FARELLA BRAUN + MARTEL LLP

# RECENT CHANGES IN CALIFORNIA AND DELAWARE BUSINESS LAWS

***What are the issues for new California entities designed to impact social issues? Do California corporations deserve an intelligible dividend statute? What are the obligations of California corporations to eradicate human slavery within their supply chains? What's new in Delaware? What changes may lie ahead for businesses in 2012?***


Presenters: Phil Peters, Sam Dibble and Brian Donnelly

Farella Braun + Martel LLP


November 8, 2011

# New Forms of Social Enterprise Corporations in California

- AB 361: Benefit Corporations.
- SB 201: Flexible Purpose Corporations.
- Signed into law on October 9, 2011.
- Effective January 1, 2012.
- Integration of profitability and special purposes without friction from existing laws.

# History of the Social Enterprise Movement in California

- Social or “green” objectives traditionally pursued through existing corporate forms.
- For profit friction:  fiduciary duties to shareholders and profit objective.
- Non-profit friction:  attracting investment and retaining entrepreneurial talent.
- LLC’s:  complexity of “super vote” on decisions relating to social mission.
- Will the hybrid movement address these challenges?

# Prior Legislative Efforts in California

- In 2008, AB 2944 (Leno) proposed amending fiduciary duties with respect to all for-profit corporations.
- Would have permitted directors to consider various factors other than financial return.
- Problem: would have imposed a new governance standard on <u>all</u> corporations without shareholder consent.
- The bill did not involve creation of new corporate form.
- The Governor vetoed the bill but laid down a challenge to the legislature.

# The Governor's Challenge Upon Veto of AB 2944

- "While this bill proposes a new model of corporate governance consisting of a package of many intriguing concepts, it is just that; a package of concepts that could produce unknown ramifications and the need for which have not been fully demonstrated. Corporate governance is a serious matter and changes should not be entered into without deliberate study and evaluation."
- The Governor stated that he was interested in many of the issues raised in support of this measure, and that California should be at the forefront of all states in considering alternative models of corporate governance for the new millennium.
- He then urged the Legislature to consider and study new styles of corporate governance that can offer alternatives to the current model, but that maintain the vital shareholder protections.
- Do the new models maintain these vital shareholder protections?

# Comparison of the Two New Entity Types

- There is much commonality in the two regimes.
  - They both authorize modification of the fiduciary duty to maximize returns for the benefit of shareholders.
  - Concepts of social enterprise, environment, sustainability, flexibility, benefit and special purpose are prevalent in both regimes.
  - However, there are key differences to take into account.

# Key Features of AB 361 (Benefit Corporations)

- The law is found in a new separate part of Corporations Code (Section 14600 et seq.)
- Existing corporations can become benefit corps with 2/3 shareholder vote.
- The entity must adopt a purpose creating general public benefit (defined as a material positive impact on society and the environment).
- May also adopt a narrower and more specific public benefit.
- A third party certifies (for a fee) whether the applicable statutory standard has been met.
- Directors are permitted to consider the effects of their decisions on employees, customers, shareholders, the community and society, and the environment.
- The entity must prepare an annual benefit report explaining whether and how general public benefits were pursued and the extent to which those benefits were created (as measured by the third-party standard).
- The corporation's annual benefit report must be made publicly available through its website.
- Duties of director/officer with regard to public benefit may only be enforced in a benefit enforcement proceeding.

# Key Features of SB 201 (Flexible Purpose Corps)

- Integrated into existing for-profit Corporations Code (i.e., appropriate sections were amended within the current comprehensive regime).
- An existing corporation or other business entity may convert to a flexible purpose corporation by a two-thirds vote.
- Articles of incorporation must designate a special purpose, which may include charitable and public purpose activities.
- A flexible purpose corporation may customize its alternative purpose.
- The special purpose designation allows the board of directors to consider the best interest of the corporation and the shareholders and whether the corporation's actions will further its special purpose.
- A flexible purpose corporation must also prepare a current report on expenditures made in pursuit of a special purpose if the expenditures will have a material adverse impact on the flexible purpose corporation.
- Current reports and portions of the annual report must be made publicly available on the corporation's website.

# Fundamental Differences Between the Entities

- Shareholder choice in developing their own special purpose vs. the third party standard.
- The nature of the fiduciary duties of directors (i.e., how will their performance be judged?).
  - Flex Purpose: Best interests of corporation and its shareholders and furthering the special purpose.
  - Benefit: Third Party Standard ("a standard for defining, reporting, and assessing overall corporate social and environmental performance").
- Could these differences potentially lead to confusion?

# The Third Party Standard (Benefit Corporations)

- Third party is selected by the directors without any recourse by the shareholders.
- The law eliminates shareholder interests as a consideration in setting the standard, (i.e., the standard is set by statute).
- The third party standard provides content for an annual “benefit report” given to shareholders.
- There is a perceived absence of effective enforcement mechanisms for directors’ duties.

# Criticism of Third Party Standard

- SB 201 requires that the shareholders determine whether the objective is “good” in their minds (rather than ceding that responsibility to a third party).
- Promotion of benefit corporation legislation by B-Labs, a certifying agency.
- Certification fees are costly and shareholders are powerless to change standard in any case.
- Benefit corporation status unnecessary since label was already available in California?

# Board Decisions (Benefit Corporations)

- Directors are *required* to consider the impacts of any action or proposed action on *all* of a long list of interests and constituencies.
- Directors are not required to give priority to any particular factor or the interests of any particular person or group.
- No rule of decision is specifically prescribed.
- What is the rule of decision: a no losers rule? A strict equality rule?
- How does one advise a benefit corporation director? Is she more or less exposed due to the absence of a decision standard?

# Potential Confusion?

- Simultaneous enactment of two regimes occupying the same field.
- The NY Times recently wrote of these developments without even noting there are two separate sets of rules.
- Who is exposed? Shareholders? Directors? Creditors? The Third Party Standard Provider?
- The role of the bar in educating clients and the public.

# The State Bar's Formal Objections to Benefit Corporations

- Elimination of fiduciary duties to shareholders: no accountability and inherent risks of self-dealing and entrenchment.
- Shareholders' interests are displaced by a litany of indefinite factors.
- Shareholders have no meaningful recourse against abuse by directors.
- The law denies shareholders the ability to affect the corporation's purpose.
- The board should be allowed to consider interests, in addition to those of the shareholders, in a balanced way that protects shareholders and holds directors accountable.

# Taxation of Hybrid Entities

- Current status
- The push for preferential treatment.

# Summary and Conclusion

- There is a current need and opportunity to educate practitioners and clients.
- There will be opportunities for lawyers to help organizations with transformative social missions.
- There are two new sets of rules (for those who want to play by them).
- “There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits *so long as it stays within the rules of the game*.” (Milton Friedman.)

# LEGISLATIVE AMENDMENTS

- AB 571 (Effective January 1, 2012)
  - New (and Intelligible) Standards for Assessing the Legality of Distributions by California Corporations (and Quasi-California Corporations)

# Background on Distributions

- When can a California corporation make a distribution to its shareholders?
- See sections 500-509 et seq. of the California Corporations Code.
- “Distributions” include dividends of cash or property and repurchases and redemptions of shares.
- Current law: a California corporation may make a distribution only if either a “retained earnings” or a two-pronged “balance sheet and liquidity” test is satisfied.

# Existing Law on Distributions

- Under the retained earnings test, a corporation's retained earnings prior to a distribution must equal or exceed the amount of the distribution.
- Under the balance sheet and liquidity test, a distribution may be made only if, after giving effect to the distribution, (a) the sum of the corporation's assets is at least equal to 125% of its total liabilities, and (b) the current assets of the corporation are at least equal to or exceed its current liabilities (or 125% of its current liabilities, if its average earnings before interest expense and taxes on income for the two preceding fiscal years were less than its average interest expense during the same period).
- Certain assets and liabilities are excluded from the balance sheet and liquidity calculations, and, consistent with generally accepted accounting principles, assets generally are valued at their historical carrying value rather than their current fair market value. Under either test, the distribution may not render the corporation insolvent.

# Purpose of Distribution Restrictions

- Protection of creditors and senior equity holders.
- Prevents draining of capital necessary to pay current obligations.
- Prevents undermining of preferences of senior equity holders.

# Problems Addressed by the New Law

- A financially healthy corporation was unable to meet applicable tests in many cases.
- Under existing law companies that do not have accumulated retained earnings and cannot satisfy both prongs of the balance sheet and liquidity test may not make distributions to their shareholders – even if the current fair market value of their assets far exceeds the amount of their liabilities.
- Adverse impacts on ability of emerging companies to raise funds from venture capital firms seeking income-producing investments.
- Personal liability of directors in the face of an unclear law.

# Amendments to Sections 500-509 of the Code

- Retained Earnings Test.
  - Existing retained earnings test is retained.
    - A corporation may make a distribution from retained earnings to the extent that its retained earnings exceed (a) the amount of the distribution plus (b) the amount, if any, of dividends in arrears on shares with preferential dividend rights.
    - Corporations may specify in their articles of incorporation that distributions under the retained earnings test can be made without regard to the preferential dividends arrears amount.

# Amendments to Sections 500-509 of the Code (continued)

- Balance Sheet Test.
  - The existing balance sheet and liquidity test is replaced with a more flexible balance sheet test.
  - A corporation may make a distribution if, immediately after the distribution, the value of its assets equals or exceeds the sum of (a) its total liabilities plus (b) the liquidation preference of any shares which have a preference upon dissolution over the rights of shareholders receiving the distribution.
  - Indebtedness is not considered a liability if the terms of such indebtedness provide that payment of principal and interest thereon are to be made only if, and to the extent that, a distribution to shareholders could be made under the balance sheet test.
  - Corporations may specify in their articles of incorporation that distributions under the balance sheet test can be made without regard to the preferential rights amount.

# Amendments to Sections 500-509 of the Code (continued)

- Board Determination.
  - A corporation's board of directors may base its determination that a distribution satisfies either the retained earnings test or the balance sheet test, and that the distribution would not render the corporation unable to meet its liabilities as they mature.
  - The determination may be based on any of the following: (a) financial statements prepared on the basis of accounting practices and principles that are reasonable under the circumstances, (b) a fair valuation or (c) any other method that is reasonable under the circumstances.
  - These changes enable corporations to take into consideration the fair market value of the corporation's assets in determining the value of its assets, rather than restricting this determination to historical carrying value.

# Amendments to Sections 500-509 of the Code (continued)

- Timing for Determination.
  - Clarification of timing for determining whether the applicable statutory tests are satisfied relative to the date a distribution is made.
  - The determination of whether a distribution satisfies either the retained earnings test or the balance sheet test is to be made as of the date the distribution is authorized, provided the distribution is paid within 120 days after the date of the authorization.

# Amendments to Sections 500-509 of the Code (continued)

- Other Changes.
  - The new law eliminates a requirement under existing law that a corporation notify its shareholders in writing each time the corporation makes a distribution to shareholders other than from retained earnings and describe the accounting treatment of such distribution.
  - The new law provides that if a corporation distributes indebtedness to its shareholders, then the restrictions on shareholder distributions in the Code must be satisfied with respect to each payment of principal and interest measured on the dates such payments are made.

# Conclusion and Summary of AB 571

- The new law is a modern approach to determining how and when shareholder distributions can be made.
- It aligns the shareholder distribution standards in California more closely with those applicable to California limited liability companies and limited partnerships and those standards followed in most other states.
- More healthy California corporations and quasi-California corporations will be able to make distributions and will no longer be subject to competitive disadvantage.

# Supply Chain Reporting Regarding Slavery and Human Trafficking (SB 657, Effective 1/1/12)

- Corporations doing business in California may confront unexpected requirements arising from the legislature's tendency to be on the leading edge of current social issues.
- The enactment of a SB 657, effective as of January 1, 2012, relating to supply chain reporting regarding slavery and human trafficking, has invoked much commentary.
- The law will require retailers and manufacturers doing business in California with worldwide revenues in excess of $100,000,000 to disclose on their web sites their efforts to eradicate slavery and human trafficking from their direct supply chains for tangible goods.
- The new law carries forward at the state level a subject matter recently addressed at the Federal level. Section 1502 of the Dodd-Frank Act imposed a new reporting requirement on publicly traded companies that manufacture products for which "conflict minerals" are used in the supply chain.
- California's new law on supply chain reporting imposes new requirements on businesses that are not entirely clear.
- For example, what due diligence must a corporation undertake to determine sources of minerals used in its component parts? What efforts to eradicate slavery and human trafficking from their supply chains are sufficient? Will web sites be reviewed and regulated? These issues and others will be the subject of much debate as Dodd-Frank rule-making proceeds and statutes such as California's are enacted.
- Corporations doing business in California must be prepared to operate in a constantly shifting regulatory landscape.

# Amendment to Section 20 of California Corporations Code (AB 285, Effective 1/1/10)

- Eliminated references to ESIGN and permits a corporation to send an “electronic transmission,” as defined, to a shareholder who has provided consent to receive such transmissions.
- The shareholder’s consent to the electronic transmission must either be preceded by or include a clear written statement from the corporation concerning (a) the shareholder’s right to receive the information on paper or in non-electronic form; (b) whether the consent applies only to that transmission, to specified categories of communications, or to all communications from the corporation, and (c) the procedures the shareholder must use to withdraw consent.
- The permissible means of electronic transmission under Section 20 include posting on an electronic message board or network, provided there is a separate notice of the posting, for all communications by the Company to the shareholder.
- *With “sustainability” continuing to be a top initiative in California and elsewhere, many corporations are choosing to reduce or eliminate paper communications with shareholders by taking advantage of the new flexibility in electronic communications with shareholders and adopting an uncertificated securities system.*

# CASE LAW DEVELOPMENTS

## (Director Inspection Rights)

- Wolf v. Devco, 185 Cal.App.4th 903 (4th Dist. 2010).
  Quinn v. Aechelon Technology, Case No. A127799 (April 25, 2011).
  - Wolf held: "a director's absolute inspection rights do not apply after the director's term, in the absence of re-election."
  - The court observed that a director could be denied the right to inspect corporate documents based on Wolf director's "potential adversary status to [the corporation]," as illustrated by the inspection request.
  - In April of 2011, however, the First District Court of Appeal rejected this limitation as "erroneous dicta" because "the [Wolf] court was discussing a former director's lack of standing to inspect corporate documents, which made the director's potentially adversarial posture irrelevant." (Quinn.) The court therefore upheld a trial court order requiring a corporation to permit a current director whose employment had been involuntarily terminated to inspect records, including records covered by the attorney-client privilege.
  - Quinn is an unpublished decision. Under Rule 8.115 of the California Rules of Court, an opinion that has not been certified for publication with limited exceptions must not be cited or relied on by a court or a party in any other action. However, practitioners should find the reasoning and arguments in Quinn useful even if they cannot cite the case as precedent.
  - Beware of the inspection rights of adversarial directors!

# Berg & Berg Enterprises, LLC v. Boyle, 178 Cal. App. 4th 1020 (Cal. App. 6th Dist., 2009).

## (Fiduciary Duty in Insolvency Zone)

- This 2009 case merits a reminder due to the continuing financial challenges facing California corporations.
- The Delaware Supreme Court determined that individual creditors of Delaware corporation that is either in the zone of insolvency or actually insolvent may not bring direct claims for breach of fiduciary duty against the directors, but they may bring derivative claims for breach of fiduciary duty against the directors once the Delaware corporation is actually insolvent.
- California courts, however, did not delve into these issues until 2009, when the California Court of Appeal materially limited the scope of director duties to creditors of an insolvent or financially distressed California corporation. The court rejected Delaware precedent and declined to provide any special fiduciary duties to creditors solely by virtue of being in the "zone" or "vicinity" of insolvency.
- At the point of insolvency, however, under the long-standing "trust fund doctrine," a director's fiduciary duties to creditors are limited to avoiding certain actions such as self-dealing or giving preferential treatment to certain creditors that have the effect of diverting, dissipating or unduly risking corporation assets that otherwise could potentially be available to pay creditors
- Berg was an appellate court decision and the California Supreme Court has not yet weighed in.
- Directors of financially distressed California corporations should note that the line between a "zone of insolvency" and "actual solvency" is difficult to identify. This triggers the need for heightened attention to making fully informed decisions, in good faith, after considering available alternatives, and while avoiding any appearance of conflicts or self-dealing. One never quite knows when the trust fund doctrine will be deemed to apply in hindsight.

# First National Mortgage Company v. Federal Realty Investment Trust 10 C.D.O.S. 1548 (9th Cir. Feb. 1, 2011)

(Enforceability of Letter of Intent)

- The court acknowledged that while creation of a valid contract requires mutual assent, an agreement is not unenforceable merely because it is subject to the approval of a formal contract. Rather, "[w]hether a writing constitutes a final agreement or merely an agreement to make an agreement depends primarily upon the intention of the parties. In the absence of ambiguity this must be determined by a construction of the instrument taken as a whole." (citing Smissaert, 163 Cal.App.2d at 830).
- Nor does calling something a "proposal," instead of a "contract" or a "lease," necessarily mean it is not meant to be binding, especially where the circumstances suggest otherwise.
- Letters of intent play an important role in transactions, "*at times it is equally important for the parties to be certain that their interim agreements in the midst of protracted negotiations can be enforced*."
- The fact that the parties were negotiating a new contract to replace the Final Proposal did not relieve either of them from their obligations under the Final Proposal, which was an existing contract.

# Holmes v. Petrovich Development Company, LLC (Jan. 13, 2011), Cal.App.4th

(Privacy and Privilege in the Workplace)

- The court found that "e-mails sent by Holmes to her attorney regarding possible legal action against defendants did not constitute 'confidential communication between client and lawyer' within the meaning of Evidence Code section 952, because Holmes used a computer of defendant company to send the e-mails even though
  - she had been told of the company's policy that its computers were to be used only for company business and that employees were prohibited from using them to send or receive personal e-mail,
  - she had been warned that the company would monitor its computers for compliance with this company policy and thus might 'inspect all files and messages . . . at any time,' and
  - she had been explicitly advised that employees using company computers to create or maintain personal information or messages 'have no right of privacy with respect to that information or message.'"
- The court went on to say that "*e-mails sent via company computer under the circumstances of this case were akin to consulting her lawyer in her employer's conference room, in a loud voice, with the door open, so that any reasonable person would expect that their discussion of her complaints about her employer would be overheard by him.*"

# Zalkind v. Ceradyne, Inc.

(Indemnities in the Context of Purchases and Sales)

- The trial court granted Ceradyne summary judgment on the basis of a two-year limitation period on indemnity claims in the asset purchase agreement. On appeal, the Zalkinds argued that the limitations period in the agreement which applied to claims for indemnification only covered claims by third parties and not direct claims against Ceradyne.
- The Court of Appeal rejected the argument based on a careful reading of various provisions of the asset purchase agreement and an analysis of the legal definition of "indemnify." The Court of Appeal also rejected the Zalkind's argument that the limitations period in the agreement violated public policy.
- The Court of Appeal's opinion illustrates:
  - California recognizes the objective theory of contracts. Thus, a party's undisclosed intent or understanding is irrelevant to contract interpretation. The indemnity clause's limitations period was not limited to 3rd party claims and this applied to 1st and 3rd party claims.
  - California statutorily defines "indemnity" as "a contract by which one engages to save another from a legal consequence of the conduct of one of the parties, or some other person." Cal. Civ. Code § 2772. Thus, silence or non-specific language results in coverage (and limitations) against both first and third party claims.
  - California has a statute governing the interpretation of contracts of indemnity – Cal. Civ. Code § 2778. However, the statute does not apply when "a contrary intention appears".

# Possible Corporate Law Developments for 2012

- Will efforts to repeal Section 2115 continue?
- Will the debate on corporate names registration continue?
- Will the 50/90 Rule precluding certain all cash transactions be eliminated?
- Will the 10-day waiting period prior to effectiveness of certain corporate transactions approved by written consent be eliminated?
- Will there be a new body of law governing California LLCs?