Delaware, as elsewhere, they may withdraw when the trust is extended.

__/ Maryland's Court of Appeals recently limited a voting trust to the statutory ten-year period despite trust language indicating a possibly longer duration. <u>Holmes</u> v. <u>Sharretts</u>, 228 Md. 358, 180, A.2d 302, 305-307 (1962).

changed by statute, as [illegible] at least one state (S.C.Code § 12-16.16 (f). The following language is suggested:

> The validity of a voting trust agreement, otherwise lawful, shall not be affected during a period of ten years from the date when it was created or extended as provided herein, by the fact that under its terms it will or may last beyond such 10 year period. _/

3. Voting Trusts and Other Control Devices: Adhering to the unmistakeable implications of earlier decisions, *Abercrombie* v. *Davies*, 36 Del.Ch. 371, 130 A.2d 338 (S.Ct. 1937) invalidated an arrangement combining a stock pooling agreement and an irrevocable proxy as a voting trust void for non-compliance with Section 218 formalities. With deference to the force of that decision's reasoning, it is suggested that, as a matter of policy, the statute now specifically make available to corporations other and more flexible procedures as alternatives to voting trusts, for reasons indicated *infra* at p. 160. Not only are pooling agreements with or without irrevocable proxies of great importance to close corporations, including *Abercrombie*-type joint ventures, but they allow sometimes needed concentration of otherwise scattered voting power through a simpler and less costly method.

_/ The statute could go futher and make clear that after the statutory period is up, the trust is inoperative, as follows: "but it shall, after the expiration of such ten year period, be inoperative unless it has been extended not earlier than eight nor more than ten years from the date when it was created or extended as herein provided," or, more simply but less clearly, "unless it has been extended as herein provided." Such a statute, in effect, excises the invalid part of the voting trust agreement and lets the rest stand.

In order to remove substantial doubts as to their validity, it is suggested that the following language, derived from Connecticut § 33-338(e), be added to Section 218:

> This Section shall not be deemed to invalidate any voting or other agreement among shareholders or any irrevocable proxy which is not otherwise illegal. _/

4. Miscellaneous: No other recommendations are made, but a few provisions in other states should be noted. New York obligates the voting trustees to keep "correct and complete books and records of account relating to the trust" and an up-to-date list of certificate holders. N.Y.Bus.Corp.Law § 621(b); several other states accord. Connecticut authorizes the trustees to designate a depositary to act under the agreement, and declares that voting trust certificates shall be as readily transferable as share certificates unless transfer is validly restricted. Conn.Gen.Stats. § 33-338(c). In New York, certificate holders are shareholders for purposes of inspecting the books. N.Y.Bus.Corp.Law § 621(c); see infra p. 168.

B. Irrevocable Proxies

Several states now have statutes expressly validating irrevocable proxies in specified circumstances constituting the necessary "interest" with which the proxy is "coupled." The purpose is to give

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_/ In Connecticut, the voting trust section "shall be construed to be permissive." This Report does not challenge the Delaware doctrine so far as it requires exact compliance with the statute by instruments intended as voting trusts, but recommends only that voting trust formalities not be imposed on other control devices despite like functions and effects.

greater certainty than is possible under the cloudy common law concepts stemming in America from Hunt v. Rousmanier's Adm'rs 21 U.S. (8 Wheat.) 174(1820), which laid down restrictive requirements for sustaining an agency (proxy) despite the undeniable economic interest of the agent (proxy-holder). No statute goes so far as to make any proxy irrevocable merely because the proxy says so or even because there is consideration for the irrevocability, and this is sound policy expecially in the corporate field. New York first clarified the area with a statutory irrevocable proxy provision now copied in several other states. Irrevocable proxies, alone and expecially combined with voting agreements, have several distinctive advantages over voting trusts: (1) by recognizing other control devices, all corporations (and especially close corporations) gain additional flexibility, (2) the irrevocable proxy, with or without a pooling agreement, is usually simpler to create and operate, (3) because shares are not transferred to trustees, the procedure is simpler, and avoids expenses peculiar to voting trust arrangements, e.g., stock transfer taxes, trustee fees, printing costs, etc., as well as possible problems under federal and state securities growing out of the exchange of shares for certificates. Accordingly, it is recommended that Delaware consider the following provision based on the New York (Section 609(f)-(h)) and Connecticut (Section 33-337) provisions:

Section , Irrevocable Proxies

(a) A duly executed proxy shall be irrevocable if it specified that it is irrevocable and if, and only so long as, it is coupled with an interst suggicient in law to support an irrevocable power coupled therewith.

(b) Without limiting the generality of subsection (a) and subject thereto, a proxy is coupled with an interest and irrevocable if it is held by any of the following or a nominee of any of the following persons:

(1) A pledgee under a valid pledge;

(2) A person who has agreed to purchase the shares under an executory contract of sale;

(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 or such extension or continuation of credit, the amount thereof, and the name of the creditor;

(4) A person who has contracted to perform services for the corporation if such a proxy is required by the contract of employment, as part of the consideration therefor, 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; or

(5) A person, including an arbitrator, who has been designated by or in the manner provided for in a voting agreement among shareholders,

provided that such proxies shall respectively be revocable after the pledge is redeemed, or the executory contract of sale has been performed, or the debt of the corporation is paid, or the period of employment has terminated, or th voting agreement among shareholders has terminated.

(c) A proxy may be revoked, notwhthstanding 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 the shares.

Reporter's Note

It is arguable that, under modern common law cases, subsection (b)'s first four categories would create a sufficient "interest." See the Pennsylvania court's reading of Delaware law in Deibler v. Chas. H. Elliott Co., 368 Pa. 267, 81 A.2d 557 (1951) (pledgee of shares holds irrevocable interest). The fifth category--voting agreements--does not under present Delaware decisional law create a legally sufficient interest, In re Chilson, 19 Del.Ch. 398, 409-411, 168 A.2d 82 (Ch.1933); also coupling a voting agreement and an irrevocable proxy has been deemed a voting trust invalid for non-compliance with Section 218 formalities, Abercrombie v. Davies, 36 Del.Ch. 371,130 A.2d 338 (S.Ct. 1957). The statutory provisions would overturn these two decisions and the specific reference to the arbitrator would provide the ground for specific enforcement of an agreement contrary to the result in Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del.Ch. 610, 53 A.2d 441 (S.Ct. 1947). Draft subsection (c) protects transferees without notice of the restriction, but a certificate referring to it is, in effect, notice. Subsection (a) saves the common law in areas not covered by the statutory irrevocable proxies under subsection (b).

A few states impose an overall time limitation on an irrevocable proxy. Connecticut has none, but New York now gives a maximum three-year life. Since irrevocable proxies are a form of control device, performing some of the voting trust's functions, it would be rational to impose a ten-year limit on both, so that no advantage time-wise accrues through the proxy device. If this is desired, the following language (from New York § 609(g)) should be added to the postamble in draft subsection (b):

> or ten years has elapsed since the date of the proxy, whichever period is less, unless the period of irrevocability is renewed from time to time by the execution of a new irrevocable proxy as permitted by this section.

C. Stockholder Voting Agreements

Delaware decisions indicate that stockholder voting agreements are not *per se* offensive to public policy, absent some clearly improper purpose. See the *Ringling* case, 29 Del.Ch. 610, 621, 53 A.2d 441 (Ch. 1947), distinguished in *Abercrombie* v. *Davies*, 36 Del.Ch. 371, 384, 130 A.2d 338 (S.Ct. 1947). Invalidation has resulted from collateral features such as irrevocable proxies. Since the Delaware law has been less than favorably disposed to all control devices, and since decisional law in other states is relatively undeveloped, it is suggested that Delaware should specifically validate pooling agreements, with a cross-reference to the draft provision on irrevocable proxies. Similar provisions now appear in New York Section 620(a); Connecticut Section 33-339; North Carolina Section 55-73(a); South Carolina Section

12-16.15. Like irrevocable proxies, voting agreements are extensively used in close corporations, but they also serve useful purposes among shareholders in larger enterprises. The following New York language is suggested:

> An agreement between two or more stockholders, 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 provided by the agreement, or as the parties may agree, or as determined in accordance with a procedure agree upon by them.

Connecticut and the Carolinas limit the voting agreement to ten years, unless extended, thereby keying its duration to the voting trust. __/ Connecticut also protects subsequent purchasers without notice of the agreement, unless it is conspicuously noted on the certificate. Section 33-339(d). These provisions are not necessary for every voting agreement, since the agreement is personal to the parties and does not run with the shares. There is more reason for these limitations if an irrevocable proxy is employed; the draft provision, supra p. 162, specifically protects subsequent purchasers of shares subject to an irrevocable proxy, and another draft provision, supra p. 163, would limit to ten years an irrevocable to a voting agreement.

__/ Conn.Gen.Stats. § 33-339(b): "Such voting agreement shall not extend beyond ten years from the date of its execution. The parties to a voting agreement, or their transferees, or any of them, may by written agreement made at any time within two years prior to the time of expiration of the voting agreement, extend its duration for an additional period not exceeding ten years, but such extension agreement shall not affect the rights or obligations of persons not parties thereto."

III. Stockholder Inspection Rights

Corporation statutes today almost invariably codify shareholder inspection rights. Indeed, all states except Georgia and Rhode Island[1/] have inspection statutes; all but eight[2/] (including Delaware) go beyond merely recognizing a right to inspect the stock ledger, and in varying degrees regulate shareholder inspection. In general, Delaware case-law parallels these developments; but several useful statutory provisions would well serve legitimate corporate interests. A draft provision, chiefly based on Model Act Section 46 and New York Section 624, appears at the end of this part of the Report and implements all recommendations.

1. Proper Purpose: Most statutes now expressly make "proper purpose" an ingredient of the inspection rights,[3/] and if not, the case law, as in Delaware, imposed the requirement. Statutes rarely deal expressly with burden of proof,[4/] but such a provision might be considered in Delaware in view of a seeming conflict between cases

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1/ Source: Model Bus.Corp.Act Annotated 119; 1964 Supp. 45.

2/ These states, besides Delaware, are Arkansas, Florida, Hawaii, New Jersey, Tennessee, Utah, and Puerto Rico.

3/ Alabama, Alaska, California, Colorado, Connecticut, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Michigan, Minnesota, New Hampshire, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Texas, Utah, Virginia, Washington, Wisconsin, and District of Columbia.

4/ In Conn.Gen.Stats. § 33-334(b), "the shareholder shall have the burden of showing that the examination is in good faith in the interest of such shareholder as such or of the corporation and not for speculative or trading purposes or any purpose inimical to the interest of the corporation or its shareholders."

requiring the shareholder seeking mandamus to allege and prove proper purpose, e.g., Nodana Pet. Corp. v. State ex rel. Brennan, 50 Del. (11 Terry) 76, 81 n. 1, 123 A.2d 243 (S.Ct. 1956); 5/ State ex rel. Bramley v. Jessup & Moore Paper Co., 24 Del (1 Boyce) 379, 388, 77 Atl. 16 (S.Ct. 1910): State ex rel. Waldman v. Miller-Wohl Co., 42 Del. (3 Terry) 73, 85, 28 A.2d 148 (Supper. 1942), and those requiring the corporation to show an improper purpose as a defense to mandamus, State ex rel. Bloch v. Sentry Safety Control Corp., 41 Del. (2 Terry) 482, 485, 24 A.2d 587 (S.Ct. 1942); Insuranshares Corp. v. Kirchner, 40, Del. (1 Terry) 105, 108, 5 A.2d 519 (S.Ct. 1939). This Report does not find the conflict conclusively resolved unless the footnote in Nodana is the final, because the latest, statement.

Some futher definition of "proper purpose" is given by statutes such as Connecticut's requirement of a "specified, reasonable, and proper purpose", and Arizona's useful provision that a "proper purpose" embraces "a purpose reasonably related to his interests as a shareholder" (Ariz. Rev.Stats. § 10-175). 6/

5/ "We assume in this case, as contended by the corporation, that a stockholder seeking inspection of the general corporate books must affirmatively allege and prove a proper purpose."

6/ New York negatives "a purpose which is in the interest of a business or object other than the business of the corporation." N.Y. Bus.Corp.Law § 624(c). While this apparently aims at shareholders seeking business information for themselves or competing businesses, the language is so vague that, arguably, it would exclude interests of the shareholder qua shareholder, e.g., to determine the value of his shares, State ex rel. Rogers v. Sherman Oil Co., 31 Del. (1 W.W. Harr.) 570, 117, Atl. 122 (1922), or the fate of certain assets, State ex rel. Miller v. Loft, Inc., 4 W.W.Harr. 538, 156 Atl. 170 (1931), or to investigate some improper transaction, Nodana Pet. Corp. v. Delaware ex rel. Brennan 50 Del. (11 Terry) 76, 123 A.2d 243 (S.Ct. 1956).

2. Percentage and Time-of-Holding Limits: Many recent statutes change the common law and authorize inspection only if a shareholder has owned his shares for at least 6 months or, alternatively, owns at least 5% of any class of shares whenever acquired.[7/] Variations appear in other states.[8/] Delaware decisions do not recognize any such limitation, and charter provisions so providing would probably violate common-law rights. See State ex rel. Brumley v. Jessup & Moore Paper Co., supra at 387-389 (inspection discretionary with directors); State ex rel. Cochran v. Penn-Beaver Oil Co., 34 Del. (4 W.W.Harr.) 81, 87-88, 143 Atl. 257 (S.Ct. 1926) (inspection rights denied by charter). Like Section 327's contemporaneous ownership requirement for maintaining derivative suits, the six-months limitation precludes buying shares merely to get at the books. But cf. Trans World Airlines, Inc. v. State ex rel. Porterie, 183 A.2d 174 (S.Ct. 1962).[9/] The percentage alternative seemingly serves no useful purpose but normally appears in the statutes.[10/]

7/ Percentage or Time of Holding: Alabama, Alaska, Arkansas, Florida, Colorado, Illinois, Iowa, Maine, Nevada, New York, North Carolina, North Dakota, Oregon, South Carolina, Texas, Virginia, and Wisconsin.

8/ Percentage and time of holding: Louisiana, Maryland, and Michigan. Percentage requirement only: Idaho, West Virginia, and D. C. Time of holding only: No states.

9/ If this statute had been in force in Delaware at the time, the opposite result would have been reached in TWA.

10/ Louisiana has an interesting provision applicable to a business competitor seeking inspection of corporate records, requiring a showing of 6-months record ownership plus 25% of the stock of the corporation whose books he seeks to inspect. La.Rev.Stat.Ann. § 12:38.

3. Equitable Interests: Some states specifically give voting trust certificate holders the same inspection rights as shareholders,[11/] and apply percentage and time limitations, if any to certificate holders.[12/] In Delaware, State ex rel. Crowder v. Sperry Corp., 41 Del. (2 Terry) 84, 92-93, 15 A.2d 661 (Super. 1940) held that an equitable interest could not obtain mandamus but (by dictum) might secure Chancery relief. Since there is obviously no policy against an equitable interest enjoying shareholder inspection rights, a single form of action should be readily available to all without jurisdiction being divided between two forums.

4. Inspection by Agents: A shareholder's agent may inspect corporate records, both in Delaware, State ex rel. Bloch v. Sentry Safety Control Corp., 41 Del. (2 Terry) 480, 486, 24 A.2d 587 (Super. 1942), and under many statutes,[13/] whose usual reference is to "agent or attorney" and, occasionally, to the shareholder's accountant.[14/] The right to copy and make extracts from inspected books, e.g., State ex rel. Rogers v. Sherman Oil Co., 31 Del. (1 W.W.Harr.) 570, 580, 117 Atl. 122 (S.Ct. 1922) is also normally codified in the new statutes.

11/ California, Connecticut, Illinois, Maryland, Minnesota, New York, North Carolina, Oklahoma, South Carolina, Wisconsin, District of Columbia.

12/ See the New York statute, for example.

13/ Model Act; Alabama, Alaska, Arkansas, California, Connecticut, Colorado, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Nevada, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Texas, Virginia, Washington, Wisconsin, and D. C.

14/ North Carolina, South Carolina

5. Inspection without Court Order; Corporation's Rights:

Several important statutes specify circumstances justifying a corporation's refusal to allow an otherwise qualified shareholder to inspect the books. The minimal requirement is a written demand to inspect, 15/ sometimes specifying advance notice, 16/ or a statement of the shareholder's purpose. 17/ Usually a demand is made if only to establish a needed element in a subsequent action for mandamus. See Nodana Pet. Corp. v. Delaware ex rel. Brennan, 50 Del. (11 Terry) 76, 123 A.2d 243 (S.Ct. 1956). Both under statutes and Delaware decisions, the corporation may insist upon reasonable hours and place for inspection.

Well worth consideration is New York's provision for the corporation to demand from the shareholder an affidavit denying participation in a sale of any shareholder list of any corporation for the past five years, and disclaiming any other intended misuse of information obtained by inspection. Accord, State ex rel. Theile v. Cities Service Co., 31 Del. (1.W.W.Harr.) 514, 527-528, 115 Atl. 773 (S.Ct. 1922) (sale of shareholder list is improper purpose defeating mandamus petition). See also State ex rel. Brumley v. Jessup & Moore Paper Co.,

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15/ Alabama, Alaska, California, Colorado, Connecticut, Illinois, Iowa, Maryland, Nebraska, North Carolina, North Dakota, Ohio, Oregon, South Carolina, Texas, Utah, Virginia, Wisconsin, Wyoming, District of Columbia

16/ N.Y.Bus.Corp.Law § 624(b) requires five days notice.

17/ Conn.Gen.Stats. § 33-334(b) requires a statement of the purpose of the inspection which, as the section later indicates, must be a "specified, reasonable, and proper purpose."

1 Boyee 379, 77 Atl. 18 (S.Ct. 1910) corporation entitled to assurances of no intended misuse of information from corporate books). The New York procedure is self-executing; the shareholder refusing an affidavit must appeal to a court which is unlikely to be convinced of the propriety of a purpose which he refused to disavow to the corporation.

6. Books Subject to Inspection: The Model Act's typical provision extends the statutory inspection right to "books and records of account,(and) minutes and record of shareholders," with a few states deleting "books and records of account." N.Y. § 624(b); Conn Gen.Stats. § 33-334(b). Hence, corporate documents not mentioned by the statute may be inspected only on a court order, *viz*., the corporation is absolutely privileged to refuse production absent court order.

7. Books located Outside State: Statutes do not specify the place where books must be kept, since, frequently, the executive offices and hence many records will be outside the state of incorporation. However, statutes, in effect, compel a record of shareholders to remain within the state of incorporation. See Delaware Section 220, and many other statutes. The Model Act (and statutes following it) permit the record of stockholders to be kept "at the office of its transfer agent or registrar" without specifying the location of that office. This would appear preferable even though the shareholder may have to go to a state other than Delaware to inspect.[18]

18/ N.Y.Bus.Corp.Law § 624(a) does require that the record of shareholders of a New York corporation remain within the state.

Three states [19] broadly empower the court to order books brought into the state or pertinent extracts or authenticated copies. This jurisdiction evidently exists in Delaware. State ex rel. Brumley v. Jessup & Moore Paper Co., 24 Del (1 Boyce) 379, 386-387, 77 Atl. 16 (S.Ct. 1910). Elsewhere courts have compelled their domestic corporations to make their books available for inspection when located in a third state.

8. Residual Power to Compel Production: Having specified limited statutory inspection rights, many states [20] expressly save plenary court jurisdiction although in this area common law rights generally survive an inspection statute. State ex. rel. Cochran v. Penn-Beaver Oil Co., 34 Del. (4 W.W.Han.) 81, 88, 143 AR. 257 (S.Ct. 1926). This reserved power permits shareholders, on a court order, to inspect documents not available as of right, e.g., minutes of directors' or committee meetings, financial records, intra-corporate memoranda and correspondence, etc. It may also enable the court, in a proper case, to suspend any statutory percentage or time-of-ownership qualifications for the inspecting shareholders, [21] or otherwise impose conditions.

19/ North Carolina, South Carolina, Wisconsin.

20/ Group I (residual power of courts preserved): Arkansas, Connecticut, Florida, Maine, Nevada, New Hampshire, New Mexico, New York, Oklahoma, Tennessee. Group II (residual power plus suspending percentage and time-of-ownership limits): Alabama, Alaska, Colorado, Illinois, Iowa, North Carolina, North Dakota, Oregon, South Carolina, Texas, Virginia, Wisconsin, District of Columbia.

21/ See Group II states in preceding footnote.

9. Procedure: This Report expresses no view on the adequacy of the present mandamus procedure, except to note that equitable owners must go to Chancery, thereby dividing up the jurisdiction depending upon the person seeking the same relief. Most other statutes continue existing procedure (usually mandamus). New York has a special statutory method, analogous to mandamus, but available to all persons entitled to inspect. N.Y. § 624(d).

10. Record Keeping Requirements: Some states, following the Model Act and including New York, compel the corporation to keep records usually specifying "books and records of account," minutes of meetings of shareholders, directors, and committees, and the record of shareholders. Delaware sufficiently encourages record keeping by permitting legally effective reliance on certain books. New York adds a useful provision recognizing current methods of record-keeping: (N.Y.Bus.Corp.Law § 624(a)):

> 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.

11. Financial Statements: A large number of states follow the Model Act in requiring each corporation, on written request, to furnish a current balance sheet and statement of operations, 22/ although language widely varies and occasionally percentage requirements are applied to the shareholder requesting the statements.

22/. Alabama, Alaska, California, Colorado, Connecticut, Iowa, Louisiana, Michigan, Minnesota, Mississippi, Montana, Nebraska, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, South Dakota, Utah, Virginia, and Wyoming.

12. Directors' Inspection Rights: No statute deals with this topic and this Report does not suggest that Delaware need do so.

Section . Shareholder's Right of Inspection

(a) As used in this section, a shareholder shall mean:

(1) Any person who shall have been a holder of record of shares of any class for at least six months immediately preceding his demand for inspection;

(2) Any person holding of record, or thereunto authorized in writing by the holders of record, of at least five percent of the outstanding shares of any class;

(3) Any person or persons who shall have been a holder of a voting trust certificate for at least six months immediately preceding his demand for inspection, or who holds voting trust certificates representing shares aggregating at least five percent of the outstanding shares of that class; or

(4) An attorney or other agent of any of the foregoing persons.

(b) Any such shareholder, in person or by attorney or other agent, shall, upon at least five day's written demand stating the purpose thereof, have the right during usual business hours to examine, for any specified, reasonable and proper purpose, the corporation's books and records of account, minutes of meetings of the shareholders, and record of shareholders, and to make copies or extracts therefrom. A proper purpose includes a purpose reasonably related to such person's interest as a shareholder.

(c) An inspection authorized by subsection (b) may be denied to the shareholder upon his refusal to furnish to the corporation, its transfer agent or registrar an affidavit that the shareholder does not seek inspection for an improper purpose and that he has not within five years sold or offered for sale any list of shareholders of any domestic or foreign corporation or aided or abetted any person in procuring any record of shareholders for any such purpose.

(d) If the corporation, or an officer or agent thereof, refuses to permit an inspection permitted by subsection (b), the shareholder may apply to the Superior Court for a writ of mandamus to compel such inspection. In any such proceeding, the corporation shall have the burden of establishing that the purpose for which inspection is sought is not a proper purpose. The court may prescribe any limitations or conditions, or award other or further relief, which to the court may seem just and proper. The court may, upon such terms and conditions as the court may prescribe, order books, documents and records, pertinent extracts therefrom, or duly authenticated copies thereof, to be brought within this State and kept in such place in this State and for such time and purposes as the order may prescribe.

(f) Nothing in this section shall impair the power of a court to compel the production for examination of the books and records of the corporation, without regard to the period of time during which the shareholder has been a shareholder or to the number of shares held by him.

__/ Subsection (d)'s wording is necessarily very tentative as the Reporter has not thought it worth-while to research the technicalities of mandamus procedure in Delaware.

Subchapter 8. Amendments of Certificate

A. Amendments before Payments of Capital

Section 241's provision for amendments by incorporators or directors (if any) prior to any receipt of capital is satisfactory in substance.

If this Report's proposal for a uniform execution-acknowledgment-filing procedure is adopted (supra pp. 1-8), a cross-reference should be substituted for much of Section 241's language, so that the section could be simplified to read somewhat as follows:

> Before the payment of any part of its capital, the incorporators, or the directors if any have been selected and qualified, of any corporation, may amend the certificate of incorporation, by executing, acknowledging and filing the instrument as provided by Sections _____ and _____. Nothing herein contained shall permit the insertion of any matter not in conformity with the provisions of this chapter.

B. Amendments by Action of Directors and Shareholders

1. Scope of Amendment Power: Section 242(a), corresponding to New York Section 801, Model Act Section 53, and a host of other statutes, gives Delaware corporations sufficient latitude to amend their certificates, especially by subsection (a)(5)'s catchall clauses. The preceding subparagraphs are, of course, examples and do not affect the scope of the amendment power. However, all new statutes give a much fuller listing of the major types of certificate amendments, and if this is desired, the Reporter will provide draft materials to accomplish this.

The two postambles following (a)(5) are standard provisions needing no change.

2. Procedure for Amending Certificate:

(a) Notice: If the recommended provisions on notice of meetings and record date (*supra* 115-121) are adopted, a cross-reference to those provisions may be substituted for Section 242(d)(1)'s second sentence. The third sentence, setting forth the contents of the notice, should remain unchanged.

(b) Election Judges: This topic is considered in the Report, *supra* at 145-149.

(c) Majority Vote: Although the Model Act and many states require a two-thirds vote of all shares, there seems to be no necessity for changing the Delaware majority vote provision. If a general provision on the required vote is adopted, as recommended *supra* pp., 131-133, a cross-reference to that draft section would be sufficient in subsection (d)(1), sentence (6).

(d) Class Voting: The principle of class voting on amendments adversely affecting class interests is intended as a safeguard. Section 242(d)(1), sentence (9), seems to cover circumstances calling for class voting although its language is vaguer and more general than the pinpointed provisions found in the new statutes, in varying forms. See New York Section 804; Model Act Section 55; S.C. Code § 12-19.5 (the most specific statement).

One substantive addition on class voting is suggested because of the frequent use of series within classes of shares. The statute should make clear that when only one or more (but less than all) series are affected, only those series have class voting privileges. See New York Section 804(b). The following language partly based on New York could be added at the end of sentence (9) of Section 242(d)(1):

> If any such amendment would affect one or more but less than all series of any class, then each series so affected shall be considered a separate class for purposes of this subsection, except that whenever the proposed amendment amakes the same change in more than one, but less than all, of the series of any class, the shares of all series so affected shall be considered a single class for the sole purpose of voting upon the amendment.

Example: In series A, B and C of X Corporation's First Preferred, A and B each have cumulative, but series C has non-cumulative, dividend rights. It is proposed to make the dividends of A & B non-cumulative. Absent the recommended provision, all three series would vote, although series C has no interest in the matter, or at least none comparable to A and B's presumed interest in preserving cumulative-dividend status. It is proper that only A and B, but not C, vote on the proposal; and indeed in some circumstances it would be unfair to A and B if C could vote and perhaps decide the issue, especially if C is controlled by management which proposes the change.

(e) Execution-Acknowledgment-Filing Certificate of Amendment: These provisions need no substantive change. But if the uniform execution, acknowledgment and filing provisions, recommended supra pp. 1-8, are adopted, a cross-reference will be sufficient, and much verbiage in sentences (6) and (7) of subsection (d)(1) can be eliminated. (This is true whether or not local recordation is retained or eliminated.)

(3) Effective Date of Amendment: Whether or not local recordation is continued, the effectiveness of the amendment should depend upon the filing of the certificate with the Secretary of State, and not upon "filing and recording" as subsection (d)(1), sentence (8) provides. See Report supra at p. 7 (general rule) and pp. 21-22 (beginning of corporate existence).

At least one state (Florida) authorizes deferring the effective date of an amendment for up to 90 days after filing with the Secretary of State. Fla.L. 1963, c. 357. Compare the last sentence of Delaware Section 251(c) permitting postponed effectiveness for 30 days. If this added flexibility is desired, Section 242 (d)(1), sentence (8), should be reworded as follows:

> Any amendment shall be effective as of the date of filing the certificate of amendment with the Secretary of State, unless the certificate postpones its effective date for not more than thirty (30) days after filing.

C. Amending Non-Stock Corporation's Certificate

No changes are recommended in Section 242(d)(2).

D. Restated Certificate of Incorporation

Under Section 104 the Secretary of State prepares a "composite certificate of incorporation" which would include all amendments then in force and delete all superseded provisions. The distinctly preferable procedure authorizes the corporation to prepare its own "restated certificate of incorporation" and submit it for filing (and recordation, if that requirement is retained), without burdening the office of the Secretary of State with its preparation. This is now customarily adopted in all new revisions, and derives from Model Act Section 59. New York Section 807 is, in this Report's view, unnecessarily elaborate, and in lieu both of the New York and the Model Act section, the following language would best accomplish the purpose, expressed by Delaware's Section 104, of conveniently setting forth "only such provisions as are in effect at the time" of the certificate:

Section Restated Certificate of Incorporation.

(a) A corporation may execute, acknowledge, and file as provided by this Act a "Restated Certificate of Incorporation" which shall integrate into a single document the text of its original certificate of incorporation, merger, or consolidation, together with all amendments theretofore adopted and, if so authorized, further amendments.

(1) If the restated certificate restates the text of the original as theretofore amended and supplemented, without making any further amendment or change, the restated certificate may be adopted by the board of directors without a vote of the shareholders. The restated certificate shall recite that it purports merely to restate but not to change the provisions of the original certificate as theretofore amended and supplemented, and that there is no discrepancy between such provisions and the provisions of the restated certificate.

(2) A corporation may restate its certificate of incorporation by submitting to the shareholders for their approval the proposed restatement thereof, with or without any amendments for which the vote of shareholders is required.

by this Chapter or by the certificate of incorporation, in which case the procedure specified in and the vote or votes required by this Chapter for amendment of the certificate of incorporation shall be applicable.

(b) The restated certificate shall be specifically designated as such and shall set forth the manner in which the restatement was authorized. Upon filing the restated certificate with the Secretary of State, the original certificate of incorporation as amended and supplemented shall be susperseded, and the restated certificate, including any further amendments and changes made thereby, shall be the certificate of incorporation of the corporation./

(c) Any amendment or change effected in connection with the restatement of the certificate of incorporation shall be subject to any other provision of this chapter, not inconsistent with this section, which would apply if separate certificate of amendment were filed to effect such amendment or change.

(d) The restated certificate shall state (1) the name of the corporation, and, if it has been changed, the name under which it was originally incorporated, and (2) the date of filing its original certificate of incorporation with the Secretary of State. The restated certificate may omit statements as to the incorporator or incorporators and the original subscribers for shares, if any.

Reporter's Note

This provision permits the director alone to restate the certificate if no new provisions are inserted since their role is ministerial in setting forth the current, and culling out the obsolete

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_/ This implements the suggestion (No. 10) contained in the letter of Richard F. Corroon, Esquire to The Hon. Clarence A. Southerland, March 19, 1964, p.3.

provisions; a shareholder vote serve no useful purpose and, unlike the Model Act, is not required. A shareholder vote is needed if the directors also add new provisions, in which case the shareholders must approve the entire instrument (by a majority vote under Section 242) and the action taken is subject to any other substantive requirement, e.g., a class vote if the restated certificate changes any rights or preferences of preferred. The restated certificate becomes effective on filing (subsection (b)), whether or not recording is retained.

E. Confirming Reorganization Plan (Section 245)

No changes are recommended in Section 245. The variations between the Delaware provision and its counterparts under the Model Act (Section 59) and in other states are merely verbal.

F. Miscellaneous Provisions

Sections 243 (Redemption, etc. of Preferred or Special Stock) and 244 (Reduction of Capital) will be considered in conjunction with this Report's analysis of Subchapter 5 dealing with financial provisions.

Subchapter 9. Merger and Consolidation

A. Mergers in General; Mergers of Domestic Corporations

This Report recommends several major substantive changes which, it is believed, will make Delaware merger procedures the most attractive in the United States. Briefly, the changes suggested are:

1. Substantial elimination of present cash appraisal rights; which will be compensated for by
2. Retention of the two-thirds vote on mergers, except in the cast of corporations which are subject to the jurisdiction of the SEC (including the expanded jurisdiction resulting from the Securities Act Amendments 1964); and
3. Recognition of a class vote of like percentages where a class vote would be necessary if the proposal took the form of a separate amendment to the certificate of incorporation.

In addition, several proposed changes will insure greater flexibility in less significant matters.

I. General Requirements for Merger

1. Vote: It is recommended that the present two-thirds vote be retained for merger. See Section 251(c). The great majority of states similarly require a two-thirds vote;1/ in two states a three-fourths or four-fifths vote is mandatory;2/ in a group

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1/ Model Act; and all states except those in the following two footnotes.

2/ Hawaii and Texas, respectively.

of other states, a majority vote is sufficient.[3/] It is recommended, however, that the two-thirds vote requirement be automatically dropped to a majority vote requirement if the corporation is one whose solicitation of proxies is subject to the jurisdiction of the Securities and Exchange Commission. This is suggested by the Virginia statute, but it is somewhat more liberal. Virginia provides that, in such circumstances, each class may approve the merger by a majority vote, but still retains the total two-third vote requirement[4/] However, if the theory of the Virginia provision is that SEC supervised disclosure insures a more knowledgeable vote by the shareholders,[5/] then that theory should logically apply to all the shares voting, and the percentage requirement should be reduced across the board. This provision will apply not only to corporations listed on the exchanges but, under the 1964 Securities Act Amendments, to corporations of a statutorily defined size and number of shareholders, whose shares are traded over-the-counter.

3/ Arkansas, Florida, Georgia, Indiana, Kentucky, Maine, Minnesota, North Carolina, Ohio, Oklahoma, Pennsylvania, Tennessee, Utah. Several of these states hedge this with restrictions; in none are appraisal rights abolished.

4/ "But if the Securities and Exchange Commission exercises jurisdiction over the proxy statement for such meeting submitted to the holders of any class of shares which is entitled to vote as a class on the plan of merger or consolidation, the plan of merger or consolidation shall be approved upon receiving the affirmative vote of the holders of a majority of the outstanding shares of each class thereon and of more than two-thirds of the total outstanding shares." Va. Code § 13.1-71.

5/ Realistically, this way of stating the theory does not hold water, in view of the usual lack of interest of shareholders; disclosure chiefly benefits the professionals, not the traditional "widows and orphans." More accurately, the role of disclosure is to shift the risk of uninformed voting and investment decisions to shareholders who have available, but ignore or cannot interpret, the disclosed facts.

Since mandatory disclosure, of itself, has a perceptible shaping effect on corporate plans—generally in the direction of shareholder protection--there is no net loss of shareholder safeguards in dropping the overall vote requirement. The two-thirds vote would continue to apply to (1) closely held corporations which are likely to want a high-vote requirement in any event, and (2) to medium-sized corporations whose shares are not closely held but are still not widely enough disseminated to come under the new federal requirements.6/

2. Shareholders Entitled to Vote: In Delaware, Section 251(c) indicates that all shareholders may vote on a merger, whether or not they are ordinarily non-voting under terms of the certificate of incorporation. Many jurisdictions are in accord,7/ but are usually more specific on this point.8/ However, very recently, there are

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6/ Shareholders of this latter class of small public corporations often most need protection, either by reasonably strict state statutes or some form of disclosure requirements. The few shareholders of the genuine close corporation can usually protect themselves by bargained-for contract provisions; the shareholders of the large public enterprises have the protection of SEC disclosure requirements and the constant surveillance of market professionals. The medium-size or small public enterprise typically lacks these potential safeguards, especially if the market for their securities is so thin as to attract little or no attention.

7/ Alabama, Alaska, California, Colorado, Connecticut, Hawaii, Illinois, Iowa, Mississippi, Nebraska, Nevada, North Carolina, North Dakota, Oregon, South Carolina, Texas, Utah, Virginia, Wisconsin, Wyoming; also Kansas, Michigan, New Jersey, New Mexico, Rhode Island, and West Virginia similarly provide, though in less specific language.

8/ It is often provided that "each outstanding share of each such corporation shall be entitled to vote on the proposed plan of merger or consolidation, whether or not such share has voting rights under the provisions of the articles (certificate) of incorporation of such corporation." Model Act Section 67, par. 2 (pre-1962 version.)

signs that this is breaking down. New York's Section 903(a) requires notice to all shareholders, but requires a two-thirds vote only of the voting shares, unless a class-vote is also required because of some special impact on a particular class of stock. The Model Act has similarly provided since 1962, 9/ although its previous versions (followed by many states) required a vote by all shareholders. The newer approach is not wholly indefensible: denying the preferred stock a statutory (versus a possible contract) voting right merely means that preferred stock is shifted towards the bondholder end of the spectrum of investment interests, and, in all events, the loss of a statutory voting right will likely be compensated for by contractual provisions of one sort or another.

Nonetheless, this Report recommends that Delaware not follow this new development. Especially if appraisal rights are to be abolished it would excessively weaken the position of preferred shares, both in appearance and in reality, if they should lose both a general right to vote on major changes and the appraisal right now incident to a merger. Moreover, if, as suggested, the voting percentage drop to a mere majority in the case of many corporations, "flexibility" and "convenience" do not call for also eliminating voting rights by ordinarily non-voting share interests. Accordingly, it is recommended that if the Committee agrees with the two major recommendations--abolishing appraisal rights and permitting majority

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9/ Other states apparently not requiring the vote of otherwise non-voting shares are: Arkansas, Florida, Georgia, Indiana, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Missouri, New Hampshire, Ohio, Pennsylvania, Tennessee, and Vermont; see also Georgia and Indiana.

action for certain classes of corporations--preferred and "special" class of shares should continue to vote on mergers.

3. Class Voting: A number of jurisdictions,[10/] unlike Delaware, require a vote by classes of stock, not generally, but when some provision of the plan of merger effects a change in the rights or preferences of a particular class which change, if made by an amendment to the certificate rather than through a merger, would call for a class vote. This is just and fair. Without endorsing the "vested rights" doctrine or related concepts, it is appropriate that class interest be as much protected when the identical change is made by one route (merger) as by another (certificate amendment). Moreover, if, as this Report recommends, Delaware abolish appraisal rights, a class vote requirement is an important counterbalance to the protection which is thereby lost. At present, when preferred rights and preferences are changed in a merger, the dissenting shareholder can obtain appraisal rights as an incident to the merger. This general concept applies to the specific case of compounding preferred stock dividend arrearages, since Havender[11/] and Hottenstein[12/] upheld this procedure. Unless it can be squarely asserted that Keller[13/] is definitely overruled by the later cases (however much

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10/ Alabama, Alaska, Arizona, California, Colorado, Connecticut, Hawaii, Illinois, Iowa, Louisiana, Maryland, Massachusetts, Michigan, Mississippi, Nebraska, Nevada, New Hampshire, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Texas, Utah, Vermont, Virginia, Wisconsin, Wyoming, and District of Columbia.

11/ Federal United Corp. v. Havender, 24 Del.Ch. 318, 11 A.2d 331(S.Ct. 1940).

12/ Hottenstein v. York Ice Mach. Corp., 136 F.2d 944 (3d Cir. 1943).

13/ Keller v. Wilson & Co., 21 Del.Ch. 391, 190 Atl. 115 (S.Ct.1936) its vitality is impaired), it is arguable that eliminating arrearages through merger, but without appraisal rights, is as objectionable as dealing with them by direct amendment. Despite the differences between the two procedures, it is hard to believe that the availability of appraisal rights in Havender and Hottenstein did not make a difference in the outcome.[14] Moreover the approval of a class is not overly difficult to obtain. Even if it is set at two-thirds, it would be appropriate to reduce any such requirement to a majority vote when the SEC has jurisdiction of the proxy statement.

4. Super -Statutory Vote Requirements: If a greater-then-majority or greater-than-two-thirds vote is desired, as it often is for close corporations, it is assumed that Section 102(b)(4) is sufficient authority, althogh some statutes now specifically so provide in the merger section.[15] In addition, several well-considered statutory revisions have specifically protected the higher vote by a statutory provision that such higher note can be amended out or otherwise removed only by that vote itself, viz., a three-fourths vote requirement for a merger or charter amendment may be changed

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14/ Obviously, this is not a logically demonstrable proposition. However, the Havender case heavily stresses the differences between recapitalization by charter amendment and through a merger (24 Del. Ch. at 333-334) including its incidental appraisal rights (24 Del. Ch. at 344) which are, of course, not available in a straight recapitalization. See also Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 132 (Ch. 1943).

15/ Typically, the statute requires the vote of "at least two-thirds of the outstanding shares" of the corporation.

only by a three-fourths vote, rather than by an ordinary majority vote.[16/]

The recommendations so far offered could be implemented by the following language:

> At the meeting, a vote of the shareholders shall be taken on the proposed plan of merger or consolidation. Each outstanding share of each corporation shall be entitled to vote on the proposed plan of merger or consolidation, whether or not such share is entitled to vote under the terms of the certificate of incorporation. The plan of merger or consolidation shall be approved upon receiving the affirmative vote of the holders of at least two-thirds of the outstanding shares of each corporation, unless any class of shares of any corporation is entitled to vote as a class thereon, in which event, as to such corporation, the plan of merger shall be approved upon receiving the affirmative vote of the holders of at least two-thirds of (1) each class of shares entitled to vote as a class thereon, and of (2) the outstanding shares of the corporation. If the Securities and Exchange Commission exercises jurisdiction over the proxy statement submitted by any corporation participating in the merger or consolidation with respect to such meeting, the plan of merger or consolidation

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16/ See Conn.Gen.Stats. § 33-329(c) generally providing that a super-statutory vote requirement in the certificate may not be amended out by a lesser vote. See also S.C.Code § 12-20.3(d)(4) (same rule for mergers).

shall be approved upon receiving the affirmative vote of the holders of a majority of the outstanding shares of such corporation; and if any class of shares is entitled to vote as a class thereon, the plan of merger shall be approved upon receiving the affirmative vote of the holders of at least a majority of (1) each class of shares entitled to vote as a class thereof, and of (2) the outstanding shares of such corporation. Any class of shares of any corporation shall be entitled to vote as a class if the plan of merger or consolidation contains any provision which, if contained in a proposed amendment to the certificate of incorporation, would entitle such class of shares to vote as a class under the provision of subsection (d) (1) of Section 242 (Amendment of Certificate of Incorporation after Payment of Capital, etc.).

5. Deferred Effectiveness of Merger: Section 251(c) permits the effective date of the merger to be postponed to the date of recording or thirty days thereafter. Presumably, recordation may be indefinitely postponed. The more usual provision sets a definite time period, ranging up to ninety days from the date of filing with the Secretary of State. However, formulated, there appears to be sufficient flexibility.

6. Abandonment of Merger: Apparently Delaware does not expressly provide for abandoning a merger. Many new statutes specifically permit the plan of merger to provide for its abandonment even after stockholder approval,[17/] and this provision is recommended. A few states go further

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17/ Model Act; Alabama, Alaska, Colorado, Illinois, Iowa, Maryland, New York, North Carolina, North Dakota, Ohio, Oregon, South Carolina, Texas, Wisconsin. Also Mississippi, Nebraska, Utah and Wyoming.

and authorize abandonment whether or not the plan of merger provides for it,[18] but this seems unnecessary and possibly undesirable. The following language is suggested:

> Any plan of merger or consolidation may contain a provision that at any time prior to filing the plan of merger or consolidation with the office of the Secretary of State, the plan may be abandoned by the board of directors of any participating corporation notwithstanding approval of the plan of merger or consolidation by the shareholders of the participating corporations.

7. Execution-Acknowledgment-Filing-Recordation: If the recommended general provision on executing, acknowledging and filing documents is adopted, much of the matter in Section 251(c) can be eliminated with a cross-reference to those sections, whether or not local recordation is continued. The same, incidentally, is true also of Sections 252(c), 253(a), 254(d), 255(c) and 256(c).

8. Some statutes now specifically provide that the certificate of consolidation (or its equivalent, however deonominated) automatically becomes the certificate of incorporation of the new corporation, and the certificate of merger automatically amends the certificate of incorporation of the surviving corporation. See New York Section 906.[19] If this result

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18/ California and Connecticut.

19/ See also Model Act Section 69(f). States with a similar provision (with occasional variations) include: Alaska, Colorado, Connecticut, Illinois, Indiana, Iowa, Mississippi, Missouri, Nebraska, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Texas, Utah, Virginia, Wisconsin, Wyoming, and District of Columbia.

is now informally accomplished in Delaware, it would be desirable to enact a provision declaratory of existing practice; if not, the statutory provision is even more attractive. The following language is suggested, based on New York § 906(b)(4):

> In the case of a merger, the certificate of incorporation shall be automatically amended to the extent, if any, that changes in the certificate of incorporation are set forth in the plan of merger; and, in the case of a consolidation, the statements which are set forth in the plan of consolidation and which are required or permitted to appear in a certificate of incorporation organized under this chapter shall be the certificate of incorporation of the new corporation.

B. Mergers Involving Foreign Corporations

To the extent that Section 251's requirements also govern mergers under Section 252, the recommendations previously made should apply. With special reference to Section 252, minor additional recommendations are submitted.

1. Section 252(a) seems needlessly restrictive by limiting a Delaware corporation's participation in an out-of-state merger to a corporation "organised under the laws of any other state or states of the United States," thereby impliedly precluding a merger with a Canadian or English or other foreign enterprise. Cf. a 1962 ruling by the Florida attorney general that, under a like statutory provision in Florida, a Florida and a Puerto Rican corporation could not merge. Op. Atty. Gen. No. 062-85 (Florida 6-18-1962). Indeed, the existing language would probably shadow a merger between a Delaware and a non-American

corporation even if the surviving corporation were a Delaware enterprise. Most of the new corporate law revisions have no such restriction. See, e.g., N.Y. § 907(a), and N.Y. § 102(a) (defining "foreign corporation" as one "formed under laws other than the statutes of" New York); Model Act Section 70; and many other states following the Model Act. The following language change is recommended in Section 252(a) (omitting parts not presently pertinent):

> (a) Any one or more corporations. . . may consolidate or merge with one or more other corporations organized under the laws of any jurisdiction other than this State . . . .

It would also be desirable to reinforce this with definition of "foreign corporation" in terms not limited to American states.

2. At least one state, Va.Code § 13.1-71(par.3), usefully provides for merger with an out-of-state corporation of a corporation required by law to be a domestic enterprise, e.g., a public utility. Permission is granted, but the domestic corporation continues to be a Virginia enterprise even if it also becomes a non-Virginia corporation, viz., dual incorporation results.[20] Of course, the occasions for this are apt to be very infrequent.

3. If a uniform execution-acknowledgment-filing-recordation procedure is adopted, Section 252(c) should be revised accordingly. Also if appraisal rights are abolished, Section 252(d) would be amended to delete references to the surviving or new corporation's undertaking to pay cash to dissenters.

20/ "No corporation that is required by law to be a domestic corporation may, by merger or consolidation, cease to be a domestic corporation, but every such corporation, even though a corporation of some other state, the United States or another country, shall also be a domestic corporation of this State."

C. Parent-Subsidiary Mergers

No substantive changes are recommended in Section 253. It is to be noted that, like Section 252, out-of-state mergers are limited to corporations organized in United States jurisdictions. Although most states require 95% ownership of a subsidiary, the 90% Delaware figure is appropriate since it makes possible short-form mergers with corporations from a few other states which also require only 90% control. 21/

It is suggested that, since rights and preferences may be changed or altered in conjunction with a short-form merger, Section 253(a) recognize a class vote under circumstances where this would be required in a Section 251 merger, and for reasons indicated in the discussion *supra* p. 186-187.

If appraisal rights are eliminated, as recommended, Section 253(e) should be accordingly changed.

D. Other Mergers (Joint Stock Companies, Non-Stock Companies, etc.)

This Report does not recommend general changes with respect to mergers authorized by Section 254 (domestic corporation and joint-stock associations), Section 255 (domestic non-stock non-profit corporations, Section 256 (domestic and foreign non-stock non-profit corporations), Section 257 (domestic stock and non-stock corporations), and Section 258 (domestic and foreign stock and non-stock corporations). To the extent that Section 251 and 252 are amended, in accord with this Report's suggestions, and also to the extent that appraisal rights are abolished,

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21/ It is to be noted that Delaware is unique among American states in authorizing a parent to merge into a subsidiary which becomes the surviving corporation; all other states having such statutes permit only a merger of a subsidiary into a surviving parent.

parts of Sections 254-258 will be affected because of their cross-references.

This Report concurs with the suggestion presented to the Bar Association Committee 23/ that the following language be added to Section 257 to deal with the problem discussed in Stevens Bros. Foundation, Inc. v. Commissioner, 324 F.2d 633, 642-646 (8th Cir. 1963), reversing the Tax Court on the construction of Section 257, see 23 T.C. 953. Although the issue was resolved favorably to the foundation, the statute should specifically neutralize any argument that its language might permit a non-profit corporation to forfeit its charitable tax status.

> Nothing in this section shall be deemed to authorize the merger of a charitable non-stock corporation into a stock corporation, whereby the charitable status of such non-stock corporation would be lost or impaired; but a stock corporation may be merged into a charitable non-stock corporation which shall continue as the surviving corporation.

E. Effect of Merger or Consolidation

In general, Section 259 and 261 accord in substance and language with provisions of all other states; a few clarifying changes are suggested:

1. It has previously been recommended that effectiveness of all transactions requiring filing and recordation should be measured from the date of filing with the Secretary of State; and this general

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22/ Letter of Richard F. Corroon, Esquire to Hon. Clarence A. Southerland, March 19, 1964, p.2.

suggestion applies to Section 259(a).

2. It would be convenient if all requirements relating to the fiduciary obligations of merging banks and trust companies be recited in subsection (b) of Section 251. Specifically, this would transfer to subsection (b) the long clause, in the middle of subsection (a), which commences "including in the case of banks and trust companies." With minimal changes in the present language, subsection (b) would read as follows:

> (b) In the case of banks or trust companies, without any order or action on the part of any court or otherwise, all appointments, designations, and nominations, and all other rights and interests as trustee, executor, administrator, registrar[23/] of stocks and bonds, guardian of estates, assignee, receiver, trustee of estates of lunatics and in every other fiduciary capacity, shall be automatically vested in the corporation resulting from or surviving such consolidation or merger: provided, however, that any party in interest shall have the right to apply to an appropriate court or tribunal for a determination as to whether the resulting corporation shall continue to serve in the same fiduciary capacity as the merged corporation, or whether a new and different fiduciary should be appointed.

3. In its counterpart to Section 261, New York § 906(b)(3) specifically provides that any action or proceeding, "whether civil or criminal," then pending by or against any corporation, "or any shareholder, officer or director thereof" is released; but may be "enforced, prosecuted, settled or compromised" as if no merger had occurred. The more specific language seems desirable.

23/ Reference should also be made to a bank or trust company serving as a transfer agent.

APPENDIX

Two proposals originating with Dewey, Ballantine, Bushby, Palmer & Wood of New York City, have been submitted to the Committee by Mr. Canby, both dealing with aspects of corporate fusions.

1. One proposal would permit merger by a domestic corporation without vote of its shareholders if (1) it is the surviving corporation and (2) not more than 15% of any class of its shares are issued to effect the merger. It is actually quite limited in scope, since it does not apply to consolidations, nor to any corporation not surviving the merger. Roughly speaking, it is an exemption for a surviving corporation which stands in the posture of a purchaser of another business. As such, it is an alternative procedure to a corporation's unquestioned power to issue its shares to purchase assets of another concern, a method not requiring a vote of the purchasing corporation's shareholders.

This procedure could be abused by successive mergers with various corporations, no one of which involved an issue of more than 15% of the previously outstanding shares. E.g., if X Corp. acquires A (with 10% of the outstanding X stock), B (with 5%), C (with 15%), and D (with 10%) all within a single year, X Corp., which started the year with 10,000 shares outstanding, would have 14,730 shares outstanding at the end of the year, without a shareholder vote on any of the four mergers. This is offset by the fact that X Corp. must have available a large number of authorized but unissued (or treasury) shares; and it is likely that, at some point, its shareholders would have to approve an increase of shares. Moreover, no statutory provision blocks X Corp. from issuing all of these shares (and more besides) in exchange for assets of A, B, C, and D Corps. Hence, the abuse is more theoretical than actual. But if this is deemed a threat, it would be possible (though not easy) to stipulate an overall ceiling on the number of shares issuable in any given time period in connection with mergers without securing shareholder consent.

Another problem is the shareholders' appraisal right on any merger. Even if appraisal rights are abolished, as this Report proposes, the Committee would wish to consider whether they should be retained for this type of merger, as they apparently would be on a Section 253 short-form merger. The analogy is not, however, with short-form mergers, but with issue of shares by a purchasing a corporation in a sale-of-assets transaction. Unlike a short-form merger, no minority shareholder participation in an enterprise is eliminated; rather, the proposed procedure is a device for corporate expansion.

Hence this Report sees no fundamental objection to the proposed procedure; and if it would reasonably serve business interests, it should be adopted. Two suggestions are offered: (1) It might be more conservative to set the percentage figure at 10% rather than 15%. (2) It should be clear that the charter may require shareholder approval for any mergers, however small the number of shares issued.

The following language could be added as Section 251(d):

> Notwithstanding the requirements of subsection (c), unless required by its certificate of incorporation, no vote of shareholders of a constituent corporation surviving a merger shall be necessary to authorize a merger if (1) the plan of merger does not change the name or the authorized shares of any class or otherwise amend the certificate of incorporation of the surviving

corporation, and (2) the authorized unissued shares or the treasury shares of any class of the surviving corporation to be issued or delivered under the plan of merger do not exceed the percent of the shares of the surviving corporation of the same class outstanding immediately prior to the effective date of the merger.

2. The second proposal--a procedure for compulsory buyout of shares in connection with a "take-over" bid--should be rejected. As presented in the Dewey Ballantine memorandum, it is a pale and inadequate replica of Section 209 of the English Companies Act of 1948, and lacks indispensable safeguard which England affords the minority shareholders. Indeed, the English statute itself is not wholly satisfactory and will likely be soon amended. See Report, Company Law Committee, Cmnd.1749 at pp. 105-110 (HMSO 1962). This Report endorses the basic theory of the English procedure and believes it would be highly desirable for eventual Delaware adoption, but it is suggested that a venture into an area so novel to American law should come only after a very thorough study of its numerous inplications.

(The next page is page 196)

APPEND[illegible]

The letter of McCutchen, Doyle, Brown, Trautman & Enerse San Francisco (dated September 14, 1964) points up a possible ness in Section 251 (b). That firm reads Section 251 (b) as pr[illegible] ing that "the shareholders of merged corporations must receive sh or securities of the surviving corporation." It is not clear that the statute dictates so narrow a result, when it states that the "agreement" of merger must state "the manner of converting the shares if each of the constituent corporations into shares or other securities of the" new or surviving corporation. It could be argued that this language does not state the sole forms of permissible considerations on merger, but only the necessary treatment when shares are exchanged for other shares or securities.

If, however, the matter is doubtful, this Report agrees that Section 251 (b) should follow the newer statutes in explicitly referring to other types of consideration, viz., cash or property. See N.Y. Corp. Law S 902(a) (3). The effect of this revision would be to extend to all mergers the permission granted by Section 253 (a) to use cash or consideration other than shares or securities in a short-form merger. The language recommended below also would permit the type of transaction referred to in the McCutchen letter, in which shares other than those of the surviving corporation are distributed to shareholders of the disappearing entity. See Calif. Corp. Code S 4103, quoted in part in the McCutchen letter at p. 2. The following rewording of the relevant part of Section 251 (b) is suggested (new matter underscored):

(b) The directors, or a majority of them, of such corporations as desire to consolidate or merger, may enter into an agreement . . . stating . . . the manner of converting the shares of each of the constituent corporations into shares or other securities of the corporation resulting from or surviving such consolidation or merger, or the cash, shares, securities, or other property or consideration to be paid or delivered in exchange for the shares of each of the constituent corporations, or any combination thereof. The agreement may include such other details and provisions as are deemed necessary. Any such agreement may provide for the payment of cash in lieu of the issuance of fractional shares of the resulting or surviving corporation.

The tax question raised in the McCutchen firm letter is not strictly relevant, since the purpose of the Delaware statute should be to allow corporations to take action they deem appropriate, even if their decision brings adverse tax consequences upon them. However, under the Internal Revenue Code, the presence of cash or property does not destroy the character of the transaction as a "reorganisation" under Section 368 (a) (1) (A), although cash and property constitutes "boot" which will be taxed to that extent. But so long as the transaction qualifies as a merger or consolidation under the state corporation law, it will qualify as a so-called "A reorganization" under the Code, and literally any type of consideration allowed by the merger statute will be permissible under tax law (subject to tax on the "boot").[/]

/ The courts may apply the "continuity of interest" doctrine, see Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933), so that a statutory merger, valid under state law, by which shareholders of constituent corporations wind up with little or no proprietary interes in the new or surviving corporation may well be denied status as a "reorganization" under the Code. See Roebling v. Commissioner, 143 F.2d 810 (3d Cir. 1944); Southwest Nat. Gas. Co. v. Commissioner, 189 F.2d 332 (5th Cir. 1951)

Shareholder Appraisal Remedy

A. Abolition of Appraisal Remedy

This Report recommends that the traditional shareholder appraisal right should be substantially abolished in Delaware.[1] The reasons for this position have been fully set forth in a recent law review article by the Reporter,[2] and will not be repeated here. Muddled theory and inconsistent treatment has always been characteristic of the appraisal right in all jurisdictions: a few transactions have been singled out to trigger cash payment rights, although other events in corporate life, often more drastic in their impact, create no such right. Delaware, for example, gives appraisal rights on merger, but not on a sale-of-assets (or exchange of shares) coupled with dissolution of the selling corporation, although the practical effects are identical. Indeed, Hariton v. Arco Electronics, Inc., 188 A.2d 123 (S.Ct. 1963), and Orzeck v. Englehart, 195 A.2d 375 (S.Ct. 1963), in substance permit the elimination of appraisal rights. This Report recommends that the statutory revision confirm the result thus reached by judicial decision.

1. The Alternatives: The possibilities for dealing with appraisal rights are at least three-fold:

1.) Eliminate appraisal rights, unless the certificate of

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1 / West Virginia is the only state which has no appraisal rights, apparently the relic of an abortive effort long ago to attract corporations.

2 / Folk, De Facto Mergers in Delaware: Hariton v. Arco Electronics, Inc., 49 Va.L.Rev. 1261-1296, esp. at pp. 1278-1281, 1294-1295 (1963).

incorporation preserves them.[3] This is analogous to the "permissive" cumulative voting right under Section 214. It has the merit of absolute simplicity.

2.) Eliminate appraisal rights with respect to any corporation when the S.E.C. exercises jurisdication over its proxy statement for the meeting at which the merger is to be approved. This would leave appraisal rights permissive for all corporations (a) whose shares are listed on exchanges or (b) which are of a specified size, have a specified number of shareholders, and whose shares are traded in the over-the-counter markets. Appraisal rights would continue mandatory for corporations which are either (a) closely held, or (b) are publicly held, but do not qualify in terms of size, number of shareholders, or trading over-the-counter. This is analogous to the recommended provision for dropping the merger vote to a majority when the S.E.C. takes jurisdiction over proxy statements, including the new class of corporations now covered by the Securities Acts Amendments of 1964.

3.) Eliminate appraisal rights except for "close corporations", *i.e.*, one whose shares are not listed on an exchange or traded in one or more of the markets maintained by brokers or dealers.[4] Appraisal rights would thus be "permissive" for all but the corporation whose shares truly have no makket. For its dissenting shareholders there is no market "out", but appraisal offers a proximate substitute.

3/ Presumably, no one would go so far as to propose that appraisal rights should be prohibited, as well as made permissive.

4/ With minor variations, this is the distinguishing mark used in New York, Florida, North Carolina, South Carolina, and Connecticut close corporation provisions.

2. The Recommended Approach: This Report recommends, first, that the appraisal right continue mandatory at least for the close corporation. Since by definition, it has no market for its shares, its shareholders must hold their shares or otherwise dispose of them in whatever way is possible, often at a sacrifice. Moreover, such a shareholder is rarely merely an investor (as he is typically, although not invariably, in a public corporation) but expects and often bargains for management-type prerogatives. Even when close corporation intereste can be disposed of, a minority interest, and expecially a dissenting minority interest, is rarely attractive. For the close corporation, this type of protection is not only needed but also accords with the desires and expectations of most of the participating interests. Hence, there are peculiarly practical reasons for continuing cash appraisal rights for the close enterprise, and, indeed, even extending them to a sale-of-assets to prevent evasion.

Assuming that an appraisal right should be guaranteed for close corporations, the questions remains whether cash appraisal rights should be mandatory for other corporations. Stated generally, this Report recommends, as a minimum, dropping cash-for-dissenters with respect to shares listed on any exchange or subject to the expanded jurisdiction of the S.E.C. under the Securities Acts Amendements of 1964. By hypothesis, there is an active market for these shares; federally required disclosure affords substantial protection; and residual equity jurisdiction to deal with "fraud" remains unimpaired. The line of demarcation between corporations subject to or exempt from appraisal rights may conveniently be drawn in terms of whether the S.E.C. "exercises jurisdiction" over the solicitation of proxies for the particular meeting at which a merger is to be considered. This formulation takes account of (1) the two stages in which the new federal requirements come into force,[5] (2) the S.E.C.'s power to exempt classes of corporations from the proxy rule requirements,[6] and (3) possible future extensions of the statute. Whether or not the S.E.C. "exercises jurisdiction" over the proxy solicitation of a given corporation can readily be determined since the event will obviously occur before the meeting and, therefore, in time to know whether appraisal rights will come into play. Hence, a definition of exempted corporations can readily be made in these terms (as it is in Virginia for a limited reduction of class voting requirements on mergers, see p.186-7 , _supra_.)

Under this formula, appraisal rights continue mandatory for "small" public corporations. Shareholders in corporations with fewer than 500 shareholders, or with unusually thin trading markets, may need appraisal as much as close corporation interests. Since the disclosure requirements do not apply to them, they lack the safeguards available to shareholders in the larger enterprises. Because of the

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5 / Under new Section 12(g)(1) of the Securities Exchange Act of 1934, corporations with more than $1,000,000 assets and more than 750 shareholders of record become subject to the new law first of all; a year later the statute applies to corporations with more than $1,000,000 assets with 500-750 shareholders of record. The time of actual application of the law is fixed by a formula stated in Section 12(g)(1). See statutory text _infra_ pp. 203-207.

6 / See new Section 12(h) of the Securities Exchange Act of 1934. Exemptions may be made "if the Commission finds, by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is no inconsistent with the public interest or the protection of investors.

enhanced opportunities for abuse, insiders of such corporations should have some incentives to deal fairly with minority interest. Such protective measures should not be dispensed with too readily, since, as a practical matter, a legislative decision to abolish appraisal rights is irreversible.

B. Mechanics of the Appraisal Remedy

The appraisal remedy statutes vary substantially throughout the various states; many of them are much more complex than Delaware's Section 262.[6/] This Report suggests several useful additional provisions to facilitate the remedy to the extent that it is retained, but does not recommend any effort at restructuring the mechanics of the remedy.

1. Reynolds Metals Co. v. Colonial Realty Corp., 190 A.2d 752 (S.Ct. 1963), affirming, 185 A.2d 754 (Ch. 1962) permitted a nominee to dissent as to less than all of the shares held of record for beneficial owners. See also Bache & Co. v. General Inv. Corp., 74 N.J. Super. 92, 180 A.2d 535, certif. denied, 38 N.J. 181, 183 A.2d 87 (1962). It is suggested that Delaware may wish, like New York and a few other states, to codify this rule in Section 262, at the same time making clear that a beneficial owner may not hedge by seeking cash for some but not all shares which he owns. The following New York language is recommended:

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6 / New York Section 623 occupies five full pages of closely printed type in the latest Corporation Trust Company edition of the new statute.

A stockholder may not dissent as to less than all shares, 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 held of record by such nominee or fiduciary.

2. Section 262(g) requires the dissenting shareholder to submit his shares to the Register in Chancery to be stamped with a notation of the pendency of an appraisal proceeding. The New York and Model Act place that responsibility on the corporation or its transfer agent, and require the shares to be so stamped at an earlier time, viz., when the shareholder demands cash payment. It also better protects purchasers without notice. The following language is suggested in lieu of present subsection (g):

At the time the stockholder demands payment for his shares of stock or within one month thereafter, he shall submit the certificate representing his shares to the corporation or to its transfer agent which shall forthwith conspicuously note thereon that a demand for payment has been made and shall return the certificate to the stockholder or other person who submitted it on his behalf. Any stockholder who fails to submit his certificate as required herein shall lose his right under this section, unless the Court of Chancery shall, for good cause, 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 after making his demand for payment under this section.

3. In many states the court may assess part of the expenses of an appraisal proceeding to one or more shareholders on finding that refusal of the corporation's payment offer was arbitrary, vexatious, or otherwise in bad faith. The following language, taken in part from New York and the Model Act, would better delimit the Court of Chancery's existing discretion to make assessments which "appear to be equitable," and would also prod shareholders with a gambling instinct to accept a reasonable offer without litigation.

> The court may assess all or part of such expenses against any or all of the dissenting stockholders who are parties to the proceeding if the court finds that their refusal to accept the corporation's offer of payment was arbitrary, vexatious, or otherwise not in good faith. In exercising such discretion, the court may consider that (A) the fair value of the shares as determined materially exceeded the amount wich the corporation offered to pay, (B) that no offer was made by the corporation, and (C) that the corporation failed to institute a proceeding to determine the value of the dissenting shares.

APPENDIX

Secutiries Act Amendments of 1964

The following new subsections have been added to Section 12 of the Securities Exchange Act of 1934:

(1) Every issuer which is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securites are traded by use of the mails or any means or instrumentality of interstate commerce shall--

(A) within one hundred and twenty days after the last day of its first fiscal year ended after the effective date of this subsection on which the issuer has total assets exceeding $1,000,000 and a class of equity security (other than an exempted security) held of record by seven hundred and fifty or more persons; and

(B) within one hundred and twenty days after the last day of its first fiscal year ended after two years from the effective date of this subsection on which the issuer has total assets exceeding $1,000,000 and a class of equity security (other than an exempted security) held of record by five hundred or more but less than seven hundred and fifty persons.

register such security by filing with the Commission a registration statement (and such copies thereof as the Commission may require) with respect to such security containing such information and documents as the Commission may specify comparable to that which is required in an application to register a security pursuant to subsection (b) of this section. Each such registration statement shall become effective sixty days after filing with the Commission or within such shorter period as the Commission may direct. Until such registration statement becomes effective it shall not be deemed filed for the purposes of section 18 of this title. Any issuer may register any class of equity security not required to be registered by filing a registration statement pursuant to the provisions of this paragraph. The Commission is authorized to extend the date upon which any issuer or class of issuers is required to register a security pursuant to the provisions of this paragraph.

(2) The provisions of this subsection shall not apply in respect of--

(A) any security listed and registered on a national securities exchange.

(B) any security issued by an investment company registered pursuant to section 8 of the Investment Company Act of 1940.

(C) any security, other than permanent stock, guaranty stock, permanent reserve stock, or any similar certificate, evidencing nonwithdrawable capital, issued by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution.

(D) any security of an issuer organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which insures to the benefit of any private shareholder or individual.

(E) any security of an issuer which is a "cooperative association" as defined in the Agricultural Marketing Act, approved June 15, 1929, as amended, or a federation of such cooperative associations, if such federation possesses no greater powers or purposes than cooperative associations so defined.

(F) any security issued by a mutual or cooperative organization which supplies a commodity or service primarily for the benefit of its members and operates not for pecuniary profit, but only if the security is part of a class issuable only to persons who purchase commodities or services from the issuer, the security is transferable only to a successor in interest or occupancy of premises serviced or to be served by the issuer, and no dividends are payable to the holder of the security.

(G) any security issued by an insurance company if all of the following conditions are met:

(i) Such insurance company is required to and does file an annual statement with the Commissioner of Insurance (or other officer or agency performing a similar function) of its domiciliary State, and such annual statement conforms to that prescribed by the National Association of Insurance Commissioners or in the determination of such State commissioner, officer or agency substantially conforms to that so prescribed.

(ii) Such insurance company is subject to regulation by its domiciliary State of proxies, consents, or authorizations in respect of securities issued by such company and such regulation conforms to that prescribed by the National Association of Insurance Commissioners.

(iii) After July 1, 1966, the purchase and sales of securities issued by such insurance company by beneficial owners, directors, or officers of such company are subject to regulation (including reporting) by its domiciliary State substantially in the manner provided in section 16 of this title,

(3) The Commission may be rules or regulations or, on its own motion, after notice and opportunity for hearing, by order, exempt from this subsection any security of a foreign issuer, including any certificate of deposit for such a security, if the Commission finds that such exemption is in the public interest and is consistent with the protection of investors.

(4) Registration of any class of security pursuant to this subsection shall be terminated ninety days, or such shorter period as the Commission that the number of holders of record of such class of security is reduced to less than three hundred persons. The Commission shall after notice and opportunity for hearing deny termination of registration if it finds that the certification is untrue. Termination of registration shall be deferred pending final determination on the question of denial.

(5) For the purposes of this subsection the term "class" shall include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges. The Commission may for the purpose of this subsection define by rules and regulations the terms "total assets" and "held of record" as it deems necessary or appropriate in the public interest or for the protection of investors in order to prevent circumvention of the provisions of this subsection.

(h) The Commission may by rules and regulations, or upon application of an interested person, by order, after notice and opportunity for hearing, exempt in whole or in part any issuer or class of issuers from the provisions of subsection (g) of this section or from section 13, 14, or 15(d) or may exempt from section 16 any officer, director, or beneifical owner of securities of any issuer, any security of which is required to be registered pursuant to subsection (g) hereof, upon such terms and conditions and for such period as it deems necessary or appropriate, if the Commission finds, by reason of the number of public investors, amount of trading interest in the securites, the nature and extent of the activites of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interests or the protection of investors. The Commission may, for the purposes of any of the above-mentioned sections or subsections of this title, classify issuers and prescribe requirements appropriate for each such class.

(i) In respect of any securites issued by banks the deposits of which are insured in accordance with the Federal Deposit Insurance Act, the powers, functions, and duties vested in the Commission under this title to administer and enforce sections 12, 13, 14(a), 14(c), and 16(1) with respect to national banks and banks operating under the Code of Law for the District of Columbia are vested in the Comptroller of the Currency, (2) with respect to all other member banks of the Federal Reserve System are vested in the Board of Governors of the Federal Reserve System, and (3) with respect to all other insured banks are vested in the Federal Deposit Insurance Corporation. The Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation shall have power to make such rules and regulations as may be necessary for the execution of the functions vested in them as provided in this subsection and none of the rules, regulations, forms or orders issued or adopted by the Commission pursuant to this title shall be in any way binding upon such officers and agencies in the performance of such functions, or upon any such banks in connection with the performance of such functions.

Section 14 of the Securities Exchange Act of 1934 now reads as follows:

(a) It shall be 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 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.

(b) It shall be unlawful for any member of a national exchange, or any broker or dealer registered under this title, 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 give or to refrain from giving a proxy, consent, or authorization in respect of any security registered pursuant to section 12 of this title and carried for the account of a customer.

(c) Unless proxies, consents, or authorizations in respect of a security registered pursuant to section 12 of this title are solicited by or on behalf of the management of the issuer from the holders of record of such security in accordance with the rules and regulations prescribed under subsection (a) of this section, prior to any annual or other meeting of the holders of such security, such issuer shall, in accordance with rules and regulations prescribed by the Commission, file with the Commission and transmit to all holders of record of such security information substantially equivalent to the information which would be required to be transmitted if a solicitation were made, but no information shall be required to be filed or transmitted pursuant to this subsection before July 1, 1964.

Section 16(a) of the Securities Exchange Act of 1934 now reads as follows (with new matter underscored): Section 16(b) is unchanged.

(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 12(g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange) a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

Subchapter X. Sale of Assets: Dissolution and Winding-up.

A. Sale of Assets

Section 271 requires approval of a majority of voting shares for a sale, lease or exchange of "all" of a corporation's assets. Presumably, there are negative implications that (a) a pledge, mortgage or other security device, and (b) a sale, lease, or exchange of less than "all" the corporate assets do not require shareholder approval. It is assumed that this Section would apply if the corporation sold "substantially all" but not its entire assets. See Stiles v. Aluminum Products Co., 338 Ill.App. 48, 86 N.E.2d 887 (1949).[1]

1. A number of statutes are now quite explicit in drawing a distinction between (a) a sale of any or all assets in the regular course of business, which requires no shareholder approval;[2] (b) a sale of "all or substantially all" assets outside of the regular course of business, which requires shareholder approval;[3] and (c) a mortgage, pledge, or other security with respect to any or all corporate assets,

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1 / A corporation manufacturing and selling cooking utensils and doing other metal frabrication was held to have sold all of its assets, for purposes of requiring stockholder approval and granting appraisal rights under Illinois law, when it disposed of everything except some stock in a subsidiary and certain liquid assets (savings bank stock and marketable securities, money, and accounts receivable).

2 / Model Act Section 71; Alabama, Alaska, Colorado, Connecticut, Illinois, Iowa, Mississippi, Missouri, Nebraska, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, South Carolina, Texas, Virginia, Wisconsin, Wyoming, District of Colubmis, New York § 909(a) reaches the same result by implication.

3 / Model Act Section 72; the jurisdictions listed in the preceding footnote require shareholder consent to a sale of assets not in the regular course of business.

which requires no shareholder approval.[4/] Even though these results would probably be reached under the Delaware statute, by virtue of the negative implications of Section 271, a question could arise as to the application of the statutory language to situations where the business of an enterprise is to sell off all its assets, *e.g.*, a real estate corporation. Obviously, shareholder approval should not be required in such circumstances, but if the corporation in fact sells off "all" its assets, arguably Section 271 would apply.

The Committee may wish to consider incorporating into Section 271 language which would explicitly dispense with shareholder approval for sales in the usual course of business, and all mortgages or pledges, unless otherwise provided by the certificate of incorporation:

> The sale, lease or exchange of all, or substantially all, the property and assets of a corporation, when made in the usual and regular course of the business of the corporation, and the mortgage, or pledge or giving of any other security interest in any or all of its property or assets whether or not in the usual and regular course of business, may be made upon such terms and conditions and for such consideration, which may consist in whole or in part of money or property, real or personal,[4A/] including shares of any other corporation, domestic

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4/ Model Act Section 71: Arkansas, California, Colorado, Florida, Georgia, Hawaii, Kentucky, Maine, Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, Virginia, Wyoming: either dispense with shareholder consent entirely or unless the certificate requires it.

4A/ This language recognizes the corporation's right to sell assets for cash or other property; Section 271 presently refers only to stock or other securities.

or foreign, as shall be authorized by its board of directors. Except to the extent that the certificate of incorporation otherwise provides, the consent or authorization of shareholders for such sale, lease, or exchange shall not be necessary.

A few states go further and attempt a statutory distinction between transactions in and out of the regular course of business.[5/] Without specifically recommending its adoption, it may be considered useful if Section 271 introduces the distinction between transactions in and out of the regular course of business.

2. It is to be noted that Section 271, unlike most statutes, does not refer to money as consideration on a sale of assets. It may be questioned whether this (a) limits the types of consideration for which assets may be sold, or (b) implies that assets may be sold for a money consideration without shareholder approval. Footnote 4A, supra.

3. It would seem appropriate to specify in Section 271 a notice period similar to the 20 day notice requirement for mergers (Section 251(c)) or the 10 day requirement for dissolution notices (Section 275(a)).

5/ See S.C. Code § 12-21.2(c); "Whether or not a transaction by a corporation occurs within the usual and regular course of business shall be determined by the circumstances of the transaction, including the character of the business in which the corporation is engaged at the time of or immediately preceding the transaction. A sale of assets may be deemed to be in the regular course of its busines if the corporation was incorporated for the purpose of liquidating such assets or property, or if the sale is a transaction or one of a series of transactions made in furtherance of the business of the corporation and not to terminate or dispose of its business." The first sentence deals with the situation presented by Eisen v. Post, 3 N.Y.2d 518, 146 N.E. 2d 779(1957) strictly interpreting the regular-course-of-business concept in terms only of purposes stated in the certificate and not with reference to the business actually engaged in at the time of the sale. The decision has been overruled by New York § 909(a) (reference to the "usual or regular course of the business actually conducted by such corporation").

4. Finally, a number of states now specifically provide that, even though shareholders have approved a sale of assets, the directors may abandon it. New York § 909(c) is typical:

> Notwithstanding shareholder authorization, the board may abandon the proposed sale, lease, exchange or other disposition without further action by the shareholders, subject to the rights, if any, of third parties under any contract relating thereto.

This abandonment provision does not apply to mortgage or pledge of assets.

5. As for vote, no change is recommended in the existing provision for a majority of the voting shares. Other states vary considerably, both in percentages (ranging up to four-fifths with two-thirds usual) and in the shares which may vote (usually all shares may vote, whether or not entitled to do so under the certificate of incorporation). If a Hariton-type transaction is effected, dissolution under Section 275(b) requires approval by two-thirds of the voting shares, so that the difference between mergers and sale-of-assets with dissolution is narrowed, assuming appraisal rights on mergers are withdrawn.

6. No changes are suggested with respect to Section 272 and 273.

B. Dissolution

Under Delaware law, a corporation's life may terminate or suspend for various reasons and under varying titles. "Dissolution" results from voluntary action of directors and shareholders (Section 275 (a)-(c)) or by written consent of all voting shareholders (Section 275(d)). Before business begins, the corporation may "surrender its corporate rights and franchises" (Section 27[illegible]). Its charter may be revoked or forfeited by judicial decree, usually for abuse of powers (Section 283). Its charter may "expire" because of a fixed life (see Section 312) or "become inoperative" for non-payment of taxes (Section 312). Many of these provisions have obviously been added from time to time as the need dictated.

The more recent statutes have, as a rule, overhauled these procedures rather throughly, treating all of them as varieties of "dissolution" to be followed by "liquidation" under uniform procedures. The Model Act now offers, rather typically, a two-step procedure: upon occurrence of these events, the corporation files a "statement of intent to dissolve," succeeded by liquidation, after which a final document ("articles of dissolution") formally recites the ending of corporate existence. This Report does not receommend that Delaware undertake a thorough revision of its dissolution procedures, but makes various suggestions for improving procedure within the existing framework thereby preserving relevant case-law. Nor has there been an effort to improve or modernize the wording of the various provisions, even though some linguistic (although not substantive) inconsistencies reveal the development of the statutory provisions over the years.

1. Dissolution Before Beginning Business and Payment of Capital. Like all other states, Section 274 applies only if the corporation has not begun business. However, unlike many other statutes Section 274 governs only if no capital has been paid in, including the $1000 minimum capital presently required by Section 104(a)(2). A number of states permit the incorporators (or directors) to dissolve even if

some capital has been paid in, provided, of course, that any payments are refunded. For instance Model Act Section 75(A)(e) provided that articles of dissolution in such a case must recite that

> the amount, if any, actually paid in on subscriptions for its shares, less any part thereof disbursed for necessary expenses, has been returned to those entitled thereto.

Thus, a corporation which has collected some money on subscriptions, but has not commenced doing business or issued shares to subscribers, may dissolve by act of the incorporators (or directors). This procedure may well be a useful addition to Section 274.

2. Dissolution by Vote of Directors and Shareholders. Section 275 requires no changes. Mandatory election judges, see Section 275(b) and (c), have already been considered at Report, supra at 145. Publication requirements, as in Section 275(c), are now quite infrequent, although they may by occasional chance, perform a useful role in notifying creditors or shareholders otherwise unaware of pending dissolution. Execution-acknowledgment-filing-recordation requirements in subsection (c) can be simplified by a cross-reference to the general provisions suggested in the Report, supra at 1-8.

The committee may wish to consider specific recognition of a class vote in connection with dissolution, as do a number of other states. For example, Model Act Section 77, which now requires only a two-thirds vote of voting shares, also stipulates a class vote if any shares are entitled to such a class vote under the certificate of incorporation. This would also recognize the fact that dissolution is often employed in conjunction with a sale of assets to bring about a merger-like result, as in the Hariton case, and that preferred stock indentures may and probably often do require a class vote of their shares in the event of dissolution. The Model Act language is as follows:

> (A resolution for dissolving the corporation) shall be adopted upon receiving the affirmative vote of the holders of two-thirds of the shares of the corporation, entitled to vote thereon, unless any class of shares is entitled to vote thereon as a class, in which event the resolution shall be adopted upon receiving the affirmative vote of the holders of two-thirds of the shares of each class of shares entitled to vote thereon as a class and of the total shares entitled to vote thereon.

3. Dissolution by Unanimous Shareholder Consent. No changes are suggested in Section 275(d). Certain other dissolution procedures will be recommended for exclusive application to close corporations when that portion of the Report is submitted.

4. Dissolution of Non-Profit Non-Stock Corporation. Despite its odd wording, Section 276 achieves the correct results. Compare Model Non-Profit Corporation Act Section 45. The second sentence is ambiguous, and a minor language change will cure this, with new matter underscored.

> If the members of the corporation not for profit and having no capital stock are entitled by its certificate of incorporation . . . they shall exercise, assume, and fulfill all of the functions . . . .

The Model Non-Profit Corporation Act also adds language making clear that the directors exercise all functions on dissolution if there are no voting members, as follows:

> If there are no members, or no members entitled to vote thereon, the dissolution of the corporation shall be authorized at a meeting of the board of directors upon the adoption of a resolution to dissolve by the vote of a majority of the directors in office.__/

5. Corporation after Dissolution: Section 278 concisely sets forth the continued existence of the corporate entity after dissolution for purposes of winding up its affairs. Many newer statutes eliminate any express requirement that winding-up by completed within three years. This has the advantage of avoiding questions as to the posture of the corporation after that period has expired. On the other hand, Delaware's special statutory provision validating subsequent suits (see Section 275, last sentence) and the doctrine of Addy v. Short, 8 Terry 157, 89 A.2d 136 (S.Ct. 1952), reversing 7 Terry 178, 81 A.2d 300 (Super. 1952) , adequately takes care of these problems. Generally, a three-year period should be sufficient, and the specific statutory requirement is a stronger incentive than the now current requirement of merely proceeding expeditiously to complete liquidation. However, for the occasional situation where liquidation must run longer

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__/ If adopted, the last phrase ("directors in office") would be deleted, and, to accord with Section 275(a), a majority of the entire board would be required to approve dissolution.

than three years, it might be useful to add language to Section 278 such as the following (new matter underscored):

> All corporations. . . shall nevertheless be continued, for the term of three years, <u>or for such longer period as the Court of Chancery in its discretion shall direct</u>, from such expiration or dissolution, bodies corporate,. . .

Some newer statutes, notably New York Section 1005 and 1006, are much lengthier and fuller than Delaware's Section 278, but it is doubtful that such provisions add much to what Section 278 states in summary form.

One provision worth considering is a statutory escheat rule for assets owing to a creditor or distributable to a shareholder who cannot be found, or is under disability, etc.__/ Many statutes follow Model Act Section 97 in providing for its payment to the state treasurer to be held for a limited time for the creditor or shareholder or his representative, and thereafter disposed of. Following the North Carolina statute, N.C. Gen.Stats. § 55-130, the statute could appropriately provide for paying the unclaimed proceeds to the University of Delaware.

6. <u>Trustees or receivers for corporations in dissolution:</u> Sections 279-282 inclusive appear to be adequate for their purposes and no changes are suggested. Since appointment of receivers and like proceedings are subject to the widest variation among the states,

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__/ Delaware rules on disposition of abandoned or unclaimed property have not been researched.

no one procedure necessarily is superior. Section 280 gives Chancery plenary jurisdiction in the premises. Compare New York Section 1008's lengthy elaboration of specific judicial powers with respect to corporate dissolutions under court supervision. It is assumed that Section 280 Chancery jurisdiction to make orders "as justice and equity shall require" would include as well some of the more specific powers which are available to Chancery with respect to insolvent corporations in receivership, e.g., Section 297 (sale of perishable or deteriorating property), Section 298 (compensation and costs of receivership), Section 299 (substituting receivers), and Section 300 (employee's lien). It is also assumed that the Chancery Rules which replace Sections 295-296 would also apply, pari passu, with respect to corporate dissolutions under judicial supervision.

7. Revocation of forfeiture of charter: Several suggestions are offered respecting Section 283.

(a) At the very least, a cross-reference should be made in Section 283 to other grounds for judicial dissolution, including Section 136(c) (non-appointment of new resident agent) and Section 323 (disobedience to writ of mandamus).

(b) In implementing the constitutional mandate (Art. IX, Sec. 1) to "provide for the revocation or forfeiture of the charters of all corporations for the abuse, misuse of non-use of their corporate powers, privileges, or franchises," Section 283 might well be somewhat more specific. One type of "abuse" is now often statedby statutes, e.g., New York Section 2202(a)(1), as a ground for revocation:

The corporation procured its formation through fraudulent misrepresentation or concealment of a material fact.

New York also states these additional grounds:

The corporation has exceeded the authority conferred upon it by law whereby it has forfeited its charter, or has conducted its business in a persistently fraudulent or illegal manner, or has misused its powers in contravention of the public policy of this State.

8. Other Provisions: In the chapter on Close Corporations, recommendations will be made regarding dissolution upon deadlock of shareholders and directors, compare Section 226, although some of these provisions may appropriately apply beyond the ambit of the closely-held enterprise.

Subchapter XI. Insolvency; Receivers and Trustees

In general, the provisions of this Chapter, together with the relevant Chancery rules, appear adequate. It is possible to work up elaborate statutory provisions as New York has done in Article 12 of the new Business Corporation Law (Sections 1201-1218), but it is not clear that these provisions achieve any better result than Delaware now obtains under present law. If anything, the repeal of Sections 295 and 296 suggests some legislative disposition to leave many details of receivership to Chancery rules ratherthan to treat them in the statute itself. However, the Committee's attention is directed to two other matters:

(1) It would seem somewhat more flexible to reverse the rule of Section 293 and provide that the trustee or receiver shall give all notices to shareholders and creditors unless Chancery orders the register in chancery to do the job. After all, the trustee or receiver bears a special relation to the court which is likely, under the present rule, to authorize the receiver or trustee to handle notices.

(2) The Model Act, and its company, along with several other states (including Connecticut, Illinois, and Pennsylvania) specifically authorize, the court to discontinue liquidation proceedings when there is no longer cause therefor. The following language would achieve this objective:

> The liquidation of the assets and business of a corporation may be discontinued at any time during the liquidation proceedings when it is established that cause for liquidation no longer exists. In such event the Court of Chancery in its discretion, and subject to such conditions as it may deem appropriate, may dismiss the proceedings and direct the receiver or trustee to redeliver to the corporation all of its remaining property and assets._/

_/ The first sentence reproduces verbatim Model Act Section 94's initial sentence. The second sentence would give Chancery considerably greater flexibility than the corresponding Model Act provision under which the court "shall dismiss the proceeedings" and redeliver undisposed property.

Subchapter XII. Renewal, Revival Extension and Restoration of Charter.

A. Revoking Dissolution

No change is suggested in Section 311 which has counterparts in many state statutes.

B. Renewing and Reviving Charter

Although Section 312 is sound in principle, some of its provisions may well be reconsidered.

(1) In Subsection (a), the following rewording is suggested:

> Any domestic corporation whose period of duration is other than perpetual and which has not amended its certificate of incorporation to make its duration perpetual may, at any time before or after the expiration of its period of duration. . .

This makes clear that a corporation with a limited term may, and probably will, amend its certificate, so that Section 312 will apply only in the unusual instance where, either deliberately or by oversight, it has not made the amendment._/ The following conforming clause should be added to Section 242(a) to expressly authorize a corporation to amend its certificate by:

> (6) Changing the period of its duration.

_/ The recommended language takes the place of the following clauses of Section 312(a): "Any corporation existing under the laws of this State, may, at any time before the expiration of the time limited for its existence. . . any any corporation existing under the laws of this State whose charter has expired by reason of failure to renew the same. . ."

(2) Subsection (e) appears to go rather far in retroactively validating all acts, contracts, etc. during the period when the corporation's charter was inoperative. The literal language suggests that any individual liabilities, accrued during this period, are lost and corporate liabilities are automatically substituted. The potential unfairness of this result is illustrated by a corporation whose charter "expired by limitation" but whose directors and/or officers did business on a personal liability basis, express or implied. Reinstatement should not automatically discharge them, and a court, confronted with the question, would probably read an estoppel limitation into the statute. Virginia has attempted to save any accrued interim personal liabilities by providing that although the corporate existence is retroactively restored such "reinstatement shall have no effect on any question of personal liability of the directors, officers, or agents in respect of the period" when the charter had lapsed. Va.Code § 13.1-92 (Supp.1962). A similar provision should appear in Delaware's Section 312(e).

(3) Section 312(h) is too rigid in requiring election of three directors to reinstate a corporation, unles a small number is permitted (somewhat backhandedly) by the language; "or they may elect a full board of directors, as provided by the by-laws" which may, perhaps, authorize fewer than three. In all events, since Section 141(b) permits fewer than three directors if not less than the number of shareholders, there is an inconsistency. The inconsistency is expecially inappropriate since often it will be closely held, perhaps single-man, corporations whose charters will lapse.

Inddeed, it would be better to simplify subsections (b), (h) and (i) by providing simply that one or more persons who were directors at the time the charter lapsed may apply for its renewal or reinstatement. Once the charter has been revived, it would then be appropriate to require, as subsection (i) does now, the calling of a stockholders' meeting to elect a new board of directors to carry on the business. As it stands now, subsections (b) and (h) seems inordinately complex for this rather limited purposes.

C. Other Provisions

No changes are suggested in Section 313 (renewal of charter of charitable corporation) or Section 314 (status of corporation).

XII. Financial Provisions

This portion of the Report deals with topics presently covered in Subchapter V, as well as the closely related provisions of Sections 243 and 244.

On many substantive points, the Delaware statute is silent where new statutes are explicit, e.g., the absence of statutory provisions which insure full legality to various uses of the surplus and capital accounts. On some points, the Delaware statute is unduly restrictive by comparison with other states, e.g., mandatory shareholder approval to retire shares redeemed or otherwise reacquired. The Delaware financial provisions employ much old-fashioned terminology which has become increasingly outdated as statutes now invariably frame their provisions in terms of financial accounting.

The Committee may well prefer to make only minimum changes in the financial provisions on the theory that the widest flexibility is insured by the fewest statutory provisions one way or another. Recognizing this, the Report has attempted to set forth the major alternatives open to the Committee by indicating the new statutory provisions to make recommendations, and to provide implementing language. The New York statute is heavily relied upon since its financial provisions embody and refine virtually every development in the numerous corporate law revisions since 1950. __/

__/ A chief source of management objections to this statute is mandatory disclosure of intimate corporate finance details. This objection should be measured against the wide flexibility granted by the substantive provisions.

A. Definitions

This Report recommends that the Delaware stature should, so far as possible, now employ the standard accounting terminology now universally employed in revised statuter. Otherwise, the Delaware statute will stand almost alone in American corporation law in its reliance upon antique and ill-defined terms largely abandoned elsewhere. The suggested definitions would clarify the financial sections and tie them together into a coherent body of readily understandable statutory rules.

1. Stated Capital: This term is a carefully defined dollar sum of three items: (1) the par value of all issued par shares, (2) for no-par shares, the stated value (total consideration less amounts allocated to capital surplus), and (3) transfers to stated capital, whether or not in connection with a stock dividend, less (4) any lawful reductions of stated capital. This definition takes the place of the old-fashioned variant terminology found in Delaware and some other unrevised statutes, viz., "capital," "stock capital", "capital stock", etc.1/ As defined, "stated capital" does not substantively change any Delaware concepts, but it is desirable clarifying term now universally adopted.

1/ Confusion is sometimes compounded when a term like "capital stock" is ambiguously used to refer to stated capital (as above defined) or total shares issued and outstanding.

2. Net Assets: This term can be readily defined as total assets less total debts: 2/ Ordinarily treasury shares are specifically excluded from total assets, Model Act S 2 (i); and New York Section 102(a) (9) specifically provides that "stated capital and surplus are not liabilities (debts)." Section 170(a) (1) presently uses "net assets" in the dividend section, doubtlessly with the sense of this definition.

3. Surplus: Given the definitions of "net assets" and "stated capital," a definition of "surplus" readily follows as the difference of those two items. Accord Section 154 (last sentence); compare Section 170(a)(1): dividends may be paid out of "net assets in excess of capital." This concept does not, of course differentiate earned surplus and any of the varieties of capital surplus, as do all of the newer statutes which specifically distinguish between permissible uses and methods of using earned and capital surplus. 3/

4. Earned and Capital Surplus: Statutes now customarily employ a definition of "earned surplus", originating with the Model Act which in turn derived the definition from accounting concepts, and

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2/ A few states also define "assets" and "debts" (or "liabilities") to round out the picture. See N.C.Gen.Stats. S 55-2; S.C.Code S 12-11.2 (Supp. 1962).
These definitions are not so widely accepted as the others and are not regarded as essential for Delaware's purposes.

3/ Under the Model Act, ordinary dividends are payable only out of earned surplus; distributions from capital surplus require shareholder action or anenabling clause in the certificate of incorporation. New York permits dividends out of any surplus, but shareholders receive special notice if the surplus is not earned.

also a definition of "capital surplus." Earned surplus is treated historically as a net balance of corporate income and gains, less certain losses and shareholder distributions. 4/ "Capital surplus" is the residue of total surplus less earned surplus, and includes, inter alia, paid-in surplus, reduction surplus, etc.

The recommended definitions are as follows:

(1) "Treasury shares" means shares of a corporation which have been issued, have been subsequently acquired by the corporation, and have not been canceled or restored to the status of authorized but unissued shares. Treasury shares are issued shares, but not outstanding shares, and are not assets.

(2) "Net assets" means the amount by which the total assets exceed the total liabilities. Stated capital and surplus are not liabilities.

(3) "Stated capital" means, at any particular time, 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

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4/ Under the universally adopted Model Act definition of "earned surplus," this is "the portion of the surplus of a corporation equal to the balance of its net profits, income, gains, and losses from the date of incorporation, or from the latest date when a deficit was eliminated by an application of its capital surplus or stated capital or otherwise, after deductiog subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent such distributions and transfers are made out of earned surplus." Section 2(1).

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, less all reductions from such sum as have been effected in a manner permitted by law.

(4) "Surplus" means the excess of net assets over stated capital.

(5) "Earned surplus" means the portion of the surplus that represents the net earnings, gains or profits (after deducting all losses) that have not been distributed to the shareholders ad dividends, or transferred to stated capital or capital surplus, or applied to other purposes permitted by law. 5/

(6) "Capital surplus" means the entire surplus of a corporation other than its earned surplus.

5/ This is the definition in New York Section 102(a)(6). The Model Act definition (Section 2(l) adds that earned surplus is determined from the date of incorporation or the latest date when a "quasi-reorganization" took place. New York deals with this in Section 517(a)(1) and (a)(5).

B. Corporate Authority to Issue Stock

In general, Section 151 give corporations the essential authority to issue all types of shares generally marketed today. All new corporation law revisions have provisions similar in substance although often quite different in language. Although the Committee may prefer not to add to the existing statute, it should have before it several provisions adopted in other states.

1. Convertible Securities: (a) Many states now specifically prohibit, like Model Act Section 14 and New York Section 519(a), the issue of shares convertible into higher ranking securities, thereby confining the conversion privilege to the typical "downstream" conversion (e.g., from bonds to shares, or preferred to common). The theory is that "upstream" conversion could seriously injure senior interests absent some specific protective clauses in indentures under which senior securities had been issued or judicial protection in an aggravated or abusive situation. Under the Delaware language, it would not be illegal for common stock to be convertible, at the holder's option, into preferred stock, or even into some form of creditor security.

(b) Under New York's Section 519, if the shareholders specifically authorize it, the directors may themselves increase the number of authorized shares into which an issue of convertible securities may be converted. This procedure may sometimes conveniently avoid an immediate increase of total authorized shares and enable the directors to make the increase as and when needed. Its chief effect in Delaware would evidently be to reduce the franchise tax (computed on authorized shares) by deferring as long as possible an increase in the number of authorized shares rather than carrying a large number of authorized but unissued shares until actually needed.

Deleting certain local references, New York's Section 519(c) provides:

> If there is shareholder approval for the issue of bonds or shares convertible into shares of the corporation, such approval may also provide that the board of directors is authorized by a certificate of amendment to increase the number of 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 privileges of any such bonds or shares convertible into shares of such class or series.

The New York statute then provides that:

> No issue of bonds or shares convertible into shares of the corporation shall be made unless:
>
> (1) A sufficient number of authorized but unissued shares of the appropriate class or series are reserved by the board to be issued only in satisfaction of the conversion privileges of such convertible bonds or shares when issued; or
>
> (2) The aggregate conversion privileges of such convertible bonds or shares when issued do not exceed the aggregate of any shares reserved under the preceding subparagraph and any additional shares which may be authorized by the board as provided by subsection ___.

2. Redeemable Shares: Under Section 151(b) only "preferred or special" stock may be made redeemable, thereby precluding redeemable common shares. Starring v. American Hair & Felt Co., 21 Del. Ch. 380, 191 Atl. 887 (Ch.), aff'd per curiam, 21 Del. Ch. 431, 2 A.2d 249 (S.Ct. 1937). However, Section 243(f) rather clumsily permits investment companies to issue common shares redeemable at the shareholder's option. This Report would suggest several points for consideration:

(a) It would be desirable to specify that shares should be redeemable, if at all, only at the option of the corporation. See Model Act Section 14; New York Section 512(a); and other states. Otherwise shareholders possess a power which can be embarassing or disastrous to the corporation, and it is not inevitably true that the corporation is strong enough to prevent such a demand from a dominant shareholder. Investment companies would naturally be excepted, but apart from these special enterprises, redemption at the shareholder's option is not necessary for flexibility. Although closely-held enterprises frequently obligate themselves to repurchase shares, they do so under specified business related conditions, such as death or termination of employment, and usually fund the prospective repurchase costs by insurance or otherwise.

(b) Under Delaware case-law, common shares may not be made redeemable. Starring v. American Hair & Felt Co., supra. One policy consideration is the importance of placing at the base of the financial structure a class of shares inescapably bearing the ultimate risk of loss. New York has recently provided that any class of common may be made redeemable if, at the time of redemption, there is outstanding a class of common which may not be redeemed and thus must bear the loss-risk. N.Y. Section 512(c). This permits greater flexibility, and it is not inconsistent with the policy of requiring at least one risk-bearing class of shares. But if two or more classes of common voting shares are employed to gain a balance of interests in a corporation, it may be extremely risky if one class can be redeemed by action of the other class or classes with or without the class vote of the affected class. Often such a result would have to be blocked either by a statutory provision or by a charter clause at least requiring consent of the affected class. The added flexibility of the unique New York provision may well be outweighed by new and different problems.

C. Consideration for Shares

1. Consideration: Quality and Kind: Since the language of Section 152, taken verbatim from Del.Const. Art. IX, Sec. 3, has apparently been sufficient to authorize all proper forms of consideration, no change will be suggested._/ However, it would be desirable to add the following provision, now customary in statutes, that reasonable incorporation expenses and reasonable underwriting charges, do not affect the fully paid and non-assessable status of any shares.

> The reasonable charges and expenses of the organization 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 non-assessable status of such shares.

Cf. Yasik v. Wachtel, 25 Del. Ch. 247, 17 A.2d 309 (Ch.1941) (semble).

2. Consideration: Quantity: Sections 153 and 154 achieve the same results as newer statutes (Model Act Section 17; New York Section 504), although the wording is distinctly archaic. It has been suggested that the new and widely-used phrase "stated capital" be substituted for "capital." Supra at 224 . Section 153(a) preserves what is apparently an historical distinction between pre- and post-1

_/ New York Section 504(a)'s phraseology is representative of current statutory provisions on quality of consideration: "Consideration for the issue of shares shall consist of money or other property, tangible or intangible, or labor or services actually received by or performed for the corporation or for its benefit, or in its formation or reorganization, or a combination thereof".

April 1929 corporations; the necessity for its continuance cannot be judged by this Report. Section 153(a)'s requirement of a two-thirds vote seems needlessly high; a majority vote is normally required today. Moreover, the Section 153(a) right of shareholders, under a certificate provision, to set the consideration of no par shares should also be available as to par shares, if desired. Section 154 uses awkward language (amount of consideration from sale of par shares allocated to capital "shall be in excess of the aggregate per value," etc.) to express the notion that consideration for par shares need be stated capital only to the extent of par.

It is suggested that Section 153 could be substantially expanded to declare appropriate statutory rules for consideration in respect of par and no-par shares, treasury shares, and share dividends, based on Model Act Section 17 and all new statutory revisions (including New York):

Section . Consideration for Shares.

(a) Shares with par value may be issued for such consideration, expressed in dollars, not less than the par value thereof, as is fixed from time to time by the board of directors, or by the shareholders if the certificate of incorporation so provides.

(b) Shares without par value may be issued for such consideration, expressed in dollars, as is fixed from time to time by the board of directors, or by the shareholders if the certificate of incorporation so provides.

(c) Treasury shares may be disposed of by the corporation for such consideration, expressed in dollars, as may be fixed from time to time by the board of directors, or by the shareholders if the certificate of incorporation so provides.

(d) If the certificate of incorporation reserves to the shareholders the right to fix the consideration for the issue of any shares, the shareholders shall, unless the certificate requires a greater vote, do so by a vote of the holders of a majority of the shares entitled to vote thereon.

(e) That part of the surplus of a corporation which is transferred to stated capital upon the issuance of shares as a share dividend shall be deemed : the consideration for the issue of such shares.

(f) If bonds, debentures, or shares are converted into, or exchanged for, shares, with or without par value, the consideration for the shares so issued in such conversion or exchange shall be the sum of (1) either the principal sum of, and accrued interest on, the bonds so converted or exchanged, or the stated capital then represented by the shares so converted or exchanged, and (2) any additional consideration paid to the corporation for the new shares, and (3) any stated capital not theretofore allocated to any designated class or series which is thereupon allocated to the new shares, and (4) any surplus thereupon transferred to stated capital and allocated to the new shares.

Reporter's Note to Revised Section 153

The revised section assumes that the distinction between pre- and post-1929 corporations need no longer stand, but if so this can easily be handled by adding a few more words in the draft section. Subsection (a) states the usual rule as to par shares, and has no counterpart in the present statute. Subsection (b) accords with present Section 154(a) (second sentence), but deletes the third sentence./ Subsection (c) states the accepted rule that once the statutorily required consideration has been received for shares, there is no need to require it again when shares are bought back and again sold; in

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/ The need for this provision is unclear. Presumably only a closely held corporation, or a rather small public corporation whose voting shares are closely held, would be the only enterprises to reserve shareholder power to set consideration. In such situations, one wonders when the directors would need to have statutory authority to sell 10% of the initial issue. In all events, if this were anticipated, the certificate could give the directors some authority to sell without shareholder determination of consideration.

practice, the rule has relevance only as an exception to the general requirement of not less than par for par shares. Subsection (d) reduces the required shareholder consent from two-thirds to a majority. Subsection (e) deals with stock dividends, where surplus is normally capitalized; it does not, of course, apply to stock splits (where no surplus need be capitalized) or to a distribution of treasury shares (as to which no statute compels capitalization of surplus). Most statutes require capitalization of surplus in connection with stock dividends, to the extent of par for par shares, and an amount determined by directors for a no-par stock dividend. Subsection (f) states the standard statutory rule regarding conversion of shares, and also includes additional language from New York Section 504(g) regarding conversion of bonds or debentures.

Section 154. Determination of Amount of Stated Capital (Re-Draft)

(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, and the excess, if any, shall be allocated to capital surplus.

(b) Upon issue by a corporation of shares without par value, the entire consideration received therefor shall constitute stated capital unless the board of directors within a period of sixty days after issue allocates to capital 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 liquidation except that portion of such consideration in excess of such preference.

(c) The stated capital of a corporation may be increased from time to time by resolution of the board of directors transferring all or any part of any 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.

Reporter's Note to Revised Section 154

This revision does not drastically change Section 154's substance, although the language is quite different; apparently no substantial corpus of case-law turns on the old wording. Subsection (a) restates somewhat more succinctly the first sentence of present Section 154; the restatement makes unnecessary the distinction taken in the clause beginning "unless all the shares," etc. Subsections (a) and (b) respectively permit allocation of consideration between stated capital and surplus, as does present Section 154 (sentence 3). Subsection (b) also introduces a now standard statutory protection for the liquidating preferences of preferred shares by, in effect, compelling that amount to stay in stated capital. Subsection (c) preserves the substance (and much of the language) of present Section 154 (sentences 4 and 5). The final sentence of present Section 154 would be superseded by the proposed definition of "surplus" (supra p. 225) and the term "capital surplus" used in the redraft would also be defined (supra p. 224).

3. Partly-Paid Shares: American jurisdictions split on delivering certificates for shares not fully paid up. The newer statutes generally prohibit certificates for unpaid shares because of the possible transfer of such certificates to bona fide purchasers. Delaware permits the certificate but requires a legend disclosing its not-fully-paid character. __/ If this procedure is continued, it would be well to add a further requirement that:

> Upon transfer of such a certificate, each new certificate shall bear a similar statement together with the name of the original holder of the shares.

Compare New York Section 623(f) (notation on certificate of shareholder seeking appraisal rights).

Section 156 permits the corporation to pay dividends in proportion to the amount paid on the shares. Absent specific provision on the subject, presumably voting rights are not similarly reduced, as a result of which it is possible for unpaid or partly-paid shares easily to control the corporation on a minimum investment.

__/ Presumably, the same legend would go on certificates issued under a stock option plan permitting the optionee to pay for his shares in installments. Cf. New York Section 505(e).

D. Stock Options

Section 157 adequately empowers corporations to issue stock options, and is actually broader than other state statutes in specifically covering "stock or other securities of the corporation." __/ Because Section 157 is generally adequate and also because of important case-law grounded on the present language, no changes are specifically recommended; but several clarifying provisions should be noted.

1. Since restricted transfer of stock options is often desired by the issuing corporation, Delaware, like New York, could conveniently authorize the certificate or the board resolution to impose any desired limitations upon transferability. See N.Y. Bus. Corp. Law S 505(c). The following rewording of Section 157 (second sentence) could accomplish this:

> The terms upon which, __/ the time or times, which may be limited or unlimited in duration, at or within which, and the price or prices at which any such shares may be purchased from the corporation upon the exercise of any such right or option, and any limitations upon the transfer of any such right or option, ~~shall be such as shall be fixed and stated~~. . . .

__/ It is assumed that this language is inclusive of the more specific references in New York (and other) statues to "authorized but unissued shares, treasury shares, or shares to be purchased or acquired." N.Y.Bus.Corp.Law S 505(a).

__/ At the equivalent point in its section 505(c), the New York statute would add the word "including," so that the enumeration of provisions which may appear in the certificate or board resolution cannot be interpreted as exclusive but only as illustrative.

2. The New York statute, Section 505(g)/, permits the directors to increase the authorized shares to meet stock option needs if the shareholders have approved a plan for issue of options or other rights. This may occasionally prove convenient; on the other hand, it should be easy enough to estimate the probable number of shares needed and to secure shareholder authorization for this or a larger number. Moreover, the New York provision weakens the traditional concept that only shareholders may increase authorized shares, and may prove potentially dangerous in some situations. See also the comments on a like provision in New York in connection with convertible securities. Supra at 228-229 .

/ "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 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."

E. Stock Certificates and Fractional Shares

Several minor changes in Section 158 may be useful:

1. The evident intention of the second sentence is to validate the common practice of engraving corporate signatures on unissued certificates, which are then manually countersigned on issue. Maximum safety under this procedure is secured if the transfer agent or registrar is independent of the corporation, and the careful language of New York Section 508(a) __/ better provides for this than the present Delaware language, which, it is suggested, could be revised as follows:

> If such certificate is countersigned (1) by a transfer agent other than the corporation itself or its employee, or,(2) by the corporation's transfer clerk and by a registrar other than the corporation or its employee, the signatures of the officers of the corporation may be facsimiles.

2. The following concise statement could conveniently replace the complex third sentence of Section 158. It also eliminates the unnecessary specific reference to "adoption" of the certificate containing deceased officers' signatures, since use of the certificate if, of itself, an "adoption":

> 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.

__/ "The signatures of the officer upon a certificate may be facsimiles if the certificate is countersigned by a transfer agent or registered by a registrar other than the corporation itself or its employee" such officer at the date of issue.

3. The Section 151(f) requirement as to certificate recitals of preferences, etc. is customarily included in the stock certificate provision. If not transferred, a cross-reference would be useful.

4. Section 167, permitting replacement of a "lost or destroyed" stock certificate should specifically refer to a "stolen" certificate; Section 168(a) should also be amended accordingly. Compare Uniform Commercial Code Section 8-405. It should be noted that if Delaware adopts the Code, Sections 167-168 and all of Subchapter VI would be replaced by Article 8 of the Code. Unless specifically preserved, as a matter of policy, Section 169 and its case-law would be inconsistent with the Code.

5. Most of the newer statutes specifically empower corporations to deal, as often they must, with fractional shares and scrip. Since the Delaware statute apparently has no such provision, the Committee may wish to consider statutory language squarely authorizing current market practices. In the typical statute, certificates for fractional shares may be issued (sometimes only in specified circumstances); but as alternatives, the corporation may pay cash for share fractions or may issue scrip with limited life. The proper treatment of fractional shares is a vexing problem whose solution, by statute, is often unsatisfactory, and in the long run

not especially important.__/ Accordingly, it is suggested that the regulation of fractional shares be left to case-law, but that the statute provide corporations with alternatives, in the following language:

Section . <u>Fractions of Shares and Scrip</u>.

(a) A corporation may, but may not be required to, issue certificates for fractions of a share.

(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 factrions 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

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__/ New York Section 509(a), in effect, permits the issue of fractional shares only "where necessary to effect share transfers, share distributions or reclassifications, mergers, consolidations or reorganizations," and provides that fractional share certificates "shall entitle the holder, in proportion to his fractional holdings, to exercise voting rights, receive dividends and participate in liquidating distributions." South Carolina compels the aggregation of share fractions, "however arising," and permits fractional share certificates only for "fractions of shares remaining after such aggregation." S.C. Code § 12-15.11(a) (Supp. 1963).

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.

F. Subscribers' Liabilities

Sections 162, 163 and 164 are primarily concerned with subscribers' liabilities for unpaid amounts on their subscriptions. These rather archaic provisions do not take account of relevant new statutory developments, perhaps because subscriptions as such are less frequently used, except by small new corporations. For these enterprises, however, several new provisions would be convenient.

1. Section 163 seemingly imposes a statutory obligation on par stock to pay up stock subscriptions only to the amount of par, although the full consideration must be paid in on no-par shares. The no-par rule accords with other statutes. The odd limitation to par unduly favors holders of low par shares which are typically sold or subscribed for at a higher price. Such favoritism is correspondingly detrimental to the corporation and its creditors. Accordingly, the statute should compel all subscribers to pay up any consideration payable under the subscription contract.

2. In the case of good faith transferees of shares or subscriptions, contemporary statutes invariably lift the statutory

requirement to pay up unpaid subscriptions, although the transferor continues liable; and a transferee with notice of nonpayment is liable. In like manner, persons holding unpaid shares as collateral and fiduciaries are not personally liable although the shareholder or the estate or trust are liable respectively. These protective provisions are recommended for the Committee's consideration.

The following New York statute, based on the Model Act and with counterparts in all new statutory revisions, would accomplish these objectives:

(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.

3. The newer statutes, almost invariably, make stock subscriptions irrevocable for a fixed period, usually six months. The subscription may specifically provide for revocability, and even if it does not under some statutes, the corporation or all other subscribers may release a subscriber's otherwise irrevocable obligation. Statutory irrevocability solves an old problem in corporation law, and the following language is recommended:

> 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 sic months from its date.

Under this language, only a pre-incorporation subscription is statutorily irrevocable; a post-incorporation subscription or contract of purchase-and-sale would be subject to ordinary contract and corporation law rules.

4. Many recent statutes now require all subscriptions (both pre-and post-incorporation) to be in writing and signed by the subscriber. This provision has all the advantages (and disadvantages) of any statute of frauds, but in the corporate field written records and evidences of obligations seem especially important. Accordingly, the following language is suggested:

> A subscription, whether made before or after the formation of a corporation, shall not be enforceable

unless in writing and signed by the subscriber. __/

5. Section 164's procedure for foreclosing on a delinquent subscriber is generally satisfactory. The required triple notice by publication is unusual although presumably no significant handicap to the corporation. Otherwise there is no need to change the section.

6. In some statutes, e.g., N.Y. Bus.Corp.Law §§ 503(c), a call for subscription payments must be "uniform as to all shares of the same class or of the same series." This eliminates favoritism to those shareholders who are exempted from the call and hardship to those who are selected for payment; for it spreads the burden of payment among all shareholders and thereby eases the financial impact on all. It certainly does not handicap or inconvenience the type of corporation which typically must resort to this procedure.

G. Dividends

1. Dividends in Cash or Property: Section 170 embodies a long-settled Delaware policy permitting dividends out of any available surplus or out of current or recent net profits ("nimble dividends"). No substantive changes are recommended. Actually, Delaware's liberal dividend policy is relatively more attractive

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__/ This is the language of New York Section 503(b). Perhaps a clearer statement would be: "A subscription, whether made before or after the formation of a corporation, shall not be enforceable against a subscriber, unless in writing and signed by the subscriber or by his agent." This language avoids the possible implication of the New York section that, absent any subscriber's signature, the subscription contract becomes wholly unenforceable.

since many states now limit dividends to earned surplus or (like New York) require detailed disclosure of dividend sources other than earned surplus. Because dividends may be paid from any available surplus, Delaware need not make the distinction taken in many statutes between dividends out of earned surplus and "distributions" from capital surplus requireing shareholder approval (as in the Model Act and statutes following it).

Most states are now more specific than Delaware's Section 173 in defining the permissible types of property in which dividends may be paid. N.Y.Bus.Corp.Law § 510(a) refers to payments "in cash or its (the corporation's) bonds or its property, including the shares or bonds of other corporations," but this is doubtlessly merely declaratory of the common understanding of Delaware's Section 173.

With respect to wasting asset corporations, the newer statute usually make a non-inclusive reference to some of these corporations. New York's Section 510(b), for instance, refers to "a corporation engaged in the exploitation of natural resources or other wasting assets, including patents, or formed primarily for the liquidation of specific assets." Since Section 170(b) was apparently framod with gas, oil, and mining companies in view it would be well to make the statutory coverage broader and more explicit. For example, is a firm opinion possible that a "wasting assets" corporation includes one formed to liquidate specific assets, e.g., a real estate development corporation?

If the standard accounting terminology (referred to *supra* at 224) is used, "surplus" would replace "net assets in excess of its capital . . . ", and "stated capital" would replace "capital" in Section 170(a).

2. Stock Dividends: Section 173 specifically authorizes stock dividends, but says nothing further on the subject. The Committee will wish to consider whether, as a matter of policy, Delaware should follow what is now the universal statutory practice of rather fully providing for the accounting treatment of stock dividends, distinguishing them from dividends in treasury shares and stock splits, and sometimes requiring disclosure of their effect on the corporate accounts. The Reporter's view is that this type of statutory provision is desirable and helpful, and perhaps lends greater assurance to businessmen, but since it is not indispensable to the statute, no specific recommendation is made for its adoption. However, for the Committee's convenience, a typical example appears in the Appendix, *infra* at ; if desired, the Reporter will submit a draft provision specially geared to the Delaware statute.

3. Director's Liabilities: Section 174's language is sound and requires no change. Several supplementary provisions should be considered.

(a) It is now customary to provide by statute that any director held liable under a statute such as Section 174 is entitled to contribution from the other guilty directors. Assuming no contribution among tortfeasors in Delaware, such a provision would change the common law rule and permit an equitable sharing of the burden; if tortfeasors may be compelled to contribute, such a statutory provision would be declaratory of the Delaware rule in this context. See, e.g., New York Section 719(c), and Model Act Section 43 (last sentence).

(b) Statutes also frequently provide for directors held liable for unlawful dividends to be subrogated to any rights of the corporation against shareholders who received dividends knowing of their illegal character. See New York Section 719(d)(1), and Model Act Section 43 (next to last sentence). Some statutes then go a step further and provide for contribution among the guilty shareholders who have been required to pay up. See S.C.Code § 12-18.19 (b)(6).

Adding the following language to Section 174 would implement these purposes:

> (b) 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 unlawful dividend.
>
> (c) Directors against whom a claim is successfully asserted under this section shall be entitled, to the extent of the amounts paid by them as a result of such claims, to be subrogated to the rights of the corporation against shareholders who received such dividend with knowledge of facts indicating that it was not lawfully paid in proportion to to the amounts received by them respectively. Any shareholder against whom a claim is successfully asserted under this

subsection shall be entitled to contribution from other shareholders who received such dividend with knowledge of facts indicating that it was not lawfully paid.

H. Purchase and Redemption of Corporation's Own Shares

1. Power to Purchase Shares: This power is granted by Section 160 (first sentence). While seemingly adequate, it may be contrasted with the usual statutory provision which, incidentally, is customarily recited in the equivalent of Section 122:

> Every corporation shall have power: * * * *
>
> To purchase, receive, take or otherwise acquire, own and hold, sell, lend, exchange, transfer or otherwise dispose of, pledge, use and otherwise deal in and with its own shares.

2. Funds Legally Available for Share Purchases: Section 160 properly permits share purchases only out of surplus. Statutes customarily permit invasion of stated capital, i.e., "impairment of capital" in its Section 160 sense, in several situations besides redemption of redeemable shares (see Section 243(a)). Although infrequently invoked, this additional authority may occasionally be needed. Hence Section 160 should permit use of stated capital if shares are purchased to eliminate share fractions, collect or compromise corporate indebtedness, or pay off dissenting shareholders' appraisal rights--the three usual situations in addition to redemptions. See, e.g., New York Section 513(b)(1)-(3); Model Act Section 5. It is usual to add that, even for such purposes, stated

capital may not be invaded if the corporation is or would become insolvent, viz., unable to pay debts currently maturing. Compare Section 243(a) (Last sentence).

3. Redemption of Shares: Although Section 243's complexity shows its repeated amendments, it is sound and, as to substance, accords with recently revised statutes. This Report does not recommend that it be rewritten. A cross-reference to the general provisions for executing and filing instruments could replace much of present subsection (c). The accounting definitions previously suggested would dovetail with much of the section's present terminology.

4. Rearrangement of Sections: Delaware's treatment of stock purchases and redemptions would gain in clarity by the following rearrangement of the relevant provisions:

(a) Transfer from Section 160 to Section 122 the power to purchase, sell, etc. shares;

(b) Transfer out of Section 160 the prohibition against a corporation voting its own shares, and add new provisions, as recommended in the Report at pp. 139-140;

(c) Add to Section 160 the recommended authority for corporations to purchase shares out of stated capital in special circumstances; and

(d) Transfer Section 243 to Subchapter 5 to be combined with or immediately follow Section 160.

5. Treasury Shares: Although the Committee may not wish the statute to be so specific on accounting matters, corporation laws now specify the consequences of retaining, distributing to

shareholders, and selling treasury shares. Particularly useful is statutory permission to attribute the entire consideration on sale to surplus, and specifically to restore to earned surplus the amount by which earned surplus had been reduced when the shares were purchased. The following language, partly based on New York Sections 515(c) and 517(a)(5), permits this:

> 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 of the corporation. Upon sale or other disposition for a consideration, the full consideration received for such shares shall be capital surplus, but if the shares were purchased out of earned surplus the directors may restore to earned surplus all or any part of the amount by which earned surplus was reduced at the time of purchase.

6. Directors' Liability: Unlike the recent revised statutes, Delaware apparently does not impose any statutory liability on directors who unlawfully purchase or redeem shares, corresponding to their Section 174 liability for unlawful dividends. Under Section 172, good faith reliance on corporate books protects a director only as to dividends but not as to share repurchases. Although the challenged director could fall back on Section 141(f), Section 172 should be amended to cover share acquisitions and redemptions. So, too, a director should have a statutory right to the Section 174 defense of absence or dissent when a share repurchase is attacked. As it now stands there is a hiatus in the statute.

I. Reduction of Capital: Redeemed and Other Reacquired Shares

Section 244 is needlessly complicated, chiefly because its "reduction of capital" concept brackets procedures which, in other statutes, receive separate treatment. In particular, Section 244 demands the same formalities, notably shareholder approval, to retire reacquired shares, as to reduce stated capital in the narrower sense of decreasing the dollar totals in the traditional capital accounts. It is suggested that this identity of treatment forces upon Delaware corporations a needlessly inconvenient procedure __/ not offset by compensating advantages to the corporation, creditors, or shareholders. Recognizing the Committee's reluctance to initiate far-reaching changes, especially in sections of long-standing, the Reporter suggests that this is an area where change would be desirable.

1. Redeemed Shares: Redeemable shares may, under Section 243(a), be redeemed out of surplus or out of stated capital (subject to certain limitations); and they may then be retired __/ or canceled __/ (Section 243(b)) and appropriate certificates of retirement or cancellation filed with the Secretary of State (Section 243(c), (d)). __/

__/ Cf. the second proposal in letter of William H. Talmage, of Falsgraf, Kundtz, Reidy and Shoup, Cleveland, Ohio, dated September 11, 1964. No state has worked out the distinction that letter suggests.

__/ "Retire" is used here to mean restoring shares to the status of authorized or unissued shares. Cf. Section 243(b).

__/ "Cancel" is used here to mean eliminating the canceled shares from authorized shares. Cf. Section 243(b).

__/ Under the Model Act and in many states, redemption itself retires or cancels the shares (without specific action by the board of directors), but thereafter a certificate of retirement or cancellation is filed.

Although the statute could be more specific as to the contents of the document to be filed, __/ the present provision is satisfactory.

Under Section 244(b), a statutory reduction of capital occurs upon "retiring shares owned by the corporation," since the dollar amounts represented by the redeemed shares no longer exist. Hence, Section 244's requirements of shareholder approval and notice-by-publication come into play. This Report's view is that the statute should no longer require a shareholder vote to retire or cancel redeemed shares, whether reacquired out of surplus or stated capital. Most new corporation laws permit the directors alone to retire or cancel redeemed shares, and there is no clear reason why Delaware should not similarly provide. Shareholder interests have some protection, since their consent in the certificate of incorporation to the issue of redeemable shares implies consent to the procedures necessary to deal with those shares on redemption.

2. Other Reacquired Shares: Section 243 deals only with redemption, purchase, conversion or exchange of "preferred or special" shares; but not with purchase or other reacquisition of shares which are not "special or preferred," *e.g.*, common. On reacquisition, presumably the board of directors may hold them as treasury shares or retire or cancel them. __/ Since Section 244 is not limited to "preferred or special" shares, its requirements would apply whenever

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__/ See Model Act Section 61.

__/ As to redeemed or converted shares of "preferred or special" classes, the option is narrowed to retiring or canceling the shares. Section 243(b). This accords with the usual provision elsewhere. Cf. Model Act Section 61; N.Y.Bus.Corp.Law § 515(a) and (b).

common shares are retired or canceled, even though the purchase was out of the surplus accounts as required by Section 160. Once again, the now standard practice permits the board of directors to retire or cancel these shares without a shareholder vote. Model Act Section 62. New York Section 515(d) compels prompt disclosure to shareholders of the effect of this action.

In short, the clear trend is to dispense with shareholder approval of retiring or canceling shares. The real safeguards lie in statutory restrictions on available funds (as to which Delaware substantially accords with most states) and, perhaps, more importantly, the application of fiduciary concepts to use of corporate funds in situations represented by Bennett v. Propp, 187 A.2d 405 (S.Ct.1962); Kors v. Carey, 39 Del.Ch. 47, 158 A.2d 136 (Ch. 1960); and Cheff v. Mathes, 199 A.2d 548 (S.Ct. 1964).

3. Stated Capital Reductions Other Than by Redemption or Reacquisition of Shares:

Stated capital has long enjoyed protection, more ritualistic than substantive, largely because of the antique lore built up on the concept of a supposedly untouchable "trust fund for creditors". With the gradual but steady decay of this doctrine, archaic restrictions have been eased, *e.g.*, the 1929 amendment reducing the shareholder vote under Section 244 from two-thirds to majority. The trust-fund doctrine was decimated when directors on issuing no-par and low-par shares, could allocate large parts of the market price to capital surplus rather than stated capital; for the premise of a viable "trust-fund" doctrine is a fixed capital relatively large in relation to prospective liabilities. Today, the operative distinction between stated capital and the surplus accounts is the ease with which dollar amounts so labeled can be reached by the directors (contract restrictions aside).

In certain situations it seems formalistic to require shareholder action to reduce capital. For instance, although directors may act alone to transfer surplus to stated capital without allocation to a specified class of shares (Section 154, sentences 4 and 5) they cannot reverse the process and re-allocate these dollar amounts to a surplus account. Directors may fix the allocation of consideration for no-par shares between stated capital and capital surplus (see Sections 153 and 154) but may not alone transfer to surplus amounts once attributed to stated capital. Directors may allocate amounts in excess of a low par to capital surplus (Section 154) but once those amounts over par are allocated, they may not subsequently be re-allocated to surplus. The logic of this approach is not clear except on the theory of stated capital as a rigidly fixed dollar figure.

New York's Section 516 logically permits directors to reduce stated capital in these three categories, with certain safeguards (more meaningful than a shareholder vote): (1) prompt disclosure of the effect of director action, Section 516(c); and (2) requiring that stated capital not fall below the aggregate par value of all par shares and the liquidating preferences of all preferred shares, Section 516(b).

This procedure is a logical step, but not as much needed as increased ease of retiring and canceling shares. But if the directors are allowed to reduce stated capital, the New York safeguards should be added; and this may involve more change than the Committee now wishes to make.

4. Mechanics of Amending Section 244: The recommendations as to retiring or canceling shares may be implemented by dropping all references to them in Section 244(b). The certificates provided for in Section 243(c) and (d) would sufficiently cover (1) redeemable "preferred or special" classes of shares which have in fact been redeemed or repurchased, and (2) other "preferred or special" classes which have been "converted or exchanged." Section 243 would not, however, cover retirement or cancellation of other reacquired shares; and additional language would have to be inserted to cover these shares.

J. Surplus and Reserves

All new statutes validate various accounting procedures which give the directors flexibility and certainty in the handling of corporate accounts. It is believed that provisions of this sort would be attractive to existing and would-be Delaware corporations.

1. Consolidated Earned Surplus: An important and widely-adopted statutory provision automatically carries forward the aggregate earned surplus accounts of constituent corporations in a merger, consolidation, or pooling-of-interests; and thus makes the combined surplus available for normal earned surplus uses. __/ The following provision is suggested:

> After merger, consolidation, or combination of two or more corporations by purchase of all or substantially all of the outstanding shares or of the property and assets of another corporation, domestic or foreign, the amount of earned surplus of the surviving, new, or purchasing corporation shall not exceed the aggregate net earned surplus of the constituent corporations as it existed immediately prior to such merger, consolidation, or combination, reduced by such distributions to shareholders and transfer of earned surplus to stated capital or capital surplus as were made in connection with the issue of shares or otherwise at the time of merger, consolidation, or combination.

__/ Of course, a deficit in Corp. A's earned surplus will reduce the plus figure in Corp. B's earned surplus on merger, etc.

A similar provision has been widely adopted, not only in Pennsylvania (see letter of Drinker Biddle & Reath, dated July 28, 1964), but elsewhere, e.g., N.Y. § 517(a)(1)(B); Model Act § 19 (Supp. 1964). __/

2. Quasi-Reorganization: Most statutes now specifically validate accounting reorganizations by which capital surplus is used to reduce or eliminate a deficit in the earned surplus account so that undistributed future earnings build up a plus figure in earned surplus, rather than gradually reduce a minus figure. Absent indenture restriction, any type of capital surplus, e.g., reduction surplus, revaluation surplus, paid-in surplus, etc., may be so employed. Two possible safeguards are available. (A) Many states require a shareholder vote, usually a majority of voting shares (as in New York and Pennsylvania) although sometimes the percentage is fixed at two-thirds (Ohio) or preferred shareholders must approve

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__/ Model Act Section 19 states this somewhat more affirmatively than New York (and the provision recommended in the text of the Report), but with substantially the same result:

> If shares have been or shall be issued by a corporation in merger or consolidation or in acquisition of all or substantially all of the outstanding shares or of the property and assets of another corporation, domestic or foreign, any amount which would otherwise constitute capital surplus under the provisions of this section (corresponding to Delaware's Section 154, see Report at p. 234) may instead be allocated to earned surplus by the board of directors of the issuing corporation except that its aggregate earned surplus shall not exceed the sum of the earned surpluses as defined in this Act of the issuing corporation and of all other corporations, domestic or foreign, that were merged or consolidated or of which the shares or assets were acquired.

(North Carolina). (B) Other states only compel disclosure of the action taken by directors, as in California, Nevada, Maryland, South Carolina, and Virginia. Sometimes, both a shareholder vote and disclosure of the effect on accounts is required, as in Ohio and New York. Perhaps, the most flexible technique is to authorize director action without a shareholder vote but require prompt disclosure to shareholders of the effect of the quasi-reorganization. The following language is suggested:

> A corporation may, by action of its board of directors, apply any part or all of its capital surplus to reduce or eliminate any deficit in the earned surplus account. Each such application of capital surplus shall, to the extent thereof, effect a reduction of capital surplus. Each such application of capital surplus shall be disclosed in the next financial statement furnished by the corporation to its shareholders or in the first notice of dividend or other distribution that is furnished to shareholders between the date of such application and the next financial statement, and in any event within six months of the date of such application.

3. Transfers to Stated Capital: Section 154 (sentence 4) already contains the standard provision allowing transfers from surplus to stated capital. Using the contemporary terminology, this could be reworded as follows:

> The board of directors may at any time transfer all of any part of earned surplus to capital surplus or to stated capital, or transfer all or any part of capital surplus to stated capital.

4. Reduction Surplus: It is normal also to provide as follows for reduction surplus:

> Any surplus resulting from reduction of stated capital, however effected, shall be capital surplus.

5. Reserves: If the foregoing provisions, or any of them are adopted, it should be stated that they do not preclude a corporation from restricting or creating reserves in any surplus account, or increasing, decreasing or eliminating any such reserves or lifting any restriction. Both Delaware's Section 171 (in the dividend context) and New York's Section 517(b) eliminate any possible implication that statutory provisions of this sort might hinder director's discretion with respect to reserving or restricting surplus accounts.

K. Pre-emptive Rights

Section 103(b)(3) allows the certificate to limit or deny pre-emptive rights. A similar provision appears in the Model Act and in many state statutes. On balance, this Report suggests that, while this provision is not wholly satisfactory, it is probably preferable to its alternatives. The chief objection is that it assumes the continued existence of a common-law pre-emptive right, the scope of which is not clearly defined even in the case-law both in Delaware and elsewhere.

Perhaps the most satisfactory alternative, if one is sought, is a statutory denial of all pre-emptive rights which may, however, be granted by the certificate, either by a general provision that pre-emptive rights exist in all stock issues for whatever purpose, or by enumerating situations where the pre-emptive right exists. Its major advantage is to clear away all common-law uncertainty by abolishing the right which exists, if at all, as a matter of contract. This provision is found in California (Sections 305(b) and 3601(f)), Indiana, Oklahoma, and Pennsylvania (Tit. 15 §§ 2852-611), and is an optional alternative under Model Act Section 24. __/

From Delaware's standpoint, the least attractive alternative is a statutory enumeration of the circumstances when pre-emptive rights do and do not exist, subject to any certificate provision expanding or contracting them. This is found, in its most complex form, in New York's Section 622. None of its advantages would be especially attractive to Delaware interests, and it would involve a more radical alteration of existing law and practice than seems necessary.

Even if no substantive change is made, the Committee may wish to consider a statutory procedure along these lines: Wherever pre-emptive rights exist, notice must be given to shareholders stating the time, price and other conditions for exercising the right. If notice is given within a fixed time period shareholders are conclusively presumed to have had a reasonable time to act. New York requires 15 days, other states a longer or shorter

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__/ The Pennsylvania provision is recommended in the letter dated September 14, 1964, from Duncan O. McKee, of Ballard, Spahr, Andrews & Ingersoll of Philadelphia, Penna., p.2, pointing out that this avoids any "unintentional grant of preemptive rights."

period.__/ Thereafter, the securites may be sold or optioned free of pre-emptive rights.__/

APPENDIX

Stock Dividends

Model Act Section 40, set forth below, is the basis for a number of state statutes dealing with stock dividends. New York Section 511(f) also compels disclosure of the effect of the stock dividend on corporate accounts.

> The board of directors of a corporation may, from time to time declare and the corporation may pay dividends on its outstanding shares in cash, property, or its own shares, except when the corporation is insolvent or when the payment thereof would render the corporation insolvent or when the declaration or payment thereof would be contrary to any restrictions contained in the articles of incorporation, subject to the following provisions:
>
> (a) Dividends may be declared and paid in its own shares out of any treasury shares that have been reacquired out of surplus of the corporation.

__/ N.Y.Bus.Corp.Law § 622(g) provides: The board shall cause to be given to each shareholder entitled to purchase shares or other securites 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 rights 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.

__/ In New York, the pre-emptive right automatically re-applies to shares not sold within one year from the expiration of the time period when shareholders may be required to act. N.Y.Bus.Corp.Law § 622(h).

(b) Dividends may be declared and paid in its own authorized but unissued shares out of any surplus of the corporation upon the following conditions:

(1) If a dividend is payable in its own shares having a par value, such shares shall be issued at the par value thereof and there shall be transferred to stated capital at the time such dividend is paid an amount of surplus equal to the aggregate par value of the shares to be issued as a dividend.

(2) If a dividend is payable in its own shares without par value, such shares shall be issued at such value as shall be fixed by the board of directors by resolution adopted at the time such dividend is declared, and there shall be transferred to stated capital at the time such dividend is paid an amount of surplus equal to the aggregate value so fixed in respect of such shares; and the amount per share so transferred to stated capital shall be disclosed to the shareholders receiving such dividend concurrently with the payment thereof.

(c) No dividend payable in shares of any class shall be paid to the holders of shares of any other class unless the articles of incorporation so provide or such payment is authorized by the affirmative vote or the written consent of the holders of at least a majority of the outstanding shares of the class in which the payment is to be made.

A split-up or division of the issued shares of any class into a greater number of shares of the same class without increasing the stated capital of the corporation shall not be construed to be a share dividend within the meaning of this section.

Sequestration

A major question before the Committee is the advisability of changing Delaware's procedure for sequestration of stock of domestic corporations. __/ So far only the alternatives of retention or repeal have been suggested, with some out-of-state law firms unqualifiedly recommending repeal. The usual ground is the alleged hardship on non-resident stockholders of being sued in Delaware, but this has been seriously questioned by the Supreme Court, see Sands v. Lefcourt Realty Corp., 35 Del.Ch. 340, 348, 117 A.2d 365 (S.Ct. 1955) and by at least one impartial law review commentator, Note, 73 Harv.L.Rev. 1579 (1960).

This Report suggests that before repealing sequestration on the basis of these assertions, it should be determined (1) that sequestration is a genuine hardship in a substantial number of cases, rather than in some sporadic or isolated instance, and (2) that sequestration is an actual deterrent to Delaware incorporation. If the latter premise is true, it is recommended that, at least for the present, the Committee seek, instead of repeal, one of several possible modifications of practice.

1. Delaware's Interest in Sequestration: Assuming some inconvenience to a non-resident sued in Delaware, the question is whether legitimate Delaware concerns sufficiently outweigh the non-resident's desire to be sued, if at all, only at home. There are several such Delaware interests:

__/ Besides Delaware, the following jurisdictions, as of 1960, had not enacted Section 13 of the Uniform Stock Transfer Act which requires seizure of a certificate or surrender to the corporation to perfect attachment of stock; California, Colorado, Florida, Georgia, Kansas, Massachusetts, Missouri, Nebraska, New Hampshire, Oklahoma, and Vermont. California's 1963 adoption of the Uniform Commercial Code may have worked an implied or express repeal of its older rule regarding attachment.

(a) Sequestration helps to center litigation concerning Delaware corporations in Delaware courts. This insures one single forum in which the litigation may be pressed to a conclusion on the merits with comparatively few major procedural obstacles. Apart from decreased effectiveness of remedies, loss of the Delaware forum will likely loosen the control of Delaware courts over Delaware corporate law questions, and tend to disperse it among other jurisdictions. Although theoretically these courts must apply Delaware law, they often lack the experience and sensitivity characteristic of Delaware courts. __/ No single tribunal, comparable to the Delaware Supreme Court, is available to coordinate decisions from other courts. Possible confusion from loss of centralized control of Delaware corporate litigation may be a long-run disadvantage.

(b) Related to this is the question whether Delaware wishes to surrender control over Delaware corporation litigation at the same time that it enacts its most comprehensive statutory revision in years. It may be desirable for its courts to continue their traditional jurisdiction while the new statutory provisions require judicial application.

(c) Repealing sequestration will likely weaken remedies for effective enforcement of fiduciary duties, especially if the revisions liberalize aspects of Delaware corporate practice. With sequestration currently available, it is usually possible to bring into a single forum both the Delaware corporation and non-resident directors accused of

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__/ As the Supreme Court has recognized, among the factors governing the Chancellor's discretion in staying a Delaware action in favor of an out of state action, is "whether or not the controversy is dependent upon the application of Delaware law which the courts of this State more properly should decide than those of another jurisdiction." General Foods Corp. v. Cryo-Maid, Inc., 198 A.2d 681 (S.Ct. 1964), affirming, 194 A.2d 43 (Ch. 1963).

wrongdoing. Outside Delaware, it may be difficult or impossible to find a single forum, state or federal, where (1) the court has jurisdiction of the case, (2) the venue of the suit is proper, and (3) all necessary and indispensable parties may be served with process. In particular, it may be impossible to gather into a single forum both the wrongdoers and the corporation which will ordinarily be an indispensable party, if the suit is a derivative action; thus a meritorious suit may be entirely defeated. _/ Only under current Delaware practice is it reasonably certain that a claim involving a domestic corporation and defendant non-resident directors can go forward reasonably free of jurisdictional and procedural obstacles irrelevant to the merits of the claim.

(d) If answering suit in Delaware is an inconvenience to some defendants in a multi-party action, it may be convenient to others. On balance, it may be a net benefit to many business interests for the litigation to be centered in a single location, near major financial centers, served by specialist courts and an experienced bar.

(e) Although sequestration is often viewed in the context of derivative suits against non-resident directors, it has other uses. Thus, it affords Delaware creditors a convenient means of reaching at

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_/ Suppose a shareholder charges directors A (a New Jersey resident) and B (a New York resident) with looting their Delaware corporation. With sequestration, it is relatively easy to bring A and B into the Court of Chancery along with the corporation. Absent sequestration, director A could presumably be sued only in New Jersey and B in New York, and whether the corporation could be joined in either state would depend on its "doing business" there. Federal court action would be complicated by requirements of "complete diversity" of parties, so that if the plaintiff is himself a New Jersey resident, he could not maintain the action against A in the New Jersey federal court; and even if he could, there would be the problem of reaching B and the corporation. Although legal ingenuity can moderate some of these difficulties, the fact is that enforcement of duties would be immeasurably more difficult.

least some out-of-state debtors.__/ Sequestration also assures a single convenient forum for litigating, if necessary, the validity of a stock issue, since all shares can automatically be brought into a single forum. Cf. Hodson v. Hodson Corp., 32 Del.Ch. 76, 80 A.2d 180 (Ch. 1938), and Note, 73 Harv.L.Rev. 1591-1592 (1960). It also provides a single forum for litigating shareholders' conflicting claims to be registered as owner. See Bartlett v. General Motors Corp., 36 Del.Ch. 131, 127 A.2d 470 (Ch. 1956).__/

2. Factors Favoring Repeal of Sequestration: This Report attempts to state impartially and then evaluate the major arguments against sequestration.

(a) Sequestration is unfair to non-resident shareholders who may be brought into an inconvenient Delaware court to answer claims, whether or not related to the shares they own. Assuming Delaware's jurisdiction is well grounded, the defendant's alternatives are unattractive: entering a defense which necessarily requires defendant to make a general appearance or suffering a default judgment. This argument is unquestionably valid, but whether is calls for repeal of sequestration is another matter. Occasions of genuine hardship may actually be infrequent; moreover, the hardship cases may be relieved by measures short of abolishing sequestrations.

(b) Sequestration goes beyond Delaware's legitimate interests in litigation involving its corporations, and their managers, and potentially sweeps into Delaware courts litigation having little significant relation

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__/ Of course, it affords out-of-state creditors the same opportunities, sometimes to be used for harassment or strategic advantage.

__/ This accords with Uniform Commercial Code Section 8-106 by which the law of the corporation's domicile is controlling as to registering transfer of the corporation's securities.

to Delaware interests. __/ It enables a non-Delaware claimant to proceed in the Delaware courts against a non-resident simply because the non-resident happens to own shares whose situs is fictionally in Delaware. Sequestration thus opens the way to serious possibilities for harassing non residents.

There are several answers to this contention. First, most of these objections could be made against any type of foreign attachment of property, but this has not persuaded states to abolish their traditional jurisdiction over property situated within their borders. Secondly, any remedy is inevitably subject to abuse, but this alone is no reason to abolish the remedy, although it is a reason to refine and perfect the remedy. Thirdly, apart from the likely infrequency of a clear use of sequestration to harass, it is assumed that Delaware courts would be able to deal with demonstrated misuse; and if not, they should be empowered to handle the problem.

(c) Even in the area of claims involving Delaware corporations, sequestration goes too far. Most states have no procedures for reaching non-resident directors, officers, and shareholders. And non-resident director statutes, in the few states which have them, are narrower in scope than Delaware's sequestration. For these statutes apply only to suit against former or incumbent directors as to matters related to their conduct in a particular corporation. In contrast, sequestration applies not only to directors but to any shockholders, and it is not therefore limited to challenging an individual's stewardship of his corporation, and may indeed have no relation at all to the corporation in which he owns

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__/ For instance, is there any bar to a Mississippi plaintiff bringing suit in Delaware for alleged libel by a defendant also a resident of Mississippi, who owns a large block of shares in a Delaware corporation? A Mississippi state court enjoined a plaintiff from proceeding with just such an action. Poole v. Mississippi Publishers Corp., 208 Miss. 264, 44 So. 2d 467 (1950).

stock, see <u>Breech</u> v. <u>Hughes Tool Co.</u>, 189 A.2d 428 (Del.S.Ct. 1963) (Breech's appearance in TWA litigation compelled by sequestering his Ford Motor Co. stock). While broader in coverage, sequestration may, unlike non-resident director statutes, be defeated by non-ownership or concealment of shares.

Although sequestration has broader coverage, it apparently is less distasteful to directors than non-resident director statutes. The breadth of sequestration makes it possible to obtain jurisdiction not only over directors but over dominant shareholders who are often the real principals behind challenged transactions. Finally, despite the apparent anomaly of sequestering a man's Ford stock to compel appearance in Trans World Airline litigation, the law has never required that seized property have a relationship to the substance of the claim beyond the fact that the defendant owns it.

(d) The theory of sequestration--that corporate stock is domiciled in Delaware wherever the certificate, the mere evidence of the stock interest, is located--is inconsistent with the prevailing theory of the stock certificate --that <u>ipso facto</u> it is the interest and is as fully transferable as a negotiable note, particularly under the Uniform Commercial Code. There are several pertinent considerations. (A) It is not necessarily inconsistent for a state to make shares fully negotiable, but at the same time save certain powers over that stock in aid of other interests. (B) If there is inconsistency, it is limited to withdrawing from the full negotiability of stock one incident--Delaware's dispensing with the conventional requirement of physical attachment of the stock certificate. Even so, Chancery's aid for the bona fide purchaser, see <u>Haas</u> v. <u>Haas</u>, 35 Del. Ch. 392, 119 A.2d 358 (Ch. 1955); <u>Bartlett</u> v. <u>General Motors Corp.</u>, 36 Del.Ch. 131, 127 A.2d 470 (Ch. 1956), protects the substance of the certificate's negotiability. Certainly the existence of wide trading markets for shares of Delaware corporations suggests the absence of doubts as to their full negotiability. (C) At least one out-of-state court has refused to attach a certificate of stock in a Delaware corporation, Mills v. Jacobs, 333 Pa. 231, 4 A.2d 152 (1939), but whether this will be generally followed is problematical. Whatever the situation under the increasingly supplanted Uniform Stock Transfer Act, the result under the Uniform Commercial Code is even less certain. Interstate comity might help to bar double attachment, but it is impossible to say how useful this will be in practice. Presumably, however, Chancery would continue to follow Haas v. Haas and the Bartlett caseeven if Delaware enacts the Code, which contains nothing inconsistent with those decisions.

In short, sequestration will present problems if all or most states adopt the Uniform Commercial Code, but it is pure speculation to conjecture just how severe the problems will be, except to suppose (with good reason) that the real threat of double attachment will be infrequent.__/

__/ In view of the Code's avowed policy of negotiability of certificates for all securities, courts in those states may consider that giving effect to physical possession of a certificate in the state overrides any inconsistent interest which Delaware may have under its theory of a Delaware situs for stock of Delaware corporations. With respect to attaching a stock certificate, Code Section 8-317 goes beyond USTA since it eliminates the provision under USTA permitting attachment of stock by enjoining its transfer. In all attachments and levys, the Code requires actual physical possession of the certificate. The theory is that, despite an injunction, the stockholder has the power to violate the injunction and transfer the certificate to a bona fide purchaser. See Overlock v. Jerome Portland Copper Mining Co., 29 Ariz. 560, 243 Pac. 400 (1926).

(e) Even if sequestration works no actual and substantial hardship to most non-resident directors, the impression that it does is damaging to Delaware's interests. It is difficult to judge whether such an impression is prevalent, but even if there is some misunderstanding about the Delaware practice, this alone seems insufficient ground for repealing sequestration, especially if possible hardship can be alleviated by other means.

3. Possible Modifications of Existing Delaware Practice:

Assuming that the Committee favors relief from some consequences of sequestration, several alternatives should be considered.

(a) Statutory Limited Appearance: Sands v. Lefcourt Realty Corp., 35 Del.Ch. 340, 117 A.2d 365 (S.Ct. 1955) rejected the contention of a non-resident defendant, whose shares had been sequestered, that he be allowed to make a "limited appearance" to defend on the merits of the suit with recovery, if any, limited to the value of the sequestered shares. The Supreme Court observed that the statute envisioned only a special appearance (to contest jurisdiction) or a general appearance (involving full submission to Delaware court jurisdiction).

A statutory limited appearance is a possible alternative. It has been adopted by some statutes and applied in several decisions (cited in the Lefcourt case, supra at 346; see especially Miller Bros. v. State, 201 Md. 535, 95 A.2d 286, 291-292 (1953)). Restatement, Judgments § 40 states that in proceedings begun by attachment or garnishment or by creditor's bill, it is only fair and "reasonable" to extricate defendant from the "difficult dilemma" of being "compelled either to lose his property, even though the claim against him is unfounded, or to submit himself personally to the jurisdiction of the court which otherwise could have no power over him." Comment a, at p. 154.

It should be recognized that a "limited appearance" statute is not consistent with the basic theory of Delaware sequestration which is simply to compel a general appearance to answer the charges. As a half-way house between a common-law special and general appearance, it does not alleviate the most frequent objection to sequestration, since it still requires the non-resident shareholder to defend the Delaware action. __/ In short, sequestration should be sustained or rejected on a decision that its "sole primary purpose", *United States* v. *Loft, Inc.*, 25 Del.Ch. 363, 367, 19 A.2d 721 (S.Ct. 1941), does or does not serve Delaware's best interests, and if sequestration is to be retained, any modifications should be consistent with that purpose. Otherwise the advantages of sequestration are lost and the usual objections are not significantly lessened.

(b) *Limiting Sequestration to Specified Claims*: It is possible to make the sequestration procedure available only to confer jurisdiction in a limited category of cases. __/ For example, a statute might provide that a defendant's stock could be sequestered only for purpose of maintaining a suit against an incumbent or former director or officer on a cause of action relating to corporate affairs during his term of office. This would import into sequestration the standard of the non-resident director statutes, see S.C.Code § 12-13.7(a) (Supp. 1963), and would thus eliminate sequestration of shares of a stockholder not a director or officer. In essence, it would create a somewhat inefficient form of non-resident director statute whose application

__/ Defendant may still feel "harassed", Delaware may still be "inconvenient" for him; litigation expenses will be still incurred. The gain, from his standpoint, is avoiding a personal judgment.

__/ A statute could, in principle, preserve sequestration in all but certain categories of cases, but this would be extremely difficult to draft.

would depend upon the accident of known ownership of shares. If it were the sole standard, obviously sequestration for other types of suits (see p. 267 supra) would be abolished.[/]

As with a statutory limited appearance, a non-resident could still object to a forced appearance in a forum "foreign" to him. Unlike a limited appearance, it would exclude certain types of cases in which Delaware's interest is less apparent or where chances of harassment are significant.

(c) Forum Non Conveniens: The doctrine of the inconvenient forum could be used to ameliorate genuine hardship in suits against non-residents, including those brought into Delaware through sequestration of stock. Apparently, Delaware has recognized discretionary stays or dismissals of Delaware actions only in cases where an already instituted suit was pending between the same parties in another jurisdiction, General Foods, Inc. v. Cryo Maid, Inc., 198 A.2d 681 (S.Ct. 1964); Winsor v. United Air Lines, Inc., 2 Storey 161, 154 A.2d 561 (Super. 1958). Forum non conveniens is not ordinarily so limited, and many decisions dismiss a suit in the forum state, even though no suit is pending elsewhere--often as a device to compel plaintiff to bring the suit in the more convenient forum. This doctrine has been applied in equity, and in Koster v. Lumbermens Mut. Cas. Co., 330 U.S. 518 (1947) the Supreme Court directed an inconvenient lower federal court to dismiss a diversity-based shareholder derivative action

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[/] Since non-resident director statutes are constitutional, see this limited use of sequestration would probably pass muster.

in New York since all facets of the case were closely related to Illinois._/ Application of the doctrine is a matter of equitable discretion, under the broad criterion of justice and convenience to parties and witnesses. The classic statement of the relevant factors appears in Gulf Oil Corp. v. Gilbert, 330 U.S. 501, 508 (1947), which were specifically approved and applied in Winsor v. United Air Lines, Inc., supra at 563-564. Of itself, the state in which the defendant is incorporated is a minor factor. Koster v. Lumbermens Mut. Cas. Co., 330 U.S. 518, 527-528. Cf. Winsor v. United Air Lines, Inc., supra at 564; General Foods Corp. v. Cryo-Maid, Inc., 198 A.2d 681 at 684.

In view of this partial recognition of the forum non conveniens concept, it is suggested that the doctrine may be expanded so as to afford relief from some objections to sequestration, by vesting the Court of Chancery with discretion to decline its unquestioned jurisdiction of the case, where Delaware is an obviously inconvenient place to litigate the issues. Application of the doctrine is consistent with the basic theory of sequestration, and retains whatever benefits are thought to flow from that procedure.

It is doubtful that many cases, initiated through sequestration,

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_/ This decision and its companion, Gulf Oil Corp. v. Gilbert, infra, are "common law" rulings. The familiar transfer provision was subsequently enacted as a substitute for dismissing one action and starting another. However, transfer under Sec. 1404 of the Judicial Code has not pre-empted the forum non conveniens doctrine. At least one federal court has recognized that it has the power to dismiss a suit in New York federal district court where a suit in a foreign tribunal (to which transfer is obviously impossible) would be more convenient. Harrison v. United Fruit Co., 141 F.Supp. 35 (S.D.N.Y. 1956) (court refuses to dismiss where convenience of Honduras tribunal not clearly proven).

would require application of the doctrine. Indeed, it should not be promiscuously granted since, after all, it deprives the plaintiff of the forum of his choice,__/ and the court of its jurisdiction. Hence, applying the doctrine requires a balancing of interests,__/ and, if necessary, some device for compensating the plaintiff for any resulting delay or inconvenience to him. Presumably, any request to apply <u>forum non conveniens</u> would be made early in the proceedings, so that the question could be disposed of promptly one way or another.

A New Jersey court, without aid of statute, has recognized judicial power to dismiss a suit in New Jersey on condition that it be promptly instituted in another specified jurisdiction with additional conditions designed to prevent plaintiff from finding himself in a worse position in the other forum. <u>Vargas</u> v. <u>A.H. Bull S. S. Co.</u>,__/ was a Jones Act suit in New Jersey by Puerto Rican seamen arising out of an accident in Puerto Rico involving a ship owned by defendant, a New Jersey corporation. Witnesses and relevant documents were situated in Puerto Rico, and testimony would be in Spanish. The New Jersey court dismissed the action, on defendant's undertaking (1) to accept service in Puerto Rico if plaintiff sued there within 90 days, (2) to

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__/ In the context of derivative suits, it would be appropriate to consider whether the state in which suit would be brought if dismissed in Delaware requires judicial approval for a compromise. Otherwise, a collusive settlement, contrary to Delaware policy, might result. Cf. <u>Koster</u> v. <u>Lumbermen's Mut. Cas. Ins. Co.</u>, 300 U. S. 518, 525 (1947)

__/ The Supreme Court of the United States has observed that "unless the balance is strongly in favor of the defendant, the plaintiff's choice of forum should rarely be disturbed." <u>Gulf Oil Corp</u>. v. <u>Gilbert</u>, 330 U. S. 501, 508 (1947).

__/ 44 N.J. Super. 536, 131 A.2d, <u>affirmed</u>, 25 N. J. 293, 135 A.2d 857 (1957), <u>cert. denied</u>, 355 U.S. 958 (1958).

pay costs and reasonable attorney fees in the New Jersey action, and (3) not to jeopardize plaintiff's Puerto Rican suit by pleading the statute of limitations.__/ The New Jersey court retained jurisdiction.

A Wisconsin forum non conveniens statute (Wisc. Stat. Ann. tit. 25 § 262.18 (Supp. 1964) infra, p. 278), in effect, codified the New Jersey approach. It envisions a stay, promptly sought by defendant, on conditions specified by the statute; if granted, Wisconsin jurisdiction is retained for a maximum of five years after which the Wisconsin suit is formally dismissed.

If Delaware adopted such a procedure in cases initiated by sequestration, the Delaware tribunal could improve on the New Jersey approach by *staying*, rather than dismissing, the action, on conditions appropriate to the case. Moreover, since, by hypothesis, the Delaware court has jurisdiction of the case through sequestration of defendant's stock, it should have the power, in its discretion, to require the defendant to post bond (up to the value of the stock) as a condition to granting defendant's stay motion and to insure performance of conditions, if any, stipulated in the stay order. However, this power, if available, should be used sparingly, as it seems abhorrent to compel defendant to purchase a convenient forum through a possibly heavy bond, and thereby thwart the *forum non conveniens* remedy.

__/ The innovating disposition of the court is shown by the further fact that admittedly defendant could not be served with process in Puerto Rico, but agreed to submit voluntarily if the New Jersey action were dismissed. Most of the opinion is concerned with the question whether dismissal is to be refused "*solely* because defendant was not subject to process in the more convenient jurisdiction *when* the action was started", 131 A.2d at 42 (emphasis in original).

If the Delaware action is to be stayed, the Delaware court should have discretion to exact other conditions. Payment of plaintiff's Delaware expenses may sometimes be appropriately required, since by hypothesis, he is being removed from the forum of his choice and, in effect, required to start the suit over. _/ Defendant should also be required to accept service of process if the convenient forum it insists upon is a jurisdiction where it could not be served; and it should also be required to waive any relevant statute of limitations in the other forum. Such conditions are not an unfair price to the defendant of granting the relief he desires--the more convenient forum. Finally, plaintiff should be required to institute his action within a specified brief period of time in the other forum.

It is believed that statutory or other specific recognition of _forum non conveniens_ would go far towards eliminating current objections to sequestration, while at the same time preserving Delaware's legitimate interests. _Forum non conveniens_, and transfer of cases within the federal system, is increasingly familiar to attorneys and to corporations. Indeed, broadened state-court jurisdiction, coupled with discretionary declination of jurisdiction, is becoming characteristic of the modern American judicial scene. It is believed that this type of approach should be considered before the traditional Delaware jurisdiction is abolished.

_/ If there is reason to suspect that plaintiff selected Delaware merely to harass defendant or gain a strategic position, reimbursement of plaintiff's Delaware expenses should be denied. This element apparently influenced the Delaware courts to stay a Delaware action in favor of a later-instituted Illinois suit between the same parties. _General Foods Corp._ v. _Cryo-Maid, Inc._, 198 A.2d 681, 684 (S.Ct. 1964), _affirming_, 194 A.2d 43, 45 (Ch. 1963). In general, any such factor should weigh heavily in defendant's favor.

APPENDIX

Wisconsin Statutes Annotated

Tit. 25, Sec. 262.19

§ 262.19 Stay of proceeding to permit trial in a foreign forum

(1) Stay an initiative of parties. If a court of this state, on motion of any party, finds that trial of an action pending before it should as a matter of substantial justice be tried in a forum outside this state, the court may in conformity with sub. (3) enter an order to stay further proceedings on the action in this state. A moving party under this subsection must stipulate his consent to suit in the alternative forum and waive his right to rely on statutes of limitation which may have run in the alternative forum after commencement of the action in this state. A stay order may be granted although the action could not have been commenced in the alternative forum without consent of the moving party.

(2) Time for filing and hearing motion. The motion to stay the proceedings shall be filed prior to or with the answer unless the motion is to stay proceedings on a cause raised by counterclaim, in which instance the motion shall be filed prior to or with the reply. The issues raised by this motion shall be tried to the court in advance of any issue going to the merits of the action and shall be joined with objections, if any, raised by demurrer or pursuant to s. 262.16. The court shall find separately on each issue so tried and these findings shall be set forth in a single order which is appealable.

(3) Scope of trial court discretion on motion to stay proceedings. The decision on any timely motion to stay proceedings pursuant to sub. (1) is within the discretion of the court in which the action is pending. In the exercise of that discretion the court may appropriately consider such factors as:

(a) Amenability to personal jurisdiction in this state and in any alternative forum of the parties to the action;

(b) Convenience to the parties and witnesses of trial in this state and in any alternative forum;

(c) Differences in conflict of law rules applicable in this state and in any alternative forum; or

(d) Any other factors having substantial bearing upon the selection of a convenient, reasonable and fair place of trial.

(4) Subsequent modification of order to stay proceedings. Jurisdiction of the court continues over the parties to a proceeding in which a stay has been ordered under this section until a period of 5 years

elapsed since the last order affecting the stay was entered in the court. At any time during which jurisdiction of the court continues over the parties to the proceedings, the court may, on motion and notice to the parties, subsequently modify the stay order and take any further action in the proceeding as the interests of justice require. When jurisdiction of the court over the parties and the proceeding terminates by reason of the lapse of 5 years following the last court order in the action, the clerk of the court in which the stay was granted shall without notice enter an order dismissing the action.

Subchapter 6. <u>Stock Transfers</u>

Subchapter VI should be left intact. If the Uniform Commercial Code is adopted in Delaware, the Uniform Stock Transfer Act will be automatically repealed. If the Code is not adopted, and in all events until its effective date if adopted, the Stock Transfer Act should continue unchanged.

The Committee's decision on the merits of sequestration will determine what is to be done to Section 202, which, together with the deletion of Section 13 of the Stock Transfer Act, precludes that Act from repealing the foreign attachment and sequestration laws.

If the Committee decides to retain sequestration, with or without modifications, and if the Code is likely to be recommended, certain changes must be made in Article 8 (Investment Securities) to conform to the corporation law. The Reporter is available to recommend the necessary changes when the Committee has made its decision on sequestration.

Subchapter 13. <u>Suits Against Corporations, Stockholders, Directors, etc.</u>

This Report does not recommend any changes in the provisions of this Subchapter. Section 324's provision for foreign attachment of shares involves many of the same considerations as the counterpart procedure in equity for sequestering shares. Section 327's provision that only a contemporaneous owner of stock may sue derivatively has been considered, <u>supra</u> at 98-99. Section 329, abolishing collateral attack on corporate existence, is a most desirable provision and should clearly be retained intact.

Subchapter 14. Foreign Corporations

Although the Committee may wish to leave Subchapter 14 unchanged, this Report will, in the interests of completeness, point out the areas in which amendments should be considered.

1. Foreign Corporation's Powers:

The Delaware statute, unlike other corporation laws, nowhere indicates the scope of powers of the qualified foreign corporation. Presumably, what is expressly stated in other statutes, is tacitly assumed by Section 341: (See Model Act Section 100)

> A foreign corporation may be authorized to do in this state any business which may be done lawfully in this state by a domestic corporation, to the extent that it is authorized to do such business in the jurisdiction of its incorporation, but no other business.

This statement, in N.Y.Bus.Corp.Law § 1301(a) (as amended in 1964), is a refined version of a provision generally found elsewhere. Its purpose is obvious: to avoid favoring a foreign over a domestic corporation with respect to permissible types of business.

2. Purpose of Local Operations:

It should be noted--although it is not necessarily objectionable--that upon qualifying, a foreign corporation may apparently do in Delaware any or all of the businesses which its charter authorizes it to do. Unlike other states, there is no compulsory disclosure as to the specific type of business which the foreign corporation intends to do locally. It is customary for the application of the foreign corporation to include (in the language of N.Y.Bus.Corp.Law § 1304(a)(3)):

> A statement of the business which it proposes to do in this state and a statement that it is authorized to do that business in the jurisdiction of its incorporation.

For the benefit of creditors and other local interests a foreign corporation should declare of record its intended local business. For instance, a Wyoming corporation, may qualify in Delaware merely by filing its charter which, under Wyoming law, need only state that its purpose is to do any lawful business. It is usual for statutes to specify the procedure by which the foreign corporation may amend its certificate of qualification to indicate changes in the business it is doing or proposes to do locally.

3. Exemptions from Qualification Requirement: The thrust of Section 343 is to exempt concerns which solicit or advertise in Delaware but consummate contracts outside the state, and those which do only an interstate business. How far exemptions are to be granted is a matter of state policy, not of constitutional requirement. This Report tends to favor relatively narrow exemptions (as in Delaware) but points out other exemptions normally granted today, even by otherwise notably "strict" jurisdictions. __/

(a) Several of the customary exemptions seem harmless:

(1) Maintaining or defending any action or suit within the state.

__/ Most of the existing Delaware exemptions are not recognized by New York; in different form, they appear in the Model Act.

(2) Holding meetings of directors or of shareholders within Delaware.

(3) [illegible] bank accounts [illegible] like institution.

(4) Engaging a Delaware institution as transfer agent, registrar, or depositary of any sort.

These four exemptions are routinely granted. See Model Act Section 99 ; N.Y. § 1301(b); etc. Presumably, Delaware would have no intention of subjecting a foreign corporation to in-state qualification merely by virtue of doing one or more of these acts, but explicit statement of this fact should be considered.

(b) A number of states grant a specific exemption to a foreign corporation which "conducts an isolated transaction completed within a period of six months and not in the course of a number of repeated transactions of like nature." N.C.Gen.Stats. § 55-131(b)(9); Model Act Section 99 . This has a generic resemblance to the Section 343(3) exemption for special services of technicians or engineers. The exemption seems overly generous, and its value to local interests is not expecially apparent.

(c) Finally, many states grant a questionable exemption for concerns which make or invest in loans, secured or unsecured, foreclose on mortgages or other security, dispose of the foreclosed property, etc. Model Act ection 99 . This exemption is noted but not recommended.

4. <u>State Action Against Unqualified Corporations:</u> Section 348 imposes minor monetary penalties upon corporations which must but do not obtain local operating authority. It would be more effective if, in addition, the Attorney General held in reserve the power, expressly

granted in other statutes, to seek an injunction against (a) any corporation which is doing non-exempt business without qualification, and (b) any corporation which has procured qualification through fraud or misrepresentation. Infrequently as such powers are invoked, their mere existence has a desirable _in terrorem_ effect. Compare Section 283(a) (domestic corporations).

5. Other Sanctions Against Unqualified Foreign Corporations:

The most effective inducement to observe qualification requirements is the now standard statutory clause barring a foreign corporation from suing in the state courts until it has qualified and paid up all back fees and penalties, if any. However, this does not bar the corporation from defending a suit, nor does it impair the validity of any contract or other transaction. New York's Section 1312 is as follows:

"(a) A foreign corporation doing business in this state without authority shall not maintain any action or special proceeding in this state unless and until such corporation has been authorized to do business in this state and it has paid to the state all fees, penalties and franchise taxes for the years or parts thereof during which it did business in this state without authority. This prohibition shall apply to any successor in interest of such foreign corporation.

(b) The failure of a foreign corporation to obtain authority to do business in this state shall not impair the validity of any contract or act of the foreign corporation or the right of any other party to the contract to maintain any action or special proceeding thereon, and shall not prevent the foreign corporation from defending any action or special proceeding in this state."

5. Application of Chapter: Technically, Subchapter 14 applies only to corporations organized under the law of some state other than Delaware. It is uncertain whether its non-application to a non-American corporation would mean that such a corporation could not do business in Delaware at all, or could enter Delaware without procuring authority. This academic question should be resolved by making clear that Subchapter 14 applies to all corporations, wherever organized. The easiest way to do this is to use the standard definition of "foreign corporation", found in most new statutes: (See Model Act § 2(b)).

> "Foreign corporation" means a corporation organized under the laws of any jurisdiction other than this State.

If used, Sections 341(e) and 343 (preamble) would refer to "No foreign corporation" rather than to "No corporation created," etc. Alternatively, the words "or the laws of any nation or jurisdiction foreign to the United States of America" could be added after the words "the laws of the United States" in each of those sections.

6. Reinstatement of Authority of Foreign Corporations in Default: It has been suggested __/ that Subchapter 14 should specifically provide that foreign corporations, whose authority to do business locally has been revoked for non filing of annual reports for two years, be reinstated upon payment of back fees and taxes. The statute so provides

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__/ See letter of F. K. Tuller of Prentice Hall Corp. System, to Howard Williams, Esquire, dated May 14, 1964.

in the case of domestic corporations. Section 312. Since the Secretary of State's office reinstates defaulted foreign corporations on payment of back fees, this desirable practice should be recognized by statute. Rather than mix foreign corporations into the already overly complex provisions of Section 312, a re-draft of Section 345 is suggested. Besides providing a reinstatement procedure (Subsection (b)), it would amplify the existing statute by describing the kind of notice which the Secretary of State should send to the defaulting corporation. A reinstatement fee of $50.00 should amply cover office expenses of the procedure if and when used by a foreign corporation.

Section 345. Failure to File Report; Termination of Authority; Reinstatement. (Re-draft)

(a) Upon failure, neglect or refusal on the part of any foreign corporation to file an annual report as required by Section 344 of this title, the Secretary of State shall investigate the reasons therefor. If the corporation has failed to file an annual report within any two year period, the Secretary of State shall thereupon send to the foreign corporation a notice that its authority to do business in Delaware has terminated, stating the reason therefor. The notice shall be sent by registered or certified mail, addressed to the registered office or principal place of business of the corporation, and it shall state the reason for the termination of authority to do business in Delaware.

(b) At any time within one year from the date of the notice of termination, the foreign corporation may apply to the Secretary of State for reinstatement of authority to do business in Delaware. The Secretary of State shall grant the application for reinstatement after the corporation has removed the default by (1) filing annual reports for the years in which reports were not filed, (2) by paying all taxes and fees for the years in which taxes and fees were not filed, and (3) by paying for the use of the State a reinstatement fee of $50.00.

BEARER SHARES AND DIRECTORS' PROXY VOTING

The Committee should make a considered decision on the question whether certain peculiarly European practices should be expressly authorized by the Delaware statute, notably bearer shares and permission for directors to act by proxy.

1. Bearer Shares: This form of stock certificates, analgous to bearer bonds, has never caught on in Anglo-American law, although it is widely used in Civil Law systems. Two American states authorize bearer shares: Connecticut and Montana,/ but there is no indication that the older Montana provision (limited to mining companies) has been widely used.

There are several legitimate uses for bearer shares, and specifically, for Delaware to authorize them. First in principle, the chief domicile of American corporations arguably should sanction a device which has proved useful in other parts of the world. Indeed, this may attract some extra-United States enterprises to seek Delaware incorporation, and would facilitate use of the Delaware Foreign Resident Corporation Act (if adopted). Second, bearer shares offer the ultimate in ready transferability and in convenient nominee stock holding. While the latter is

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/ See Appendix, *infra*, setting forth the texts of these statutes susceptible to abuses,/ it may also have legitimate uses for residents of countries which would take hostile action against such stock interests if they could be readily determined.

On the other hand, bearer shares invite serious abuse. Their use overseas is often intended to aid the evasion by concealment of the share assets. Their use also hinders administration of securities regulation laws. Voting of bearer shares if often inconvenient, and from the management standpoint it may be undesirable to have a large number of voting shares with which management finds itself unable to communicate except by newspaper advertisement; and in some cases, procuring a needed quorum and vote may be difficult. The very negotiability of bearer shares is a disadvantage to the shareholder who loses his shares. In short, bearer shares negative the unquestioned advantages of stock registration; and their use would run contrary to a disposition, evident among many bankers and corporations, to curb the use of bearer bonds in favor of fully registered instruments. Finally, bearer shares are sufficiently alien to almost all American corporation and investment security laws and concepts that their authorization and use could well have unexpected consequences in other branches of the law. Certainly, corporations deciding to use them must draft their charters carefully to take account of the special problems of bearer shares, unless (as is unlikely) Delaware

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/ Among these would be concealment of shares in a sequestration proceeding.

should enact a statutory provision similar to Montana's.

It is suggested, therefore, that the balance of convenience is against bearer shares. It is doubtful if an overseas company would come to Delaware merely because bearer shares are authorized, or dissuaded from doing so merely because Delaware did not permit them. So far as foreign resident corporations are concerned, the statute could easily make clear that the share structure of the corporations remains intact, viz., that if it had bearer shares in its original domicile, it need not change over if it takes up Delaware residence / Going beyond this, but not to the point of blanket authorization, a statute could authorize a Delaware corporation whose shareholders are predominately non-residents of the United States to issue bearer shares to such non-residents. This formulation would, in prectice, limit the device to non-American concerns chiefly owned by non-residents. However, a general authorization of bearer shares would be undesirable.

2. Directors' Proxy Voting: A destinctive rule of European corporation law permits directors to vote by proxy, as shareholders do in this country. Not only is this contrary to the traditional concept of a directors' meeting as a forum to exchange ideas, but it also legalizes dummy directors and offers a device for virtually totalitarian control. It is not

/ Acceptance of bearer shares of foreign resident corporations seems implicit in the New Brunswick statute.

clear, too, how director proxy voting would square with American concepts of directors' fidiciary duty, including the "duty of care" and oversight of corporate affairs.

Once again, authorization vel non of director proxy voting is alone unlikely to attract or repel a company considering Delaware incorporation. This is particularly true since many asserted advantages are available through statutes (such as Section) authorizing informal director action. Further authorization for directors to vote by proxy would add nothing genuinely desirable to conveniences already available.

Appendix B: AMERICAN STATUTES RELATING TO BEARER SHARES

Revised Codes of Montana Title 15

15-608 (5959) Stock certificate may be issued to bearer. Any corporation now existing or hereafter created or organized under or by virtue of the laws of the state of Montana, and having a capital stock non-assessable and fully paid within the meaning of the laws of this state, and whose object or purpose, in whole or in part, is to carry on the business of mining within this state, shall have the power to and may, by a vote of its stockholders, holding at least three-fourths of its capital stock, authorize or provide for the transfer and issue of certificates of stock which shall entitle the holder or bearer to the ownership of the same upon delivery and without transfer by indorsement or on the books of such corporation, subject, however, to the by-laws of the corporation and the provisions of this act, but no such transfer or issue shall be made except upon surrender and cancellation of the certificate or certificates so to be transferred, and all bearer certificates so issued shall be delivered to and receipted for on the books of the company by the stockholder or his authorized agent at whose request such transfers shall be made, and thereafter, so far as the corporation is concerned, the bearer of any such bearer certificate shall for all purposes, except that of holding office, be deemed a stockholder of the company, owning and holding the number of shares of its capital stock represented by such bearer certificate, and the stock or shares thereby represented shall be listed to bearer on the list of stockholders and other books of the company.

15-609 (5960) Foreign registry--proxy. Any corporation which shall have issued bearer certificates may establish agencies in other states and in foreign countries whereat holders or bearers of bearer certificates may, under such regulations as the corporation shall prescribe, register and deposit their bearer certificates of stock for voting purposes. Such corporation shall have the right to appoint and prescribe the duties of, fix the compensation, and remove at pleasure its agent or agents at such agencies, and also to establish rules and regulations for registering and depositing bearer certificates of stock, and may at any time close up or terminate any such agency. Whenever, at any meeting of the stockholders of such corporation for election or other purposes, any such agent shall certify to the corporation in such manner as it may prescribe, that there is registered and deposited with him, to be held by him until after the meeting for which such registration and deposit shall have been made, a bearer certificate or certificates describing each by its face number, number of shares represented, and date of issue, and stating when and by whom deposited, the person who shall have made such deposit, may, in writing attested by such agent, appoint some suitable person to represent him at such meeting as his proxy, and there vote the shares of stock represented by his said bearer certificate or certificates so deposited, and thereupon the person to whom such proxy shall have been given may vote the shares of stock represented by such bearer certificate or certificates, in all matters and things upon which votes are cast or had at such meeting.

15-610 (5961) Notice of meetings waived

It shall not be necessary for the corporation or its officers or trustees or directors to give any personal notice or notice by mail to holders or bearers of such bearer certificates of any meeting of stockholders for the purpose of electing trustees or directors, or for any other purpose, or of any action taken or proposed to be taken by such corporation or its stockholders or its trustees or its directors at any meeting, but such notice may, in every case, be given to such holder or bearers of bearer certificates by publication in a newspaper as now provided by law, and shall be valid and binding. Every holder of a bearer certificate shall be held to have waived any notice of any stockholders' meeting for any purpose, or of any action or proposed action of the corporation or its stockholders or trustees or directors, except by publication in some newspaper when it is required by law.

15-611 (5962) Bearer may vote.

Except as herein provided, stock or shares of stock represented by a bearer certificate can only be voted or represented by actual production of such bearer certificate at the time of voting or representation, and by the bearer thereof. In all cases the actual production of a bearer certificate shall, so far as the corporation is concerned, be conclusive evidence of the bearer's right to vote or represent the shares it represents.

15-612 (5963) Dividends payable to bearer.

Dividends to holders of bearer certificates shall only be paid to the bearers thereof upon production of such certificates, except where such certificates of stock have attached to them dividend coupons payable to bearer, in which case dividends may be paid to the bearer of the proper dividend coupon upon its presentation and surrender, without the production of the certificate to which such dividend coupons belonged.

15-613 (5964) Bearer certificates convertible into registered certificates. Bearer certificates may at any time be converted into registered certificates, such as are now provided for by law, upon the request of the bearer of such bearer certificates, and the surrender of such bearer certificates to the corporation and the cancellation thereof, and registered certificates may also be converted and exchanged for bearer certificates at the request of the owners of such registered certificates, and the surrender and cancellation thereof.

General Statutes of Connecticut, Chapter 33

Section 33-345. Requirements for Share Certificates. * * *

(a) Each certificate representing shares shall set forth upon the face thereof as at (sic) the time of issue: (1) The name of the corporation; (2) a statement that the corporation is organized under the laws of this state; (3) the name of the person to whom issued, <u>or that the same is issued to bearer</u>; (4) the number, class and designation of series, if any, of shares which such certificate represents; and (5) the par value of each share represented by such certificate or a statement that the shares are without par value. (Emphasis supplied)

Introduction

In recent years, various west European nations have enacted statutes which authorize their domiciliary corporations to emigrate when certain emergencies specified by the statute occur. For such a corporation, "emigration" takes the form of a transfer of the corporation's registered office ("siege social") from its domiciliary state to some other location outside the range and effect of the emergency. Switzerland, for instance, authorizes a Swiss corporation to transfer its registered office from canton to canton within Switzerland, or outside the country. Netherlands corporations can readily emigrate from Europe to Netherlands colonies in the western hemisphere.

The status of a refugee corporation is far from clear. New Brunswick has enacted a statute which makes that province a host state for a refugee corporation, and specifies the conditions permitting it to acquire the special status of a New Brunswick foreign resident corporation. Briefly stated, it does not become a "domestic" corporation, for it does not acquire the powers of a corporation of the host state but during its residence there it has only its original corporate powers, and its officers and directors enjoy only such authority as they had at home. Nor does it become a "foreign" corporation in the traditional American sense, for its purpose in leaving its original jurisdiction is not to do business in the host state,___/ but rather to acquire, if possible, a safe and peaceful location from which to conduct its established operations--

___/ Of course, a foreign resident corporation may wish to secure authority to do business in the host state, just as any corporation of State A may apply to state B to do business in state B.

a concept expressed by the European statement that the emigrating corporation transfers it registered office or "siege social" to the host state for the term of the emergency. Thus described, the status of a foreign resident corporation is new to American law and does not correspond to any of the traditional classes of corporations. It is possible that a host state would, without specific statutory authority from its legislature, receive within its borders a refugee corporation from a friendly country; and certain decisions during the Second World War gave limited recognition to acts taken by refugee corporations. Nevertheless, it is desirable for a potential host state such as Delaware to give specific statutory recognition and status to a non-United States corporation which invokes the law of its jurisdiction of incorporation to emigrate to a safe locale. Such a Delaware statute should closely mesh with the terms of the law or decree permitting a non-United States corporation to leave its domicile.

As indicated above, the statute of a host state such as Delaware would confirm the foreign resident corporation only with the powers it possesses under the law of its domicile and its charter, subject, of course, to any limitations in terms of local public policy. The corporation would have its official or "registered" office in Delaware, just as a domestic or an ordinary foreign corporation does now, although a European corporation's registered office or "siege social" has a deeper significance, for it quite difinitely fixes the corporation's domicile. In general, the foreign resident corporation's operations would not be changed by the registered office transfer, and its directors and officers would continue to exercise their powers as before. The statute should, of course, specifically validate acts within their authority. The assumption is that if a foreign resident corporation has acted in accordance with the terms of (a) the law of its jurisdiction of incorporation and its charter, (b) the law authorizing it to transfer its registered office, and (c) the relevant law of the host state, the corporation's acts will be recognized both in the host state and in all other friendly jurisdictions. Such a statute is not a device to bring assets out of its domicile, but rather a method to insure, for the duration of its stay in the host state, that its operations can go forward as normally as possible and with as wide legal recognition as possible.

It should also be noted that a foreign resident corporation status is useful only in emergencies short of all-out nuclear war. In order to broaden the usefulness of the proposed Delaware statute, two additions have been made to the rather narrow New Brunswick statutory provisions. First, the Delaware proposal recognizes many types of emergencies as occasions for a corporation to be received in Delaware as a foreign resident corporation. Second, it also recognizes that Delaware may play host to refugee corporations whose jurisdictions of incorporation have neglected to enact statutes authorizing their domiciliary corporations to emigrate. This Report knows of no such statutes in Latin America, but corporations in those countries may well have a most acute need to leave an emergency or revolutionary situation and seek safety elsewhere. Because of the continuously volatile situation in Africa, and the possible threat to the Rhodesias and South Africa, certain corporations may seek to transfer their registered offices. Hence, the Delaware statute should, unlike the

New Brunswick law, at least leave open the possibility of receiving corporations from countries which have not enacted legislation comparable to that in Switzerland, Netherlands, etc.

The proposed Delaware statute borrows from the New Brunswick law, although it makes important substantive changes in the direction of greater accommodation to corporations needing its benefits. Language has been considerably altered to reflect established American, rather than British and Canadian, legal usage. Since the Swiss statute permits entities other than business corporations to emigrate, the Delaware proposal has gone beyond the New Brunswick limitations so as to permit Delaware to play host to all types of enterprises which need to emigrate. Whether or not the Committee wishes to give its statute this broad coverage is a fundamental policy decision; but it should be noted that, from the European standpoint, it would be a large advance over the New Brunswick law--currently the only available "host state" statute in the western hemisphere (apart possibly from the Netherlands colonies).

Statutory Text and Reporter's Notes

Section 1. Short Title

This Act shall be known and may be cited as the Delaware Foreign Resident Corporations Act of 1965.

Section 2. Purposes and Interpretation of Statute.

(a) This statute shall be liberally construed to effectuate as completely as possible its purposes which are:

(1) To give effect to statutes enacted by jurisdictions friendly to the United States of America authorizing corporations of such jurisdictions to transfer their registered offices in time of war or other emergency.

(2) To preserve the assets and property of the foreign corporation so far as possible from impairment, destruction, or confiscation as a result of the emergency occasioning transfer of the registered office to Delaware.

(3) To enable the corporation to continue the conduct and operation of its business and affairs as conveniently as may be possible under the circumstances; and to facilitate action by its directors and officers; and

(4) To protect the rights and interests of creditors and shareholders of the foreign resident corporation.

(b) In cases not covered by the terms of this Act, the courts of this state shall formulate and apply rules of decision not inconsistent with the provisions of this Act which shall best effectuate the purposes of this Act.

Reporter's Note

It is desirable to include this provision in a statute which breaks new ground to such an extent as this act, in order to give the courts guidance in situations which are likely to arise but which are not covered by the terms of the statute. In the dislocation following war, revolution, etc., the nature of the difficulties are virtually unpredictable, and it is apprepriate to give courts some clear but flexible standards for formulating rules of decision and expressly to authorize them to work out the law in this area.

Section 3. Definitions

As used in this Chapter, unless the context otherwise requires:

(a) The term "corporation" includes incorporated organizations, private law corporations, whether or not organized for business purposes, public law corporations, and partnerships and proprietorships.

Reporter's Note:

This definition involves a very important policy judgment as to the coverage of the statute. The definition here presented is coterminous with the scope of the Swiss decree (art. 1) and covers all types of enterprises, both incorporated and unincorporated. The New Brunswick statute is clearly limited to business corporations in the Anglo-American sense. The broader coverage of the proposed Delaware statute would be more responsive to European needs and would include important enterprises which could not acquire refugee status under the New Brunswick statute. On the other hand, the reception into Delaware of somewhat unfamiliar types of entities may present problems in the office of the Secretary of State, but these would seem to be chiefly matters of classification. If overseas enterprises are actively encouraged to take advantage of the Delaware statute, in advance of emergencies, etc., many of the special problems could be worked out, and the statute revised in the light of experience.

(b) "Jurisdiction of incorporation" means the state under whose laws a corporation is created or organized.

(c) A "foreign corporation" is any corporation whose jurisdiction of incorporation is a jurisdiction other than the United States of America or any of the states or territories of the United States of America.

Reporter's Note:

The definition of "foreign corporation" is expressly limited to this chapter and does not affect the coverage of Subchapter 14.

(d) The "registered office" of a foreign corporation includes a registered office, siege social, head office, principal office, principal place of business, permanent office, or any like term indicating the domicile of the foreign corporation.

Reporter's Note:

This definition is derived from a phrase in Section 1 of the New Brunswick statute; the terminal phrase is added for completeness. The term "registered office" is routinely used in this sense in the Swiss decrees.

(e) A "foreign resident corporation" or a "Delaware foreign resident corporation" is a foreign corporation whose application to transfer its registered office to Delaware has become effective.

Reporter's Note:

This term is obviously narrower in scope than "foreign corporation." The same distinction is taken in Section 1 of the New Brunswick statute.

(f) The "Delaware registered office" of a foreign resident corporation means the registered office, within Delaware, designated by its original or amended application.

Reporter's Note:

Draft Section 5(a)(6) requires the application to designate the location of the Delaware registered office and requires an agent resident there.

(g) The "law of the jurisdiction of incorporation" of a foreign corporation includes codes, statutes, decrees, orders in council, executive orders, and governmental regulations and rules.

(h) The "charter" of a corporation is the fundamental instrument or instruments, other than the law of the jurisdiction of incorporation, governing the business and affairs of the corporation, and includes, without limitation, a charter, certificate of incorporation, articles of incorporation, articles of agreement, articles of partnership, code of regulations, and by-laws.

Reporter's Note:

The contrast, common to Anglo-American and foreign law, between the corporation law and the charter, appears both in the New Brunswick statute and the Swiss decrees.

(i) The term "officers and directors" includes, besides such persons, trustees or managers, partners and managing partners, and all other persons performing functions equivalent to those of officers and directors, however named or described in any relevant instrument.

Reporter's Note:

This term must be broadly defined to include top managerial personnel, by whatever name or description; and if the statute is to apply to partnerships and other unincorporated groups (see definition of "corporation" in subsection (a)), an appropriate reference should be made. See Swiss decree, art. 2, § 2.

(j) The term "shareholder" includes, besides a shareholder of an incorporated business enterprise, the holder of a beneficial interest in any other type of enterprise, whether or not incorporated, and in the case of a non-profit corporation or association it includes a member of the corporation or association.

Reporter's Note:

Assuming the desirability of making the statutory provisions available to unincorporated and non-profit undertakings (see definition of "corporation", supra, and Reporter's Note thereto), the term shareholder must be defined with appropriate breadth, especially for use in Section 7(d) and Section 8.

Section 4. Authority of Foreign Corporation to Become a Delaware Foreign Resident Corporation.

(a) Any foreign resident corporation may, by compliance with

Section 4 of this Act, transfer its registered office to Delaware and become a foreign resident corporation if the law of its jurisdiction of incorporation permits it to transfer its registered office in order to protect its assets, rights, or interests (1) in time of war, invasion, international conflict, revolution, other emergency, or (2) for any other reason permitted by the law of its jurisdiction of incorporation.

(b) Although the law of its jurisdiction of incorporation does not provide for a transfer of the registered office of a foreign corporation, such a corporation may nevertheless, transfer its registered office to Delaware and become a foreign resident corporation if (1) it has furnished the information required by Section 5 of this Act so far as the circumstances of the case permit, (2) it seeks to transfer its registered office in order to protect its assets, rights, or interests in time of war, invasion, international conflict, revolution, other emergency, or for any other reason not inconsistent with the public policy of the United States of America or of the state of Delaware, and (3) the law of its jurisdiction of incorporation, as it existed immediately prior to the event occasioning the transfer of the registered office, did not expressly prohibit a transfer of the registered office of the foreign corporation.

(c) This Act shall not of itself preclude a foreign corporation from incorporating as a domestic corporation under this title.

Reporter's Note:

Subsection (a) authorizes a foreign corporation to become a Delaware foreign resident corporation if the foreign statute permits this, and states reasons which substantially accord with the scope of permission under the Swiss statute. See also Section 1 of the New Brunswick Act. Subsection (b) is designed to extend the benefits of the Delaware statute to foreign corporation whose jurisdictions of incorporation have not specifically authorized transfer of the registered office. Although most west European nations have such enabling legislation, this is apparently not true of many countries (Latin America, for instance). It would seem appropriate for Delaware to receive corporations from such lands unless the law of the domiciliary country was, at the time of transfer, obviously hostile to such transfer. The New Brunswick statute does not specifically deal with this problem, but its careful wording seemingly leaves open the possibility that New Brunswick could play host to a foreign corporation despite no specific authorization in the law of its jurisdiction of incorporation. No good reason appears for not specifically authorizing Delaware to play host in like circumstances. It is, of course, assumed that no corporation can transfer its registered office if this would violate American foreign policy or Delaware public policy.

Section 5. <u>Application of Foreign Corporation to Become a Foreign Resident Corporation.</u>

(a) A foreign corporation may, at any time, file an application to become a Delaware foreign resident corporation, setting forth in the English language the following information:

(1) The name of the foreign corporation, together with an English translation of its name.

(2) Its jurisdiction of incorporation.

(3) A reference to the law of its jurisdiction of incorporation authorizing the foreign corporation to transfer its registered office.

(4) A list of the officers and directors who are to manage

the affairs of the foreign resident corporation, together with: (A) a statement defining the authority which the directors and officers shall have in the operation of the foreign resident corporation, and (B) a statement setting forth the procedures by which successor officers and directors are to be elected or appointed to fill any vacancy, however occurring, among the listed directors and officers.

(5) A statement of the number, classes, and character of the shares which the foreign resident corporation is authorized to issue, and the number of outstanding shares of each class; or if there are no shares, a statement of the proprietary interests in the corporation; or, where appropriate, a statement of the classes, number, and rights of members.

(6) The address of the proposed registered office in Delaware, and the name and address of the agent within Delaware of the foreign resident corporation upon whom process or notice may be served; and an undertaking that, in the event that process or notice cannot be served with due diligence upon the agent, service may be made upon the Secretary of State of Delaware.

(7) The date when, if the application is accepted for filing, the foreign corporation will become a foreign resident corporation.

(b) The application shall be accompanied by the following documents, in the original language and by an English translation if any document is in a language other than English:

(1) A duly authenticated copy of the charter of the foreign resident corporation.

(2) A copy of the pertinent portion of the law of the jurisdiction of incorporation under which the foreign corporation in incorporated.

(3) A copy of the law of the jurisdiction of incorporation permitting a foreign corporation to transfer its registered office outside the jurisdiction of incorporation.

(4) A certificate from the highest diplomatic or consular official accredited to the United States of America consenting to the transfer of the registered office of the foreign corporation.

(c) The application shall be accompanied by a certificate of a member of the Bar of the State of Delaware stating that, in the opinion of counsel, the applicant foreign corporation is entitled to apply for status as a Delaware foreign resident corporation, and that its application complies with the requirements of this section.

(d) An application need not be accompanied by a list of shareholders.

(e) The application, accompanying documents, and certificate of counsel shall be delivered to the Secretary of State for filing. Except in the case of a postponed effective date as permitted by subsection (g), the Secretary of State shall thereupon file the documents and shall issue a certificate that the foreign corporation is a Delaware foreign resident corporation as of the filing date. The certificate of the Secretary of State shall be recorded in the county in Delaware in which the registered office of the foreign resident corporation is located.

(f) Except in the case of a postponed effective date as permitted by subsection (g), upon the filing with the Secretary of State of the documents required by this section, the foreign corporation is a Delaware foreign resident corporation, notwithstanding any failure to record the certificate in the county in which the registered office of the foreign corporation is located.

(g) If the effective date of the application is postponed to a date subsequent to filing with the Secretary of State, the following provisions shall apply:

(1) Notwithstanding subsection (f) of this section, the foreign corporation does not become a Delaware foreign resident corporation until the effective date specified in the application.

(2) The application, all accompanying documents and the certificate of counsel shall be sealed and held by the Secretary of State in secrecy, unless any law of the United States requires disclosure, or unless the foreign corporation has expressly consented to public filing prior to the effective date.

(3) The foreign corporation at any time prior to the effective date, may amend its application, may withdraw documents already filed, and may substitute other documents for those withdrawn.

(4) The foreign corporation shall keep statements in its application and accompanying documents current so as to reflect any changes subsequent to filing which would make the statements in the application or documents misleading.

(5) On the effective date, the Secretary of State shall issue a certificate that the foreign corporation is a Delaware foreign resident corporation.

(h) An effective date for an application may be stated by reference to the conditions and circumstances whose occurrence will make effective a transfer of the registered office of the foreign corporation. Notification that the transfer has become effective may be given by telephone, telegraph, radio, or such other means of communication as are reasonably available. A statement that effectiveness will occur automatically is sufficient if the application specifically states the circumstances under which a transfer of the registered office will automatically occur.

Reporter's Note:

Section 5 sets forth in detail the requirements for an application to become a foreign resident corporation (subsection (a)), the necessary exhibits (subsection (b)), and the required certificate of counsel (subsection (c)), together with provisions governing filing and recording (subsection (e)), and the effective date of the application (subsections (f), (g), and (h).

This section is of substantive significance since the act of filing the application effects transfer of the registered office to Delaware and thus creates the status of a Delaware foreign resident corporation. However, by permitting the effective date to be postponed beyond the filing date, the statute enables corporations to take all necessary steps in advance of any emergency, so that, if some event occurs, the transfer can take effect by a simple act of notification by any reasonable means of communication. See subsection (h). Transfer may take place automatically --a right which may be most important if communications are interrupted. See subsection (h). Although effectiveness may be postponed under the New Brunswick law, the Delaware draft statute is more complete in dealing with this important problem. Like New Brunswick, the corporation may insist upon secrecy of documents prior to an effective date.

The required contents of the application (subsection (a)) and the necessary accompanying documents (subsection (b)) require no special explanation. Subsection (c) requires a Delaware attorney to include a certificate expressing counsel's opinion on two points: (1) that the foreign corporation has standing to apply for status as a foreign resident corporation, and (2) that its application meets the formal requirements of Section 4. It is believed that these opinions are not inappropriate for professional statement, and that they will be a substantial aid to the Secretary of State in administering a new and untried type of statute. Certainly, it is assumed that Delaware counsel may, if desired, seek supporting opinion from other attorneys expert in the law of the applicant corporation's jurisdiction.

Section 6. Powers of a Foreign Resident Corporation

(a) A foreign resident corporation shall have and may exercise all of the powers granted to it by its charter and by the law of its jurisdiction of incorporation as such charter and law existed immediately prior to the beginning of the war, invasion, revolution, international conflict, emergency, or other event which occasioned the transfer of the registered office.

(b) A foreign resident corporation may exercise its powers and conduct its business and affairs at any place within or without Delaware. Notwithstanding any provision of the law of its jurisdiction of incorporation or of its charter, no foreign corporation or foreign resident corporation shall transact in Delaware any business which a corporation organized under the laws of Delaware could not lawfully transact in Delaware.

(c) A foreign resident corporation shall continue to conduct its business in its corporate name or in a name which is an English translation of its corporate name, but any name so used shall be followed by the words "Foreign Resident Corporation, Delaware" or by the abbreviation "F.R.C.Del."

Reporter's Note:

This section is constructed from scattered provisions of the New Brunswick Act, together with several clauses not contained in that statute but designed to clarify some issues not resolved in New Brunswick.

Subsection (a) preserves to the Delaware foreign resident corporation all corporate powers granted in its jurisdiction of incorporation, and measures these powers by the state of the law immediately preceding the emergency. See Section 2 of the New Brunswick Act. The proposed Delaware statute, unlike New Brunswick, distinguishes corporate powers (Section 5) and authority of officers and directors (Section 6) for separate treatment which better accords with the organization of American statutes.

This Report considered, but decided against, adding a further clause granting to all Delaware foreign resident corporations the same powers as domestic corporations possess, unless a particular power would be inconsistent with the corporation's charter or the law of its jurisdiction of incorporation or would violate Delaware public policy. No such provision is found in the New Brunswick Act. Granting the full panolpy of corporate powers arguably would attract foreign corporations, and especially foreign subsidiaries of Delaware enterprises, particularly in view of the more limited provisions of the New Brunswick law. On the other hand, this provision seems inconsistent with the theory of a foreign resident corporation statute whose purpose is to receive the foreign corporation in the host state with its corporate powers and structure as nearly intact as possible. Since the Swiss statute--presumably typical--does not recognize the possibility of any such accretion of corporate powers, but instead restricts corporate action in the new domicile, a wholesale grant of additional powers by the Delaware statute might be regarded by foreign jurisdictions as an undesirable feature. Even with the suggested limitations on these additional powers, directors and officers of the foreign resident corporation would probably be uncertain whether exercising a particular corporate power outside the charter and the law of the original jurisdiction would conflict with local public policy.

Subsection (b) does impose one necessary limitation: a foreign corporation may not do in Delaware any business which a Delaware corporation could not legally transact in the state. This formulation is superior to the approach in New Brunswick's Section 9 which would seemingly outright bar a foreign corporation from New Brunswick if none of its corporate purposes are ones for which a domestic enterprise could be established. The Delaware provision would allow the state to play host to any foreign corporation but would bar it from doing within Delaware any business which a Delaware enterprise could not do. This would permit the foreign corporation to do its business anywhere else in the world subject, of course, to limitations in the law or policy of "third states" where the corporation may actually do business. Thus, Delaware may have reason to preclude a Swedish corporation from pursuing certain activities in Delaware, but no reason to preclude it from doing so in Brazil if Brazilian law and policy permit this.

Subsection (b) explicitly recognizes that a foreign resident corporation may conduct its affairs at any place within or without Delaware.

Subsection (c) specifies conditions on the use of the corporate name and, like New Brunswick Section 4, requires disclosure of its new status.

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Section 7. Directors and Officers of Foreign Resident Corporation.

(a) The directors and officers of a foreign resident corporation shall have such authority as is specified in the statement required by subsection (a)(4)(A) of Section 5 which may grant to them any authority which was or might have been granted to them under the charter of the foreign resident corporation or under the law of its jurisdiction of incorporation as such charter and law existed immediately prior to the beginning of the war, invasion, revolution, international conflict, emergency or other event which occasioned the transfer of the registered office.

(b) In particular, but without limiting the authority recognized by subsection (a) of this section, directors of a foreign resident corporation shall have authority (1) to acquire, control, use, and dispose of any property received for or to the account of or held in the name of the foreign resident corporation, prior or subsequent to the transfer of its registered office to Delaware and (2) to make contracts and other obligations binding the foreign resident corporation, perform or secure the performance of contracts or obligations of the foreign resident corporation and to discharge contracts or obligations. Any payment, transfer, delivery or other disposal of any property to or on the order of such person or persons acting within his authority shall be conclusively presumed lawful and shall be a complete discharge and release of any liability of the person holding, paying, transferring, delivering or otherwise disposing of such property to or on the order of such person. The officers and directors shall have full authority to obligate the foreign resident corporation and discharge any contract or other obligation to which it is a party or by which it may be or is affected.

(c) The directors and officers of a foreign resident corporation may meet or act or otherwise conduct the business and affairs of the corporation at any place within or without Delaware.

(d) Directors may vote or act by proxy if the charter or law of the jurisdiction of incorporation of the foreign resident corporation so permits.

(e) The listed directors of a foreign corporation shall withhold any dividends or other distributions on shares or interest on bonds or other obligations of a foreign resident corporation from any shareholder or bondholder (or any class of shareholders or bondholders, including shareholders or bondholders in a specified state or territory or location), if in the opinion of two-thirds of the directors of the corporation the shareholder or bondholder or any class of them does or would not have the full beneficial use of dividends, distributions, or interest paid to him or for his account. As to any dividends or interest so retained, the foreign resident corporation shall be deemed trustee for the true owners of the shares or bonds, and an amount equal to the retained dividends, distributions, or interest shall be kept in a separate trust account.

Reporter's Note

Subsection (a) recognizes the authority of directors and officers in language similar to New Brunswick's Section 2. Subsection (b), like New Brunswick's Section 6, specifies certain powers of the directors and officers to handle property and make contracts, and expressly validates such action. Hence, third persons may rely on action by directors within the statute: title transfers are protected, and contracts will be upheld. Not only would the Delaware courts respect such action, but a major premise of the statute is that "third states" will also give full recognition to acts taken by the directors of the foreign resident corporation. Compare Anderson v. N.V. Transandine Handelmaatschappij, 289 N.Y. 9, 43 N.E.2d 502 (1942); Lorentzen v. Lydden & Co., (1942) K.B. 202 (1941).

Under subsection (c) directors and officers may take action within or without Delaware. Cf. Section 211 of the General Corporation law. Subsection (d)'s express recognition of proxy voting by directors of foreign resident corporations would dispel any doubt that, at least as to such corporations, this form of director action, ordinarily rejected in American jurisdictions, would not violate public policy.

Subsection (e) is of major importance. Based on New Brunswick's Section 10, it expressly permits withholding of dividends and interest from persons otherwise entitled to it, if two-thirds of the directors conclude that the recipient does not have the "full beneficial use" of the money. The Delaware statute is broader than New Brunswick, for it applies both to interest and to dividends, and it requires a two-thirds rather than a unanimous vote to withhold dividends. Furthermore, it eliminates any question as to the necessity of making individual decisions on each potential recipient, by permitting the directors to act with respect to classes of shareholders, including classes of persons within a designated country or territory. Directors as trustees for dividends and interest withheld.

Like New Brunswick, the proposed Delaware statute does not go further in dealing with the details of director action, e.g., quorum, vote (except on withholding dividends declared), reliance on records, breach of duty, indemnification, and so on. It is believed that (1) this is best left to the terms of the charter and law of the original jurisdiction, and (2) if these are silent or ambiguous, the problems would best be resolved on a case-by-case basis. Too many details would be apt to conflict with the diverse (and for most of us unknown) provisions of foreign laws and charters.

Section 8. Shareholders of Foreign Resident Corporation.

(a) The shares of a foreign resident corporation may be in bearer or registered form, as permitted by the law of its jurisdiction of incorporation or by its charter.

(b) Meetings of shareholders shall be held as may be required by and in substantial compliance with the charter of the foreign resident corporation and the law of its jurisdiction of incorporation. Unless prohibited by the law of the jurisdiction of incorporation, meetings of shareholders may be called and conducted in accordance with the provisions of this title applicable to meetings of corporations incorporated under the laws of Delaware.

(c) The meeting of shareholders of a foreign resident corporation may be held at any place either within or without the state of Delaware.

(d) Notice of meetings of shareholders of a foreign resident corporation need not be mailed or otherwise given to any shareholder of record whose address is within any territory with which normal mail service with the United States of America has been interrupted, or if communication is made unlawful by any law of the United States of America or by any rule, regulation, proclamation or executive order issued under any such law. In such circumstances, the foreign resident corporation shall have no duty to apply to any governmental authority or agency for a license or permit to give such notice. Failure to give notice whenever excused by this subsection shall not invalidate the meeting or any action taken at the meeting.

(e) At any shareholder's meeting, the shareholders present in person or represented by proxy shall be deemed a quorum.

(f) No action shall be taken at any meeting of shareholders (1) to replace any directors or officers listed as required by subsection (a)(4) of Section 4, or (2) to alter or change the procedures by which successor directors and officers are to be elected or appointed to fill vacancies among the listed directors, or (3) to limit or alter the authority of the listed directors of their successors. Successor directors and officers may be elected or appointed at a meeting of shareholders if and so far as the statement required by subsection (a)(4) of Section 4 authorizes the shareholders to take such action.

If no provision authorizes the shareholders to elect successor directors and officers or to fill vacancies, any incumbent directors or officer, or any shareholder within Delaware, may apply to the Court of Chancery for appropriate relief. Appropriate relief includes, but is not limited to, (1) an order convening a meeting of shareholders to elect successor directors or officers or to fill vacancies, and (2) an order appointing a successor director or officer either for a limited or an indefinite period of time.

(g) An incumbent director or officer, or any shareholder, or the Secretary of State may apply to the Court of Chancery for an order removing a listed director or officer on the ground of dishonesty, fraud, or misfeasance in office.

(h) Any action taken at a shareholders' meeting held in accordance with the provisions of this section shall be deemed the act of the foreign resident corporation.

Reporter's Notes:

This section sets forth minimum requirements for action by shareholders. Under the definition in Section 3(j), the term shareholder means, where applicable, a member or partner or holder of a beneficial interest. Hence, this section may be used to validate action taken by enterprises other than corporations.

Subsection (b) is the basic requirement that shareholder meetings be held if required by the corporation's charter or the law of its original jurisdiction; unless so required, it is not intended to impose any obligation to hold meetings.

Subsection (b) through (e) states various rules, most of them comparable to provisions in New Brunswick's Section 7, governing details of the conduct of meetings. These are permissive and designed to facilitate the conduct of meetings, rather than regulatory or restrictive. Subsection (c) is comparable to Section 211 of the General Corporation Law. Subsection (d) dispenses with notice of meetings in language taken from New Brunswick Section 7 and Section 230 of the Delaware statute. Subsection (e)'s provision that shareholders present constitute a quorum adopts for foreign resident corporations the ancient common law rule for shareholder quorums.

Subsection (f) is restrictive but protective, for it prohibits the shareholder meetings from ousting the listed directors and officers and changing the procedures specified in the basic instruments filed with the Secretary of State. This protects the corporation from action taken by a hostile body of shareholders whose efforts might be contrary to the best interests of the corporation and to the charter and law of the original jurisdiction. It also helps to stabilize the position of the directors and officers in a period of great turmoil and uncertainty.

Subsection (f) goes beyond the New Brunswick statute in specifying a judicial procedure for electing or appointing successor directors and officei if the basic instruments filed with the Secretary of State do not so provide, or if they do not cover a particular case or situation. Since it is impossible to foresee whether the stated procedures will be adequate in all circumstances, it is certainly wise to recognize expressly some power in the Delaware courts to meet unanticipated situations.

Subsection (g), without counterpart in New Brunswick, authorizes applications to the Court of Chancery to remove listed directors and officers for fraud, dishonesty, etc. It is certainly undesirable to entrench the listed directors and preclude shareholders from removing them, without at the same time expressly recognizing residual power to deal with abuses;

and court action is clearly the best remedy, considering the likely diversity of procedures and standards specified in charters and statutes from jurisdictions of incorporation.

Subsection (h) specifically validates shareholder action taken in accord with the provisions of this section.

Subsection (a) eliminates any policy questions as to the validity of bearer shares of foreign corporations.

Section 9. Rights of Creditors.

(a) When a foreign corporation has been granted the status of a Delaware foreign resident corporation:

(1) The foreign corporation shall not be deemed to have been liquidated, wound-up or dissolved;

(2) All property, assets, rights, privileges, and franchises of the foreign corporation continue unimpaired and without interruption as the property, assets, rights, privileges and franchises of the foreign resident corporation.

(3) No rights of creditors of the foreign corporation and no liens or charges upon its property and assets are discharged or in any way impaired, but all such rights, liens and charges shall be deemed to be rights against the foreign resident corporation, and liens and charges against its property and assets.

(b) Nothing in this section shall prevent the foreign resident corporation from pleading any defense recognized by the laws of this State by reason of facts arising out of the state of war or other emergency in the jurisdiction of incorporation.

(c) The courts of Delaware shall not have jurisdiction of any cause of action arising prior to the transfer to Delaware of the registered office of a foreign resident corporation unless, prior to transfer of its registered office to Delaware, such cause of action could have been asserted against the corporation in a proper jurisdiction.

Reporter's Note:

This section substantially follows Section 10 of the New Brunswick statute, but with greater refinement and precision of language. Its theory is that the legal person of the foreign corporation both before and after transfer of its registered office remains uninterrupted, just as a refugee individual continues to be the same person both in his native land and in the state in which he seeks refuge. Thus, the foreign corporation and the foreign resident corporation do not stand in any relationship of predecessor and successor corporations, but are the same corporation. This is the general theory which, while not explicitly so stated in the statute, underlies the specific provisions of subsection (a) that no liquidation occurs, that all assets continue unimpaired, and all creditor rights and liens remain in full force and effect. Subsections (b) and (c) respectively recognize defenses growing out of the emergency, and withdraw jurisdiction of claims which could not have been asserted prior to the transfer of the registered office.

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Section 10. Effect of Revocation, etc. of Charter or Law of Original Jurisdiction of Incorporation.

(a) The powers of a foreign resident corporation, the authority of its directors or officers, the operations and management of its business, the title to its property and assets, and the rights and powers of its shareholders shall not be affected by, and the courts of this state shall give no recognition to, any revocation, annulment, amendment, or other change of the law of its jurisdiction of incorporation if such purported revocation, annulment, amendment or other change occurs after the event which occasioned the transfer of its registered office, except that this provision shall not apply to any law duly enacted by a temporary, provisional, or exile government of its jurisdiction of incorporation if at the time of such enactment such government has been recognized by the United States of America.

Reporter's Note:

The purpose of this provision is quite frankly to preserve unchanged, so far as possible, the powers, rights, assets, etc. of the foreign corporation. This is accomplished by a general rule which renders inoperative any change in the law of its jurisdiction of incorporation. Generally, this is intended to insulate the foreign resident corporation from changes in the law by an enemy or revolutionary government. The assumption both of the Swiss decrees and of the Delaware (and New Brunswick) statutes is that a provision freezing the legal status quo, and immunizing the corporation from changes in the law of its original jurisdiction, will be honored by the courts of the host state and also by courts and governments of "third states". Absent such a provision, the court of a "third state" might feel bound to give effect to some change of law made by an enemy or revolutionary government now in control of the jurisdiction of incorporation (so long as consistent with international law, public policy of the forum, or some other like standard). With such a provision as the Delaware statute contains, bolstered by counterpart clauses in the Swiss decrees, it is hoped that "third states" will look to the law antedating the emergency. At least friendly states would thus have a sound legal basis for refusing to enforce a claim adverse to the interests of the corporation as it existed prior to the emergency.

The last clause of subsection (a) goes beyond New Brunswick in recognizing the possibility of a valid change in the law of the jurisdiction of incorporation, subsequent to transfer of the registered office, if made by a government in exile recognized by the United States at the time of the exile government's decree. It would seem unwise to immunize the corporation's legal status from changes of the law made by a friendly government, and indeed any such provision might be regarded as contrary to American foreign policy. The New York decision in Anderson v. N.V.Transandine Handelmaatschappij, 289 N.Y. 9, 43 N.E.2d 502 (1942) gave effect in New York courts to a decree by the recognized Netherlands government-in-exile vesting all corporate assets in that government, and thus immunizing them from attachment and levy.

Section 11. Withdrawal of Foreign Resident Corporation.

Unless a foreign corporation has incorporated as a domestic corporation, any foreign resident corporation whose registered office has been transferred to Delaware may thereafter voluntarily transfer its registered office outside of Delaware to another jurisdiction, or may voluntarily return to its jurisdiction of incorporation by filing with the Secretary of State an application to withdraw from Delaware. The application shall be accompanied by an authenticated copy of the resolution of the listed directors and officers authorizing such withdrawal from Delaware, and by a certificate by the highest diplomatic or consular officer accredited to the United States of America from the government (recognized by the United States of America) of the jurisdiction of incorporation consenting to such withdrawal. Upon receipt of the application and the accompanying documents and the paying of any fees and taxes, the Secretary of State shall file the application, and the corporation shall, as of the time of filing, cease to be a Delaware foreign resident corporation.

Reporter's Note:

This provision is based on Section 3 of the New Brunswick Act which permits withdrawal either on a certificate of the highest diplomatic officer or on a resolution of the listed directors and officers. It is believed that Delaware should follow a stricter rule and require both action by the directors and a consent from the appropriate diplomatic or consular official. This helps to assure that withdrawal from Delaware is both the voluntary act of the directors (and presumably in the corporation's best interests) and in accord with the policy of the original jurisdiction of incorporation. It is also important to have diplomatic consent since statutes such as the Swiss decree, art. 3 § 1 impose additional requirements on re-transfer of the registered office.

APPENDIX

Acts of the General Assembly of New Brunswick, 2d Sess. 1963

Chapter 5

FOREIGN RESIDENT CORPORATIONS ACT

Her Majesty, by and with the advice and consent of the Legislative Assembly of New Brunswick, enacts as follows:

1. Any company or corporation which is organized and exists under the laws of any jurisdiction other than New Brunswick (hereinafter called "foreign corporation") and has determined to protect its interests in time of war or other emergency by transferring its registered office, siege social, head office or chief place of business, as any such descriptive phrase may be defined by or used in the law under which it is organized (each hereinafter referred to as "registered office"), may make an application to operate within New Brunswick as a Foreign Resident Corporation as defined and permitted under the provisions of this Act and may simultaneously with or at any time prior to making such application file with the Minister of Finance, any or all documents required herein to support such application. If filed prior to said application, such documents shall be sealed and held by the Minister of Finance in strictest secrecy by number, other identification mark, or in such other manner as he determines is most likely to preserve such secrecy. The foreign corporation may withdraw any or all such documents from time to time or substitute others in its discretion prior to the effective date of its application. A foreign corporation desiring to transfer its registered office to New Brunswick and to operate therein as a Foreign Resident Corporation shall support its application by the following documents, together with English translations thereof, or, when any of such documents are unavailable or difficult to produce, any documents in lieu thereof acceptable to the Minister of Finance:

(a) a copy of its charter, articles of incorporation, or other documents evidencing its incorporation and a copy of that portion of the laws of the state, nation, or political subdivision thereof under which it is organized which defines the terms of its creation and legal existence.

(b) a copy of the law or decree issued under law of the jurisdiction which created it permitting a corporation, desirous of protecting its interests in time of war or other emergency, to transfer its registered office to a jurisdiction other than the jurisdiction of its creation;

(c) a list of its officers and directors who are to act as such within New Brunswick, and a statement

(i) defining the authority which each shall have in the operation of the Foreign Resident Corporation, and

(ii) setting out the manner in which their successors are to be appointed in the event of the death, disability, refusal or inability to act of one or more of the listed officers and directors.

(d) the address of its proposed registered office in New Brunswick and the name and address of a person upon whom notices and other papers may be served on its behalf;

(e) in the case of a corporation created under the jurisdiction of a foreign state or nation, a certificate from the highest diplomatic or consular officer accredited to Canada as ambassador, minister, or otherwise from that state or nation that as such representative of the foreign country and in its name he approves and recognizes the validity of each document submitted by the foreign corporation and that the state or nation from which he is accredited to Canada as aforesaid recognizes that the foreign corporation was validly created and is validly subsisting and that the officers and directors listed may in accordance with their defined authority validly receive, control and dispose of any property of the foreign corporation, in its name and on its behalf, may make contracts in the name of such foreign corporation and otherwise conduct the business of the foreign corporation after the transfer of its registered office to New Brunswick, and that the foreign corporation, in applying to transfer its registered office, has complied with all relevant laws of the jurisdiction which created it, including those which permit such transfer of registered office.

2. The officers and directors so listed and, where applicable, so certified, as provided in clauses (c) and (e) of section 1, shall have such authority as specified in the statement defining their authority which may include any powers which were or might have been granted to them under the charter and by-laws of the foreign corporation and the laws of the jurisdiction which created it, as such laws existed immediately prior to the commencement of the war or occurrence of the emergency which was the occasion of its transfer of registered office and no revocation, annulment, amendment, or other change of or in any laws on which the rights and duties of such officers and directors depend, or which otherwise affect the operation of the foreign corporation, or the title to its property, shall be effective, provided, however, that no powers may be exercised by any of the said officers and directors which cannot be authorized under the laws of New Brunswick for comparable corporate officers and directors.

3. At any time after receipt of an application by a foreign corporation to transfer its registered office, the Minister of Finance, subject to section 9 shall issue a certificate approving the transfer of the registered office of the foreign corporation to such place within

New Brunswick as shall be designated in the application and recognizing the continuance within New Brunswick of such foreign corporation which may thereafter exist and operate within New Brunswick as a Foreign Resident Corporation, but shall be limited in its operations to those permitted under the laws of New Brunswick. A foreign corporation whose registered office has been so transferred and which has thus been duly established and authorized to do business from its registered office within New Brunswick pursuant to this Act, shall be known as a "Foreign Resident Corporation" and shall enjoy such status until it shall have voluntarily transferred its registered office outside of New Brunswick, unless its status shall be changed or its purposes, objects and powers modified in accordance with sections 9 and 11. The voluntary return to its original jurisdiction of a Foreign Resident Corporation or voluntary transfer of its registered office from New Brunswick, shall be established by the filing with the Minister of Finance of a certificate to that effect

(a) by the highest diplomatic officer accredited to Canada as ambassador, minister or otherwise from that state or nation under whose jurisdiction the foreign corporation was created; or

(b) by the listed officers and directors of the Foreign Resident Corporation.

4. A Foreign Resident Corporation shall continue to conduct its business in its corporate name, in a name which is a translation into English of said name, or by such other name or designation which describes or identifies the said Foreign Resident Corporation, as the Minister of Finance approves, but any name so used shall be followed by the initials "F.R.C.".

5. It shall not be necessary to set out the names or addresses of any of its shareholders in any application by a foreign corporation to acquire the status of Foreign Resident Corporation.

6. Whenever the Minister of Finance shall issue a certificate to a foreign corporation granting to such foreign corporation the status of Foreign Resident Corporation, he shall also issue a certificate of the names of the officers and directors who shall operate the Foreign Resident Corporation as listed in accordance with clause (c) of section 1 and such persons shall have the authority to receive, control and dispose of any property received for or on account of or held in the name of such Foreign Resident Corporation prior or subsequent to the transfer of its registered office to New Brunswick, and any payment, transfer, delivery, or other disposal of any property to or on the order of such person acting within his authority, as defined shall be conclusively deemed to be lawful and shall constitute a complete discharge and release of any liability of the person holding, paying, transferring, delivering or otherwise disposing of such property, to or on the order of such person and such officers or directors shall have full authority to obligate the the Foreign Resident Corporation and give acquittance for performance of any contract or other obligation to which such Foreign Resident Corporation is a party or by which it is or may be affected. Any such officer or director who for any reason would not be qualified to act as

such under the laws of New Brunswick shall be granted 30 days in which to comply with such laws, including the purchase of any qualifying shares of said Foreign Resident Corporation, which the Foreign Resident Corporation is hereby authorized to issue and make available to him under such terms and conditions as in the opinion of the Minister of Finance may be just.

7. Notice of annual or special shareholders' meetings of a Foreign Resident Corporation need not be mailed or otherwise given to any shareholder of record whose address is within any territory to which there has been an interruption of normal mail service from New Brunswick, and any failure to give notification of a shareholders' meeting to any shareholder of record outside New Brunswick shall not invalidate the meeting or any action taken at such meeting and the shareholders represented at the said meeting, in person or by proxy, shall be deemed a majority for the purposes hereof. Any and all annual or special meetings shall be held in accordance with the formal requirements for meetings of companies incorporated under the Companies Act and in accordance with the laws of New Brunswick and any action taken at such meeting shall be deemed the authoritative act of said Foreign Resident Corporation, except that

(a) only the listed officers and directors shall have the authority to act as such officers and directors at any such meeting; and

(b) no action shall be taken at any such meeting to replace any of the listed officers and directors or curtail or in any way affect the authorities granted to them or their successors in accordance with clause (c) of section 1.

8. Whenever a certificate shall have been issued to a foreign corporation as in section 3 hereof provided, such Foreign Resident Corporation shall have all the powers and rights originally granted to it by the jurisdiction which created it, except such powers and rights as may not be granted under the laws of New Brunswick to companies or corporations and except as further limited by the Minister of Finance in his discretion.

9. A foreign corporation none of whose purposes or objects are within those for which a company may be incorporated under the laws of New Brunswick shall not be eligible to become a Foreign Resident Corporation and no Foreign Resident Corporation may exercise any corporate activities within New Brunswick except those for which a company may be incorporated under the laws of New Brunswick. The Minister of Finance may at the time of receiving the application of a foreign corporation to become a Foreign Resident Corporation refuse such application if he believes the granting thereof would be in contravention of or prejudicial to the public interest or may limit

the purposes, objects and powers of such Foreign Resident Corporation, and at any time after the issuance of a certificate to a foreign corporation granting to it the status of Foreign Resident Corporation the Minister of Finance may limit the time for which such certificate shall be effective, or may cancel the same upon three months' notice in writing to the Foreign Resident Corporation, delivered or mailed, postage prepaid and registered, addressed to the Foreign Resident Corporation at its registered office in New Brunswick.

10. All rights of creditors, both domestic and foreign against the foreign corporation which has been granted the status of a Foreign Resident Corporation and all liens upon its property and rights shall be unimpaired and none of its property, rights, contracts or obligations shall be prejudicially affected by the granting of such status, nor shall the foreign corporation be deemed to have been liquidated or dissolved, but nothing herein contained shall prevent the Foreign Resident Corporation from pleading such defenses as may be recognized under the laws of New Brunswick by reason of the facts arising out of the state of war or other emergency in the jurisdiction which created it, nor shall the courts recognize, as against the Foreign Resident Corporation, any cause of action arising prior to the transfer of its registered office to New Brunswick which could not have been brought against the foreign corporation prior to such transfer, and any obligations undertaken or other liabilities incurred by the Foreign Resident Corporation, after the transfer of its registered office, shall be in accordance with the laws of New Brunswick. Moreover, the listed directors of the Foreign Resident Corporation shall withhold any dividends declared on shares of the Foreign Resident Corporation from any shareholder of record who, in the unanimous opinion of the said listed directors, does not, under the laws or regulations then in force of that jurisdiction within which he resides or sojourns, have the full and complete use and benefit of any dividends paid to him or for his account, but such directors shall, for any such dividends withheld, be trustees for the true owners of the said shares and shall segregate an amount equal to said dividends and otherwise be responsible for them as trustees thereof.

11. The Minister of Finance in his discretion may permit the Foreign Resident Corporation to apply for letters patent under section 20 of the Companies Act, or any provision substituted therefor.

12. The Lieutenant-Governor in Council may establish, alter and regulate a tariff of fees to be paid under this Act, and, in particular fees to be paid on the filing of documents and the making of applications hereunder and annual fees to be paid by the Foreign Resident Corporation.

Text as set forth in 1963 ACTS OF NEW BRUNSWICK GENERAL ASSEMBLY, pp. 29-34.

CLOSE CORPORATIONS

This report recommends Delaware's adoption of statutory provisions favoring the closely held corporation, i.e., the enterprise whose shares are not traded in any markets maintained by brokers and dealers. Two important reasons are persuasive: (1) Closely held enterprises far outnumber any other type of corporation in America, even if each single corporation produces relatively little revenue from annual fees and taxes, etc. (2) Most states have failed to adopt statutory provisions giving close corporations the flexibility they need to fulfill their distinctive character which is, essentially, that of an "incorporated partnership."

This report has recommended a number of provisions which should be considered. These statutory provisions are not, however, in terms limited to close corporations, although in practice they will usually be invoked only by such enterprises. This report has not expressly limited the recommended provisions for several reasons. (1) The normal definition of "close corporation" -- in terms of no active trading of shares in brokers' markets -- is not wholly satisfactory. (2) If certain rules of law are confined to close corporations, serious problems can arise if the corporation's close character is gradually lost as its shares begin to find their way into markets. No statutes have so far dealt with the problems of transition from "close" to "public" corporation. (3) If certain rules of law are limited to close corporations, this may have unintended repercussions elsewhere in the law of corporations. For instance, if a statute broadly authorizes stock transfer restrictions for corporations so long as they are close, this may cast doubt on the validity of stock transfer restrictions in public corporations, e.g., in connection with private placement or intra-state sale of securities. More specifically, if certain rules apply only to close corporations, and other rules to large public corporations, there may be an excluded middle problem: what rules govern corporations whose shares are just beginning to find a small market? For these reasons, it seems better not to confine these rules of law to close corporations, although in one or two special situations such a limitation should be imposed.

1. Informal Action by Shareholders and Directors

Existing provisions of the General Corporation Law already authorize informal action effected without a meeting but through written consent, both by directors (Section 141 (g)) and by shareholders (Section 226). In general, these provisions are adequate, subject to the minor changes previously suggested in the Report at pp. 61-61A and 151-152. Obviously, these two permissive provisions should not be limited to close corporations but should be available to any corporation, whatever its size, which can conveniently use them.

2. Super-statutory quorum and vote requirements

This Report has already recommended that the Delaware statute should explicitly and unmistakeably authorize corporations to establish quorum and voting requirements at any level above the statutorily required percentage, up to and including unanimous quorum or vote requirements. See Report at 20-21 and 62-63 (vote) and 61B-62 (quorum). Corporations should, if they desire, be able to stipulate such requirements for any type of action to be taken. But cf. Sellers v. Joseph Bancroft & Sons, Inc., 23 Del. Ch. 13, 26, 2 A. 2d 108 (Ch. 1938) (Chancellor questions validity of unanimous vote requirement which would "make a charter provision practically irreplaceable"). Permission for high quorum and vote requirements should not be limited to close corporations, although in practice they are rarely employed outside of close enterprises.

Since a super-statutory vote requirement ordinarily reflects a more or less carefully framed bargain among the interests within a corporation, it should, so far as possible, be protected from change (usually a reduction is involved). The danger is that, say, a four-fifths vote requirement might be amended out of the certificate of incorporation by an amendment adopted by a majority vote under Section 242 (d) (1). If the certificate

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Unanimous quorum or vote requirements are hardly contrary to public policy, and are, indeed, necessarily accepted in the case of a two-man corporation, where each shareholder owns 50% of the stock. Obviously, the stock of both is necessary for a quorum at a shareholders meeting, and the vote of both blocks of stock is likewise essential to pass any resolution. Similar considerations would apply to quorum and voting requirements for the two directors (see Section 141 (b)).

specified that its high-vote requirements could be changed only by that vote itself, it would be possible first to amend out this clause by a majority vote, and then to amend out the high-vote requirements. Although conceivably the courts might refuse to countenance such a procedure, protecting a bargained-for high-vote requirement is certain only if the statute stipulates that it may be changed only by that vote itself, e.g., a two-thirds vote requirement may be changed only by a two-thirds vote, or a three-fourths vote requirement only by a three-fourths vote. Conn. Gen. Stats. § 33-329 (c) states that:

> "Any provision in the certificate of incorporation prescribing the vote required for any purpose and complying with this section may not itself be amended by a vote less than the vote therein required."

See also S. C. Code § 12-19.4 (c), 12-20.3 (d), and 12-21.3 (b).

Although this may appear to introduce a needless rigidity into the corporate affairs, the fact is that a drastic alteration of a bargained-for structure of quorum and vote requirements may very much upset the bargain and thwart the reasonable intentions and expectations of the parties. Moreover, in the long run preserving the bargained-for balance of power within the corporation may produce less regidity than upholding high quorum and vote requirements. In all events, such deadlock and inflexibility as may result is only a part of a larger problem in the close corporation, which should be handled by flexible judicial procedures suggested below, *infra* at .

3. Number of Directors

This Report questions whether Section 141 (b) is needlessly inflexible in requiring that all shares be owned "beneficially and of record" by fewer than three shareholders in order for the corporation to have fewer than three directors. For example, if all shares are owned by two voting trusts representing two families, but each trust has four beneficiaries, Section 141 (b) would evidently require at least three directors. It is not clear what policy is served by requiring "beneficial" ownership by fewer than three shareholders, and the Illinois statute recently deleted this requirement from language otherwise identical with Delaware's. See Ill. Corp. Law § 157.34.

4. Permitting Restrictions on Board of Directors

The clear tendency of close corporation practice, now often expressly validated by recent statutes, is to diminish the role of the directors of small corporations, and to permit the shareholders to manage corporate affairs directly, like partners in a partnership. A large body of case-law, especially in New York, has gradually permitted close corporations to vary their structure and operational procedures more or less substantially from the "corporate norm", viz. the corporate organization and method of operation specified by statutes. Some of the most carefully considered corporation statutes -- especially New York, Connecticut, North Carolina, South Carolina, Florida and California -- now specifically authorize flexible procedures for close corporations, although not always limiting these permissive provisions to the small enterprise. This Report recommends that the Delaware statute should follow suit by expressly recognizing this real need of close corporations.

(a) At least three statutes have specifically declared that no agreement among shareholders of a close corporation "shall be invalid as between the parties thereto on the ground that it is an attempt by the parties thereto treat the corporation as if it were a partnership or to arrange their relationships in a manner that would be appropriate only between partners." N. C. Gen. Stats. § 55-73 (b); 1963 Fla. Stats. Ch. 63-379, § 6 (2); S. C. Code § 12-16.22(a) (1963 Supp.). North Carolina and Florida permit such agreements except "where the shares of the corporation are at the time or subsequently become generally traded in the markets maintained by securities dealers or brokers." N. C. Gen. Stats. § 55-73 (b); 1963 Fla. Stats. Ch. 63-379, § 1(2). Usually these procedures may appear in a "side agreement in writing" or in the charter or by-laws of the corporation. The advantage of this provision is its blanket authorization for close corporations to order their internal affairs as they see fit. Agreements could thus be made as to "any phase of the affairs of the corporation, whether to the management of its business or division of its profit, or otherwise" (N. C. Gen. Stats. § 55-73(b); Fla. Stats. Ch. 63-379, § 6(2)), and would presumably authorize all of the shareholders to agree to abolish the board of directors — a procedure expressly sanctioned in Florida (Fla. Stats. Ch. 63-379, § 3). It does not, of course, suspend duties of fair dealing to the corporation and among the shareholders, whether or not they are parties to the agreement, nor are transferee shareholders ordinarily bound apart from consent or actual notice of the restrictions.

(b) A number of statutes now sanction agreements among shareholders, or certificate or by-law provisions, restricting the powers and discretion of the board of directors. New York decisions were the first to uphold such contracts against contentions that they violated statutes mandatorily committing to the directors exclusive power to manage the business and affairs of the corporation. See McQuade v. Stoneham, 263 N. Y. 323, 189 N. E. 234 (1934); Clark v. Dodge, 269 N. Y. 410, 199 N. E. 641 (1936). Contra, West v. Camden, 135 U. S. 507 (1890); Jackson v. Hooper, 76 N. J. Eq. 592, 75 Atl. 658 (1910). New York has now codified the results of its decisions by authorizing provisions in the certificate of incorporation which would be "otherwise prohibited by law as improperly restrictive of the discretion or powers of the board in its management of corporate affairs." Statutes vary in the conditions they specify for the validity of such arrangements:

(1) New York specifically protects subsequent shareholders who are bound by the restrictions only if they consented to or actually knew of the restrictions, while other states leave this to

judicial determination. The New York appraoch is preferable.

(2) All states expressly impose on shareholders consenting to the restrictions such liabilities and duties as the directors would have absent the restriction. This is clearly an essential protective clause.

(3) New York, Florida, and South Carolina permit director restriction arrangements only for corporations whose shares are not traded, while North Carolina has no such limitation. This is a policy determination. The case-law does not appear to adopt such a limitation; and statutory confinement to the truly close corporation would throw grave doubt on the validity of any director restraints in a corporation any of whose shares have been traded by brokers and dealers. Deleting the limitation would probably permit greater flexibility, and would also avoid difficult problems as to just when the restrictions ceased to be valid because of the beginning of trading in the shares. Protection for the purchasing shareholders is available through conditions (1) and (2) noted above.

(4) New York requires the restriction to appear in the certificate of incorporation; other statutes, and case-law apart from statute, do not so require, but would recognize restrictions in the certificate, by-laws, or a side agreement. Although recital in the certificate insures constructive notice, this is not essential to protect third parties who will not be prejudiced, under accepted

legal concepts, by unknown limitations and restrictions. Requiring recital of the restrictions in the certificate does add an element of inflexibility.

(5) New York requires the incorporator(s) or all shareholders (whether or not entitled to vote) to accept the restrictions on directors, while North Carolina, Florida, and South Carolina (and case-law apart from statute) uphold an agreement among less than all shareholders. The New York procedure is quite inflexible, for it would require unanimous consent to the slightest restriction on powers of the directors, e.g., any requirement that shareholders approve a particular type of action otherwise within the discretion of directors. Also, by implication it would seem to void every agreement which did not comply exactly with the detailed terms of the statute. Sharehold[illegible] parties to an agreement would still be protected against oppression or high-handedness, since statutes permitting restrictions on directors do not and are not intended to overturn duties of fair-dealing and good faith both to the corporation and to the shareholders.

(6) The existence of an agreement restricting directors should be "conspicuously noted" on all certificates representing shares in the corporation.

If the Committee decides to adopt a provision permitting restrictions on directors, a brief and simple statute (as in Florida and North Carolina), declaring that no public policy is violated, would be more desirable than the detailed prescriptions of the New York section. In short, it would be better to let the corporate bar and the courts develop this branch of the law without too much statutory detail.

(c) In its close corporation statute, Florida, alone among the states, has taken the logical next step of authorizing a close corporation to abolish the board of directors if so provided by the certificate of incorporation. Fla. Stats. Ch. 63-379, § 3. The recital in the certificate gives adequate notice to creditors, subsequently shareholders, and other third parties. As indicated, above, this provision is available only to close corporations and would presumably become invalid when shares begin to be traded, although in many instances the shareholders will anticipate this event and amend the certificate of incorporation to remove the provisions for operating the corporation without directors. Under the Florida provision, the normal liabilities and duties of directors rest upon the shareholders, and for other ourposes the shareholders are deemed to be "directors".

Although the Florida provision is a logical development of this branch of the law, it is not clear that it accomplishes much more than statutory provisions permitting a close corporation to operate its internal affairs like a partnership, or authorizing restrictions on directors' powers. Indeed statutory permission to operate internally as a partnership may well enable a close corporation to by-pass the election of a board of directors.

Since the Florida provision does not add much of substance to the type of provisions already suggested, it would seem desirable not to adopt it but rather to abide development in this branch of the law.

5. Stock Transfer Restrictions

Stock transfer restrictions are increasingly important both for the close corporation, which wishes to keep its shares within the original group, and for other corporations, which wish to block either a public distribution of shares privately placed or interstate distribution of shares sold intrastate, pursuant to exemption under federal and state securities laws. Few states have given statutory consideration to restricting or expanding permissive transfer restrictions. The basic law is, of course, that of personal property (of which shares are traditionally a species), and its policy against restraints on alienation._/ Consequently, only certain types of stock transfer restrictions can possibly pass muster, and probably only first option, by-and-sell agreements, and similar arrangements are unquestionably valid. See Lawson v. Household Finance Corp., 17 Del. Ch. 343, 152 Atl. 723 (S.Ct. 1930). The highly useful "consent restraint" — by which shares may be transferred only with the affirmative consent of directors or other shareholders, or the proposed purchaser may be vetoed — stands in doubt in most American jurisdictions.

_/ This contrasts with the English view that shares of of stock are choses in action and are not subject to the law and policy relating to restraints on alienation.

The only usual statutory provisions are those in the Uniform Stock Transfer Act (Del. Corp. Law §194) and the Uniform Commercial Code (Section 8-204) requiring that any "otherwise valid" stock transfer restriction be recited or "conspicuously noted" on the stock certificate; but these provisions say nothing as to the substantive validity of a particular restriction.

Another reason for stock transfer restrictions is the need for corporations electing subchapter S status under the Internal Revenue Code to prevent transfers of stock which would disrupt their special tax status. Relevant here are the tax law requirements that such corporations may have no more than 10 shareholders and may have no shareholders other than natural persons (and certain trusts and estates).

Connecticut has adopted a statutory stock transfer providiond, Conn. Gen. Stats. S 33-306a, but without substantive provisions indicating what sorts of restrictions are valid, it adds little to the law.

The following is suggested for consideration:

<u>Section ______________ Stock Transfer Restrictions.</u>

(a) A restriction on the transfer of shares of a corporation is not unlawful if it is reasonable in view of all the circumstances and if

(1) It complies with Section 8 - 204 of the Uniform Commercial Code [or with Section 192 of the Delaware Corporation Law]

(2) It is in writing; and

(3) It contains terms which

(a) Obligate the holder of the shares proposed to be transferred to offer to the corporation or other shareholders of the corporation or any other holders of securities of the corporation or any combination of them a prior opportunity, to be exercised within a reasonable time, to purchase the shares proposed to be transferred;

(b) Obligates the corporation or other shareholders of the corporation or any other holders of securities of the corporation or any combination of them to purchase shares which are the subject of an agreement respecting the purchase and sale of shares;

(c) Require the directors of the corporation to give their consent to any proposed transfer of shares, or to the proposed purchaser of the shares, and the directors act reasonably and in good faith in withholding consent.

(d) Prohibit the transfer of the shares to designated persons or categories of persons, and such designation is reasonable in view of all circumstances.

(b) A restriction on transfer of shares, as permitted by subsection (a), shall be applicable only to the shares of shareholders who are parties to an agreement restricting transfer of shares, or who voted in favor of a provision of the certificate of incorporation or of the by-laws restricting transfers of shares. The by-laws or the certificate of a corporation may also provide that a restriction on transfer of shares shall be applicable to shares subsequently issued or sold directly by the corporation./

(c) The provisions of subsection (a) do not exclude any other lawful restrictions on transfer of securities.

6. Remedies for Deadlock and Abuse in Close Corporations.

Two distinctive, if not unique, close corporation problems are (1) the existence of a deadlock either among the directors or the shareholders, and (2) the unusually vulnerable position of minority shareholders and their susceptibility to "freeze-out" operations by the controlling interests. Traditional equitable remedies have been inadequate, and as these problems have come to light efforts to anticipate and resolve them have resulted in more careful drafting of the basic documents for the close corporation, and the enactment of statutes giving courts broader powers to deal with these difficulties. The ABA Model Act, following the Illinois law, authorizes judicial dissolution on several grounds, including those recognized by Delaware's Section 226 for appointment of a receiver. In addition to the numerous states which have enacted the Model Act (including its dissolution provision), and

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/ Subsection (b) is based on Conn. Gen. Stats. § 33-306a.
Infra at p. 357

leaving aside certain instructive English statutes, a group of other states have devised specific remedies to deal with the problems of deadlock and of the injured minority share interests: California, Connecticut, Florida, New York, North Carolina, Ohio and South Carolina. These procedures are designed primarily to give the court alternatives less drastic than ordering the corporation dissolved or appointing a receiver.

A. Appointing Receivers (Section 226)

(1) Grounds for Relief: The present Delaware statute authorizes appointment of a receiver if an "equally divided vote" has resulted in no election of directors for two years or at an election under Section 224. The "equally divided vote" test is too narrow, since deadlock may result just as well from some other division or split among the shareholders. Thus a charter requirement of unanimous voting may create deadlock precluding corporate action if a single shareholder objects. Similarly, corporate action can be blocked by a 75-25, 2/3-1/3, or 60-40 division where the articles respectively call for a 75%, 66-2/3% or 60% vote to take action. Hence, the statute should be reworded to provide at the very least as follows:

> Whenever the shareholders are so divided that they have failed to elect directors at two successive annual elections or at an election held in accordance with Section 224 of this title . . . .

This proposed language follows most statutes in deleting the reference to an "equally divided vote."

Statutes now customarily authorize judicial intervention on other grounds. Virtually all the new acts give courts discretion to dissolve (or to appoint a receiver) on the ground that a deadlock among the directors precludes action by the board with resulting injury to the corporation. Pennsylvania, (Pa. Bus. Corp. Act S 1107 (A) (4)) authorizes judicial dissolution on finding:

> (4) That the directors are deadlocked in the management of the corporate affairs and the shareholders are unable to break the deadlock, and that irreparable injury to the corporation is being suffered or is threatened by reason thereof.

South Carolina's Section 12-22.15 (a) (1) avoids exclusive reliance on the overly strict test of "irreparable injury" and permits judicial dissolution if:

> (1) The directors of the corporation are so divided respecting the management of the corporation's business and affairs that the votes required for action by the board of directors cannot be obtained and the shareholders are unable to terminate the division, with the consequence that (A) the corporation is suffering or will suffer irreparable injury, or (B) the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally.

See also New York S 1104 (a) (1); North Carolina S 55-125 (a) (1); Connecticut S 33-382 (a) (2) (1), for comparable provisions. This Report recommends that Delaware's Section 226 add this as ground for judicial intervention.

At lease three recent statutes authorize judicial action on the ground that the acts of directors or controlling interests are fradulent or "oppressive." Pennsylvani's Section 1107 (A) (2) so provides when

> The acts of the directors, or those in control of the corporation, are illegal, oppressive, or fradulent, and . . . it is benenficial to the interests of the shareholders that the corporation be wound up and dissolved.

The South Carolina provision (S. C. Code S 12-22. 15 (a) (3) is similar in intent, but more specifically refers to actions by directors or controlling interests which are "oppressive or unfairly prejudicial either to the corporation or to any shareholder whether in his capacity as a shareholder, director or officer of the corporation." _/

A number of statutes authorize a fourth ground for judicial action, viz., that the corporation's assets are being misapplied or wasted. e.g., Pennsylvania S 1107 (A) (3).

New York's Section 1104 (a) (3) authorizes judicial dissolution because "there is internal dissension and two or more factions of shareholders are so divided that dissolution would be beneficial to the shareholders," but this ground may be asserted only by the holder of at least one-third of the corporation's shares.

_/ This language is designed to take account of the fact that in a closely held corporation "oppressive" action may and often does take the form of depriving a shareholder of his rights as a director or officer, rather than attacking his stock interest as such. The Jenkins Committee in England has recommended that its chief statutory remedy for this type of "oppression" (Section 210 of the Companies Act) be amended to overrule a Scottish decision, Elder v. Elder & Watson, Ltd., (1952) Sess. Cas. 49, which would limit judicial action to cases of injury to a shareholder's stock interest. See *infra* at p. 350

(2) Type of Relief: Like the Model Act, all of the statutes so far cited contemplate that the court will dissolve the corporation. Delaware's Section's 226 provisions appointment of a receiver who may be empowered to continue to operate the corporation if the Court of Chancery so orders. Absent such an order, presumably the receiver would proceed with his normal functions, including payment of creditors and distribution of the remaining assets to shareholders. Although the Delaware approach of appointing a receiver where other statutes would authorize dissolution is clearly preferable, some close-corporation deadlocks may be so intractable, and mutual confidence among the shareholders so far dissipated, that dissolution may be the only feasible remedy. See Chayes, Madame Wagner and the Close Corporation, 73 Harv. L. Rev. 1532, 1545-1546 (1960), and Israels, The Sacred Cow of Corporate Existence - Problems of Deadlock and Dissolution, 19 U. Chi. L. Rev. 778 (1952). In such circumstances, the court should have authority to go ahead with dissolution of the corporation. This Report will also recommend certain other procedures which should be available to the court in the close-corporation situation and which do not carry the stigma of receivership or terminate the corporation's operations.

(3) Who May Petition for Judicial Action: Delaware, like most states, properly permits a single stockholder to seek judicial action for deadlock and it should retain this feature even if the

grounds are expanded, as suggested above. New York's Section 1104 seems needlessly rigid in requiring that at least one-third of the shareholders file petitions for dissolution./ It is believed that the courts can readily dispose of frivolous suits by single shareholders seeking to misuse their standing to petition for judicial action.

(4) Limitation to Close Corporations: Although these statutes authorizing judicial dissolution (or appointment of a receiver) are designed cheifly for close corporations, no state (including Delaware) has in terms so limited the statute. This is desirable. Leaving aside the difficulties of satisfactorily defining the close corporation, the useful role of courts should not be limited to the smallest corporation. Such a limatation would make it uncertain whether the courts could take any remedial action as to corporations which are not "close". Certainly, judicial action is necessary in case of deadlock, or waste or misuse of corporate assets, whatever the size of the corporation. In actual practice, most of the situations covered by these statutes will arise in corporations with few shareholders; and the permissible statutory relief will rarely have any application to the public held enterprise. Hence, even if Section 226 is substantially expanded, it should not be confined to close corporstions.

As an alternative or supplement to dissolution or appointing a receiver, several states and England have developed judicial pro-

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/ Except that under New York's Section 1104(c) a single shareholder may seek dissolution on the ground that a deadlock among the shareholders has precluded election of directors at two consecutive annual meetings.

-edures to deal with deadlock or injury to minority interests. Again these procedures tend to be useful only in the small corporation, although the application of these statutes is not expressly so limited. The purpose of each statute is to give the court broader discretion than the usually available choice of ordering or not ordering dissolution of a corporation, or appointing or not appointing a receiver.

(1) Appointment of a Provisional Director: California's Section 819 _/ authorizes the court, in the event of deadlock, among the directors of a corporation, to appoint a provisional director who must be an "impartial person", "neither a shareholder nor a creditor of the corporation" nor related to the other directors. The provisional director is not a receiver; he has only the "rights and powers" of a director of the corporation, including the right to notice, to vote at the directors' meeting, and to receive reasonable compensation. He continues as a director until the other directors break the deadlock which prompted his appointment, or until he is removed by court order or by written consent of a majority of the voting shares. One-third of the outstanding shares may petition for his appointment which is, of course, discretionary with the court.

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p.359

_/ See *infra*, at text of the California Statute.

The provisional director is only superficially similar to a court appointed receiver. As the leading California case observes, "a receiver takes possession of all corporate property and assets and exercises complete control over all the affairs of the corporation including the management of its everyday business," while, in contrast, the provisional director "is merely a director and has none of the plenary powers which are granted to a receiver." In the matter of Jamison Steel Corp., Cal. App. 2d , 322 P. 2d 246, 250 (1st Dist. 1958). A second distinction is that the "drastic" or "heroic" remedy of a receiver is invoked only when "there is an actual or threatened cessation or domination of the business" and is so thoroughly associated in the minds of the public with the appointment of a receiver" that the remedy is to be avoided. Id. at 250. In contrast, the provisional director remedy is "a less severe remedy which is available to protect the rights of the parties and does not reflect upon the financial standing or good name of the corporation nor does it take the property out of the hands of the owners or the persons actually administering its business. There is a readily discernible difference between a corporation not able to conduct its business to advantage or being in danger of impairing or losing its property and a corporation which is in danger of cessation or diminution of operations." Id. at 251.

The three reported California appellate cases applying to the California statute have involved close corporations exclusively. Thus, in Jamison Steel, there were four shareholders; the two factions each elected two members to the four man board. A like situation was present in Edlund v. Los Altos Builders, 106 Cal. App. 2d 350, 235 P.2d 28 (1st Dist. 1951), except that here the original action was one to dissolve the corporation, and the trial court granted relief through appointing a provisional director. And in Desert Club v. Superior Court, 99 Cal. App. 2d 346, 221 P.2d 766 (2d Dist. 1950), two shareholders, each with 50% of the stock were each directors and upon their reaching an impasse, one of them successfully petitioned the court to appoint a provisional director.

With respect to procedure, the California statute is intended "to provide a summary procedure to protect and to preserve" the busines from injuries growing out of deadlock. Edlund, case, supra, 235 P.2d at 31. And both in that case and in Desert Club, the appointment was made on affidavits, but without a hearing or evidence. Procedurally, in Edlund, which started as a petition to dissolve the corporation, the appointed, although, as Desert Club and Jamison Steel indicate, the more usual procedure seems swift and sure and well designed to solve the problem it was fashioned for.

(2) Three states have devised a procedure which would be useful in dealing with deadlock or, more broadly, serious dissension within small corporations. In California, Connecticut, (Conn. Gen. Stats. S 33-384) and West Virginia,/ shareholders may bail the corporation out of a receivership instituted by other shareholders by purchasing the receivership-petitioner's shares at a price subject to court supervision. In California it is the fair cash value of the shares; in Connecticut it is the appraised value. California requires the purchasing shareholder to give bond with security to assure payment

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/ See infra at p. 359 for text of the Connecticut Statute for the petitioner's shares. In each state the purchase is, in effect, compulsory, provided the purchaser pays the fair cash or appraised value and meets any other statutory (or judicial) requirements. Connecticut also provides, S 33-384 (h), that a receivership instituted by a creditor may be dismissed if one or more shareholders satisfy the claim.

None of these statutes has dealt with the potential hazard of a "strike" shareholder seeking a receivership solely or primarily to compel a buyout of his shares. It would seem feasible to warn against such a practice by giving the court discretion to dismiss the receivership and to tax all or some of the expenses of the receivership to the shareholder seeking receivership to the shareholder seeking receivership, if it appears that the proceeding was instituted in bad faith for the primary purpose of securing the purchase of the petitioner's shares. Actually, the corporation or other shareholders will often welcome the opportunity to purchase the shares and thereby not only terminate the action but also be permanently rid of the trouble-maker. Judicial control of the proceedings and the determination of the fair cash value should prevent abuse, especially if the statute also carries some sanction for abuse of the procedure.

(3) <u>Section 210 of the English Companies Act</u>:_/ The most far-reaching, and most effective, procedure for dealing with internal

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_/ Because English and Scottish cases and statutes are often inaccessible, two copies of a collection of materials prepared for classroom use by the Reporter have been sent to the Committee's office at the Delaware Trust Building in Willimgton.

strife within small corporations is an English statute which was apparently inspired by the West Virginia and California provisions for compulsory buy-out of a minority shareholder's interest, but which goes substantially beyond these or the Connecticut statutes. As presently worded, Section 210 provides that an English court, on finding that the circumstances justify judicial dissolution but that dissolution would "unfairly predjuice" the corporation and its shareholders, may grant relief alternative to dissolution. For the court may, "with a view to bringing to an end the matters complained of (by the petitioning shareholder), make such order as it thinks fit, whether for regulating the conduct of the company's affairs in future, or for the purchase of the shares of any members of the company by other members of the company or by the company" [illegible]. The court may make "any alteration in or addition to" corporate documents corresponding to the certificate of incorporation and by-laws. Obviously, this power is equitable in nature and is to be used only in the court's sound discretion. The three reported cases applying the statute disclose the court's sparing but effective use of its broadly granted powers; each corporation was closely held. Scottish Cooperative Wholesale Society Ltd. v. Meyer, (1959) A. C. 324 (H.L. 1958) (subsidiary owned by two individual minority shareholders and a corporate majority shareholder) (court ordered buy-out of minority interests at fair value; In re H. R. Harmer Ltd., (1959) Week. L. Rep. 62 (C. A. 1958) (corporation owned by six shareholders; limited relief granted against senile controlling shareholders).

See also Elder v. Elder & Watson Ltd., (1952) Sess. Cas. 49 (Ct. Sess. 1st Div. 1958) (statute held inapplicable under facts of the case.).

The English statute has worked so successfully that the English Company Law Amendment Committee ("Jenkins Committee") has recommended expansion of Section 210, and in particular making its broad equitable relief available even where the fact situation is not so grievous as to call for judicial dissolution. Report, Company Law Committee, Cmnd. No. 1749 (June 1962). In short, the English statute would, if amended as recommended, provide a general remedial jurisdiction for most forms of deadlock and abuse within closely held corporations, although the statute is not in terms confined to such enterprises.

Although statutes similar to Section 210 have been adopted or recommended in several Commonwealth nations, South Carolina is the only American jurisdiction to borrow the English idea, despite recommendations by the leading authority on close corporations. See O'Neal, Expulsion or Oppression of Business Associates: "Squeeze-outs" in Samll Enterprises §§ 8.02, 8.08 (1961). The South Carolina statute, infra at p.362, embodies most of the Jenkins Committee recommendations with respect to the English prototype.

It is to be noted that the English statute duplicates the Connecticut provision noted supra at p.349, to the extent that it authorizes a court-ordered purchase of shares by the corporation or by other shareholders. However, since neither the corporation nor ... or more shareholders may be willing or financially able to purchase the shares of a dissenting minority interest, this form of relief may not always be useful or possible. Hence, the English statute does afford courts a wider flexibility.

(4) Recommendations: This Report recommends that the Committee add statutory provisions empowering the Court of Chancery to grant relief in addition to its present authority to appoint a receiver. A provision modeled on the English Section 210 is unquestionably the most comprehensive and efficacious supplemental remedy. If the Committee prefers to consider more specific procedures, it is suggested that statutes be adopted to permit appointment of a provisional director (as in California) and to authorize a buy-out of a dissenter's shares (as in Connecticut). It is assumed that the present authority to appoint a receiver, under Section 226, will be extended. This combination of statutory procedures should provide an effective armory of weapons for dealing with many of the usual problems of the close corporation, and give Delaware a significant lead over other states in the close corporation field.

ONE-MAN CORPORATIONS

Several states have statutes specifically validating corporations in which all shares are owned both beneficially and of record by a single person, E. G., N. C. Gen. Stats. s 55-3.1;

Fla. Stats. Ch. 62-379, S 2, in response to judicial suggestions holdings that the corporate entity collapses under such circumstances, and the individual is fully liable./ See Park Terrance Inc. v. Phonix Indem. Co., 243 N. C. 595, 91 S. E. 2d 584 (1956). Delaware does not need such a statute, since the truly one-man corporation is impliedly recognized by Section 141 (b), and, if adopted, by the proposed statute permitting a single incorporator, see Report at p , *supra*.

/ Statutory requirements for multiple incorporators and directors are the usual grounds for invalidating a corporation all of whose shares are owned by a single person; and the Delaware statute, as presently written and if amended as proposed, would eliminate any basis for this argument.

Joint Subsidiaries and Other Joint Ventures

Jointly owned subsidiaries and other joint venture corporations comprise a species of close corporations, since these enterprises are ordinarily owned by a very few, often only two, corporate shareholders who desire, at least as much as two- or three-man corporations, to keep the enterprise close. Delaware has an interest here, since at least 13 of 25 joint-venture corporations recently studied by the Harvard Law Review staff_/ are incorporated in Delaware--a number outstripping any other jurisdiction. This Report has already recommended that Section 122 should be amended specifically to empower corporations to enter into joint ventures and like undertakings. Report, supra at 42. Many close corporation principles, previously recommended, are equally applicable to joint venture corporations, e.g., specific authorization of super-statutory quorum and voting requirements, by which participants may insure themselves a veto over proposed corporate action (see 78 Harv.L.Rev. at 398-403); procedures for dealing with deadlocked boards_/ (Id. at 403-413); validation of stock transfer restrictions (Id. at 418-421); and a general recognition that the directors of a joint venture corporation may be controlled by the parent corporation-shareholders.

_/ Note, Joint Venture Corporations: Drafting the Corporate Papers, 78 Harv.L.Rev. 393-425 (December 1964), is an unusually thorough study, although it is limited to discussion of 50/50 joint ventures, Id. at 393, n.1. See "With the Editors," Id. at vii-viii, for a description of the procedure used in the study.

_/ Deadlock is especially likely because of the prevalence of even-numbered boards of directors. Of 35 ventures, 31 had even-numbered boards. 78 Harv.L.Rev. at 398, n.26.

Joint-venture enterprises, even more than the ordinary close corporation, are fashioned through meticulous drafting of the corporate instruments. The close corporation provisions already suggested would certainly validate almost any type of internal corporate structure on which the corporate "partners" agree. The procedures for dealing with corporate deadlock should also prove useful. However, it is suggested that, if the Committee adopts the California-type procedure for appointing a provisional director, the statute should permit the certificate of incorporation to nullify its application to a particular enterprise. Judicial power to force a deadlock-breaking director on the parties to a joint-venture corporation would apparently be distasteful, see 78 Harv.L.Rev. at 407-408, esp. at n.75.

STATUTORY PROVISIONS RELATING TO CLOSE CORPORATIONS

1. NORTH CAROLINA GENERAL STATUTES, SECTION 55-73

(a) An otherwise valid contract between two or more shareholders that the shares held by them shall be voted as a unit for the election of directors shall, if in wirting and signed by the parties thereto, be valid and enforceable as between the parties thereto, but for not longer than ten years from the date of its execution. Nothing herein shall impair the privilege of the corporation to treat the shareholders of record as entitled to vote the shares standing in their names, as provided in G. S. 55-59 nor impair the power of a court to determine voting rights as provided in G. S. 55-71.

(b) Except in cases where the shares of the corporation are at the time or subsequently become generally traded in the markets maintained by securities dealers or brokers, no written agreement to which all of the shareholders have actually assented, whether embodied in the charter or bylaws or in any side agreement in writing and signed by all the parties thereto, and which relates to any phase of the affairs of the corporation, whether to the management of its business or division of its profits or otherwise, shall be invalid as between the parties thereto, on the ground that it is an attempt by the parties thereto to treat the corporation as if it were a partnership or to arrange their relationship in a manner that would be appropriate only between partners. Notwithstanding any other provision of this section or of this chapter, the provisions of G. S. 55-59 (a) shall not apply to such an agreement. A transferee of shares covered by such agreement who acquires them with knowledge thereof is bound by its provisions.

(c) An agreement between all or less than all of the shareholders, whether solely between themselves or between one or more of them and a party who is not a shareholder, is not invalid, as between the parties thereto, on the ground that it so relates to the conduct of the affairs of the corporation as to interfere with the discretion of the board of directors, but the making of such an agreement shall impose upon the shareholders who are parties thereto the liability for managerial acts that is imposed by this chapter upon directors.

2. NEW YORK BUSINESS CORPORATION LAW, SECTION 620

(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 as improperly restrictive of the discretion or powers of the board in its management of corporate affairs 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 the shares of the corporation are not 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) 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 vote of the holders of two-thirds of all outstanding shares entitled to vote thereon or by the holders of such greater proportion of shares as may be required by the certificate of incorporation for that purpose.

(e) Alternatively, if a provision authorized by paragraph (b) shall have ceased to be valid under this section, the board may approve a certificate of amendment under section 805 (Certificate of amendment or of change; 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 or every certificate for shares issued by such corporation. (As amended by Ch. 834, L. 1962; Ch. 746, L. 1963.)

3. CONNECTICUT GENERAL STATUTES, SECTION 33-306a

Imposition of Restrictions on share transfers. Nothing in this chapter shall be construed as prohibiting or invalidating restrictions on the transfer of shares of a corporation if such restrictions are not otherwise illegal, and if such restrictions are imposed either (a) by bylaws adopted by shareholders applicable only to the shares of shareholders voting in favor thereof and if it so provides, to shares subsequently issued or sold directly by the corporation, or (b) by agreement among any number of shareholders, or among any number of shareholders and the corporation, applicable only to the shares of such agreeing shareholders having sufficient voting power to adopt a bylaw to such effect, to shares subsequently issued or sold by the corporation...

4. PENNSYLVANIA BUSINESS CORPORATION LAW, SECTION 1107

§ 1107. Involuntary Proceedings for Winding up and Dissolution. - A. The Several courts of common pleas of the Commonwealth may, upon petition filed by a shareholder of a business corporation, entertain proceedings for the involuntary winding up and dissolution of the corporation, when it is made to appear:

(1) That the objects of the corporation have wholly failed, or are entirely abandoned, or that their accomplishment is impracticable; or

(2) That the acts of the directors, or those in control of the corporation, are illegal, oppressive, or fraudulent, and that it is beneficial to the interests of the shareholders that the corporation be wound up and dissolved; or

(3) That the corporate assets are being misapplied or wasted, and that it is beneficial to the interests of the shareholders that the corporation be wound up and dissolved; or

(4) That the directors are deadlocked in the management of the corporate affairs and the shareholders are unable to break the deadlock, and that irreparable injury to the corporation is being suffered or it is threatened by reason thereof. . . .

B. The several courts of common pleas of this Commonwealth may, upon petition filed by a creditor of a business corporation whose claim has either been reduced to judgment and an execution thereon returned unsatisfied, or whose claim is admitted by the corporation, entertain proceedings for the involuntary winding up and dissolution of the corporation when, in either case, it is made to appear that the corporation is unable to pay its debts and obligations in the regular course of business, as they mature, or to afford reasonable security to those who may deal with it.

C. Any petition for the involuntary winding up and dissolution of a corporation, authorized to be filed under this section, shall be filed with a court of common pleas of the country in which the registered office of the corporation is located.

5. NEW YORK BUSINESS CORPORATIONS LAW, SECTION 1104

(a) Except as otherwise provided in the certificate of incorporation under section 613 (Limitations on right to vote), the holders of one-half of all outstanding shares of a corporation entitled to vote in an election of directors may present a petition for dissolution on one or more of the following grounds:

(1) That the directors are so divided respecting the management of the corporation's affairs that the votes required for action by the board cannot be obtained.

(2) That the shareholders are so divided that the votes required for the election of directors cannot be obtained.

(3) That there is internal dissension and two or more factions of shareholders are so divided that dissolution would be beneficial to the shareholders.

(b) If the certificate of incorporation provides that the proportion of votes required for action by the board, or the proportion of votes of shareholders required for election of directors, shall be greater than that otherwise required by this chapter, such a petition may be presented by the holders of more than one-third of all outstanding shares entitled to vote, on non-judicial dissolution under section 1001 (Authorization of dissolution).

(c) Notwithstanding any provision in the certificate of incorporation, any holder of shares entitled to vote at an election of directors of a corporation, may present a petition for its dissolution on the ground that the shareholders are so divided that they have failed, for a period which includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired or would have expired upon the election and qualification of their successors. (As amended by Ch. 748, L. 1963).

6. CALIFORNIA CORPORATIONS LAW, SECTION 819

Section 819 - Provisional Director: (a) Action for Appointment. If a corporation has an even number of directors who are equally divided and cannot agree as to the management of its affairs, so that its business cannot longer be conducted to advantage or so that there is danger that its property and business will be impaired and lost, the superior court of the county where the principal office of the corporation is located may, notwithstanding any provisions of the articles or by-laws of the corporation and whether or not an action is pending for an involuntary winding up or dissolution of the corporation, appoint a provisional director pursuant to this section. Action for such appointment may be filed by one-half of the directors or by the holders of not less than 33 1/3 percent of the outstanding shares.

(b) Qualifications; rights and powers; exemption for certain corporations. The provisional director shall be an impartial person, who is neither a shareholder nor a creditor of the corporation, nor related by consanguinity or affinity within the third degree to any of the other directors of the corporation, or to any judge of the court by which he is appointed. The provisional director shall have all the rights and powers of a director, and shall be entitled to notice of the meetings of the board of directors and to vote at such meetings, until the deadlock in the board of directors is broken or until he is removed by order of the court or by order of the court of by vote or written consent of the holders of a majority of the voting shares. He shall be entitled to receive such compensation as may be agreed upon between him and the corporation, and in the absence of such agreement he shall be entitled to such compensation as shall be fixed by the court.

7. CONNECTICUT GENERAL STATUTES, SECTION 33-384

(a) Whenever a petition for judicial winding up is filed by a shareholder or shareholders as provided in section 33-382, hereinafter in this section referred to as "petitioner," any other shareholder may at any time within sixty days after the filing of such petition, or at such later time as the court in its discretion may allow, apply to the court to have the fair value of the petitioner's shares appraised.

(b) The court shall thereupon by its judgment determine the fair value of the petitioner's shares as of the day prior to the date on which such petition was filed, exclusive of any element of value arising from such filing. It may, if it so elects, appoint one or more persons as appraisers to receive evidence and recommend a decision on the question of fair value. The appraisers shall have such power and authority as shall be specified in the order of their appointment or an amendment thereof.

(c) Within ten days after written notice from the clerk of the court that such appraisal has been filed, the applicant shall file with the court a signed statement stating whether he elects to buy the petitioner's shares at the appraisal. If he does elect to buy them, he shall at the time of filing such statement deposit the amount of such appraisal in cash, or certified check, with the clerk of the court.

(d) If deposit is made as provided in subsection (c), an order of sale shall be entered directing the petitioner forthwith to turn over his share certificates to the court for delivery to such applicant, or his nominee. The deposit shall be paid over to the petitioner by the clerk on receipt of the certificates representing such shares, duly endorsed for transfer. Upon entry of such order of sale, the petitioner shall no longer be a shareholder of the corporation except for purposes of appeal therefrom and, upon motion, of the applicant, the petition of judicial winding up proceeding shall be dismissed and such other orders entered continuing the corporation as the court may direct. The court may direct that notice of such dismissal be given to such interested persons as it deems proper and may take all such reasonable action as it deems proper to provide fair opportunity for shareholders desiring to continue the corporation to purchase the shares of shareholders desiring to dissolve the corporation, and fair opportunity for the latter to sell their shares to the former, at the appraised fair value thereof.

(e) If the applicant fails to make the deposit as provided in subsection (c), the proceeding shall proceed in due course. If the applicant fails to make the deposit, no other shareholder may proceed as applicant as provided in subsection (a), but the court may, in its discretion, in the course of the proceedings, permit other shareholder to make deposit as provided in subsection (c) and in such case shall proceed as provided in subsection (d).

(f) The expenses of the appraisal shall be taxed by the court and shall be paid by the applicant if he fails to make the deposit as provided in subsection (c), but otherwise shall be taxed against the corporation and added to the final costs of the action.

(g) Whenever dissolution of a corporation has been effectively voted by shareholders entitled to dissolve the same, but the holders of a majority of directors have not voted in favor of dissolution, any shareholder who has not voted for dissolution may, within thirty days after such vote was taken, apply to the superior court for the county where the principle office of the corporation is located, or any judge thereof, to have the fair value of shares voted for dissolution appraised. In a proceeding brought pursuant to this subsection, process shall be served on the corporation as in other civil actions, such notice shall be given to shareholders and such other interested persons as the court or judge deems proper, and it shall not be necessary to make service on shareholders. The court or judge shall, in such proceeding, proceed substantially as provided in sub-sections (b), (c), (d), (e), and (f) of this section, with such variations therefrom as may be reasonably required to provide fair opportunity for shareholders of such corporation desiring to continue the same to purchase the shares of such minority shareholders desiring to dissolve the corporation, and fair opportunity for the latter to sell their shares to the former, at the appraised fair value thereof.

(h) Whenever a petition for judicial winding up is filed by a creditor as provided in section 33-382, the court or judge may, in its or his discretion, dismiss the action on motion of any shareholder or shareholders who satisfy the claim of such creditor.

8. COMPANIES ACT, 1948, 8-9 GEO. VI, c. 38, SECTION 210

§ 210 -- (1) Any member of a company who complains that the affairs of the company are being conducted in a manner oppressive to some part of the members (including himself) or, in a case falling within subsection (3) of section one hundred and sixty-nine of this Act, the Board of Trade, may make an application to the court by petition for an order under this section.

(2) If on any such petition the court is of opinion-

(a) that the company's affairs are being conducted as aforesaid; and

(b) that to wind up the company would unfairly prejudice that part of the members, but otherwise the facts would justify the making of a winding-up order on the ground that it was just and equitable that the company should be wound up;

the court may, with a view to bringing to an end the matters complained of, make such order as it thinks fit, whether for regulating the conduct of the company's affairs in future, or for the purchase of the shares of any members of the company by other members of the company or by the company and, in the case of a purchase by the company, for the reduction accordingly of the company's capital, or otherwise.

(3) Where an order under this section makes any alteration in or addition to any company's memorandum or articles, then, notwithstanding in any other provision of this Act but subject to the provisions of the order, the company concerned shall not have power without the leave of the court to make any further alteration in or addition to the memorandum or articles inconsistent with the provisions of the order; but subject to the foregoing provisions of this subsection, the alterations or additions made by the order shall be of the same effect as if duly made by resolution of the company and the provisions of this Act shall apply to the memorandum or articles as so altered or added to accordingly.

(4) An office copy of any order under this section altering or adding to, or giving leave to alter or add to, a company's memorandum or articles shall, within fourteen days after the making thereof, be delivered by the company to the registrar of companies for registration; and if a company makes default in complying with this subsection, the company and every officer of the company who is in default shall be liable to a default fine.

(5) In relation to a petition under this section, section three hundred and sixty-five of this Act shall apply as it applies in relation to a winding-up petition and proceedings under this section shall, for the purpose of Part V of the Economy (Miscellaneous Provisions) Act, 1926, be deemed to be proceedings under this Act in relation to the winding up of companies.

9. SOUTH CAROLINA CODE OF LAWS, SECTION 12-22.23

§ 12-22.23 Discretion of Court to Grant Relief Other Than Dissolution.

(a) In any action filed by a shareholder to dissolve the corporation on the grounds enumerated in § 12-22.15 corresponding to N. C. Gen. Stats. S 55-125 (a) (1) (4) , the court may make such order or grant such relief, other than dissolution as in its discretion it deems appropriate, including, without limitation, an order

(1) Cancelling or altering any provision contained in the articles of incorporation, or any amendment thereof, or in the by-laws of the corporation;

(2) Cancelling, altering, or enjoining any resolution or other act of the corporation;

(3) Directing or prohibiting any act of the corporation or of shareholders, directors, officers or other persons party to the action; or

(4) Providing for the purchase at their fair value of shares of any shareholder either by the corporation or by other shareholders.

(b) Such relief may be granted as an alternative to a decree of dissolution, or may be granted whenever the circumstances of the case are such that relief, but not dissolution, would be appropriate

10. FLORIDA STATUTES, CHAPTER 63-379.

The text of this statute appears at pages 364, 365, 366 infra.

See 77 Harv. L.Rev. 1551-1554 (June 1964) for a useful comment.

CORPORATIONS-CLOSE CORPORATIONS

CHAPTER 63-379

SENATE BILL NO. 690

An Act relating tocorporations for profit whose shares of stock are not generally traded in the markets maintained by securities dealers or brokers; recognizing existence of corporation notwithstanding acquisition of all its shares of stock by one or by two persons; permitting provisions in articles of incorporation with respect to management by stockholders rather than by board of directors; permitting stockholders and directors to take action by written consent without a meeting; permitting stockholder agreements with respect to management and other matters; permitting removal of directors at any time, with or without cause; providing remedy upon deadlock of directors or stockholders; providing an effective date.

Be it enacted by the Legislature of the State of Florida:

Section 1. (1) The provisions of this Act shall extend to all close corporations, but shall be deemed permissive and not mandatory; provided, however, that this act shall have no application to any close corporation in existence upon the effective date hereof unless such previously existing close corporation shall elect to bring itself within the provisions of this act by written consent of the owners of a majority of the voting stock.

(2) As used herein, "close corporation" means a corporation for profit whose shares of stock are not generally traded in the markets maintained by securities dealers or brokers..

(3) Whenever applicable, the provisions of this Act shall apply notwithstanding any provision of this Act to the contrary.

(4) Wherever used herein, unless otherwise stated, "stockholders" shall mean "stockholder" if there be only one stockholder of a corporation.

Section 2. (1) The existence of a corporation, hereafter or heretofore formed under the laws of this State, shall in no respect be deemed impaired by the acquisition of all the shares of stock of such corporation by one person or by two persons, nor shall the corporation, by such acquisition, be deemed no to possess any managerial boards or bodies or any capacities, powers or authority which it would have possessed with three or more stockholders, nor shall the corporation, upon such acquisition, be deemed to have become dormant, inactive or incapable of acting as a corporation.

(2) The acquisition, heretofore or hereafter, of all of the shares of stock of a corporation by one person or by two persons is hereby declared to violate no policy or provision of the laws of this state.

Section 3. The Articles of Incorporation of a close corporation may provide that the business of the corporation shall be managed by the stockholders of the corporation rather than by a board of directors, provided that there be not less than three stockholders; and, if the Articles of

Incorporation provide as aforesaid, the following provisions shall apply:

(1) Wherever the context requires, the stockholders of such close corporation shall be deemed directors of such corporation for purposes of applying the provisions of Chapter 608, Florida Statutes.

(2) The stockholders of such close corporation shall be subject to the liabilities imposed by Chapter 608, Florida Statutes, for action taken by directors.

(3) Any action required or permitted by Chapter 608, Florida Statutes, to be taken by the directors of a corporation may be taken by action of the stockholders of such close corporation at a meeting of the stockholders or as provided in Section (5) hereof.

Section 4. If the business of a close corporation is managed by a Board of Directors, action taken by the directors or the members of an executive committee of the directors without a meeting shall nevertheless be Board or committee action if written consent to the action in question is signed by all the directors or members of the committee, as the case may be, and filed with the minutes of the proceedings of the Board or committee, whether done before or after the action so taken.

Section 5. Any action of the stockholders of a close corporation may be taken without a meeting if consent in writing, setting forth the action so taken, shall be signed by all the persons who would be entitled to vote upon such action at a meeting and filed with the secretary of the corporation as part of the corporate records. Such consent shall have the same force and effect as a unanimous vote of the stockholders, and may be stated as such in any certificate or document filed with the Secretary of State under this chapter.

Section 6. (1) The stockholders of a close corporation may enter into a written agreement, embodied in the Articles of Incorporation or by-laws of the corporation, or in a side agreement in writing and signed by all the parties thereto, relating to any phase of the affairs of the corporation, including, but not limited to the following:

(a) Management of the business of the corporation.
(b) Declaration and payment of dividends or division of profits.
(c) Who shall be officers or directors, or both, of the corporation.
(d) Restrictions on transfer of stock.
(e) Voting requirements, including the requirements of unanimous voting of stockholders or directors.
(f) Employment of stockholders by the corporation.
(g) Arbitration of issues as to which the stockholders are deadlocked in voting power or as towhich the directors are deadlocked and the stockholders are unable to break the deadlock.

(2) No written agreemant to which stockholders bf a close corporation have actually assented, whether embodies in the charter or by-laws of the corporation or in any side agreemant in writing and signed by all the parties thereto, and which relates to any phase of the affairs of the corporation, whether to the management of its business or division of its profits or

otherwise, shall be invalid as between the parties thereto, on the ground that it is an attempt by the parties thereto to treat the corporation as if it were a partnership or to arrange their relationships in a manner that would be appropriate only between partners.

(3) If the business of a close corporation is managed by a Board of Directors, an agreement among all or less than all of the stockholders, whether solely among themselves or between one or more of then and a party who is not a stockholder, is not invalid, as among the parties thereto, on the ground that is so relates to the conduct of the affairs of the corporation as to interfere with the discretion of the Board of Directors, but the making of such an agreement shall impose upon the stockholders who are parties thereto the liability for managerial acts that is imposed by the laws of this state upon directors.

Section 7. The stockholders of a close corporation entitled to elect a director of such corporation may at any time remove such director, with or without cause, by like action of the stockholders as required for the election of such director, absent a contrary provision by agreement or in the by-laws or Articles of Incorporation of the corporation.

Section 8. The circuit court, sitting in chancery, may entertain a petition of any stockholder for involuntary dissolution of any close corporation and, at the hearing, may appoint a receiver or trustee of the corporation and order it dissolved, pursuant to the procedure provided in Section 608.29, Florida Statutes, when it is made to appear:

1. That the directors of the corporation are deadlocked in the management of the corporate affairs and the stockholders are unable to break the deadlock, or

2. That the stockholders are deadlocked in voting power; and

3. Arbitration or any other remedy provided in any written agreement of the stockholders upon deadlock of the directors or stockholders has failed.

Section 9. This Act shall take effect September 1, 1963.
Became a law without the Governor's approval.
Filed in Office Secretary of State June 12, 1963.

Miscellaneous Recommendations

A. Widows' Compensation and Pensions: The Committee may wish to consider specific statutory recognition of the frequent practice of corporate payments to widows and dependents of deceased corporate officers. Cases in some jurisdictions suggest that such payments merely waste the corporate assets, or that there is no "consideration" therefor. Pennsylvania uses language in Section 316 of its Business Corporation Law which would dissipate any doubt as to the validity under state law of such payments:

> § 316. PENSIONS.—Every business corporation may, by resolution of its board of directors, grant allowances or pensions to its directors, officers, and employees, and, after their death, to their dependents or beneficiaries, whether or not such a grant was made during their lifetime.

B. Jurisdiction of Courts to Compel Inspection of Corporate Books and Records:/ In Delaware, at present, the Superior Court rather than the Court of Chancery, has jurisdiction to compel inspection of corporate books and records. This is probably due to the historical fact that mandamus, an "extraordinary" legal writ, was the standard remedy and could obviously be obtained only in a court of law. Since almost all corporate law litigation is in the Court of Chancery, it would seem appropriate to transfer to that tribunal the jurisdiction now exercised by the Superior Court. This seems especially

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/ The Reporter has assumed that a recommendation to alter the jurisdiction of courts with respect to specific corporate law matters is within the Committee's authority.

appropriate since actions to secure access to corporate books are ordinarily incident to suits which will be brought in Chancery. Also, at present, Chancery is the only forum at least for equitable owners to secure an order opening corporate books for their inspection, since State ex rel. Crowder v. Sperry Corp., 41 Del. (2 Terry) 84, 92-93, 15 A.2d 661 (Super. 1940) held that such an owner could not obtain mandamus but suggested that Chancery might give needed relief. This particular form of splitting jurisdiction between Chancery and the Superior Court has already been criticized by this Report, supra at 168. The recommendation there made is broadened into a suggestion that all inspection right suits be transferred to Chancery. This would involve dropping the historic mandamus procedure, and substituting therefor a statutory inspection right, as is many states. See, e.g., N.Y. Bus. Corp. Law § 624(d) Conn. Gen. Stats. § 33-334(b). This need not alter the nature and scope of the substantive right of inspection.

C. Corporate Books and Records as Evidence: The Committee may wish to consider a useful Connecticut statute (Conn. Gen. Stats. § 33-415), also adopted in South Carolina (S.C. Code § 12-24.9 (Supp. 1963)), specifically designed to recognize the *prima facie* correctness of statements of fact contained in certain specified corporate documents, chiefly the minutes of meetings./ This obviously encourages careful and accurate record-keeping. It also transfers the burden

/ This accords with existing Delaware law. See Young v. Janas, 34 Del.Ch. 287, 2[illegible]-294, 103 A.2d 299 (Ch.195[illegible]).

to the party contesting the facts stated in the minutes to prove that the minutes are inaccurate or false or otherwise unworthy of acceptance at face value. Thus, since the stated facts are not conclusive, but only prima facie evidence, it always remains possible to rebut the statements.

The Connecticut statute is as follows:

> Sec. 33-416. Certified records of corporations as prima facie evidence. The original or a copy of the record of minutes of the proceedings of the incorporators of a corporation, or of the proceedings or meetings of the shareholders or any class of shareholders, or of the directors, or of any committee thereof, including any written consent, waiver, release or agreement entered in such record or minutes, or the original or a copy of a statement that no specified proceeding was had or that no specified consent, waiver, release or agreement exists, shall, when certified to be true by the secretary or an assistant secretary of a corporation, be received in the courts as prima facie evidence of the facts stated therein. Every meeting referred to in such certified original or copy shall be deemed duly called and held, and all motions and resolutions adopted and proceedings had at such meeting shall be deemed duly adopted and had, and all elections of directors and all elections or appointments of officers chosen at such meeting shall be deemed valid, until the contrary is proved; and whenever a person has acted in good faith in reliance upon any such certified original or copy, it is conclusive in his favor.

Introduction

After consideration of the difficult problems presented by close corporation provisions, I have decided to submit alternative draft statutes. I do so because there is necessarily involved a major policy judgment which only the Committee should make. By submitting complete alternative drafts, the Committee will be in a better position to make that judgment than if I attempted on my own to make the judgment and merely sketch out the alternative. The two provisions are designated Statute A and Statute B.

Statute A consists of various provisions which would be scattered throughout the present General Corporation Law rather than collected into a single "close corporation subchapter." It would include five special sections applicable solely to close corporations. The remaining provisions would apply to all corporations, although some would, by their intrinsic character, be meaningful only in a close corporation context, even though not specifically limited to close corporations. The five sections which are so limited employ a definition of "close corporation" which has been adopted in the following states: Florida, New York, North Carolina, and one or two others. In formulating this test, I have used language derived from the New York statute: whether or not the shares are listed on any securities exchange or regularly quoted in any over-the-counter market maintained by brokers or dealers in securities. I point out that this definition has an inescapable flaw: a close corporation can lose its status as such as a result of events not wholly within its control, and the point in time when status is lost may be uncertain since it may be unpredictable when shares come to be "regularly quoted" as against occasionally or sporadically quoted or sold.

Statute B is a close corporation statute consisting of fifteen sections, plus some other statutory provisions which should not be limited to close corporations but should be available to other corporations regardless of size or distribution of shares. I have been unwilling to construct an entire close corporation statute upon the conventional definition quoted above, and have, instead, devised a definition not found in any other American statute, but used in virtually every English and Commonwealth "companies act" to set apart "private companies" from "public companies"--categories which correspond approximately to our "close corporation" and "public-issue corporation." Although novel in this country, the definition, coupled with certain protective provisions, has a significant advantage: maintenace of close corporation status is almost entirely within the control of the corporation and its shareholders and not subject to the involuntary loss of status because of extraneous events such as unwanted trading in the stock. Statute B also has the advantage of putting into a single subchapter a number of unusual and novel provisions the very presence of which in the general corporation law might be disconcerting to larger corporations, which may be concerned about the possible impact upon them of these new provisions. Thus, it is a more conservative approach to adopt a sound (even though novel) definition of the close corporation and put the new provisions into a separate subchapter which isolates them from unexpected application to larger corporations, both existing and future. Even close corporations are not compelled to come under the new subchapter: its privileges apply only if the corporation elects to be governed by the subchapter, and if it does not it may still organize and operate under the general corporation law. I point out that the proposed subchapter has been drafted so as to include all small corporations which can elect to be taxed under Subchapter S of the United States Internal Revenue Code (Section 1371-1377), but it is not limited to those corp-

Statutes A and B are set forth in full text, so that the Committee can examine each proposed statute as a whole without constant cross-reference between the two drafts. Each draft statute includes identical provisions to appear in the general corporation law. See pages 4-19, _infra_. The special provisions of Statute A and Statute B then follow. Each section carries a brief Reporter's Note with references to the appropriate pages of the Report.

In conclusion, I recommend that the Committee approach the problem through Statute B with its special subchapter applicable solely to close corporations. However, the choice is a policy matter for the Committee; my purpose is to articulate the factors relevant to this policy decision.

Part I

AMENDMENTS TO GENERAL CORPORATION LAW

Statutory provisions which are common to Statute A and Statute B. Although predominantly of interest to close corporations, these provisions should be applicable to all corporations.

Section 1. Number of Directors

(Revision of Section 141(b))

(b) * * * * in cases where all the shares of a corporation are owned of record by either one or two stockholders, the number of directors may be less than three but not less than the number of stockholders.

Reporter's Note:

See Report at 332 for reasons for deleting the phrase "beneficially and" between "owned" and "of record" in present Section 141(b).

* * * * * * * *

Section 2. Quorum and Vote of Directors

(Revision of Section 141(b))

A majority of the total number of directors shall constitute a quorum for the transaction of business, unless the certificate of incorporation requires a greater number. Unless so required, the by-laws may provide that a number less than majority shall constitute a quorum, which in no case shall be less than one-third of the total number of directors nor less than two directors, except that when a board of one director is authorized under the provisions of this Section, then one director shall constitute a quorum. The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors, unless the certificate of incorporation shall require a vote of a greater number.

Reporter's Note:

The reasons for this revision of Section 141(b) are stated on pp. 61B, 62, and 63 of the Report. It is essential for close corporations that the statute explicitly authorizes greater-than-majority quorum and vote requirements. See Section 8, infra, for a special statutory provision designed to prevent a high vote requirement from being amended out of the certificate of incorporation by a lesser vote.

* * * * * * * *

Section 3. Vacancies and Newly Created Directorships

(Revision of Section 223)

Unless it is otherwise provided in the certificate of incorporation, vacancies and newly created directorships resulting from any increase in the authorized number of directors may be filled by a majority of the directors then in office, though less than a quorum, or by a sole remaining director. If by reason of death or resignation or other cause a corporation should at any time have no directors in office, then any stockholder or an executor, administrator, trustee or guardian of a stockholder or other fiduciary entrusted with like responsibility for the person or estate of a stockholder may call a special meeting of stockholders in accordance with any provisions of the certificate of incorporation or the by-laws, or may apply to the Court of Chancery for a decree summarily ordering an election as provided in

Section 224 of this title.

Reporter's Note:

The above provisions would be a substitute for the present language:

> "Vacancies and newly created directorships resulting from any increase in the authorized number of directors, may be filled by a majority of the directors then in office, though less than a quorum, unless it is otherwise provided in the certificate of incorporation or by laws" * * * *

See Report at pages 55-56 for discussion of all recommended changes except that in the last sentence. This is designed for close corporations with one or two directors who may be simultaneously killed or otherwise incapacitated, leaving the corporation without any directors in office. The provision would validate by-law or charter clauses dealing with such a situation, and it would also authorize a shareholder, or an executor or administrator, to invoke Chancery jurisdiction. The provision is suggested by Section 35 of the recent Wyoming Business Corporation Law, Wyo. Stats. 17-36

* * * * * * * *

Section 4. Written Consent to Director's Action..

(Revision of Section 141 (g))

Unless otherwise restricted by the certificate of incorporation or by-laws, any action required or permitted to be taken at any meeting of the board of directors or governing body or of any committee thereof, may be taken without a meeting if all members of the board or governing body or committee, as the case may be, consent thereto in writing, and the writing or writings manifesting consent are filed with the minutes or proceedings of the board, governing body, or committee.

Reporter's Note:

The above provision implements the recommendations on pp. 61-61A of the Report, and assumes, as Section 141(g) does now, that all members of the board or committee must approve action taken without a meeting. See Appendix, pp. 18-19 *infra*, for a comment on a provision which would permit board or committee action by less than all members assuming that all had notice.

* * * * * * * *

Section 5. Consent of Stockholders in Lieu of Meeting.

(Revision of Section 228)

Alternative 1: Assuming that the Committee does not wish to broaden the privilege of less than all shareholders acting by written consent, but wishes to retain Section 271's permission for a majority of shareholders to approve a sale of assets, then Section 228 should not be changed in any respect.

Alternative 2: If the Committee wishes to broaden the privilege of less than all shareholders acting by written consent, *i.e.*, does not wish to limit this privilege exclusively to action taken under Section 271, then Section 228 should read as follows: (See pages 151-152 and 329 of the Report.)

Whenever the vote of stockholders at a meeting thereof is required or permitted to be taken in connection with any corporate action, by any section of this chapter, the meeting and vote of stockholders may be dispensed with, if all of the stockholders who would have been entitled to vote upon the action if such meeting were held, shall consent in writing to such corporate action being taken. Nothing herein contained shall be construed to alter or modify the provisions of any section of this title or any provision in a certificate of incorporation not inconsistent with this title under which the written consent of the holders of less than all outstanding shares of the corporation entitled to vote thereon is sufficient for action by the corporation. In the event that the action which is consented to is such as would have required the filing of a certificate under any of the other sections of this chapter, if such action had been voted upon by the stockholders at a meeting thereof, the certificate filed under such other section shall state that written consent has been given hereunder, in lieu of stating that the stockholders have voted upon the corporate action in question, if such last mentioned statement is required thereby.

Reporter's Recommendation:

I recommend adoption of Alternative 1. Neither the statute governing written consent by directors or by shareholders generally authorizes such action by less than all the directors or shareholders, as the case may be, and it seems odd that an exception is carved out for a sale of assets. At the very least, this permission should not be expanded, and it would seem more consistent with existing law to delete this special permission altogether. However, if the Committee believes it desirable as a matter of policy to allow action by consent of at least the number of directors or shareholders whose vote would be required at a meeting, it would be best to adopt a general provision along with safeguards in terms of notice to all persons having a right to vote. See Appendix, infra at p. .

* * * * * * * *

Section 6. Vote of Stockholders.

(Revision of Section 102(b)(4))

(b) In addition to the matters required to be set forth in the certificate of incorporation by sub-section (a) of this section, the certificate of incorporation may also contain any or all the following matters-- * * * *

(4) Provisions requiring for any corporate action the vote of a larger proportion of the stock or any class thereof or of any other securities having voting power than is required by this chapter.

Reporter's Note:

See Report at pp. 20-21. The above provision adds the phrase "or of any other securities having voting power" taken verbatim from Section 216 (Quorum) and to conform precisely with Section 221. See Section 8, infra, for a special statutory provision designed to protect a high vote requirement from being amended out of the certificate of incorporation by a lesser vote.

* * * * * * * * *

Section 7. Quorum at Stockholder Meetings

(Section 216)

Reporter's Note:

I recommend no change in the existing provision permitting the certificate of incorporation or by-laws to specify quorum requirements.

* * * * * * * *

Section 8. Repeal, Modification or Amendment of Vote of Directors or Stockholders in Certificate of Incorporation.

Whenever the certificate of incorporation shall require for action by the board of directors or by the stockholders or any class or series of stockholders the vote of a greater number or proportion than is required by any section of this title, the provision of the certificate of incorporation requiring such greater vote shall not be altered, amended or repealed except by such greater vote.

Reporter's Note:

In order to assure that a high vote requirement in the certificate of incorporation will not be removed by a lesser vote, even though the lesser vote is authorized by statutes, it is necessary that the statute protect the high vote requirement, which is often crucial in the distribution of power within a close corporation. This proposed clause is discussed in detail in the Report at pp. 330-331.

This proposed statutory provision would protect both high votes required for director action (see Section 2, revising present Section 141(b)) and for shareholder action (see Section 6, revising Section 102(b)(4)).

There is no comparable clause protecting a high quorum requirement.

Section 9. Voting Agreements

(a) A written agreement between two or more stockholders concerning the manner in which the parties thereto shall vote their shares for the election of directors or on any other matters requiring stockholder action under the provisions of this title or of the certificate of incorporation, shall be valid and enforceable. Any such agreement may provide that the shares held by the parties shall be voted as provided by the agreement, or as the parties may agree, or as determined in accordance with a procedure stated in the agreement or thereafter agreed to by them. In a suit by a stockholder who is a party to such an agreement, the Court of Chancery may enjoin another party or parties to the agreement from voting his or their shares in violation thereof, and may also grant such other or further relief as it deems appropriate under the circumstances to enforce the agreement. If the corporation is a party to the suit, the Court of Chancery may set aside action resulting from voting the shares in violation of the agreement, and if the suit is under Section 225 of this Title the Court of Chancery may grant such relief as that section authorizes.

(b) A voting agreement shall not extend beyond ten years from the date of its execution. The parties to the agreement or their transferees or any of them may, by written agreement made at any time not more than two years prior to the expiration date of the voting agreement, extend its duration for an additional period not exceeding ten years from the expiration date of the agreement as originally fixed or as extended as herein provided. Any such extention agreement shall not affect the rights or obligations of persons not parties thereto.

Reporter's Note:

This provision is without counterpart in existing Delware law. It is discussed in some detail in the Report at pp. 163-164, although draft language was not submitted at that time. Although most frequently applicable to close corporations, the permission given by this statutory provision should not be limited to such enterprises but should be available generally.

* * * * * * * *

Section 10. Irrevocable Proxies

(a) A duly executed proxy shall be irrevocable if it states that it is irrevocable and if and only so long as it is coupled with an interest sufficient in law to support an irrevocable power coupled therewith.

(b) Without limiting the general provision of Subsection (a), a proxy is coupled with an interest and is irrevocable if it is held by any of the following persons or his nominee:

(1) A pledgee under a valid pledge;

(2) A person who has agreed to purchase shares under an executory contract of sale;

(3) A creditor who extends or continues credit

to the corporation in consideration of the proxy if the proxy states that it is given in consideration of the extension or continuation of credit, the amount thereof, and the name of the creditor;

(4) A person who has contracted to perform services for the corporation if his contract of employment requires such a proxy as part of the consideration therefor and if the proxy states that it was given in consideration of the contract of employment and states the name of the employee and the period of employment contracted for; or

(5) A person, including an arbitrator, who has been designated by or in the manner provided in a voting agreement authorized by Section 9, but the proxy shall become revocable, as the case may be, when the pledge is redeemed, or the executory contract of sale of shares is performed, or the debt of the corporation is paid, or the period of employment is terminated, or the voting agreement is terminated.

(c) An irrevocable proxy permitted by this section shall not be effective beyond ten years from the date of its execution, unless the proxy is extended, by written agreement made at any time not more than two years prior to the expiration date of the proxy, for an additional period not exceeding ten years from the expiration date of the proxy as originally fixed or as extended as herein provided. Any such extension of the proxy shall not affect the rights or obligations of persons not parties thereto.

(d) A purportedly irrevocable proxy may be revoked by a purchase of shares subject to the proxy unless the existence of the proxy and its irrevocability is conspicuously noted on the face or back of the certificate representing the shares or is actually known to the purchaser.

Reporter's Note:

This provision, without counterpart in present Delaware law, was recommended in the Report at pp. 159-163, and reference is made to the explanation there. Although most frequently of use to close corporations, it should not be limited to them but be generally available to any corporation regardless of size or share distribution.

* * * * * * * *

Section 11. Voting Trusts

(Revision of Section 218)

(b) At any time within two years prior to the time of expiration of any such voting trust agreement as originally fixed or as extended as herein provided, one or more beneficiaries of the trust under such voting trust agreement may, by agreement in writing and with the written consent of such voting trustees, extend the duration of such voting trust agreement for an additional period not exceeding ten years from the expiration date of the trust as originally fixed or as extended as herein provided.

(c) This section shall not be deemed to invalidate any voting or other agreement among stockholders or any irrevocable proxy which is not otherwise illegal.

Reporter's Note:

Section 218 is not reproduced in its entirety, since the proposed changes affect only a portion of the statute. These changes are discussed in the Report at pp. 156-159. Subsection (b) is revised to clarify the law concerning an extension of a voting trust. Subsection (c) is new and makes clear that voting trusts, voting agreements, and irrevocable proxies are separate and independent devices for shareholder control arrangements.

* * * * * * * *

Section 12. Extensions; Invalidity of Voting Agreements, Irrevocable Proxies or Voting Trusts Lasting More than Ten Years.

The validity of a voting agreement, irrevocable proxy, or voting trust, if otherwise lawful, shall not be affected during a period of ten years from the date when it was executed or extended as provided in this subchapter by the fact that under its terms it will or may last beyond such ten year period; but after the expiration of such ten year period, it shall be inoperative unless it has been extended as provided in this subchapter.

Reporter's Note:

This section was recommended in the Report at pp. 157-158 but it is expanded to cover not only voting trusts but also shareholder voting agreements and irrevocable proxies.

Other Statutory Provisions

The Report has recommended various other statutory revisions of substantial interest to close corporations. All of these would be parts of the General Corporation Law rather than limited to close corporations. For most of these proposals, draft language has already been supplied. Accordingly, these statutory provisions are not reproduced again, but reference is made to the pages of the Report where they are discussed.

Report Pages	Subject
13	Single incorporator
26 et seq.	Simplification of the incorporation procedure.
32-33	By-laws.
42	Corporate power to enter into partnership and joint ventures.
43	Corporate power to insure lives of directors, officers, etc.
56-59	Removal of directors.
59-60	Classes of directors.
66	Removal of officers elected by the shareholders.
68 et seq.	Transactions by directors and officers with their corporation.
94-96	Indemnification of directors and officers.
122	Waiver of notice.
134-135	Cumulative voting.
141-145	Rules concerning voting shares owned in joint tenancy, etc.
165-174	Shareholder inspection rights.
196-200	Shareholder appraisal rights.
260-262	Shareholder pre-emptive rights.

APPENDIX

Comment to Section 4

The following language would not only implement the recommendations on pp. 61-61A of the Report, but would go further than present Section 141(g) and permit action without a meeting even though less than all directors, etc. consent to the action. Stated affirmatively, it would validate written consents by a majority which would be sufficient to take the proposed action at a duly called meeting of the directors. In include this alternative since there are some who hold that the privilege of action-without-a-meeting should not be confined merely to unanimous consents; the argument is that if a majority can act at a meeting to override dissenters, the same should be true even if no meeting is held, provided, of course, that all have notice. Accordingly, if the Committee wishes, as a matter of policy, to expand the privilege of acting without a meeting to permit less than all to do so, the following revision of Section 141(g) is recommended:

> Unless otherwise restricted by the certificate of incorporation or by-laws, any action required or permitted to be taken at any meeting of the board of directors or governing body or of any committee thereof, may be taken without a meeting if (1) all members of the board or governing body or committee, as the case may be, are given or waive notice of the action, and (2) such action is consented to in writing by that number of members of the board or governing body or

committee which would be sufficient for the purpose if the action were taken at a meeting, and (3) the writing or writings manifesting consent are filed with the minutes or proceedings of the board, governing body, or committee.

Reporter's Recommendation: I recommend Section 4, *supra* at pp.7-8, which would leave undisturbed the requirement of Section 141(g) that all directors, etc. consent. This would require a meeting if some refuse to consent, thereby permitting a change of views and a vote. I believe that, if the matter is in dispute, there is some risk of overreaching when a mere majority can act without a meeting and without the opportunity for both sides of the question to be aired. Concededly, this cuts down on "convenience", but, it is suggested, there are greater values than convenience.

Statute A

Section A-1 through Section A-12

These are statutory provisions which should appear in the General Corporation Law. They are set forth in full text in Part I, supra at pp. 5-19, and are not reproduced in Statute A.

(Sections A-13 through A-17 are primarily applicable to close corporations, but in Statute A they are not specifically so limited; therefore, they should appear as new sections of the General Corporation Law.)

(These two provisions, Sections A-18 and A-19, are expressly limited in their application to close corporations.)

Section A-13. <u>Restrictions on Transfer of Securities</u>

(a) A written restriction on the transfer or registration of transfer of a security of a corporation, if permitted by this section and noted conspicuously on the security, may be enforced against the holder of the restricted security or any successor or transferee of the holder including an executor, administrator, trustee, guardian or other fiduciary entrusted with like responsibility for the person or estate of the holder. Unless noted conspicuously on the security, a restriction, even though permitted by this section, is ineffective except against a person with actual knowledge of the restriction.

(b) A restriction on the transfer or registration of transfer of securities of a corporation may be imposed either by the certificate of incorporation or by the by-laws or by an agreement among any number of security holders or among such holders and the corporation. No restriction so imposed shall be binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction.

(c) A restriction of the transfer of securities of a corporation is permitted by this section if it contains terms which:

(1) Obligate the holder of the restricted securities to offer to the corporation or to any other holders of securities of the corporation or to any other

person or to any combination of the foregoing, a prior opportunity, to be exercised within a reasonable time, to acquire the restricted securities;

(2) Obligate the corporation or any holder of securities of the corporation or any other person or any combination of the foregoing, to purchase the securities which are the subject of an agreement respecting the purchase and sale of the restricted securities;

(3) Require the directors or the holders of any class of securities of the corporation to consent to any proposed transfer of the restricted securities or to approve the proposed transferee of the restricted securities;

(4) Prohibit the transfer of the restricted securities to designated persons or classes of persons, and such designation is not manifestly unreasonable.

(d) Any restriction on the transfer of the shares of a corporation for the purpose of maintaining its status as an electing small business corporation under Subchapter S of the United States Internal Revenue Code is conclusively presumed for a reasonable purpose.

(e) Any other lawful restriction on transfer or registration of transfer of securities is permitted by this section.

(f) If a restriction on transfer of a security is held not to be permitted by this section, the corporation shall nevertheless have an option, for a period of thirty days after the judgment setting aside the restriction becomes final, to acquire the resticted securities or any of them at a price which agreed upon by the parties subject to the approval of the Court of Chancery, or if no agreement is reached as to price then at the fair value as determined by the Court of Chancery. In order to determine fair value, the Court may appoint one or more persons as appraisers to receive evidence and recommend a decision in the question of fair value. The appraisers shall have such power as appraisers under Subsection (b) of Section A-17. (Jurisdiction of Court of Chancery to Require Purchase of Shares).

(g) The Court of Chancery shall have jurisdiction to enforce any restriction on transfer or registration of transfer of any securities permitted by this section, and also to set aside any restriction in cases of fraud, breach of duty or oppression.

Reporter's Note:

The reasons for adopting a statute broadly authorizing stock transfer restrictions are stated in the Report at pp. 338-341. The draft statute is an improved and expanded version of one proposed at pp. 339-341.

Subsection (a) states the general rule validating stock transfer restrictions "permitted by this section", together with requirements, keyed to the language of the Uniform Commercial Code, as to notice of restriction. In particular, see Code Section 8-204, rephrasing the rule of Uniform Stock Transfer Act Section 15 (Del. Corp. Law § 194). The section applies not merely to shares of stock, but like the Uniform Commercial Code rule, to any securities, thereby including convertible debentures where it is desired to restrict transfer both of the debenture and of the underlying stock if the debentures are converted.

Subsection (b) states where the stock transfer restriction may appear (certificate of incorporation, by-laws, or shareholder agreement) and limits effectiveness of restrictions imposed upon already issued securities.

Subsection (c) deals with the substantive validity of transfer restrictions, i.e., restrictions "permitted by this section." Subsection (d) broadly validates stock transfer restrictions designed to maintain a close corporation's status as an electing small business corporation under Subchapter S of the Internal Revenue Code. Of necessity, it applies only to corporations with fewer than ten shareholders. Subsection (e) recognizes the validity of any other lawful transfer restrictions and removes any negative implications from the recitals in subsections (d) and (c).

Subsection (f) is a unique effort to deal with transfer restrictions which fail for some reason or other, e.g., the restriction is unreasonably burdensome, or it is of a type not authorized (such as absolute restraint on alienation of unlimited duration), etc. Since, presumably, the restriction was intended for some not unlawful reason, the original purpose of the restriction should be effectuated via a statutory option in the corporation to purchase the stock at an agreed price or at fair value.

If this statute, broadly validating transfer restrictions, is adopted, specific Chancery jurisdiction should be granted to deal with misuse of the power which many stock transfer restrictions vest in the corporation or shareholders, and subsection (g) makes the existence of such power explicit.

Section A-14. Agreements Restricting Discretion of Directors

A written agreement among all or less than all of the stockholders, whether solely among themselves or between one or more of them and a party not a stockholder, is not invalid, as between the parties to the agreement, on the ground that it so relates to the conduct of the business and affairs of the corporation as to restrict or interfere with the discretion or powers of the board of directors. The effect of any such agreement shall be to relieve the directors and impose upon the stockholders who are parties to the agreement the liability for managerial acts or omissions which is imposed on directors by this title to the extent and so long as the discretion or powers of the board in its management of corporate affairs is controlled by such provision.

Reporter's Note:

The problem treated by this section is discussed in the Report at pp. 334-337. It implements the recommendation (see pp. 336-337) that Delaware should consider " a brief and simple statute . . . declaring that no public policy is violated" by agreements restricting director discretion, in lieu of "the detailed prescriptions of the New York section" (Section 620). "In short, it would be better to let the corporate bar and the courts develop this branch of the law without too much statutory detail." It also follows the recommendation on p. 335 that the statutory provision should not be limited to close corporations, although those corporations will be the most frequent users.

Section A-15. Appointment of Custodian of Corporation on Deadlock or for Other Cause.

(a) The Court of Chancery, on application of any stockholder of a corporation, may appoint one or more persons to be custodians, and if the corporation is insolvent, to be receivers of and for the corporation, when it is established that:

(1) The stockholders are so divided that at an election held in accordance with Section 224 of this Title, they have failed to elect successors to directors whose terms have expired or would have expired upon the qualification of their successors; or

(2) The stockholders are so divided that for a period which includes not less than two consecutive annual meeting dates, they have failed to elect successors to directors whose terms have expired or would have expired upon the qualification of their successors; or

(3) The directors of the corporation are so divided respecting the management of the corporation's business and affairs that the votes required for action by the board of directors cannot be obtained and the stockholders are unable to terminate the division, with the consequence that the business of the corporation is suffering or threatened with irreparable injury; and with respect to subsections (2) and (3), it is further established that arbitration or other remedy provided by the certificate of incorporation or by-laws or any

written agreement of the stockholders upon the occurence of deadlock has failed; or

(4) The corporate assets are being wasted or misapplied, or the acts of the directors or those in control of the corporation are illegal or fraudulent or dishonest, or are oppressive or unfairly prejudicial either to the corporation or to any stockholder whether in his capacity as a stockholder or director or officer of the corporation and it is further established that appointment of a receiver is to the advantage of the stockholders generally; or

(5) The petitioning stockholder has a right under a provision of the certificate of incorporation as permitted by Section A-19 to dissolution of the corporation; or

(6) The corporation has abandoned its business and has failed within a reasonable time to take steps to dissolve and liquidate its affairs and distribute its assets.

(b) A custodian appointed under this provision shall have all the powers and title of a receiver appointed under Section 291 of this title, but the authority of the custodian is to continue the business of the corporation and not to liquidate its affairs and distribute its assets, except when the Court shall otherwise order and except in cases arising under subparagraphs (5) and (6) of the preceding subsection.

(c) In lieu of appointing a custodian under this section, the Court of Chancery may, in a case arising under subsection (a)(3) of this section, appoint a provisional director as provided by Sectinn A-16 (Jurisdiction of Court of Chancery to Appoint a Provisional Director in Certain Cases) if the Court determines that the interests of the corporation of the stockholders generally will be more effectively protected and furthered by appointing a provisional director rather than a custodian. But appointment of a provisional director does not preclude any subsequent order of the Court appointing a custodian or receiver.

Reporter's Note:

This section implements the recommendations in the Report at pp. 341-346, and adopts and refines language from several of the most recent statutory provisions, including New York, Pennsylvania, Connecticut, the Model Act, etc.

I have employed the terms "custodian" in lieu of "receiver" since the latter term carries implications of insolvency which will often not be the case when relief is warranted, or implications of wrongdoing which is not necessarily true when the directors or stockholders are deadlocked. The Committee may prefer to use the term "receiver" or to choose some other term, such as "trustee" or "manager", etc. Whatever the title, the "custodian" has the powers of a "receiver" under present Section 226, including the power to continue the business unless otherwise ordered by the Court of Chancery. This is a great improvement over the Model Act (and other statutes) which envision prompt dissolution as the sole remedy.

Subsection (a) spells out the grounds for applying for appointment of a "custodian" or "receiver." Subsection (b) states the powers of the "custodian." Subsection (c) recognizes, as an alternative to appointment of a "provisional director", and indicates when the Court may designate the latter in lieu of a "custodian." See Section A-16 infra, and discussion of the "provisional director" in the Report at pp. 347-349.

Like similar statutes in other states, this draft provision is not limited to close corporations, although, in practice, they are the ones most likely to take advantage of it.

Section A-16. Jurisdiction of Court of Chancery to Appoint a Provisional Director in Certain Cases.

(a) Notwithstanding any contrary provision of the certificate of incorporation or the by-laws or agreement of the stockholders, the Court of Chancery may appoint a provisional director for a close corporation if the directors of the corporation are so divided respecting the management of the corporation's business and affairs that the votes required for action by the board of directors cannot be obtained with the consequence that:

(1) The business of the corporation is suffering or threatened with irreparable injury, or if

(2) even though irreparable injury is not suffered or threatened, the business and affairs of the corporation can no longer be conducted to the advantage of the stockholders generally.

(b) An application for relief under this section may be filed by at least one-half of the number of directors then in office, or by the holders of at least one-third of all shares then entitled to elect directors, or if there be more than one class of shares then entitled to elect one or more directors then by the holders of two-thirds of the shares of any such class, but the certificate of incorporation may provide that a lesser proportion of the directors or of the stockholders or of a class of stockholders may apply for relief under this section.

(c) A provisional director shall be an impartial person who is neither a stockholder nor a creditor of the corporation or of any subsidiary or affiliate of the corporation, and whose further qualifications, if any, may be determined by the Court of Chancery. A provisional director is not a receiver of the corporation and does not have the title and powers of a receiver appointed under sections 226 and 291 of this title. A provisional director shall have all the rights and powers of a duly elected director of the corporation, including the right to notice of and to vote at meetings of directors, until such time as he shall be removed by order of the Court of Chancery or by the holders of a majority of all shares then entitled to vote to elect directors or by the holders of two-thirds of the shares of that class of voting shares which filed the application for appointment of a provisional director. His compensation shall be determined by agreement between him and the corporation subject to approval of the Court of Chancery which may fix his compensation in the absence of agreement or in the event of disagreement between the provisional director and the corporation.

(d) Even though the requirement of subsection (b) of this section relating to the number of directors or stockholders who may petition for appointment of a provisional director are not satisfied, the Court of Chancery may nevertheless appoint a provisional director if permitted by subsection (c) of Section A-15 (Appointment of Custodian of Corporation on Deadlock or For Other Cause).

Reporter's Note:

This provision implements the recommendation (See Report at pp. 347-349) that Delaware consider adopting the California alternative to dissolution (or receivership) in the event of deadlock, namely, appointment of a provisional director. See Report at p. 359 for the text of the California statute. The draft Delaware provision differs in some details from its California prototype.

(1) A provisional director may be appointed, at the court's discretion, on showing actual or threatened injury or an inability to conduct the corporation's business to the general advantage of the shareholders. The former test ties in with the standard for appointing a "custodian" (see draft Section A-15(a)(3)), while the latter test is taken from the California statute. The use of the dual standard means that a lesser showing of injury, actual or threatened, is enough to justify appointing a provisional director than in the case of an application to designate a "custodian" or "receiver."

(2) The California and the draft statutes differ in minor respects as to the persons who have standing to seek appointment of a provisional director.

(3) Subsection (d) of the draft statute ties in with Section A-15(c). Together the two provisions make clear that the Court of Chancery has discretion to designate a provisional director in lieu of a "custodian" or "receiver" even though the person who sought appointment of a "custodian" under Section A-15 would not have standing initially to seek appointment of a provisional director under Section A-16(b).

Although not in terms limited to close corporations, this statute will rarely be of use if shares are widely distributed in view of the rather high percentage of directors and shareholders required to bring suit.

Section A-17. Jurisdiction of Court of Chancery to Require Purchase of Shares.

(a) Whenever any stockholder or stockholders (hereinafter referred to as the "applicant") files an application with the Court of Chancery under Section A-15 (Appointment of Custodian of Corporation in Deadlock or for Other Cause), any other stockholder or the corporation (hereinafter referred to as the "petitioner") may, at any time within thiry days after the filing of petitioner's application or at such later time as the Court in its discretion may allow, petition the Court for an order requiring the applicant to sell its shares to the petitioner at their fair value.

(b) The Court shall thereupon determine whether it is in the best interests of the corporation and of the stockholders generally to require that the applicant's shares shall be ordered sold to the petitioner. If it so determines, then the Court shall then fix the fair value of the applicant's shares. The Court may appoint one or more persons as appraisers to receive evidence and recommend a decision on the question of fair value. The appraisers may examine any of the books and records of the corporation the stock of which he is charged with the duty of valuing, and he shall make a determination of the value of the shares upon such investigation as to him seems proper. The appraiser shall also afford a reasonable opportunity to the parties interested to submit to him pertinent evidence on the value of the shares. The appraiser, also, shall have such powers and authority as may be conferred upon masters by the rules of the Court of Chancery or by the order of his appointment.

(c) The appraiser shall promptly determine the value of the applicant's stock and shall file his report respecting such value in the office of the Register of Chancery and notice of the filing of such report shall be given by the Register in Chancery to the parties in interest. Such report shall be subject to exceptions to be heard before the Court both upon the law and facts. The Court shall by its decree determine the value of the applicant's stock. Within ten days after the Court has entered its decree determining the fair value of the applicant's shares, the petitioner shall file with the Court a signed statement as to whether he elects to buy the applicant's shares at the value fixed by the Court. If he does elect to buy them, he shall at the time of filing the statement deposit the amount of the fair value in cash, or certified check, with the Register of the Court of Chancery.

(d) If petitioner makes the deposit as provided in subsection (c), an order of sale shall be entered directing the applicant forthwith to turn over his share certificates to the Court for delivery to petitioner or his nominee. The deposit shall be paid over to the applicant by the Register in Chancery on receipt of the certificates representing such shares, duly endorsed for transfer. Upon entry of the order of sale, the applicant shall no longer be a stockholder of the corporation except for purposes of appeal therefrom and, upon motion of the applicant, the application under Section A-15 shall be dismissed and such other orders entered continuing the business of the corporation as the Court may direct. The Court may direct that notice of dismissal be given to such interested persons as it deems proper and may take all such reasonable action as it deems proper to provide fair opportunity for stockholders desiring to continue the corporation to purchase the shares of stockholders desiring to dissolve the corporation, and fair opportunity for the latter to sell their shares to the former, at the appraised fair value thereof.

(d) If the petitioner fails to make the deposit as provided in subsection (c), the proceeding under Section A-15 shall go forward in due course. If the petitioner fails to make the deposit, no other stockholder may proceed as petitioner as provided in subsection (a), but the Court may, in its discretion, in the course of the proceedings, permit other stockholders to make deposits as provided in subsection (d).

(f) The cost of any such appraisal, including a reasonable fee to and the reasonable expenses of the appraiser, but exclusive of fees of counsel or of experts retained by any party, shall be determined by the Court and taxed against the petitioner if he fails to make the deposit as provided in subsection (c). If it is shown that the application under Section A-15 was made in bad faith primarily for the purpose of compelling the purchase of the applicant's shares, the Court may at any time during the proceeding dismiss the application and may tax to the applicant any or all expenses of the proceeding, including the cost of the appraisal, as the Court shall deem equitable. In all other cases, the cost of the appraisal shall be taxed against the corporation and added to the final cost of the proceeding.

(g) At any time at or after the Court determines that the applicant's shares shall be ordered sold to the petitioner, the Court may require the applicant to submit his stock certificates to the Register in Chancery for notation thereon of the pendency of the appraisal proceeding, and if the applicant fails to comply with such direction the Court may dismiss the application under Section A-15 or make such other order as the Court deems appropriate.

Reporter's Note:

This draft section implements the recommendation in the Report at pp. 349-350. It derives in large part from the Connecticut statute on stock buy-outs (reproduced in the Report at pp. 359-361), but the draft statute resolves certain problems left uncertain under the Connecticut prototype. Most significant is subsection (b)'s authorization for the Court of Chancery to determine whether a stock buy-out is in the best interests of the corporation, after which it orders appraisal, if that is needed to determine fair value. In Connecticut, the court has no discretion to refuse to order a buy-out; on a shareholder's application to compel a purchase of a petitioner's shares, the court must then and there order appraisal.

The language of subsection (b) dealing with the appraiser's rights is taken almost verbatim from present Section 262(e) and (f). Subsection (f) indicates how costs of the appraisal are to be taxed, chiefly with a view to discouraging "strike" applications to compel stock buy-outs. Subsection (g) parallels Section 262(g).

This section is not limited to closely held corporations but can apply to all. If the Committee fears the consequences of making the compulsory stock buy-out generally applicable, it can be confined to close corporations as it is in Section B where it is a part of the special subchapter on close corporations.

Section A-18. Operating Corporation as Partnership.

(a) Except in the case of a corporation any class of whose shares are at the time or subsequently become listed on any securities exchange or regularly quoted in any over-the-counter market maintained by securities brokers or dealers, no written agreement among stockholders of a corporation, nor any provision of the certificate of incorporation or of the by-laws of the corporation, which agreement or provision relates to any phase of the affairs of the corporation, including but not limited to the management of its business or declaration and payment of dividends or other division of profits or the election of directors or officers or the employment of stockholders by the corporation or the arbitration of disputes, shall be invalid on the ground that it is an attempt by the parties to the agreement or the stockholders of the corporation to treat the corporation as if it were a partnership or to arrange relations among the stockholders or between the stockholders and the corporation in a manner that would be appropriate only among partners.

(b) The fact that the shares of a corporation are or subsequently become listed on any securities exchange or regularly quoted in an over-the-counter market maintained by securities brokers or dealers does not of itself invalidate an agreement among stockholders of a corporation or a provision of the certificate of incorporation or of the by-laws of the corporation even though of a type described by this section. A transferee of shares who acquires shares with actual knowledge of such an agreement among stockholders or provision of the certificate of incorporation or of the by-laws is bound thereby.

Reporter's Note:

This provision is recommended in the Report at pp. 333-334 and is applicable only to close corporations which are, for purposes of this section, defined in terms of shares listed on an exchange or quoted in an over-the-counter market. (See introduction at p. 2, supra.) The statutory provision is permissive, not restrictive: it authorizes the shareholders to arrange their affairs inter sese as they see fit, without regard to "corporate norm" conventions. Subsection (b) eliminates any implication that, if shares come to be quoted on an OTC market, any and all agreements among the parties become invalid. It would be a most unfortunate consequence if such bargains and arrangements were ipso facto voided; rather it should be a question for the court whether the agreements are inconsistent with a corporation whose shares are now more widely held than formerly. The statute does not, and could not, state any generally applicable test; but at least it can make clear that the agreements are not automatically voided. In my judgment, this is as far as the statute should go, but it certainly should go this far.

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Section A-19. Stockholders' Option to Dissolve Corporation

(a) The certificate of incorporation of any corporation organized under this title may include a provision granting to any stockholder, or the holders of any specified number or class of outstanding shares, an option to have the corporation dissolved at will or upon the occurrence of any specified event or contingency. Whenever any such option to dissolve is exercised, the parties shall proceed as if all stockholders had consented in writing to dissolution of the corporation as provided by Section 275(d) of this title.

(b) If the certificate of incorporation as originally filed does not contain a provision authorized by subsection (a), the certificate may be amended to include such provision if authorized by an affirmative vote of the holders of all outstanding shares, whether or not entitled to vote, unless the certificate of incorporation specifically authorizes such an amendment by a vote which shall be not less than two-thirds of all the outstanding shares whether or not entitled to vote.

(c) Each certificate of shares in any corporation whose certificate of incorporation authorizes dissolution as permitted by this section shall conspicuously note the existence of the provision. Unless noted conspicuously on the certificate, the provision is ineffective except against a person with actual knowledge of the provision.

(d) A provision authorized by this section shall not be effective if at the time the provision is inserted in the certificate of incorporation or subsequent thereto, any class of the shares of the corporation are listed on any securities exchange or regularly quoted in any over-the-counter market maintained by securities brokers or dealers.

Reporter's Note:

This provision is limited to close corporations. Indeed it would be most undesirable for any shareholder or group of shareholders to have an option to bring about dissolution of the corporation. For close corporations, it is as justifiable as it is for a partner to have a right to dissolve a partnership at will. The statute is permissive; it does not confer on a shareholder any statutory option to bring about dissolution, but only recognizes that the certificate of incorporation may confer such an option on shareholders. As indicated by the draft statute, the option must be publicized through the certificate of incorporation and it must appear on all stock certificates. The draft statute also provides that an option to dissolve can be added to the certificate of only by a unanimous vote of all shares, unless the certificate authorizes, by at least a two-thirds vote, a vote less than a unanimous vote to insert such an option. In this way, shareholders of an existing close corporation are protected from an unwanted amendment of the charter to grant an option to one or more shareholders to bring about dissolution at will.

The draft provision is modeled in Section 1002 of the New York Business Corporation Law, as amended.

Statute B

Sections B-1 through B-12

These are statutory provisions which should appear in the General Corporation Law. They are set forth in full text in Part I, supra at pp. 5-19, and are not separately reproduced in Statute B.

Subchapter X - CLOSE CORPORATIONS

Subchapter X - CLOSE CORPORATIONS (continued)

Subchapter X. CLOSE CORPORATIONS

Section X-1. Application of Subchapter; Rules of Construction; Application of Other Law.

(a) This subchapter applies to all close corporations as defined in Section X-2 (Definition of "Close Corporation"), but its provisions are to be deemed permissive and not mandatory. Unless a corporation elects to become a close corporation under this subchapter, it remains subject in all respects to the provisions of the general corporation law of this State, but not to the provisions of this subchapter.

(b) Whenever applicable, the provisions of this subchapter apply notwithstanding any contrary provisions of this title other than this subchapter; but otherwise, the provisions of this title and of any other statute or rule of law shall continue applicable to close corporations.

Reporter's Note:

Subsection (a) makes clear that a corporation does not come under this subchapter unless it elects to do so; hence, a small corporation may organize and operate under the general corporation law even if it could, if it chose, meet the tests of the close corporation subchapter and operate under its provisions.

Subsection (b)'s effect is to make all provisions of the general corporation law applicable except so far as the close corporation subchapter otherwise provides. This is necessary, since the subchapter does not spell out details of corporate finance, meetings, mergers, and so on.

To avoid possible problems on construction of the subchapter, it may be useful to add to this section the following sentence: "Unless the context otherwise indicates, the term 'corporation' when used in this subchapter means a 'close corporation.'"

Section X-2. Definition of "Close Corporation"

(a) A close corporation is a corporation whose certificate of incorporation contains the provisions required or permitted by Section 102 of this title and in addition provides that:

(1) All of the corporation's outstanding shares of all classes shall be held of record by twenty or fewer persons; and

(2) All of the outstanding shares of all classes shall be subject to a restriction on transfer permitted by Section X-9 (Restrictions on Transfer of Securities); and

(3) The corporation shall make no public offering of any of its securities of any class.

(b) The certificate of incorporation may set forth the qualifications of stockholders, either by specifying classes of persons who shall be entitled to be holders of record of any class of the shares of the close corporation, or by enumerating classes of persons who shall not be entitled to be holders of any class of the shares of the close corporation.

(c) For purposes of determining the number of holders of record of the shares of a close corporation, shares which are community property of a husband and wife (or the income from which is community income) under the applicable community property law of any state, or which are held by a husband and wife as joint tenants or as tenants by the entireties or as tenants in common, shall be treated as held by one stockholder.

Reporter's Note:

This definition of "close corporation" governs all of Subchapter X. It is an effort to provide a more precise delimitation of this class of corporations than is possible under the definition used in two sections of Statute A (Sections A-18 and A-19). Rather than let close corporation status depend upon whether in fact the corporation's shares are or are not quoted in an over-the-counter market--a matter which may not be sufficiently within the control of the corporation--I have sought to make close corporation status depend so far as possible upon objectively ascertainable facts stated in the certificate of incorporation.

This definition is not spun out of whole cloth, but has two major antecedents. Its most evident parentage is Section 28(1) of the English Companies Act, 11 & 12 Geo. 6, c. 38, set forth in the appendix, infra at . This English definition of the "private company" (in many respects the analogue of the American close corporation) appears also in virtually all important Commonwealth statutes. Like the draft Delaware provision, the English statute confers "private company" status on corporations whose articles (1) restrict the right to transfer its shares, (2) limit the number of members (shareholders) to fifty (twenty, under the Delaware draft statute), and (3) forbids public offering of any securities. The second source is the definition of "small business corporation" in Section 1371(a) of the United States Internal Revenue Code; such a corporation qualifies for special tax treatment if it does not

"(1) have more than 10 shareholders;
(2) have as a shareholder a person (other than an estate) who is not an individual;
(3) have a non-resident alien as a shareholder; and
(4) have more than one class of stock."

Thus there is precedent for approaching the close corporation problem through a test such as England uses, particularly when it can readily accomodate corporations seeking special tax status under the Internal Revenue Code.

I point out that some highly regarded commentators would object to a test based on number of shareholders and urge the test based on presence or absence of trading in the corporation's shares. I take a contrary position for practical reasons. I believe that even if the number-of-shareholders test is not perfect, it is easier to administer and more certain and definite in its operation than any other standard. This is especially true if, as in the draft statute, the test is the number of shareholders of record. This determination can be readily made from corporate records; it does not involve inquiry, often difficult and possibly fruitless, into questions of beneficial ownership.

It must be stressed that the definition of "close corporation" is more inclusive than the federal tax law definition of the "small business corporation." Thus, the Delaware statute could accomodate many corporations which could not qualify for special tax treatment because, e.g., the corporation has more than one class of stock, or because it has more than ten stockholders, or because it has a stockholder other than an individual or an estate. This is deliberate. The state statute ought not to be limited only to those corporations which can qualify under the federal test, although it must be broad enough to accomodate all of them, as the draft Delaware provision does. For instance, a subsidiary jointly owned by two or three corporations cannot qualify as a "small business corporation", but it should certainly have such advantages, if it wishes them, as the draft subchapter affords close corporations.

Subsection (a) requires a close corporation to recite certain restrictions in its certificate of incorporation. Apart from these provisions, the close corporation organizes itself like any other Delaware corporation, and may include the usual clauses in its certificate.

Subsection (a) adopts the English test of "private company." The number of shareholders--twenty--is arbitrary; the Committee may wish to raise or lower the number anywhere between ten (federal tax law) and fifty (England). The second requirement--stock transfer restrictions-- is discussed in the note to Section X-9 dealing with that topic. The third requirement, forbidding a public offering of any securities, is implied by the very idea of a close corporation. Of course, any time the corporation decides to go public, it need only amend its charter (under draft section X-6) whereupon it is subject in all respects to the general corporation law.

Subsection (b) gives the corporation broad power to set forth qualifications for its shareholders. Thus, a corporation chiefly concerned with achieving and preserving status as a "small business corporation" for tax purposes will include recitals that no person other than an individual or estate nor a non-resident alien may be shareholders. Reciting shareholder qualifications also puts transferees on notice and precludes them from being bona fide purchasers of the shares under Section X-7. I should point out that, for the close corporation, an overriding consideration is keeping the shares close--preventing them from getting into the hands of outsiders--and this subchapter is drafted with that idea at the forefront.

Subchapter (c) adopts almost verbatim the federal tax rule on counting husband and wife shareholders as one. See Internal Revenue Code § 1371(c).

Section X-3. Filing of Certificate of Incorporation of Close Corporation.

A close corporation shall be formed in accordance with the provisions of Section 101 through 108 of this title, except that:

(a) The certificate of incorporation shall set forth the provisions required by Section X-2 (Definition of Close Corporation), and

(b) The words "CLOSE CORPORATION" shall be conspicuously noted on the copies of the certificate of incorporation filed in the office of the Secretary of State and recorded in the office of the county where the principal office of the corporation is to be located in this State.

Reporter's Note:

Under this provision, a close corporation is organized just like any other Delaware corporation, except for the recitals required by Section X-2 and the close corporation notation. To the extent that the Committee has adopted the Report's various proposals for simplifying the incorporation procedures, e.g., single incorporator, close corporations will also benefit.

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Section X-4. Election of Existing Corporation to Qualify as Close Corporation.

Any corporation organized under the laws of this State may qualify as a close corporation under this subchapter by executing, acknowledging, and filing with the Secretary of State an amendment to its certificate of incorporation stating that it elects to qualify as a close corporatinn and setting forth the provisions required by Section X-2 (Definition of "Close Corporation") to appear in the certificate of incorporation of a close corporation, and conspicuously noting the words "CLOSE CORPORATION" on the certificates of amendment filed in the office of the Secretary of State and recorded in the office of the county where the principal office of the corporation is located in this State. Such amendment shall be adopted in accordance with the requirements of Section 242 of this title, except that any such amendment must be approved by a vote of the holders of record of at least two-thirds of the shares entitled to vote at an election of directors of the corporation.

Reporter's Note:

This section states the procedure for an existing corporation, organized under the general corporation law, to elect to operate under the new subchapter. It would apply to corporations organized both before and after the effective date of the close corporatinn subchapter (assuming it is adopted). The usual rules of Section 242 govern the charter amendment electing close corporation status, except that a two-thirds vote of all voting shares is necessary rather than a simple majority.

* * * * * * * *

Section X-5. Continuation of Close Corporation Status.

A corporation whose certificate of incorporation complies with Section X-2 (Definition of "Close Corporation") and X-3 (Filing of Certificate of Incorporation) remains a close corporation under this subchapter until

(a) It files with the Secretary of State a certificate of amendment deleting from its certificate of incorporation the provisions required by Section X-2 (Definition of "Close Corporation") to be stated in the certificate of incorporation; or

(b) Any one of the conditions stated in Section X-3 (Definition of "Close Corporation") is in fact no longer applicable to the corporation.

Reporter's Note:

This section states the two ways in which close corporation status may be lost. The corporation may voluntarily surrender its status by charter amendment under Section X-6; it would do this when, for instance, it decides to go public or to admit more than twenty shareholders or relieves its shares of all transfer restrictions. The corporation may involuntarily lose its status if some one or more of the qualifying conditions ceases to be applicable. The theory of this subchapter, and especially of Sections X-7 and X-8, is that most close corporations will not wish to lose status involuntarily and should be aided in preserving the privileges they have under the subchapter. Thus, while loss of status will eventually result when one of the basic conditions becomes inapplicable, the corporation has opportunities under Section X-7 and X-8 to correct the situation and save its status. Compare the proviso to Section 29 of the English Companies Act, 11 & 12 Geo. 6, c.38, set forth in the Appendix, *infra* at .

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Section X-6. <u>Voluntary Termination of Close Corporation Status by Amendment to Certificate of Incorporation</u>.

A corporation may voluntarily terminate its status as a close corporation by adopting an amendment to its certificate of incorporation deleting the provisions required by Section X-2 (Definition of "Close Corporation") to be stated in the certificate of incorporation. Any such amendment shall be adopted in accordance with Section 242 of this title except as otherwise provided in this section. On any such amendment terminating its status as a close corporation, if there is more than one class of shares, each such class of shares shall be entitled to vote on the amendment whether or not entitled to vote by the terms of the certificate of incorporation. The amendment must be approved by a vote of the holders of record of at least two-thirds of the shares of each class, and also by a vote of the holders of record of at least two-thirds of all of the outstanding shares of the corporation. The certificate of incorporation may provide that on any amendment to terminate status as a close corporation, a greater vote of any class or of all shares shall be required, and if the certificate of incorporation contains such a provision, that provision shall not be amended, repealed or modified by any vote less than that required to terminate status as a close corporation. Any amendment shall be effective as of the date of filing the certificate of amendment with the Secretary of State, unless the certificate postpones its effective date for not more than thirty (30) days after such filing.

Reporter's Note:

This section spells out procedure for voluntarily converting from close corporation status to operation under the general corporation law. A high vote is required (two-thirds of all shares plus two-thirds of each class of shares, irrespective of voting rights). This is necessary to preserve rights and privileges which presumably have been created by mutual agreement among the shareholders and which might be lost or jeopardized or their validity put in doubt if the enterprise strips itself of close corporation status. A high vote requirement is also necessary to aid the corporation in preserving its status as a "small business corporation" under the Internal Revenue Code (Sections 1371-1377). Indeed, the tax law requires consent of all shareholders to elect such tax treatment, Int. Rev. Code of 1954 § 1372(a), or to revoke an election, Int. Rev. Code of 1954 § 1372(e)(2). Probably, many close corporations will therefore require unanimous shareholder consent to amend the certificate to surrender close corporation status.

The last sentence of the subsection permits the certificate of amendment to state a deferred effective date. See Report at p. 178.

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Section X-7. Transferees of Shares of a Close Corporation; Notice to Transferees.

(a) If shares of a close corporation are transferred to any person who is not entitled under any provision of the certificate of incorporation as permitted by subsection (b) of Section X-1 (Definition of "Close Corporation") to be the holder of record of shares of such corporation, such person is conclusively presumed to have notice of the fact of his ineligibility to be a shareholder of that corporation.

(b) If its certificate of incorporation states the number of persons, not in excess of twenty, who are entitled to be holders of record of the shares of a close corporation, and if transfer of shares to any person would cause the shares to be held by more than the number of persons, not in excess of twenty, permitted by the certificate of incorporation to be holders of shares of the corporation, the transferee of the shares is conclusively presumed to have notice of this fact.

(c) If the certificate of shares of any close corporation conspicuously notes the fact of a restriction on transfer of shares of the corporation, and the restriction is one which is permitted by Section X-9 (Restrictions on Transfers of Securities), the transferee of the shares is conclusively presumed to have notice of the fact that he has acquired shares in violation of the stock transfer restriction, if such acquisition does in fact violate the restriction.

(d) Whenever any transferee of shares has, or is conclusively presumed under this section to have, notice either (A) that he is a person not eligible to be a holder of shares of the corporation or (B) that transfer of shares to him would cause the shares of the corporation to be held by more than the number of persons permitted by the certificate of incorporation to hold shares of the corporation, or (C) that transfer of shares is in violation of a restriction on transfer of shares, the corporation may, at its option, refuse to register transfer of the shares into the name of the transferee of such shares.

(e) The provisions of this section shall not be applicable if the transfer of shares, even though otherwise contrary to subsections (a), (b), or (c), has been consented to by all shareholders of the close corporation, or if the close corporation has amended its certificate of incorporation as provided by Section X-6 (Voluntary Termination of Close Corporation Status, etc.).

(f) The term "transfer" as used in this section is not limited to a transfer for value.

(g) The provisions of this section do not in any way impair any rights of a transferee including any right to rescind the transaction or to recover under any applicable warranty express or implied.

Reporter's Note:

This is a key provision in protecting the corporation from transfers of its shares which may result in loss of close corporation status or introduction of unwanted shareholders in the closely held enterprise. The theory of this section is that these share interests are really the equivalent of partnership interests rather than of readily transferable shares of larger corporations. Restricting transfer of closely held share interests is or should be no more objectionable than the commonly accepted partnership doctrine of delectus personae which bars new partners except with consent of the present partners. Accordingly, it is not unreasonable to impose on the transferee of a close corporation share interest the risk that he is acquiring something which he should not be privileged to keep, and in effect this section so provides. The technique employed is to burden the transferee with constructive notice that he may be an ineligible holder (a fact he can determine by checking the charter) or that his acquisition of the shares may cause the number of shareholders to exceed twenty (a fact which he should carefully determine before acquiring a share interest) or that he takes shares contrary to a stock transfer restriction (a fact recited on the stock certificate). Subsection (d) then declares that in such cases the corporation may refuse to register transfer into hisn ame on the corporate stock records. If the transferee is a purchaser for value, he has, of course, a right to rescind the transaction or a right under the Uniform Commercial Code Section 8-306(2)(a) to recover on the transferor's warranty that the transfer was "effective and rightful."

This section does not adversely affect a legitimate transfer of a close corporation share interest. Presumably, the transferee will protect himself with consents from all existing shareholders or an undertaking by the corporation.

I again stress the fact that in a close corporation context the right to restrict share transfers is usually far more important than the traditional corporation law "value" of free and ready transferability of shares; and the law should accordingly recognize the different policy considerations.

* * * * * * * *

Section X-8. Involuntary Termination of Close Corporation Status.

(a) If any event occurs as a result of which one or more of the conditions required by Section X-2 (Definition of "Close Corporation") ceases in fact to be applicable, the corporation's status as a close corporation under this chapter shall not automatically terminate if

(1) within seven days of the occurrence of the event, or within seven days after the event has been discovered, the corporation executes and files with the Secretary of State a statement setting forth the fact that one of the conditions required by Section X-2 has ceased to be applicable, and

(2) the corporation immediately takes such steps as are necessary to correct the situation which threatens its status as a close corporation, including, without limitation, refusal to register transfer of shares which have been wrongfully transferred as provided by Section X-7 (Transferees of Shares of Close Corporations; Notice to Transferees), or a proceeding under subsection (c) of this section.

(b) In lieu of action subsection (a), the corporation may elect to terminate its status as a close corporation by adopting an amendment as provided by Section X-6 (Voluntary Termination of Close Corporation Status); and its status shall terminate as of the date of filing the amendment with the Secretary of State.

(c) The Court of Chancery shall have jurisdiction to issue all orders necessary to prevent the corporation from losing its status as a close corporation by restraining any act or threatened act on the part of the corporation or a shareholder which would be inconsistent with any of the conditions required by Section X-2 (Definition of "Close Corporation") unless it is an act approved in accordance with Section X-6 (Voluntary Termination of Close Corporation Status). The Court of Chancery may restrict any transfer or threatened transfer of securities contrary to the terms of the certificate of incorporation or of any transfer restriction permitted by Section X-9 , may enjoin any offering or threatened public offering of securities of the corporation.

(d) If the corporation fails or refuses to take timely action as required by subsections (a) or (b), the Attorney General may apply to the Court of Chancery for an order appointing a receiver, with the powers conferred on receivers by Section 291 of this title,for the purpose of dissolving the corporation and liquidating its business and affairs; but such proceding shall be dismissed if the corporation complies with the requirements either of subsection (a) or (b) and also pays the costs of the dissolution proceeding.

Reporter's Note:

Under this draft section, a change of one of the conditions required by Section X-2 for close corporation status does not automatically cause its status to terminate. Rather subsection (a) gives the corporation a brief opportunity in which to correct the situation, although, to protect the creditors and the public, it must promptly file a statement with the Secretary of State indicating that close corporation status is threatened since one of the conditions has become inapplicable. In aid of the corporation, the Court of Chancery is vested by subsection (c) with broad jurisdiction to redress actual or threatened events which would cause the corporation to lose its close corporation status. Subsection (b) authorizes the corporation if it wishes, to come under the general corporation law. Subsection (d) is an ultimate sanction against a corporation which refuses to act one way or another to clarify its status.

Section X-9 Restrictions on Transfer of Securities

(a) A written restriction on the transfer or registration of transfer of a security of a corporation, if permitted by this section and noted conspicuously on the security, may be enforced against the holder of the restricted security or any successor or transferee of the holder including an executor, administrator, trustee, guardian or other fiduciary entrusted with like responsibility for the person or estate of the holder. Unless noted conspicuously on the security, a restriction, even though permitted by this section, is ineffective except against a person with actual knowledge of the restriction.

(b) A restriction on the transfer or registration of transfer of securities of a corporation may be imposed either by the certificate of incorporation or by the by-laws or by an agreement among any number of security holders or among such holders and the corporation. No restriction so imposed shall be binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction.

(c) A restriction of the transfer of securities of a corporation is permitted by this section if it contains terms which:

(1) Obligate the holder of the restricted securities to offer to the corporation or to any other holders of securities of the corporation or to any other

person or to any combination of the foregoing, a prior opportunity, to be exercised within a reasonable time, to acquire the restricted securities;

(2) Obligate the corporation or any holder of securities of the corporation or any other person or any combination of the foregoing, to purchase the securities which are the subject of an agreement respecting the purchase and sale of the restricted securities;

(3) Require the directors or the holders of any class of securities of the corporation to consent to any proposed transfer of the restricted securities or to approve the proposed transferee of the restricted securities;

(4) Prohibit the transfer of the restricted securities to designated persons or classes of persons, and such designation is not manifestly unreasonable.

(d) Any restriction on the transfer of the shares of a corporation for the purpose of maintaining its status as an electing small business corporation under Subchapter S of the United States Internal Revenue Code is conclusively presumed for a reasonable purpose.

(e) Any other lawful restriction on transfer or registration of transfer of securities is permitted by this section.

(f) If a restriction on transfer of a security is held not to be permitted by this section, the corporation shall nevertheless have an option, for a period of thirty days after the judgment setting aside the restriction becomes final, to acquire the resticted securities or any of them at a price which agreed upon by the parties subject to the approval of the Court of Chancery, or if no agreement is reached as to price then at the fair value as determined by the Court of Chancery. In order to determine fair value, the Court may appoint one or more persons as appraisers to receive evidence and recommend a decision in the question of fair value. The appraisers shall have such power as appraisers under Subsection (b) of Section X-15 (Jurisdiction of Court of Chancery to Require Purchase of Shares).

(g) The Court of Chancery shall have jurisdiction to enforce any restriction on transfer or registration of transfer of any securities permitted by this section, and also to set aside any restriction in cases of fraud, breach of duty or oppression.

Reporter's Note:

The reasons for adopting a statute broadly authorizing stock transfer restrictions are stated in the Report at pp. 338-341. The draft statute is an improved and expanded version of one proposed at pp. 339-341.

Subsection (a) states the general rule validating stock transfer restrictions "permitted by this section", together with requirements, keyed to the language of the Uniform Commercial Code, as to notice of restriction. In particular, see Code Section 8-204, rephrasing the rule of Uniform Stock Transfer Act Section 15 (Del. Corp. Law § 194). The section applies not merely to shares of stock, but like the Uniform Commercial Code rule, to any securities, thereby including convertible debentures where it is desired to restrict transfer both of the debenture and of the underlying stock if the debentures are converted.

Subsection (b) states where the stock transfer restriction may appear (certificate of incorporation, by-laws, or shareholder agreement) and limits effectiveness of restrictions imposed upon already issued securities.

Subsection (c) deals with the substantive validity of transfer restrictions, i.e., restrictions "permitted by this section." Subsection (d) broadly validates stock transfer restrictions designed to maintain a close corporation's status as an electing small business corporation under Subchapter S of the Internal Revenue Code. Of necessity, it applies only to corporations with fewer than ten shareholders. Subsection (e) recognizes the validity of any other lawful transfer restrictions and removes any negative implications from the recitals in subsections (d) and (c).

Subsection (f) is a unique effort to deal with transfer restrictions which fail for some reason or other, e.g., the restriction is unreasonably burdensome, or it is of a type not authorized (such as absolute restraint on alienation of unlimited duration), etc. Since, presumably, the restriction was intended for some not unlawful reason, the original purpose of the restriction should be effectuated via a statutory option in the corporation to purchase the stock at an agreed price or at fair value.

If this statute, broadly validating transfer restrictions, is adopted, specific Chancery jurisdiction should be granted to deal with misuse of the power which many stock transfer restrictions vest in the corporation or shareholders, and subsection (g) makes the existence of such power explicit.

Section X-10. Agreements Restricting Discretion of Directors

A written agreement among all or less than all of the stockholders, whether solely among themselves or between one or more of them and a party not a stockholder, is not invalid, as between the parties to the agreement, on the ground that it so relates to the conduct of the business and affairs of the corporation as to restrict or interfere with the discretion or powers of the board of directors. The effect of any such agreement shall be to relieve the directors and impose upon the stockholders who are parties to the agreement the liability for managerial acts or omissions which is imposed on directors by this title to the extent and so long as the discretion or powers of the board in its management of corporate affairs is controlled by such provision.

Reporter's Note:

The problem treated by this section is discussed in the Report at pp. 334-337. It implements the recommendation (see pp. 336-337) that Delaware should consider " a brief and simple statute . . . declaring that no public policy is violated" by agreements restricting director discretion, in lieu of "the detailed prescriptions of the New York section" (Section 620). "In short, it would be better to let the corporate bar and the courts develop this branch of the law without too much statutory detail." It also follows the recommendation on p. 335 that the statutory provision should not be limited to close corporations, although those corporations will be the most frequent users.

Section X-11 Abolishing Board of Directors.

The certificate of incorporation of a close corporation may provide that the business of the corporation shall be managed by the stockholders of the corporation rather than by a board of directors. So long as this provision continues in effect,

(1) No meeting of stockholders need be called to elect directors;

(2) Unless the context clearly requires otherwise, the stockholders of the corporation shall be deemed to be directors for purposes of applying provisions of this title; and

(3) The stockholders of the corporation shall be subject to all liabilities which this title imposes upon dimectors.

Such a provision may be inserted in the certificate of incorporation if all incorporators and subscribers or all holders of record of all outstanding shares, whether or not having voting power, authorize such a provision. An amendment to the certificate of incorporation to strike out such a provision shall be authorized if approved by a vote of the holders of two-thirds of all outstanding shares of the corporation, whether or not entitled to vote thereon, or by the holders of such greater proportion of shares as may be required by the certificate of incorporation for the purpose of such an amendment. If the certificate of incorporation 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. Even though so noted, a transferee of shares of a corporation which has abolished its board of directors is not bound thereby unless he consents in writing to a continuation of such arrangement.

Reporter's Note:

Although this statutory provision would appear to be a most radical innovation in corporation law, it does no more than recognize the fact that in many closely held corporations the shareholders do not bother to elect directors but in fact proceed as if they were partners *inter se*, as in fact they are. In practice it is feasible to use it only in the smallest corporations, *e.g.*, three or four shareholdersenterprises at the most. This statutory permission to abolsih the board of directors does not prejudice substantive interests. Creditors, of course, cannot be adversely affected by shareholders' internal arrangements. So far as fiduciary duties are concerned, the draft statute places upon the shareholders the obligations which would otherwise rest upon directors, as is also true of any other director liabilities. Subparagraph (2) in effect, requires that whenever a statutory provision refers to "directors" the term is to be read as "shareholders." Finally, the section gives meaningful protection to petentially affected interests. The board may be abolished at the corporation's inception only if all incorporators and all subscribers agree to the arrangement; subsequently, it may be inserted only if all shareholders consent. Transferees are not bound by the arrangement unless they consent in writing; notice through certificate recitals is an insufficient basis for imposing potential partnership liabilities on transferees. This provision is modeled on Section 3 of the Florida Close Corporation Law. See Report at pp. 364-365.

Most documents of a corporation without directors can be executed by all of the shareholders, just as may instruments of a small partnership are handled. If the Committee has adopted the proposed uniform section on execution of documents required to be filed with the Secretary of State, see Reportat pp. 3-5, documents required to be filed by a "board-less" corporation may be executed "in any event, by the holders of all of the outstanding shares of the corporation." (Subsection (c)(c)(D), Report p. 4)

Section X-12. Appointment of Custodian of Corporation on Deadlock or for Other Cause.

(a) The Court of Chancery, on application of any stockholder of a corporation, may appoint one or more persons to be custodians, and if the corporation is insolvent, to be receivers of and for the corporation, when it is established that:

(1) The stockholders are so divided that at an election held in accordance with Section 224 of this Title, they have failed to elect successors to directors whose terms have expired or would have expired upon the qualification of their successors; or

(2) The stockholders are so divided that for a period which includes not less than two consecutive annual meeting dates, they have failed to elect successors to directors whose terms have expired or would have expired upon the qualification of their successors; or

(3) The directors of the corporation are so divided respecting the management of the corporation's business and affairs that the votes required for action by the board of directors cannot be obtained and the stockholders are unable to terminate the division, with the consequence that the business of the corporation is suffering or threatened with irreparable injury; and with respect to subsections (2) and (3), it is further established that arbitration or other remedy provided by the certificate of incorporation or by-laws or any

Section X-12. Appointment of Custodian of Corporation on Deadlock or For Other Cause. (REVISED)

(a) The Court of Chancery, on application of any stockholder of a corporation, may appoint one or more persons to be custodians, and if the corporation is insolvent to be receivers, of and for the corporation when it is established that:

(1) The stockholders are so divided that at an election held in accordance with Section 224 of this Title, they have failed to elect successors to directors whose terms have expired or would have expired upon qualification of their successors; or

(2) The stockholders are so divided that for a period which includes not less than two consecutive annual meeting dates, they have failed to elect successors to directors whose terms have expired or would have expired upon the qualification of their successors; or

(3) The directors of the corporation are so divided respecting the management of the corporation's business and affairs that the votes required for action by the board of directors cannot be obtained and the stockholders are unable to terminate the division, with the consequence that the business of the corporation is suffering or is threatened with irreparable injury; or

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(3A) If, pursuant to Section X-11 (Abolishing Board of Directors), there be no board of directors, the shareholders are so divided respecting the management of the corporation's business and affairs that the business of the corporation is suffering or is threatened with irreparable injury; and

with respect to subsections (2), (3) and (3A), it is further established that arbitration or other remedy provided by the certificate of incorporation or by-laws or any

(This section continued on p. 64)

written agreement of the stockholders upon the occurence of deadlock has failed; or

(4) The corporate assets are being wasted or misapplied, or the acts of the directors or those in control of the corporation are illegal or fraudulent or dishonest, or are oppressive or unfairly prejudicial either to the corporation or to any stockholder whether in his capacity as a stockholder or director or officer of the corporation and it is further established that appointment of a receiver is to the advantage of the stockholders generally; or

(5) The petitioning stockholder has a right under a provision of the certificate of incorporation as permitted by Section X-16 to dissolution of the corporation; or

(6) The corporation has abandoned its business and has failed within a reasonable time to take steps to dissolve and liquidate its affairs and distribute its assets.

(b) A custodian appointed under this provision shall have all the powers and title of a receiver appointed under Section 291 of this title, but the authority of the custodian is to continue the business of the corporation and not to liquidate its affairs and distribute its assets, except when the Court shall otherwise order and except in cases arising under subparagraphs (5) and (6) of the preceding subsection.

(c) In lieu of appointing a custodian under this section, the Court of Chancery may, in a case arising under subsection (a)(3) of this section, appoint a provisional director as provided by Section X-13 (Jurisdiction of Court of Chancery to Appoint a Provisional Director in Certain Cases) if the Court determines that the interests of the corporation of the stockholders generally will be more effectively protected and furthered by appointing a provisional director rather than a custodian. But appointment of a provisional director does not preclude any subsequent order of the Court appointing a custodian or receiver.

Reporter's Note:

This section implements the recommendations in the Report at pp. 341-346, and adopts and refines language from several of the most recent statutory provisions, including New York, Pennsylvania, Connecticut, the Model Act, etc.

I have employed the terms "custodian" in lieu of "receiver" since the latter term carries implications of insolvency which will often not be the case when relief is warranted, or implications of wrongdoing which is not necessarily true when the directors or stockholders are deadlocked. The Committee may prefer to use the term "receiver" or to choose some other term, such as "trustee" or "manager", etc. Whatever the title, the "custodian" has the powers of a "receiver" under present Section 226, including the power to continue the business unless otherwise ordered by the Court of Chancery. This is a great improvement over the Model Act (and other statutes) which envision prompt dissolution as the sole remedy.

Subsection (a) spells out the grounds for applying for appointment of a "custodian" or "receiver." Subsection (b) states the powers of the "custodian." Subsection (c) recognizes, as an alternative to appointment of a "provisional director", and indicates when the Court may designate the latter in lieu of a "custodian." See Section X-13 infra, and discussion of the "provisional director" in the Report at pp. 347-349.

Like similar statutes in other states, this draft provision is not limited to close corporations, although, in practice, they are the ones most likely to take advantage of it.

Section X-13. <u>Jurisdiction of Court of Chancery to Appoint a Provisional Director in Certain Cases.</u>

(a) Notwithstanding any contrary provision of the certificate of incorporation or the by-laws or agreement of the stockholders, the Court of Chancery may appoint a provisional director for a close corporation if the directors of the corporation are so divided respecting the management of the corporation's business and affairs that the votes required for action by the board of directors cannot be obtained with the consequence that:

(1) The business of the corporation is suffering or threatened with irreparable injury, or if

(2) even though irreparable injury is not suffered or threatened, the business and affairs of the corporation can no longer be conducted to the advantage of the stockholders generally.

(b) An application for relief under this section may be filed by at least one-half of the number of directors then in office, or by the holders of at least one-third of all shares then entitled to elect directors, or if there be more than one class of shares then entitled to elect one or more directors then by the holders of two-thirds of the shares of any such class, but the certificate of incorporation may provide that a lesser proportion of the directors or of the stockholders or of a class of stockholders may apply for relief under this section.

(c) A provisional director shall be an impartial person who is neither a stockholder nor a creditor of the corporation or of any subsidiary or affiliate of the corporation, and whose further qualifications, if any, may be determined by the Court of Chancery. A provisional director is not a receiver of the corporation and does not have the title and powers of a receiver appointed under sections 226 and 291 of this title. A provisional director shall have all the rights and powers of a duly elected director of the corporation, including the right to notice of and to vote at meetings of directors, until such time as he shall be removed by order of the Court of Chancery or by the holders of a majority of all shares then entitled to vote to elect directors or by the holders of two-thirds of the shares of that class of voting shares which filed the application for appointment of a provisional director. His compensation shall be determined by agreement between him and the corporation subject to approval of the Court of Chancery which may fix his compensation in the absence of agreement or in the event of disagreement between the provisional director and the corporation.

(d) Even though the requirement of subsection (b) of this section relating to the number of directors or stockholders who may petition for appointment of a provisional director are not satisfied, the Court of Chancery may nevertheless appoint a provisional director if permitted by subsection (c) of Section X-12 (Appointment of Custodian of Corporation on Deadlock or For Other Cause).

Reporter's Note:

This provision implements the recommendation (See Report at pp. 347-349) that Delaware consider adopting the California alternative to dissolution (or receivership) in the event of deadlock, namely, appointment of a provisional director. See Report at p. 359 for the text of the California statute. The draft Delaware provision differs in some details from its California prototype.

(1) A provisional director may be appointed, at the court's discretion, on showing actual or threatened injury or an inability to conduct the corporation's business to the general advantage of the shareholders. The former test ties in with the standard for appointing a "custodian" (see draft Section X-12(a)(3)), while the latter test is taken from the California statute. The use of the dual standard means that a lesser showing of injury, actual or threatened, is enough to justify appointing a provisional director than in the case of an application to designate a "custodian" or "receiver."

(2) The California and the draft statutes differ in minor respects as to the persons who have standing to seek appointment of a provisional director.

(3) Subsection (d) of the draft statute ties in with Section X-12(c). Together the two provisions make clear that the Court of Chancery has discretion to designate a provisional director in lieu of a "custodian" or "receiver" even though the person who sought appointment of a "custodian" under Section X-12 would not have standing initially to seek appointment of a provisional director under Section X-13(b).

Although not in terms limited to close corporations, this statute will rarely be of use if shares are widely distributed in view of the rather high percentage of directors and shareholders required to bring suit.

Section X-14. <u>Jurisdiction of Court of Chancery to Require Purchase of Shares.</u>

(a) Whenever any stockholder or stockholders (hereinafter referred to as the "applicant") files an application with the Court of Chancery under Section X-12 (Appointment of Custodian of Corporation in Deadlock or for Other Cause), any other stockholder or the corporation (hereinafter referred to as the "petitioner") may, at any time within thiry days after the filing of petitioner's application or at such later time as the Court in its discretion may allow, petition the Court for an order requiring the applicant to sell its shares to the petitioner at their fair value.

(b) The Court shall thereupon determine whether it is in the best interests of the corporation and of the stockholders generally to require that the applicant's shares shall be ordered sold to the petitioner. If it so determines, then the Court shall then fix the fair value of the applicant's shares. The Court may appoint one or more persons as appraisers to receive evidence and recommend a decision on the question of fair value. The appraisers may examine any of the books and records of the corporation the stock of which he is charged with the duty of valuing, and he shall make a determination of the value of the shares upon such investigation as to him seems proper. The appraiser shall also afford a reasonable opportunity to the parties interested to submit to him pertinent evidence on the value of the shares. The appraiser, also, shall have such powers and authority as may be conferred upon masters by the rules of the Court of Chancery or by the order of his appointment.

(c) The appraiser shall promptly determine the value of the applicant's stock and shall file his report respecting such value in the office of the Register of Chancery and notice of the filing of such report shall be given by the Register in Chancery to the parties in interest. Such report shall be subject to exceptions to be heard before the Court both upon the law and facts. The Court shall by its decree determine the value of the applicant's stock. Within ten days after the Court has entered its decree determining the fair value of the applicant's shares, the petitioner shall file with the Court a signed statement as to whether he elects to buy the applicant's shares at the value fixed by the Court. If he does elect to buy them, he shall at the time of filing the statement deposit the amount of the fair value in cash, or certified check, with the Register of the Court of Chancery.

(d) If petitioner makes the deposit as provided in subsection (c), an order of sale shall be entered directing the applicant forthwith to turn over his share certificates to the Court for delivery to petitioner or his nominee. The deposit shall be paid over to the applicant by the Register in Chancery on receipt of the certificates representing such shares, duly endorsed for transfer. Upon entry of the order of sale, the applicant shall no longer be a stockholder of the corporation except for purposes of appeal therefrom and, upon motion of the applicant, the application under Section X-12 shall be dismissed and such other orders entered continuing the business of the corporation as the Court may direct. The Court may direct that notice of dismissal be given to such interested persons as it deems proper and may take all such reasonable action as it deems proper to provide fair opportunity for stockholders desiring to continue the corporation to purchase the shares of stockholders desiring to dissolve the corporation, and fair opportunity for the latter to sell their shares to the former, at the appraised fair value thereof.

(d) If the petitioner fails to make the deposit as provided in subsection (c), the proceeding under Section X-12 shall go forward in due course. If the petitioner fails to make the deposit, no other stockholder may proceed as petitioner as provided in subsection (a), but the Court may, in its discretion, in the course of the proceedings, permit other stockholders to make deposits as provided in subsection (d).

(f) The cost of any such appraisal, including a reasonable fee to and the reasonable expenses of the appraiser, but exclusive of fees of counsel or of experts retained by any party, shall be determined by the Court and taxed against the petitioner if he fails to make the deposit as provided in subsection (c). If it is shown that the application under Section ~~X~~ 12 was made in bad faith primarily for the purpose of compelling the purchase of the applicant's shares, the Court may at any time during the proceeding dismiss the application and may tax to the applicant any or all expenses of the proceeding, including the cost of the appraisal, as the Court shall deem equitable. In all other cases, the cost of the appraisal shall be taxed against the corporation and added to the final cost of the proceeding.

(g) At any time at or after the Court determines that the applicant's shares shall be ordered sold to the petitioner, the Court may require the applicant to submit his stock certificates to the Register in Chancery for notation thereon of the pendency of the appraisal proceeding, and if the applicant fails to comply with such direction the Court may dismiss the application under Section ~~X~~ 12 or make such other order as the Court deems appropriate.

<u>Reporter's Note:</u>

This draft section implements the recommendation in the Report at pp. 349-350. It derives in large part from the Connecticut statute on stock buy-outs (reproduced in the Report at pp. 359-361), but the draft statute resolves certain problems left uncertain under the Connecticut prototype. Most significant is subsection (b)'s authorization for the Court of Chancery to determine whether a stock buy-out is in the best interests of the corporation, after which it orders appraisal, if that is needed to determine fair value. In Connecticut, the court has no discretion to refuse to order a buy-out; on a shareholder's application to compel a purchase of a petitioner's shares, the court must then and there order appraisal.

The language of subsection (e) dealing with the appraiser's rights is taken almost verbatim from present Section 262(e) and (f). Subsection (f) indicates how costs of the appraisal are to be taxed, chiefly with a view to discouraging "strike" applications to compel stock buy-outs. Subsection (g) parallels Section 262(g).

This section is not limited to closely held corporations but can apply to all. If the Committee fears the consequences of making the compulsory stock buy-out generally applicable, it can be confined to close corporations as it is in Section 8 where it is a part of the special subchapter on close corporations.

Section X-14: new subsection (h)

(Compulsory Buy-out of Shares Entitled to Dissolve Corporation or Otherwise Voted for Dissolution.)

(h) A proceeding under this section to require the sale of shares at their fair value may also be brought whenever (1) a shareholder has exercised an option to dissolve the corporation as permitted by Section X-16 (Shareholder's Option to Dissolve Corporation), or (2) in any other case, whenever dissolution of the corporation has been effectively voted by or consented to by shareholders entitled to dissolve the corporation but the holders of a majority of the shares regularly entitled to elect a majority of the board of directors have not voted for or consented to dissolution of the corporation. The proceeding may be brought by any shareholder who has not voted for or consented to dissolution, and it shall be instituted within thirty days after the vote or consent or other action has been taken to dissolve the corporation. In any such case the Court of Chancery shall proceed substantially as provided in subsections (a) through (g) of this section, with such variations therefrom as may be reasonably necessary to afford fair opportunity for shareholders desiring to continue the corporation to acquire the shares of those shareholders desiring to dissolve the corporation, and fair opportunity to the latter to sell their shares to the former at the fair

Section X-14, new subsection (h). Cont.

value of such shares. The Court of Chancery may, if it deems it appropriate, require that the shareholders desiring to continue the corporation post bond, with or without surety as the Court may determine, to prevent loss or injury to the shareholders desiring to dissolve the corporation.

Reporter's Note

This subsection is suggested as a possible addition to Section X-14, which gives Chancery jurisdiction to compel the purchase and sale of shares in certain circumstances. In particular, subsection (h) would avoid the destruction of going concern values, incident to many dissolutions, by enabling shareholders who want to continue the corporate business to force a buy-out, at a fair price, of those who want to scrap the enterprise. The wording of the section is such that compulsory sale of shares would occur only when, because of the terms of the charter or by-laws, a minority of shareholders have power to bring about dissolution. Thus, subsection (h) is closely tied to the dissolution option provision (Section X016), and may prove especially useful if a single shareholders (or a particular class of shareholders) have been given an option to terminate the corporation's life. Proposed subsection (h) is based on Section 33-384(g) of the Connecticut General Statutes. The final sentence of subsection (h) authorizes the Court to require bond of those whose petition for a stock buy-out may delay dissolution to the possible detriment of those who have voted for dissolution and expect to realize cash or other ready assets from the distribution.

Section X-14.1. Confidential Treatment of Proceedings under Sections X-12, -13, and -14.

With respect to any proceedings under Section X-12 (Appointment of Custodian of Corporation on Deadlock or for Other Cause) or Section X-13 (Jurisdiction of Court of Chancery to Appoint a Provisional Director in Certain Cases) or Section X-14 (Jurisdiction of Court of Chancery to Require Purchase of Shares), the Court of Chancery, on application of any party to the proceeding made at any time during the proceeding, may order that all or any part of the proceedings be conducted in chambers and may make such orders as it thinks fit to preserve the secrecy of the records ofthe case, if the Court is satisfied that confidential treatment of matters disclosed or likely to be disclosed during the proceedings will be in the best interests of the corporation.

Reporter's Note

I have drafted this additional section in response to a sound suggestion from Professor F. Hodge O'Neal of the Duke University School of Law. This suggestion in turn derives from the Report of the Departmental Committee on Company Law Amendment of Northern Ireland, Cmd. 393 at p. 11. See O'Neal, Developments in the Regulation of the Close Corporation, 50 Cornell L.Q. 641, 657 n. 75 (Summer 1965). The North Ireland suggestion is directed to proceedings under Section 210 of the English Companies Act (see Report at pp. 361-362). Although I have not recommended that Delaware adopt a provision comparable to England's Section 210, I believe that the considerations prompting the North Irish suggestion are equally applicable to those provisions which I have urged for consideration in Delaware. In particular, disclosures as to intra-corporate conflict may be so damaging that courts should be encouraged to act in camera to prevent publicity which may be detrimental particularly when there is no compelling necessity for publicly airing private corporate affairs. For example, in determining the appropriate "fair price" of shares ordered sold under

Section X-14.1 (cont.)

Section X-14, it may be relevant to show that a product manufactured by the corporation but competitive with like products of other enterprises can, for reasons peculiar to the corporation, be manufactured at an unusually low cost; obviously, such sensitive information should remain confidential, and the abive proposed provision (Section X-14.1) would enable the Court of Chancery to furnish the needed protection. Compare the efforts of Duncan Electric Co., a relatively small enterprise, to keep confidential certain information which otherwise will have to be disclosed under SEC rules implementing the Securities Acts Amendments of 1964: "SEC to Hear Unlisted Firm's Complaint Disclosure Rules Would Aid Competitors," _Wall Street Journal_, Sept. 8, 1965, p.2, col.3. So, too, details concerning intra-corporate deadlock for which the remedy of a custodian (see Section X-12) or a provisional director (see Section X-13) should not be publicly disclosed. Such information as to bitter disputes within a close corporation invite other companies to fish in troubled waters.

Section X-15 <u>Operating Corporation as Partnership.</u>

No written agreement among stockholders of a corporation, nor any provision of the certificate of incorporation or of the by-laws of the corporation, which agreement or provision relates to any phase of the affairs of the corporation, including but not limited to the management of its business or delcaration and payment of dividends or other division of profits or the election of directors or officers or the employment of stockholders by the corporation or the arbitration of disputes, shall be invalid on the ground that it is an attempt by the parties to the agreement or the stockholders of the corporation to treat the corporation as if it were a partnership or to arrange relations among the stockholders or between the stockholders and the corporation in a manner that would be appropriate only among partners.

(Reporter's Note follows on p. 75)

Reporter's Note (to Sec. X-15)

This provision is recommended in the Report at pages 333-334, and as there suggested it would be applicable only to closely held corporations. This provision is permissive, not restrictive. It authorizes the shareholders to arrange their affairs *inter se* as they see fit, without regard to "corporate norm" conventions. The provision is substantially identical with Section A-18, *supra* at p. 37, but does not employ the close corporation test used in Section A-18, viz., whether shares are listed on an exchange or quoted in the OTC market.

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Section X-16. Stockholders' Option to Dissolve Corporation

(a) The certificate of incorporation of any corporation organized under this subchapter may include a provision granting to any stockholder, or the holders of any specified number or class of outstanding shares of stock, an option to have the corporation dissolved at will or upon the occurrence of any specified event or contingency. Whenever any such option to dissolve is exercised, the parties shall proceed as if all stockholders had consented in writing to dissolution of the corporation as provided by Section 275(d) of this title.

(b) If the certificate of incorporation as originally filed does not contain a provision authorized by subsection (a), the certificate may be amended to include such provision if authorized by an affirmative vote of the holders of all outstanding shares, whether or not entitled to vote, unless the certificate of incorporation specifically authorizes such an amendment by a vote which shall be not less than two-thirds of all the outstanding shares whether or not entitled to vote.

(c) Each certificate of shares in any corporation whose certificate of incorporation authorizes dissolution as permitted by this section shall conspicuously note the existence of the provision. Unless noted conspicuously on the certificate, the provision is ineffective except against a person with actual knowledge of the provision.

Reporter's Note:

This provision is limited to close corporations. Indeed it would be most undesirable for any shareholder or group of shareholders to have an option to bring about dissolution of the corporation. For close corporations, it is as justifiable as it is for a partner to have a right to dissolve a partnership at will. The statute is permissive; it does not confer on a shareholder any statutory option to bring about dissolution, but only recognizes that the certificate of incorporation may confer such an option on shareholders. As indicated by the draft statute, the option must be publicized through the certificate of incorporation and it must appear on all stock certificates. The draft statute also provides that an option to dissolve can be added to the certificate of only by a unanimous vote of all shares, unless the certificate authorizes, by at least a two-thirds vote, a vote less than a unanimous vote to insert such an option. In this way, shareholders of an existing close corporation are protected from an unwanted amendment of the charter to grant an option to one or more shareholders to bring about dissolution at will.

The draft provision is modeled in Section 1002 of the New York Business Corporation Law, as amended.

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Section X-17. Effect on Other Provisions of This Title.

The provisions of this subchapter shall not be deemed to repeal any statute or rule of law which is or would be applicable to any corporation which is organized and conducts its business and affairs under the provisions of this title (other than this subchapter) nor as implying that any like rules of law are or may not be applicable to any such corporation.

Reporter's Note

This provision is inserted so as to avoid any implication that the statements of rules and principles of law governing close corporations are or cannot also be applicable to other corporations. It is intended to preserve the legal status quo as to such corporations. The last clause is intended to leave open the possibility that, as to corporations organized under the general corporation law, certain rules of law may be applied to such corporations, e.g., rule of law concerning stock transfer restrictions.

Appendix

Companies Act, 1948, 11 & 12 Geo. 6, c.38 §§ 28-30.

28.--(1) For the purposes of this Act, the expression "private company" means a company which by its articles--

(a) restricts the right to transfer its shares; and
(b) limits the number of its members to fity, not including persons who are in the employment of the company and persons who, having been formerly in the employment of the company, were while in that employment, and have continued after the determination of that employment to be, members of the company; and
(c) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

(2) Where two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this section, be treated as a single member.

29. Where the articles of a company include the provisions which, under the last foregoing section, are required to be included in the articles of a company in order to constitute it a private company but default is made in complying with any of those provisions, the company shall cease to be entitled to the privileges and exemptions conferred on private companies under [enumerated sections of the Companies Act, whose provisions are not here pertinent] * * * *

Provided that the court, on being satisfied that the failure to comply with the conditions was accidental or due to inadvertence or to some other sufficient cause, or that on other grounds it is just and equitable to grant relief, may, on the application of the company or any other person interested and on such terms and conditions as seem to the court just and expedient, order that the company be relieved from such consequences as aforesaid.

30.--(1) If a company, being a private company, alters its articles in such manner that they no longer include the provisions which, under section twenty-eight of this Act, are required to be included in the articles of a company in order to consitute it a private company, the company shall, as on the date of the alteration, cease to be a private company and shall, within a period of fourteen days after the said date, deliver to the registrar of companies for registration a statement in lieu of prospectus in the form and containing the particulars set out in Part I of the Third Schedule of this Act and, in the cases mentioned in Part II of that Schedule, setting out the reports specified therein, and the said Parts I and II shall have effect subject to the provisions contained in Part III of that Schedule: * * * *