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New Amendments to Washington Corporate Law Impact Mergers, Defective Corporate Acts and Forum Selection Clauses

BY MICHAEL HUTCHINGS

Washington recently adopted a series of amendments to its business corporation act which will affect both public and private companies incorporated in Washington. The amendments specifically (1) adopt a statutory procedure for the ratification and validation of defective corporate actions, (2) authorize and enable forum selection clauses, (3) permit asset drop-down transactions without parent corporation shareholder approval, (4) eliminate term limits on voting trusts and shareholder agreements, and (5) permit short-form downstream mergers. The amendments became effective July 23, 2017.

Adopting statutory procedure for ratification and validation of defective corporate actions

In 2013, in its *Boris v. Schaheen* (C.A. No. 8160-VCN (Del. Ch. Dec. 2, 2013)) decision, the Delaware Court of Chancery found an array of purported stock issuances to be invalid and held that the invalid issuances could not be ''ratified''—i.e., retroactively validated. In the decision, the Court made broad statements about defects relating to the issuance of stock and when and whether those defects can be ratified, which could be viewed as limiting the ability of corporations to ratify certain defects under Delaware law, at least in the stock issuance context. Importantly, if attempted stock issuances are void because a corporation did not follow the proper formalities and those issuances are not properly ratified or cannot be ratified, a person thought to own the related stock may not actually be a shareholder.

Michael Hutchings is a partner at DLA Piper, where he provides general counsel services to public and private technology companies, and represents clients in connection with mergers and acquisitions, public offerings, technology licensing, corporate partnerships, commercial agreements, venture capital financing, and other transactions.

Under the new chapter of the Washington Business Corporation Act, defective corporate actions can either be ratified by action of the board and, where applicable, approval of the shareholders, or validated by judicial action.

The principles from this case could apply as well to other actions purportedly taken by corporations that may not have been properly authorized, such as the failure of the incorporator to validly appoint an initial board of directors, the issuance of shares that are in excess of the authorized number of shares, and the absence of a board or shareholder resolution authorizing a corporate action.

Largely in response to the *Boris* decision, Delaware amended its General Corporation Law to add provisions providing a process for corporate ratification and judicial validation of defective corporate actions. The ABA Committee on Corporate Laws recently followed suit with an amendment to the Model Business Corporation Act (MBCA) to add a similar ratification procedure.

Under the new chapter of the Washington Business Corporation Act (WBCA), which was largely modelled on the MBCA proposal, defective corporate actions can either be ratified by action of the board and, where applicable, approval of the shareholders, or validated by judicial action. The ratification and validation procedures are intended to be available only where there is objective evidence that a corporate action was defectively implemented. For example, the new chapter permits ratification of shares previously issued which are subsequently determined to have been issued improperly. It does not permit the corporation to retroactively issue shares as of an earlier date where there is no objective evidence (e.g., resolutions, issuance of share certificates, subscription or share purchase agreements, entries in the share ledger, or some other documentary evidence that shares were issued or intended to be issued) that shares had been previously issued.

In cases where ratification takes place by action of the board, the new chapter includes a number of important safeguards that are similar to those of the MBCA and Delaware. First, the board must in its resolution detail the nature of the defective corporate action and the reasons why the action was defective. Second, the ratification must be submitted to the shareholders for approval if such approval is required at the time of ratification or would have been required at the time of the original action. If shareholder approval is not required, notice of the board ratification must be given to all shareholders, which notice must also give them notice of time limits on any judicial action to review the ratification procedure. Third, if the action being ratified would have required an amendment to the articles of incorporation to be filed with the Secretary of State's office, that filing is required in connection with the ratification. Finally, any board ratification of a defective corporate action is subject to review by the courts for compliance with the procedures in the new chapter.

The procedures in the new chapter are not the exclusive means of ratifying defective corporate actions. However, this new chapter will likely help Washington corporations and their directors and shareholders by providing a clear path that will result in a corporate action that was initially taken without proper authorization being deemed valid as a matter of law.

Authorizing and enabling forum selection provisions

In recent years, there has been significant growth in the frequency of shareholder lawsuits challenging acquisitions, mergers and other significant actions by U.S. corporations. These transactions typically attract multiple lawsuits, often in multiple jurisdictions. A significant number of corporations, looking for ways to increase predictability and control the cost of shareholder litigation, have designated in their bylaws or articles of incorporation an exclusive set of courts—typically in the state of the company's incorporation—where derivative and other ''internal corporate'' claims may be brought. Internal corporate claims typically include derivative actions, claims alleging breach of fiduciary duty by corporate directors or officers, and other lawsuits relating to the internal affairs of the company and governed by state corporation law.

Many legislative authorities have recognized the benefits of forum selection clauses in corporate organizational documents, and the clear legislative and judicial trend favors their authorization and enforcement. Forum selection provisions provide significant benefits to corporations and do not impose undue burdens on plaintiffs seeking to litigate matters of director and officer fiduciary duties and other internal corporate matters.

In 2015, the Delaware Legislature amended the Delaware General Corporation Law to add a section addressing forum selection provisions. This provision allows corporation to include in its certificate of incorporation or bylaws a requirement that all internal corporate claims be brought in the courts of Delaware, provided jurisdictional requirements are met.

Also in 2015, the ABA Committee on Corporate Laws revised the MBCA to enable the adoption of forum selection provisions. The MBCA provision, like the Delaware provision, specifically enables forum selection provisions, but it is slightly broader in scope because it enables a corporation to designate, in addition to the courts of the state of incorporation, the courts of any other jurisdictions with which the corporation has a reasonable relationship.

The ability to designate the courts in which internal corporate claims may be brought will likely confer a number of benefits to Washington corporations, including:

- outcomes of internal corporation litigation that are higher quality and more consistent with Washington public policy, as claims based on state corporation laws will be decided by courts with the most expertise in interpreting the applicable law;
- potentially greater efficiency in the resolution of claims where time often is of the essence, such as in merger and acquisition transactions;
- reduction of inconsistent outcomes in lawsuits based on identical or similar facts but decided by disparate courts;
- lower litigation costs by eliminating the need to defend similar litigation in multiple courts or multiple jurisdictions; and
- reduction of forum shopping by plaintiffs and their counsel.

An enabling statute will also eliminate uncertainty as to the enforceability of forum selection clauses, reducing the need for collateral litigation burdening the judicial system on this procedural issue. In contrast, having Washington courts decide more internal corporate disputes benefits the development of state jurisprudence on a range of substantive corporate law.

The new section of the WBCA authorizes a corporation to include in its articles of incorporation or bylaws a requirement to use an exclusive forum for the adjudication of internal corporate claims. Under the new section, the provision must specify at least one Washington state court. The provision may also include additional specified courts in one or more additional jurisdictions with a reasonable relationship to the corporation.

Permitting asset drop-down transactions without parent corporation shareholder approval

An asset ''drop-down'' transaction is a transaction in which a corporation transfers assets to a subsidiary en-

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tity solely in exchange for equity in, or as a capital contribution to, the subsidiary entity. These transactions are generally undertaken by a corporation for tax and other corporate structuring reasons and often involve the transfer of assets to a wholly-owned subsidiary.

Because Washington law generally recognizes the separate corporate existence of the parent and subsidiary, it has been unclear to many practitioners whether a vote of the parent corporation's shareholders would be required if a wholly-owned subsidiary, after an asset drop-down, intended to dispose of assets that constituted all or substantially all of the assets of the parent corporation on a consolidated basis. Similar to the drop-down issue, this interpretational difficulty has existed because it simply has not been clear whether the assets of the subsidiary should also be deemed to be assets of the parent corporation for purposes of the shareholder approval requirement that applies to the sale or other disposition of all or substantially all of a corporation's assets other than in the usual course of business. If the assets were deemed to be held by both the parent and the subsidiary, no vote of the parent corporation's shareholders should be required for a drop-down of all or substantially all of the parent corporation's assets, but a vote by the parent corporation's shareholders should be required for a sale of those assets by the subsidiary. On the other hand, if the assets were deemed to be assets of the subsidiary, but not the assets of the parent corporation, a vote of the parent corporation's shareholders should be required for a drop-down of the assets, but not for a sale by the subsidiary of those assets.

The new changes to the WBCA clarify that approval of an asset drop-down transaction by the parent corporation's shareholders is not required if the assets are dropped down to a wholly-owned subsidiary

In addition, there have been a number of unnecessary disadvantages Washington corporations faced when obtaining parent corporation shareholder approval for an asset drop-down transaction to a wholly-owned subsidiary: it is costly, takes significant time, involves (for public companies) the Securities and Exchange Commission, invites competition, and could trigger dissenters' rights.

In 2005, the Delaware Legislature adopted revisions to DGCL intended to clarify the approvals required for asset drop-down transactions. The Delaware provision specifically permits a parent corporation's board of directors to approve an asset drop-down transaction without obtaining approval of the parent corporation's shareholders. Similarly, the MBCA includes provisions permitting the parent corporation's board of directors to authorize asset drop-down transactions without obtaining approval of the parent corporation's shareholders.

The new changes to the WBCA clarify that approval of an asset drop-down transaction by the parent corporation's shareholders is not required if the assets are dropped down to a wholly-owned subsidiary (direct or indirect). In addition, the changes require approval of a sale or other disposition of the assets of the subsidiary by the parent corporation's shareholders if the subsidiary's assets constituted all, or substantially all, the assets of the parent corporation.

Eliminating term limits on voting trusts and shareholder agreements

There are three methods by which shareholders of a Washington corporation may implement an arrangement for the voting of their shares:

- A voting trust—which allows a named trustee to vote shares subject to the trust;
- A shareholder agreement—which gives shareholders broad discretion to agree how to exercise or divide voting power; and
- A voting agreement—which permits shareholders to determine the manner in which they will vote their shares.

Historically, the maximum term of a voting trust has been ten years and the presumptive term of a shareholder agreement has also been ten years. However, there is no mandatory or default term for a voting agreement. Washington's mandatory ten-year term on voting trusts and the presumptive ten-year term on shareholder agreements were not in accord with the generally enabling nature of the WBCA and do not reflect a widely-held view that shareholders should have freedom to contract with regard to the voting of their shares.

Neither Delaware law nor the MBCA include limits or presumptions on the length of terms of voting agreements or voting trusts. The changes to the WBCA now eliminate the ten-year limit on voting trusts and the presumptive ten-year limit on shareholder agreements, consistent with similar provisions in Delaware and under the current version of the MBCA.

Permitting short-form downstream mergers

A short-form merger is a transaction in which a corporation (parent corporation) owning at least 90 percent of the outstanding shares of each class of another corporation (subsidiary) may effect a merger of the subsidiary and parent corporation without a vote of the shareholders of either corporation. In Washington, a parent corporation has been able to effect an upstream merger of the subsidiary into the parent corporation without a vote of the subsidiary's shareholders, but has not been able to effect a downstream merger of the parent corporation into the subsidiary without a vote of the subsidiary's shareholders because the WBCA has not permitted short-form downstream mergers.

The reasons to merge a parent corporation and its subsidiary can arise in a variety of contexts. For example, a holding company may wish to simplify its corporate structure by effecting a merger with its operating subsidiary. Because the subsidiary is the operating entity in the structure, an upstream merger often involves a variety of complications relating to governmental permits and licenses, transfer of titled or registered assets, and assignment of contracts. There typically would be significant advantages to merging the holding company downstream into the operating subsidiary, leaving the operating subsidiary as the surviving corporation.

The same may be true in a ''two-step'' public company acquisition, where the acquiring party, typically through a wholly-owned subsidiary, makes an offer to acquire at least a majority of the target company's outstanding shares and, following consummation of the tender offer, merges the target company and its subsidiary to cash out the target company shareholders who did not tender their shares in the tender offer. If the acquiring party acquires at least 90 percent of the target company's outstanding shares in the tender offer, it can effectuate the back-end merger without a vote of the target company's remaining shareholders through the short-form merger process. For the same reasons described above, it may be preferable to merge the acquisition subsidiary into the target company so that the target company is the surviving corporation. However, the historical short-form merger provision in the WBCA would only permit a merger of the target company into the acquisition sub, not a merger of the acquisition sub into the target company.

Most states permit short-form downstream mergers, in which the parent corporation merges into the subsidiary corporation without a vote of the shareholders of either corporation. These states include influential commercial law states, such as California, Delaware, and New York. Similarly, the MBCA allows short-form downstream mergers of a parent corporation into its subsidiary without a vote of the shareholders of either corporation.

The changes to the WBCA now allow short-form downstream mergers in Washington. This will help promote efficient transactions, preserve shareholder rights, and bring Washington in line with the national trend allowing downstream short-form mergers as well as align with the current version of the MBCA.

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