ANALYSIS OF THE 1999 AMENDMENTS TO THE DELAWARE GENERAL CORPORATION LAW

By Lewis S. Black, Jr. and Frederick H. Alexander
Morris, Nichols, Arsht & Tunnell
Wilmington, Delaware

INTRODUCTION

The Delaware General Corporation Law was amended for the tenth consecutive year with a stated effective date of July 1, 1999. The Delaware legislature adopted a number of changes intended to increase flexibility for stock corporations. In addition, this year the legislature approved several changes affecting nonstock corporations. Although the General Corporation Law is noted chiefly for the flexibility and predictability it offers for stock corporations, Delaware is also frequently chosen as the domicile for nonstock corporations, including agricultural and other cooperatives. There are currently over 8,600 nonstock corporations incorporated in Delaware. In addition to the changes to the current statute, the legislature adopted three entirely new sections dealing, respectively, with (1) the jurisdiction of the Court of Chancery, (2) the conversion of alternative entities, such as limited partnerships, to corporations and (3) the conversion of corporations to alternative entities. Some of the 1999 amendments have potentially far-reaching effects, such as making it clear that transfer restrictions on shares can include restrictions on the number of shares owned by a stockholder. In addition, the 1999 amendments introduce the concept of conversion of a corporation to a limited liability company or other business entity without the need for a merger.

This article describes the changes effected by the 1999 amendments and supplements previous reports published by Aspen Law & Business and its predecessor, Prentice Hall Law & Business, describing amendments to the General Corporation Law.[1]

---

1. Arsht and Stapleton, Analysis of the New Delaware Corporation Law; Analysis of the 1967 Amendments to the Delaware Corporation Law; Analysis of the 1969 Amendments to the Delaware Corporation Law; Analysis of the 1970 Amendments to the Delaware Corporation Law; Arsht and Black, Analysis of the 1973 Amendments to the Delaware Corporation Law; Analysis of the 1974 Amendments to the Delaware Corporation Law; Analysis of the 1976 Amendments to the Delaware Corporation Law; Black and Sparks, Analysis of the 1981 Amendments to the Delaware Corporation Law; Analysis of the 1983 Amendments to the Delaware Corporation Law; Analysis of the 1984 Amendments to the Delaware Corporation Law; Analysis of the 1985 Amendments to the Delaware Corporation Law; Analysis of the 1986 Amendments to the Delaware Corporation Law; Analysis of the 1987 Amendments to the Delaware Corporation Law; Analysis of the 1988 Amendments to the Delaware General Corporation Law; Analysis of the 1990 Amendments to the Delaware General Corporation Law; Analysis of the 1991 Amendments to the Delaware General Corporation Law; Analysis of the 1992 Amendments to the Delaware General Corporation Law; Analysis of the 1993 Amendments to the Delaware General Corporation Law; Black and Alexander, Analysis of the 1995 Amendments to the Delaware General Corporation Law; Analysis of the 1996 Amendments to the Delaware General Corporation Law; Analysis of the 1997 Amendments to the Delaware General Corporation Law; Analysis of the 1998 Amendments to the Delaware General Corporation Law, Prentice Hall, Inc. 1967, 1969, 1970, 1973, 1974, 1976, 1981, 1983, 1984, 1985, 1986, 1987, 1988, 1990, 1991, 1992, and 1993, Aspen Law & Business, 1994, 1995, 1996, 1997, and 1998, respectively.

Analysis of the 1999 Amendments to the Delaware General Corporation Law

Lewis S. Black, Jr., Esq.
and
Frederick H. Alexander, Esq.

Reprinted From
Aspen Law & Business

CORPORATION

FORMATION

Contents of certificate of incorporation [§ 102].—Section 102(a)(1) of the General Corporation Law specifies certain requirements for the names of corporations, and requires, in particular, that corporate names contain a word or abbreviation indicating the entity's corporate status.[2] The 1999 amendments eliminate any implication that abbreviations of the corporate indicator, such as "Co." or "Inc." must contain punctuation. The amendments also clarify that corporate indicators from foreign jurisdictions (such as "plc" or "GMBH") may be used in lieu of the English language corporate indicators more familiar to Americans. The drafters of the amendment believed that such abbreviations were not materially less likely than traditional corporate indicators to put third parties on notice of the limited liability of the corporation's stockholders or members.

Interpretation and enforcement of the certificate of incorporation and by-laws [§ 111].—Section 111 is a new provision of the General Corporation Law declaring that the Court of Chancery has subject matter jurisdiction over any action brought to interpret, apply or enforce the provisions of a corporation's certificate of incorporation or its by-laws. While the Court of Chancery has subject matter jurisdiction over most corporate disputes, its jurisdiction is limited to equitable matters, such as lawsuits alleging a breach of fiduciary duty, or other matters in which jurisdiction is expressly conferred by statute, such as contested elections of directors or suits to resolve corporate deadlock, *see* 8 *Del. C.* § § 225 and 226. Because the enforcement of charter or by-law provisions may not always clearly fall under the Court of Chancery's equitable jurisdiction, some such disputes must be litigated in the Superior Court of Delaware. In light of the Court of Chancery's national reputation and special expertise in corporate matters, as well as its demonstrated capacity to handle business litigation, the drafters of the amendment believed that giving the Chancery Court jurisdiction over all matters involving the interpretation of corporate charters and by-laws was in the best interests of Delaware's jurisprudence and its corporate constituency.

STOCK AND DIVIDENDS

Dividends; payment; wasting asset corporations [§ 170].—Section 170 of the General Corporation Law authorizes the payment of dividends to stockholders and to members of membership corporations out of a corporation's surplus or, in limited cases, net profits. Because Section 173 prohibits the payment of dividends other than in accordance with the General Corporation Law, and because Section 170 is the only provision of the General Corporation Law authorizing such payment, dividends may not be paid unless one of the sources specified in Section 170 is available. The 1999 amendments revise Section 170 to eliminate any implication that membership corporations that are not "organized for profit" are prohibited from paying dividends to their members. Any such implication in the existing language was thought to be overly restrictive in that some cooperative organizations might be considered not organized for profit, but might nevertheless make payments to their members that could be characterized as dividends, including so-called "patronage dividends".

2. The requirement of a corporate designator was eliminated in 1995 in the limited case of corporations certifying that they have total assets of not less than $10 million.

STOCK TRANSFERS

Restriction on transfer of securities [§ 202].—The 1999 amendments with potentially the most far-reaching consequences involve changes in Section 202 of the General Corporation Law. That section permits the imposition of restrictions on the transfer of stock and other securities of Delaware corporations either in the corporate charter or bylaws, or by contract. The 1999 amendments clarify the types of transfer restrictions that are permitted, and in particular, make it clear that restrictions on transfer of the type necessary to preserve the tax advantages of net operating losses ("NOLs") and afforded to entities that qualify as real estate investment trusts ("REITs") under the United States Internal Revenue Code (including some requirements not commonly thought of as transfer restrictions) are fully available to Delaware corporations.

The amendments make several changes to Section 202 to provide increased flexibility and utility. First, the section has been expanded to apply not only to restrictions on transfer, but also to restrictions on the amount of a corporation's securities that may be owned by any person or group of persons. Thus, in reliance on the statute, as amended, a transfer restriction could require holders to dispose of shares if they become owners of more than a designated percentage of a corporation's shares, even if the breach of the threshold percentage was not caused by a transfer of the securities subject to the restriction. For example, if a corporation repurchases its stock, the ownership level of stockholders who do not participate in the transaction could increase. Under Section 202, as amended, a transfer restriction could require holders in such circumstances to dispose of shares in order to reduce their holdings to the permitted level.

In addition, the amendments add a new paragraph (c)(4) to Section 202, which expressly authorizes restrictions that obligate holders of securities to sell or transfer securities to the corporation or a third party. While the case law arguably already included such forced transfer provisions under the rubric of transfer restrictions, *see Greene v. E.H. Rollins & Sons, Inc.*, 2 A.2d 249 (Del. Ch., 1938), this change makes it clear that such provisions are permitted transfer restrictions.

The foregoing provisions of the statute recognize, and insofar as they clarify its scope, validate, provisions found in the certificates of incorporation of a number of Delaware corporations designed to preserve NOLS and protect REIT status. In addition, the express statutory authorization of forced sale or transfer provisions may be particularly useful to corporate practitioners looking to create new types of instruments.

The amendments to Section 202 also broadly expand the types of transfer restrictions that are "conclusively presumed to be for a reasonable purpose." The significance of this conclusive presumption arises from the common law imposition of a reasonableness test on transfer restrictions. In at least one case, it has been held that the adoption of Section 202 in 1967 did not eliminate this test. *See Grynberg v. Burke*, 378 A.2d 139 (Del. Ch., 1977). The conclusive presumption, which formerly applied to restrictions for the purpose of maintaining tax advantages and, specifically, to restrictions imposed for the purpose of maintaining an election to operate as a subchapter S corporation, has been expanded expressly to apply to restrictions imposed for the purpose of preserving NOLs or qualifying as a REIT, and has also been expanded to apply to any restrictions imposed for the purpose of maintaining any statutory or regulatory advantage or for the purpose of complying with any statutory or regulatory requirements.

AMENDMENT OF CERTIFICATE OF INCORPORATION; CHANGES IN CAPITAL AND CAPITAL STOCK

Amendment of certificate of incorporation after receipt of payment for stock; nonstock corporations [§ 242].—Section 242 governs the amendment of certificates of incorporation of both stock and nonstock corporations. The 1999 amendments have simplified the procedure for amending the certificates of incorporation of nonstock corporations. Previously, if the certificate of incorporation of a nonstock corporation did not otherwise provide, it could only be amended by a vote of the governing body followed by a second vote of that body to take place in not less than 15 nor more than 60 days. Since the statute did not require a vote of the members of a nonstock corporation to amend its charter, this "second reading" apparently substituted for member approval. The 1999 amendments delete the second approval requirement for amendment of a nonstock corporation's charter. The charter can now be amended by one vote of a majority of the members of its governing body. It should be noted that while this amendment simplifies the default rule for imposing amendments, it does not prohibit corporations from imposing such a second vote, or from requiring that charter amendments be approved by members.

MERGER OR CONSOLIDATION

Merger or consolidation of domestic corporations [§ 251].—Section 251 of the General Corporation Law addresses the basic long-form merger between two Delaware corporations. The 1999 amendments contain a very technical change to subsection (g), the provision of Section 251 that authorizes certain holding company mergers. The general purpose of Section 251(g) is to permit a corporation, by merger with its own indirect subsidiary, to convert to a holding company structure without obtaining the vote of its stockholders. In order to protect the rights of stockholders, Section 251(g) imposes a number of requirements, including a requirement that stockholders of the newly-created holding company be entitled to vote on certain actions that take place at the operating company level. The 1999 amendments eliminate the implication that stockholders of the parent holding company are entitled to vote on elections of directors of the subsidiary operating company, since such a provision is not necessary to protect the interests of the stockholders.

Merger of parent corporation and subsidiary or subsidiaries [§ 253].—Section 253 is the so-called "short form" merger statute. It permits a corporation owning 90% of the stock of all classes of stock of a subsidiary to merge the subsidiary into itself or to merge downstream into the subsidiary, without any action by the board of directors or stockholders of the subsidiary. The short-form merger has great utility. It is used regularly, for example, as the final step in an acquisition when an offerer wants to cash out minority stockholders following a successful tender offer. However, prior to the 1999 amendments, Section 253 was available only where the parent corporation owned 90% of all classes of stock of the subsidiary, even if one or more of those classes were not generally entitled to vote on mergers. Since holders of that class would not be entitled to vote on a long-form merger, the drafters of the 1999 amendments believed that it was unnecessary to consider those classes in determining whether a parent stockholder controlled a

sufficient number of votes to cause a short-form merger. Thus, the amendments eliminate the 90% ownership requirement with respect to shares that are not generally entitled to vote on mergers.

Merger or consolidation of domestic nonstock corporations [§ 255].—Section 255 governs the merger of Delaware nonstock corporations. Prior to the effectiveness of the 1999 amendments, the vote required to approve such a merger was two-thirds of the total number of members entitled to vote for the governing body of the corporation. The 1999 amendments eliminate the requirement of per capita voting and reduce the percentage required to a bare majority of the voting power. This conforms the vote required in a nonstock corporation merger to the vote required for stock corporations. As is the case with other votes required by the General Corporation Law, this percentage may be increased by a provision of the corporate charter pursuant to the authority granted in Section 102(b)(4).

Conversion of other entities to a domestic corporation [§ 265].—Section 265 is a new section providing for the conversion of alternative entities, *i.e.*, limited liability companies, limited partnerships or business trusts, into Delaware corporations. Prior to the adoption of this statute, the principal way to change from an alternative entity to a corporation was to merge the alternative entity into the corporation. While the surviving corporation would, as a matter of corporation law, have all the rights and obligations of the old alternative entity, such a merger created, as a technical matter, a new entity, which might affect the contract rights or regulatory status of the merging entity. The purpose of the conversion statute is to permit the same entity to survive in a different form, thereby avoiding the contract and regulatory issues involved in a merger. The procedure for conversion requires that the converting entity file a certificate of conversion with the Delaware Secretary of State as well as a certificate of incorporation creating the new entity. The statute expressly provides that the existence of the corporation is deemed to have commenced on the date the alternative entity commenced its existence. The statute also provides that the conversion is to be approved in the manner provided for by the agreement governing the alternative entity, *e.g.*, the limited liability company agreement or limited partnership agreement, and by applicable law. Mergers of limited partnerships, limited liability companies and business trusts with corporations continue to be governed by Sections 263, 264 and 254 of the General Corporation Law, respectively.

Conversion of a domestic corporation to other entities [§ 266].—The 1999 amendments also include a new provision parallel to Section 265 that permits a corporation to convert to a limited liability company, limited partnership or business trust. The statute provides that, in order to engage in such a conversion, the board of directors must adopt a resolution and submit it to stockholders. In order to be approved, such a conversion must be approved by all stockholders of the corporation, whether voting or non-voting. Conversions of corporations to limited partnerships, limited liability companies and business trusts by way of a merger continue to be governed by Sections 263, 264 and 254 of the General Corporation Law, respectively.

The adoption of Sections 265 and 266 continues the trend in Delaware to permit changes from one business form to another and to permit movement among jurisdictions. Section 252 of the General Corporation Law permits Delaware corporations to merge into corporations of any state or any jurisdiction other than the United States.

Similarly, the same section permits non-Delaware corporations formed anywhere in the world to reincorporate into Delaware. Section 388 of the General Corporation Law permits non-U.S. corporations (which include a wide variety of entities) to domesticate into Delaware. The procedure and effect is very similar to the conversion of an alternative entity into a corporation authorized by Section 265. Section 390 permits Delaware corporations to transfer or continue in any jurisdiction outside the United States; again, this provision closely parallels Section 266.

For more information about **Corporation,** write: Customer Service Department, Aspen Law & Business, A Division of Aspen Publishers, Inc., 7201 McKinney Circle, Frederick, MD 21704; or call toll free 1-800-901-9074.

If you want additional copies of the article, please contact the authors.