Washington State
House of Representatives
Office of Program Research

BILL ANALYSIS

Judiciary Committee

SB 5011

Title: An act relating to the business corporation act.

Brief Description: Concerning the business corporation act.

Sponsors: Senators Pedersen, Padden, Frockt, Fain and Kuderer; by request of Washington State Bar Association.

Brief Summary of Bill

- Establishes procedures for the ratification or validation of defective corporate actions.
- Allows a corporation's articles of incorporation or bylaws to contain forum selection provisions with respect to internal corporate proceedings.
- Provides that approval of the shareholders of a parent corporation is not required for the transfer of any or all of the parent corporation's property and assets to one or more wholly-owned subsidiaries.
- Provides that the disposition of all or substantially all of the assets of a subsidiary of a corporation, if not in the usual and regular course of business, is to be treated as a disposition by the parent corporation if the subsidiary constitutes all or substantially all the assets of the parent corporation.
- Eliminates the 10-year limit on the duration of voting trust agreements and shareholder agreements.
- Provides that a parent corporation owning at least 90 percent of the outstanding shares of each class of a subsidiary corporation may merge itself into the subsidiary without approval of the shareholders of the subsidiary.

Hearing Date: 3/9/17

Staff: Edie Adams (786-7180).

Background:

This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.

The Washington Business Corporations Act (WBCA) provides requirements for the creation, organization, and operation of corporations and the relationship between shareholders, directors, and officers of the corporation. Many of the provisions of the WBCA provide default rules that may be altered or modified in the corporation's articles of incorporation or bylaws. The articles of incorporation and the bylaws are the governing documents for the corporation and set forth rules with respect to numerous organizational and operational issues.

The WBCA is modeled largely after the American Bar Association's (ABA) revised Model Business Corporations Act (MBCA). The Corporate Act Revision Committee of (CARC) of the Business Law Section of the Washington State Bar Association periodically reviews the WBCA and makes recommendations for updating the WBCA to keep it up to date with developments in the law and changes made to the MBCA and to Delaware corporations law, which is considered a leading jurisdiction in corporate law. The CARC recommends amendments to the WBCA addressing five issue areas: ratification or validation of defective corporate actions; forum selection provisions; asset drop-down transactions; voting trusts and shareholder agreements; and short-form downstream mergers.

Defective Corporate Actions and Forum Selection Provisions.
Recent revisions to the MBCA and Delaware corporate law have established procedures for the ratification or validation of defective corporate actions and allowed forum selection provisions governing actions involving internal corporate proceedings.

When a board of directors takes corporate action without following the applicable requirements of the law or the corporation's governing documents, the action may be void or voidable for lack of proper authorization. In 2015, Delaware established a procedure for ratifying and validating defective corporate actions after a 2013 Delaware Court of Chancery case found that an invalid stock issuance was void and could not be subsequently validated. The MBCA was subsequently amended to include a procedure for ratification and validation of defective corporate actions. Under these procedures, the defective corporate action may be ratified by adoption of a resolution by the board of directors, and where required, approval of the shareholders, or may be validated through a judicial proceeding.

Forum selection provisions are provisions added in the corporation's articles of incorporation or bylaws providing that any action involving internal corporate affairs must be brought in a particular court or courts. In 2015, Delaware amended its corporations law to allow a corporation to require claims involving internal corporate affairs to be brought in the courts of Delaware, provided jurisdictional requirements are met. The ABA's Corporate Laws Committee adopted a revision to the MBCA in 2015 that authorizes a corporation to adopt a forum selection provision that allows a corporation to designate the courts of the state of incorporation and the courts of any other jurisdiction with which the corporation has a reasonable relationship.

The WBCA does not contain a procedure authorizing corporate ratification or court validation of defective corporate actions, nor does it specifically authorize a corporation's governing documents to include forum selection provisions governing actions involving internal corporate proceedings.

Asset Drop-Down Transactions.

Under the WBCA, there are a number of corporate actions that may be taken by the board of directors only upon approval of the shareholders, including any sale or other disposition of all or substantially all of the corporation's property otherwise than in the usual course of business. The board of directors must recommend adoption of the proposed sale or other disposition to the shareholders, except under certain circumstances, and the shareholders entitled to vote must approve the transaction by two-thirds of the votes entitled to be cast, unless the articles of incorporation requires a greater or lesser voting requirement.

An asset drop-down transaction is a transaction that involves a corporation transferring assets to a subsidiary entity in exchange for equity in, or as a capital contribution to, the subsidiary entity. Any asset drop-down transaction involving all or substantially all of the parent corporation's property would require approval of the parent corporation's shareholders.

Voting Trusts and Shareholder Agreements.
One or more shareholders may create a voting trust that authorizes a trustee to vote or otherwise act on behalf of the shareholders. A voting trust is formed by the shareholders signing an agreement setting out the provisions of the trust and transferring their shares to the trustee. The trustee must make a list of all owners of beneficial interests in the trust and the number and class of shares of each owner of a beneficial interest transferred to the trust and deliver copies of the list and agreement to the corporation's principal office. Voting trusts are valid for a term of 10 years and may be extended, with consent of the trustee, for an additional term of not more than 10 years.

The shareholders of a corporation may enter into a binding shareholder agreement governing the exercise of corporate powers, the management of the business and affairs of the corporation, or the relationship among the shareholders, directors, and the corporation. A valid shareholder agreement must be in writing, signed by all persons who are shareholders at the time of the agreement, and made known to the corporation. Shareholder agreements may be amended only by all shareholders at the time of the amendment unless otherwise provided in the agreement. Shareholder agreements are valid for 10 years unless the agreement provides otherwise.

Short-Form Downstream Mergers.
As a general rule, in order for two or more corporations to merge, a plan of merger must be adopted by the board of directors of each corporation that is a party to the merger, and the plan of merger must be submitted to and approved by the shareholders of each corporation. The WBCA provides that shareholder approval is not required for a merger of a subsidiary corporation into a parent corporation owning at least 90 percent of the outstanding shares of each class of the subsidiary corporation (called a "short-form upstream merger"). The parent corporation must provide notice of the merger and a copy of the plan of merger to each shareholder of the subsidiary within 10 days after the merger becomes effective. There is no similar provision allowing the merger of a parent corporation into a subsidiary ("downstream merger") without shareholder approval.

Summary of Bill:

Ratification or Validation of Defective Corporate Actions.
Procedures are established for the ratification or validation of defective corporate actions. A "defective corporate action" means: (a) any corporate action purportedly taken that is and was

within the power of the corporation, but is void or voidable due to a failure of authorization; and (b) an overissue. An "overissue" means the purported issuance of shares of a class or series in excess of the number of shares of a class or series the corporation was authorized to issue at the time of the purported issuance, or the purported issuance of shares of any class or series that was not authorized for issuance by the articles of incorporation at the time of the purported issuance.

The ratification or validation procedures established by the act are not the exclusive means of ratifying or validating defective corporate action. The absence or failure of ratification or validation according to the act does not create a presumption that the corporate action is or was a defective corporate action or is void or voidable.

Ratification of Defective Corporate Action: The board of directors may ratify a defective corporate action by adopting a resolution stating the defective corporate action to be ratified, the date of the defective corporate action, the nature of the failure of authorization with respect to the defective corporate action, and that the ratification of the defective corporate action is approved. If the defective corporate action involved the purported issuance of shares, the resolution must include the number and class or series of shares and the date or dates on which the shares were purportedly issued.

To ratify a defective corporate action involving the election of the initial board of directors, a majority of the persons exercising the power of directors at the time of ratification must adopt a resolution stating the name of the person or persons who first purportedly approved corporate action as initial directors, the earlier of the date on which that person or persons first purportedly approved corporate action or purportedly were elected as initial directors, and that the ratification of the election of the person or persons as initial directors is approved.

The shareholders must approve ratification of the defective corporate action if shareholder approval is required at the time of the ratification or would have been required at the time of the defective corporate action. Quorum and voting requirements for shareholder approval of the ratification are provided. If ratification of a defective corporate action involving the purported issuance of shares results in an overissue, the board of directors and shareholders must approve an amendment to the articles of incorporation to increase the number of shares of a class or series or to create a class or series of shares so there would be no overissue.

Notice Requirements: Requirements are established for providing notification of ratification or validation of defective corporate action. Where the board of directors ratifies a defective corporate action that does not require shareholder approval, or where a court has validated a defective corporate action, the corporation must promptly provide notice to each holder of valid shares and putative shares of the approved ratification or validation. If the ratification requires shareholder approval, the corporation must comply with specified notice requirements depending on whether approval is to be given at a meeting or without a meeting. The notifications must include a copy of the resolution or provide specified information concerning the ratified defective corporate action, and must also include a statement concerning the time period for commencing an action to challenge the ratification.

Proceedings to Validate or Challenge Ratification of Defective Corporate Action: A corporation, a director, or a shareholder may bring a proceeding in superior court to validate any defective corporate action that has not been ratified by the board of directors or to determine that any

ratification of a defective corporate action is not valid due to failure to comply with procedural requirements for ratification.

In determining whether to validate a defective corporate action, the court may consider any factors the court deems proper, including:

- whether the defective corporate action was originally approved or effectuated with the belief that it was in compliance with the law, the articles of incorporation or bylaws, and any relevant corporate resolution or agreement;
- whether the corporation and board of directors treated the defective corporate action as valid;
- whether any person has acted in reliance on, or would be harmed by failure to validate, the defective corporate action; and
- whether any person would be harmed by validation of the defective corporate action.

A proceeding challenging ratification of a defective corporate action must be commenced within 60 days following the validation effective date. "Validation effective date" means the later of: (a) the time at which the ratification is approved by the shareholders, or if shareholder approval is not required, the time at which the notice of ratification becomes effective; and (b) the time at which any articles of validation become effective. The 60-day time period does not apply to a person who did not receive required notification of the ratification.

Effect of Ratification or Validation: A defective corporate action that is ratified or validated in accordance with the requirements of the act is deemed to be a valid corporate action taken on the date of the defective corporate action. Each share or fraction of a share purportedly issued pursuant to a defective corporate action that is ratified or validated is deemed a valid share or fraction of a share issued at the time it was purportedly issued. Any corporate action taken in reliance on defective corporate action that is subsequently ratified or validated is deemed to be valid as of the time that corporate action was taken.

Articles of validation must be submitted to the Secretary of State for any defective corporate action that is ratified or validated if the action would have required a record to be filed with the Secretary of State under any other provision of the law. The articles of validation must include specified information, including the defective corporate action that was ratified or validated, the date of the defective corporate action, the failure of authorization with respect to the defective corporate action, and the date of ratification or validation.

Forum Selection Provisions.

A new provision is established authorizing forum selection provisions with respect to internal corporate proceedings. An "internal corporate proceeding" means any proceeding:

- asserting a claim based on a violation of a duty by a director, officer, or shareholder;
- commenced or maintained in the right of the corporation;
- asserting a claim arising under a provision of the articles of incorporation or bylaws; or
- asserting any other claim concerning the internal affairs of the corporation.

The articles of incorporation or bylaws may require any or all internal corporate proceedings to be commenced and maintained exclusively in any specified courts in this state or in any other jurisdictions with which the corporation has a reasonable relationship. A forum selection provision may not: confer jurisdiction on any court, over any person, or of any proceeding;

prohibit commencing or maintaining an internal corporate proceeding in the courts of Washington; or require claims asserted in an internal corporate proceeding to be determined by arbitration. If the court or courts of this state specified do not have jurisdiction, but any other court or courts specified do have jurisdiction, then the proceeding may be brought either in any court of this state with jurisdiction or any other court specified in the provision that has jurisdiction. If no court specified in the provision has jurisdiction, then the proceeding may be brought in any court that has jurisdiction.

Asset Drop-Down Transactions.
Unless the articles of incorporation require otherwise, approval of the shareholders of a parent corporation is not required for the transfer of any or all of the parent corporation's property and assets to one or more wholly-owned subsidiary entities. The sale, lease, exchange, or other disposition of all or substantially all of the assets of one or more subsidiaries of a corporation, if not in the usual and regular course of business, is to be treated as a disposition by the parent corporation, and thus requires approval of the shareholders of the parent corporation, if the subsidiary or subsidiaries constitute all or substantially all of the assets of the parent corporation.

"Subsidiary" is defined to mean an entity in which the corporation has a controlling interest. "Controlling interest" means ownership of an entity's outstanding shares or interests in such number as to entitle the holder to elect a majority of the entity's directors or other governors without regard to voting power which may thereafter exist upon a default, failure, or other contingency.

Voting Trusts and Shareholder Agreements.
The 10-year default limit on the duration of voting trust agreements and 10-year presumptive limit on shareholder agreements are eliminated. A limit on the duration of a voting trust agreement or shareholder agreement must be set forth in the agreement. An agreement subject to a 10-year duration under existing law remains subject to the 10-year limitation, except that a voting trust agreement may be amended to provide otherwise by unanimous agreement of the parties to the agreement.

Short-Form Downstream Mergers.
A parent corporation owning at least 90 percent of the outstanding shares of each class of a subsidiary corporation may merge itself into the subsidiary without approval of the shareholders of the subsidiary. The surviving corporation must provide notice of the merger and a copy of the plan of merger to each other shareholder of the subsidiary within 10 days after the merger becomes effective. A merger of a parent corporation into a subsidiary is otherwise subject to the merger requirements of the WBCA.

Appropriation: None.

Fiscal Note: Not requested.

Effective Date: The bill takes effect 90 days after adjournment of the session in which the bill is passed.