

## CHAPTER 2

### Basic Corporate Documents

#### ORGANIZATION AND GOOD STANDING

The question of organization and good standing is frequently the first inquiry on the legal aspects of acquisition review and is of primary importance. Counsel will review basic corporate documents such as the Certificate or Articles of Incorporation, Bylaws, and the corporate minute book of the target corporation (Company). The phrases "duly organized," "validly existing," "duly incorporated," and "good standing" are routinely used in corporate transactions, whether in the representations and warranties made in the stock purchase agreement or in legal opinions rendered in connection with the transaction. There is, however, significant disagreement in the legal community concerning what such phrases mean and what investigations are necessary to make such representations or render such opinions.<sup>1</sup> The following sections outline the basic procedure for examining a corporation's organization and good standing and highlight some of the interpretive issues that arise in the course of such an investigation. Although this inquiry is not generally prone to the semantic difficulties of opinion writing, the literature on opinion writing is helpful in analyzing many of these issues in the context of a due diligence investigation.

The following sections also address the circumstances under which counsel should conduct the same investigation with respect to subsidiaries, predecessors, and affiliates.

#### A. Documents Customarily Reviewed

To conduct the acquisition review, obtain and review the documents listed below.

- \_\_\_ 1. Certified copies of the Company's Certificate or Articles of Incorporation and all amendments thereto to date, as well as any proposed amendments.
- \_\_\_ 2. Certified copies of the Company's Bylaws, as amended to date.
- \_\_\_ 3. Minute books of the Company, including minutes of the meetings of the board of directors, any committees (whether of the board or otherwise), and shareholders, for the last five years to date.
- \_\_\_ 4. List of all jurisdictions in which the Company is currently qualified to do business as a foreign corporation.
- \_\_\_ 5. List of locations of all plants, offices, or other facilities of the Company.
- \_\_\_ 6. Certificates of Authority or Qualification issued by each jurisdiction in which the Company is authorized to do business as a foreign corporation.
- \_\_\_ 7. Certificates of Existence (where available) or Good Standing (long form) or Tax Certificates issued by the appropriate governmental authority in the state of the Company's incorporation and in each state in which the

Company is qualified to transact business as a foreign corporation.

\_\_\_ 8. All documents with respect to any partnership or joint venture affiliations of the Company, including partnership or joint venture agreements and all other documents necessary and appropriate under applicable state law to determine the due organization, qualification, or good standing of each such partnership or joint venture with which the Company is affiliated.

## B. Procedures to Be Followed

The following checklist outlines the basic inquiries to be addressed, issues to be resolved, and procedures to be followed in an acquisition review of the Company's organization and good standing.

### 1. Due Incorporation and Due Organization

\_\_\_ a. Confirm that the Certificate or Articles of Incorporation and all amendments thereto were properly executed and filed by examining these documents in conjunction with applicable state law.

\_\_\_ b. Review minute books to confirm that:

\_\_\_ (1) the initial election of directors was procedurally correct under applicable law.

\_\_\_ (2) the board of directors held an organizational meeting in a timely manner after incorporation documents were filed.

\_\_\_ (3) bylaws of the Company were properly adopted.

\_\_\_ (4) necessary officers were elected.

\_\_\_ (5) stock was properly authorized and issued.

\_\_\_ (6) the minimum consideration for starting business, pursuant to state law, was received.

\_\_\_ c. Compare the review of minute books with the review of provisions of the Certificate or Articles of Incorporation and Bylaws (e.g., as to the number of directors authorized to be elected) to confirm that all organizational actions taken by the Company were taken in accordance with these documents, as well as with applicable law.

### 2. Valid Existence and Good Standing

\_\_\_ a. Confirm that the Company has not ceased to exist as a corporation through merger, forfeiture of its charter, nonpayment of taxes, etc., by examining the minute books, all filings made with state agencies, and Good Standing or Tax Certificates issued by appropriate state authorities.

### 3. Bylaws

Review the Bylaws with particular attention to the following items:

\_\_\_ a. The quorum, notice, and other procedural requirements for meetings of both shareholders and directors.

\_\_\_ b. The number and qualification of directors, provisions regarding removal of directors, and filling vacancies on the board.

\_\_\_ c. Any classification or staggering with respect to the election of

directors.

- \_\_\_ d. Officers required to be elected.
- \_\_\_ e. Provisions concerning the indemnification of directors and officers.
- \_\_\_ f. Provisions addressing how to amend the Bylaws.
- \_\_\_ g. Provisions requiring the signature of certain officers on stock certificates and other corporate documents.
- \_\_\_ h. Special voting provisions, including provisions permitting director or shareholder action without a meeting, including telephone meetings.

#### 4. Minutes

Review the minutes of the meetings of the Company's directors, any committee, whether created by the board of directors or otherwise, and shareholders, with particular attention to the following items:

- \_\_\_ a. All material contracts and transactions were identified, including employment contracts, pension plans, leases, loans, acquisitions, and other transactions, and any pending or threatened litigation.
- \_\_\_ b. Shareholders' and directors' meetings have been held at least annually.
- \_\_\_ c. At each meeting of directors or shareholders at which any corporate action was taken, a quorum of either group was present as provided in the Bylaws.
- \_\_\_ d. Directors who voted with respect to corporate action were, at every such meeting, properly elected by the shareholders.
- \_\_\_ e. Directors properly authorized all issuances of shares of the Company and valued any noncash consideration paid for issued shares.
- \_\_\_ f. Any director or shareholder vote taken in connection with material corporate transactions, including mergers, consolidations, etc., of the Company, was duly recorded.

#### 5. Qualification as a Foreign Corporation

- \_\_\_ a. Determine all jurisdictions in which the Company is currently qualified to do business as a foreign corporation, and obtain Certificates of Authority or Certificates of Good Standing (e.g., relating to payment of taxes) for each of these jurisdictions.
- \_\_\_ b. Inquire about the location of all offices, plants, or other facilities of the Company, as well as all jurisdictions in which the Company has significant contacts in any connection.
- \_\_\_ c. Determine necessity for qualification in other jurisdictions.
- \_\_\_ d. If the Company may be changing its name in connection with the transaction, confirm that the new name can be used in all relevant states of incorporation or qualification by conducting a name search with the appropriate state governmental authority.

#### 6. Company's Subsidiaries, Predecessors, and Affiliates

- \_\_\_ a. With respect to subsidiaries and affiliates of the Company, perform all routine organizational and good standing inquiries as outlined above.

The scope of such an investigation in the context of predecessor entities will depend on how long ago the acquisition occurred and the importance of the predecessor to the Company's current holdings.

\_\_\_ b. Confirm that, except as disclosed in the Company's books and acquisition documents, no outstanding shares of any subsidiary of the Company are held by any individual or entity other than the Company.

\_\_\_ c. Determine whether any subsidiary or affiliate has voted the Company's shares, particularly if such action is prohibited by law.

\_\_\_ d. Review the organizational documents of any entities previously acquired by the Company, and determine whether they were properly acquired (e.g., the previously acquired entity's stock was valid and properly authorized at the time of acquisition).

\_\_\_ e. Review predecessor entities with respect to material contracts and other obligations or liabilities the Company may have assumed.

\_\_\_ f. Determine whether the Company or any of its subsidiaries have or operate under any partnership or joint venture agreements and, if so, obtain and review such agreements to ensure that such entities are properly and currently organized. Further investigation of any affiliates concerning material contracts, for example, will depend on counsel's assessment of the importance of such affiliates to the Company.

### C. Comment

The starting point for any acquisition review should be the Company's Certificate or Articles of Incorporation, since it is the instrument that defines the basic aspects of the corporate existence and nature.<sup>2</sup> A copy of the Certificate or Articles should be obtained from the Secretary of State of the state of incorporation, along with all amendments to date.

Initially, counsel should review the major components of the Certificate or Articles. This review will reveal any stated duration for corporate existence; the number and class of authorized capital stock of the Company, if there is more than one class of stock; the rights, powers, and privileges of each such class; provisions concerning preemptive rights and cumulative voting; provisions concerning indemnification of officers and directors or the scope of director liability; and, in many states, the identity of the initial directors. A general examination of these and other provisions in the Certificate or Articles may lead to further inquiry into matters beyond the scope of due organization and good standing.

#### 1. Due Incorporation and Due Organization

It is common to require the Company and its shareholders to represent that the Company has been "duly incorporated" or "duly organized." Often, these terms are used interchangeably, but they have different meanings. In its most narrow usage, "due incorporation" relates only to whether the Certificate or Articles of Incorporation were properly filed in accordance with applicable state law and allowed the creation of a corporate entity. "Due organization" relates to those additional procedural actions beyond

the mere filing of the Certificate or Articles of Incorporation that are required by statute to organize the corporation properly. Many commentators, however, believe that "due incorporation" has a much broader meaning and that a corporation may not be duly incorporated unless its Certificate or Articles of Incorporation were properly filed and it was also "duly organized." Whatever terminology counsel ultimately settles on for making representations and warranties in the stock purchase agreement, or for rendering legal opinions, the acquisition review, to the extent practicable, should include procedures to cover the broadest possible meaning.

The Certificate or Articles should be checked against the law of the state of incorporation that was in effect at the time the Company was incorporated, and at the time each subsequent amendment occurred, to determine whether each document contained all of the information and provisions that were statutorily required at each relevant time, and whether each document was properly adopted, executed, and filed. Several commentators have noted the difficulty of reconstructing historical corporation statutes to determine what the law was on the date of incorporation or amendment.<sup>3</sup> Certificates of Incorporation are routinely issued by the secretary of state or other appropriate regulatory authority at the time of filing. The business corporation acts of several states recognize such Certificates as prima facie evidence of due incorporation.<sup>4</sup> While many commentators believe that it may not be sufficient to rely on such a Certificate for purposes of rendering an opinion on the question of "due incorporation," in the context of performing an acquisition review, reliance on such a Certificate may be the only practical alternative. This, of course, depends on pertinent facts such as the duration of the Company's existence, the number of amendments to its Articles, and other similar considerations. It is important to verify that the entity is "duly incorporated" and not simply a "corporation." To conclude only that the Company is a "corporation" permits the possibility that the Company is a de facto corporation.<sup>5</sup> This is, of course, a possibility that counsel will wish to rule out.<sup>6</sup>

The relevant considerations of "due organization" are compliance with the procedures following filing of the Certificate or Articles of Incorporation with respect to (1) election of initial directors, (2) organizational meeting of the board of directors, (3) adoption of Bylaws, (4) election of required officers, (5) initial authorization and issuance of stock, (6) initial receipt of statutorily required consideration for issued stock, and (7) any other matter statutorily required for doing business as a corporate entity.<sup>7</sup> Examination of the Company's Certificate or Articles of Incorporation, minute books, and stock record books, as well as applicable law, should confirm that the necessary action has been taken.

The failure to file Articles or a Certificate of Incorporation, or filing them defectively, may prevent corporate existence ab initio and thereby result in the loss of protection afforded by the business corporation laws.

Alternatively, a de facto corporate existence could be created, a situation to be avoided.<sup>8</sup> Failure to complete the due organization of a corporation can preclude any valid corporate action, result in the personal liability of purported officers and directors,<sup>9</sup> or render the "corporation" a joint venture.<sup>10</sup>

## 2. Valid Existence and Good Standing

Counsel should be satisfied that the Company has not ceased to exist, "for example, through merger, liquidation, dissolution, the forfeiture or suspension of its charter or the expiration of its stated term of existence."<sup>11</sup> This type of investigation is usually associated with the terms "valid existence" or "good standing." Although both terms refer to the status of the Company as it exists subsequent to its initial organization and through the present, each term may have a different meaning in the context of a particular state's business corporation laws. The term "validly existing" generally refers to the absence of a legal cessation of existence by reason of a merger, dissolution, liquidation, or the expiration of the duration of the corporate existence as it is provided in the Certificate or Articles of Incorporation. The phrase "good standing" is generally understood to indicate that a corporation has paid its franchise taxes and taken all other actions necessary to preclude an involuntary cessation of existence. The two terms are often confused or used interchangeably because some states issue certificates providing that a corporation is "in good standing." Depending on the applicable state law, this certificate may indicate that the corporation has paid any necessary franchise taxes and that the corporation is "validly existing" with respect to its Certificate or Articles of Incorporation or other documents filed under law.

Despite the difference in meaning of the phrases "validly existing" and "good standing," confirmation that no problems have arisen with respect to either phrase may be obtained by examining the Certificate or Articles of Incorporation, a "long-form Good Standing Certificate listing all documents filed with the applicable state agency affecting the Certificate or Articles of Incorporation, a franchise tax certificate (whatever it may be called) stating that the corporation is current on its franchise tax obligations, and the minute books of the Company.

## 3. Bylaws

Counsel should initially review the Bylaws to become familiar with the Company's internal procedural rules and regulations. Items to look for in the Bylaws include (1) quorum, notice, and other procedural requirements for meetings of directors and shareholders; (2) the number, qualification, and removal provisions relating to directors; (3) classifications or staggering of the board; (4) officers required to be elected; (5) indemnification of directors and officers; (6) how the Bylaws may be amended; (7) provisions requiring signatures of certain officers on stock

certificates and other corporate documents; and (8) special voting provisions, including provisions permitting director or shareholder action without a meeting, including telephone meetings. Familiarity with these and other provisions of the Bylaws will facilitate other aspects of the acquisition review, such as verifying the valid issuance of shares, examining the validity of a variety of corporate transactions, and confirming corporate authority for the instant transaction.<sup>12</sup>

#### 4. Minutes

Examination of the Company's minute books should be conducted early in the process, because such an examination may well serve as a road map to various areas of inquiry. Review of the minutes discloses a myriad of information concerning prior corporate actions including references to material contracts and transactions, employment contracts, pension plans, leases, loans, acquisitions, or other transactions, and any pending or threatened litigation. The due authorization and valid issuance of shares is confirmed through a review of the minutes.<sup>13</sup> In reviewing the minutes, counsel should initially confirm that (1) directors' and shareholders' meetings have occurred at least annually; (2) quorums were present for all votes of directors or shareholders; and (3) officers and directors have been duly elected and qualified.<sup>14</sup> Defects or irregularities in any of these matters may adversely affect the validity of certain corporate transactions, thereby requiring corrective action where possible.

#### 5. Qualification as a Foreign Corporation

The acquisition review must address the issue of the Company's qualification to do business in foreign jurisdictions in which the character or location of the properties owned or leased by the Company, or the nature of the business conducted by the Company, makes such qualification necessary or prudent. The consequences of failing to qualify where such qualification is required may be significant. For example, virtually all states have statutes that deny foreign corporations transacting business in their jurisdictions the right to enforce contracts executed within that state.<sup>15</sup> In at least four states, subsequent remedial qualification may not permit enforcement of prequalification contracts entered into within such states.<sup>16</sup> Even if subsequent qualification is permitted, it could require the payment of substantial taxes and/or penalties. The denial of access to the courts of a state sometimes applies to the successors-in-interest of an unqualified corporation.<sup>17</sup> In the context of acquisitions, such a successor-in-interest may turn out to be the purchaser. Finally, the failure to qualify in a state may also result in monetary penalties against the Company and against persons acting on behalf of the Company.<sup>18</sup>

Counsel should determine each jurisdiction in which the Company is qualified or believes that it is qualified to transact business as a foreign corporation. The Company's qualification, valid existence, and good

standing should be confirmed in each such jurisdiction by ordering applicable Certificates of Authority or Qualification and Good Standing from appropriate governmental authorities.

Counsel should independently determine, through review of the Company's minutes, contracts, and other corporate documents, as well as interviews with appropriate representatives of the Company, each location at which the Company maintains an office, plant, or other facility, and identify each jurisdiction in which the Company has significant contacts or engages in frequent activities. The relevant facts must then be analyzed in light of each relevant jurisdiction's corporation laws to determine whether the character or location of the properties or the nature of the business requires qualification in jurisdictions other than those in which the Company is currently qualified.

This analysis will likely require examining the corporation laws of a state in which counsel is not licensed. In those circumstances, counsel may be well advised to retain local counsel, especially because state qualification requirements vary substantially, and corporate activity that might require qualification in one state may not in another.<sup>19</sup>

## 6. Company's Subsidiaries, Predecessors, and Affiliates

### a. Subsidiaries

Acquisition reviews generally extend to the Company's significant subsidiaries. All organization and good standing matters should be investigated as a matter of course. Counsel will need to confirm that, except as disclosed in the acquisition documents, there are no outstanding shares of the subsidiary issued to persons or entities other than the Company. Further investigation, such as review of material contracts and examination of licenses, will depend on the significance of the subsidiary's activities or holdings on a consolidated basis. It is also important to recognize that some state corporation laws prohibit the voting of any shares of the parent held by a subsidiary on any matter.<sup>20</sup>

Therefore, the corporate minutes of the parent may need to be reviewed to ensure that no shareholder vote was invalidated as a result of noncompliance with such a rule.

### b. Predecessors

Entities previously acquired by the Company through statutory merger should be identified by reviewing counsel and, depending on the predecessor's importance to the Company's consolidated holdings, reviewed to ascertain any problems arising from defects in the acquired entity's organization and good standing, the validity of its securities, or material contracts or other obligations or liabilities that may have been assumed in connection with the acquisition.<sup>21</sup> Entities acquired more than five years in the past may require little or no examination in the discretion of counsel. If the Company has acquired assets of another company in exchange for stock,

access to the other company's books and records may not be available. In those cases, the review may be limited to examining the validity of the corporate authorization for the sale of assets to the Company. When access to information concerning the acquired entity is, for any reason, limited or unavailable, counsel may rely on opinions of the predecessor's counsel rendered at the time of acquisition in which counsel reasonably believes such opinions were competent.

### c. Affiliates

Any partnership or joint venture affiliations of the Company or any of its subsidiaries should be reviewed in a fashion similar to the examination of subsidiaries. Specifically, all partnership or joint venture agreements should be obtained and examined to determine the type and scope of the Company's affiliation with such an entity. This examination includes inquiry into the proper organization of the entity; whether any state filings were made with respect to such an entity; whether the entity operates under an assumed name and, if so, whether it has made proper filings in that regard; whether the entity is properly qualified or registered in foreign jurisdictions or whether such qualification should be sought; whether the entity has obtained all necessary governmental permits or regulatory authorizations to conduct its business; and what the partnership or joint venture agreement may require in terms of consents to the proposed transaction. Further investigation, such as the review of material contracts, and examination of permits, licenses, or the like, will depend on the significance of the affiliate's activities or holdings on a consolidated basis.

## CAPITALIZATION AND SHAREHOLDERS

In this phase of the due diligence investigation, counsel must identify the selling shareholders; examine the authority of each to execute, deliver, and perform his or her obligations under the stock purchase agreement; deal with any special issues presented by minor, incompetent, or deceased shareholders, shares held in trust or subject to voting trusts, or other special voting agreements or arrangements; and determine that the shares the purchasers intend to acquire are duly authorized, validly issued, fully paid, and nonassessable. Certain issues raised in the following outline and discussion concerning the validity of shares of the Target Company may be rendered moot by the acquisition of all Company stock; and therefore such issues, although appropriate for consideration, are not likely to present an impediment to the stock acquisition. Issues concerning the validity of shares of a selling corporation in an asset sale may have more serious implications.

### A. Documents Customarily Reviewed

\_\_\_ 1. Certified copies of the Company's Certificate or Articles of Incorporation and all amendments thereto to date, as well as any proposed

amendments.

- \_\_\_ 2. Certified copies of the Company's Bylaws, as amended to date.
- \_\_\_ 3. Minute books of the Company, including minutes of the meetings of the board of directors, any committee (whether of the board or otherwise), and shareholders for the last five years to date.
- \_\_\_ 4. The Company's stock transfer or stock ledger books.
- \_\_\_ 5. Audited consolidated financial statements of the Company and all subsidiaries for the last three to five years.
- \_\_\_ 6. The form(s) of the Company's stock certificates and the language of all legends or specific terms appearing thereon.
- \_\_\_ 7. All stock option, bonus, incentive, or pension plans, and any other agreements to issue shares of the Company or any of its subsidiaries in the future.
- \_\_\_ 8. All agreements relating to the beneficial ownership, voting rights, or pledge of the Company's common or preferred stock.
- \_\_\_ 9. All agreements under which registration or preemptive rights are granted to shareholders of the Company.
- \_\_\_ 10. All agreements, offering circulars, letters of intent, written proposals, or memoranda of any oral proposals for the disposition, acquisition, or distribution of any of the assets or shares of the Company.
- \_\_\_ 11. List of all shareholders of the Company, cross-checked against the stock books and disclosing the status of ownership of each (e.g., joint, in trust, minor).
- \_\_\_ 12. All reports to shareholders and proxy statements prepared by or on behalf of the Company or any of its subsidiaries for any of the past three years.
- \_\_\_ 13. An opinion from auditors regarding the fully paid and nonassessable character of the Company's shares.
- \_\_\_ 14. All shareholder correspondence with the Company for the last year.
- \_\_\_ 15. All filings made by the Company or any of its subsidiaries with the Securities and Exchange Commission or any similar federal or state regulatory agency for the past five years.

#### B. Procedures to Be Followed

The following checklist outlines the basic inquiries to be addressed, issues to be resolved, and procedures to be followed in a review of the Company's capitalization and shareholders.

##### 1. Identity and Authority of Shareholders

- \_\_\_ a. Confirm that the list of shareholders has been cross-checked with the stock transfer books and is correct.
- \_\_\_ b. Establish the number and type of shares held by each shareholder of record. All agreements restricting the voting or transfer of shares, including voting trusts or agreements and shareholders' agreements, should be identified and reviewed in connection with the shareholders' power to perform the proposed transaction.

\_\_\_ c. Identify all shares held by minors, incompetents, trustees, shareholders of record now deceased, etc., and the procedures for effecting the transfer, conversion, etc., of such shares.

\_\_\_ d. Identify shareholders who are officers and directors of the Company, and all agreements or laws restricting their transfer of shares, if any.

\_\_\_ e. Review shareholder correspondence to confirm that it does not disclose any potential barriers to the contemplated transaction.

## 2. Status of Shares to Be Acquired

### a. Due Authorization

\_\_\_ (1) Determine the type and number of duly authorized, issued, and outstanding shares of the Company by examining the Company's Certificate or Articles of Incorporation and all amendments thereto to date, the stock transfer books, and the minutes of all directors' meetings.

\_\_\_ (2) Review all legends appearing on issued shares, as well as the specific terms of preferred shares, to identify any restrictions on transfer and any rights accruing upon transfer or merger (e.g., the right to convert or redeem).

\_\_\_ (3) Establish that the Company had authority to issue the type of shares examined under its Certificate or Articles, Bylaws, and applicable state law.

\_\_\_ i. Par value

\_\_\_ ii. Class

\_\_\_ iii. Rights and preferences, if any

\_\_\_ iv. Limitations or restrictions, if any

\_\_\_ (4) Confirm that the issuance of all of the Company's shares was properly authorized by the Company's board of directors.

\_\_\_ i. Notice was properly given for all relevant directors' or shareholders' meetings.

\_\_\_ ii. A quorum of directors or shareholders was present at all relevant meetings, and the number of votes required to approve the issuance was received.

\_\_\_ (5) Identify all shares reserved for issuance pursuant to any stock option, stock bonus, employee plans, etc.

\_\_\_ (6) Confirm that an overissue of shares beyond the number authorized in the Certificate or Articles of Incorporation has not occurred, and is not likely to occur, as a result of shares reserved for issuance in other agreements by reviewing any such agreements in connection with the Certificate or Articles and minutes.

### b. Valid Issuance

\_\_\_ (1) Elements of due authorization have been reviewed and are present.

\_\_\_ (2) Confirm that the type of consideration permitted by applicable law was paid and actually received by the Company for the shares issued.

\_\_\_ i. Review applicable state law.

\_\_\_ ii. Review minute and stock ledger books.

\_\_\_ (3) Confirm that stock certificates for issued shares were properly

executed by authorized officers of the Company as provided by applicable law or the Bylaws, and that such certificates were delivered.

\_\_\_ (4) Confirm that no agreements limited or otherwise prohibited the prior issuance of shares by the Company.

\_\_\_ (5) Confirm that no shareholders have absolute redemption rights by examining the Certificate or Articles, minute books, and the certificates themselves, if possible.

\_\_\_ (6) Confirm that shares were not issued in violation of preemptive rights or the express terms of the Company's preferred stock, if any.

#### c. Fully Paid and Nonassessable

\_\_\_ (1) Determine whether the Company received the minimum consideration for issued shares required by its Certificate or Articles and applicable state law existing on the date of each such issuance.

\_\_\_ (2) Determine whether the consideration paid for issued shares was of a permissible type under state law.

\_\_\_ (3) Determine whether any noncash consideration paid for stock was properly valued by the board of directors pursuant to applicable law.

\_\_\_ (4) Determine whether the consideration recited in the minutes or stock books was actually received by the Company.

\_\_\_ (5) Confirm that shares issued in connection with mergers, consolidations, reorganizations, etc., if any, are "fully paid" as a matter of law.

#### d. Preemptive Rights and Other Agreements

\_\_\_ (1) Determine whether shareholders of the Company have any preemptive rights by examining the Certificate or Articles of Incorporation in conjunction with applicable state law, as well as any agreements purporting to grant preemptive rights to shareholders.

\_\_\_ (2) Determine whether any waivers of preemptive rights have been or should be obtained.

\_\_\_ (3) Review the terms of any preferred stock of the Company to determine whether any issuance of shares by the Company was in violation of such terms.

\_\_\_ (4) Review any shareholder agreements to determine whether the prior issuance of any of the Company's shares was in violation of such agreements.

### C. Comment

#### 1. Identity and Authority of Shareholders

The purpose of the following checks is to determine the identity of the selling shareholders and their authority to sell their stock and otherwise perform their obligations under the transaction documents. Counsel must determine whether the voting power of shares is subject to any formal or informal voting trust or agreement,<sup>22</sup> who has power of attorney, whether any shares are held by minors or shareholders of record now deceased, or whether any other agreement exists that places the authority to vote or transfer shares in the hands of someone other than the shareholder of

record.<sup>23</sup> For this purpose, an acquisition review of shareholder status should do several things: (1) establish the names and addresses of each shareholder of record, cross-checked against the stock transfer books; (2) identify the number and type of shares held by each shareholder, as well as how the shares are held (e.g., solely, in trust, jointly)<sup>24</sup>; (3) identify shareholders who are also officers or directors of the Company and check for stock holdback or other agreements, as well as any state or federal laws, that prevent or limit the transfer of shares by such individuals; (4) identify whether any shares are held by minors; (5) identify shareholders of record who are deceased<sup>25</sup>; and (6) conduct a review of all shareholder correspondence within the past year. Examination of shareholder correspondence may disclose written objections to a proposed major corporate action.

After the individual shareholders have been identified, as well as how the shares are held with respect to each, appropriate action must be taken as the circumstances require to ensure the authority of each shareholder to execute and deliver the documents and perform the obligations thereunder. For example, when shares are owned by a minor, the consent of guardians should be obtained for any proposed sale. Likewise, if a shareholder of record is now deceased, counsel should contact the executor or administrator of the estate to establish his or her authority to sell the shares and willingness to do so.

## 2. Status of Shares to Be Acquired

### a. Due Authorization

As a preliminary matter, in a review of a corporation's capitalization and shareholders, inquiry must be made by counsel as to the current status and number of the authorized and issued capital stock. Counsel must first establish that the basic corporate documents permitted all prior issuances of shares, that director and shareholder approvals of such issuances were valid, and that the current numbers of actually issued shares comport with the corporate authorizations and stock ledger or transfer books. The number of authorized shares may be discovered by examining the Company's Certificate or Articles of Incorporation and all amendments thereto to date. The number of issued and outstanding shares generally may be discovered in one of two ways: (1) by examining audited financial statements or (2) by reviewing the stock transfer books of the Company. It is important to note that shares may be "issued" but not "outstanding." For example, when issued shares have been reacquired by the Company, unless cancelled or otherwise retired (i.e., treasury shares), such shares are issued but not outstanding. It is also important to verify that there has been no "overissue" of stock beyond the number of shares authorized in the Certificate or Articles of Incorporation. "Overissue" concerns also arise with respect to rights granted pursuant to stock options, warrants, employee plans, or other agreements pursuant to which shares may be issued

in the future or securities or rights convertible into shares have been issued. A sufficient number of authorized but unissued shares should be reserved to cover the issuance of the maximum number of shares that may be issued under any such options, plans, or agreements. If previously issued shares have been cancelled, counsel must determine whether such cancellation reduced the number of authorized shares pursuant to the Company's Certificate or Articles of Incorporation or state law. The term "duly authorized," as applied to stock, generally means that the Company had the power under applicable law to issue the shares in question, its Certificate or Articles of Incorporation, and Bylaws at the time of issuance, and that all corporate action necessary to authorize or ratify the issuance was taken.<sup>26</sup> After the possibility of overissue has been eliminated, counsel should examine the authority of the Company to issue the type of share in question. Counsel must confirm that the Company had the power to issue "shares of the par value, class, and having the rights, preferences, limitations, and other attributes" of the shares actually issued.<sup>27</sup> This confirmation requires review of the applicable state law and the Company's Certificate or Articles of Incorporation. Several common corporate record defects encountered in "due authorization" type investigations include the following: (1) the failure to give notice to directors or shareholders concerning a meeting in which the number of authorized shares was increased or decreased, (2) circumstances in which the Company has created a new class of stock without authority to do so in its Certificate or Articles of Incorporation and where applicable law prevents such action,<sup>28</sup> (3) lack of a quorum at a directors' or shareholders' meeting in which action was taken to authorize or cancel shares, (4) "overissue" of shares beyond the number authorized in the Certificate or Articles of Incorporation,<sup>29</sup> (5) the failure to permit voting as a class, and (6) the issuance of shares on the basis of Certificates or Articles of Incorporation specifying and authorizing dollar amounts of shares to be issued, but not specifying the number of shares authorized.<sup>30</sup> Counsel must examine the possibility that shares issued without meeting due authorization criteria may be void or voidable by the purchaser of the shares.<sup>31</sup> However, neither situation is desirable, because "void" shares must be canceled and "voidable" shares are cancelable at the option of the purchaser.

#### b. Valid Issuance

The term "validly issued" generally means that the issuance of stock was "duly authorized," the purchaser gave proper consideration for the stock, and certificates representing the shares issued were properly executed and delivered.<sup>32</sup> This term may also encompass determinations that no agreement limited or prohibited the Company from issuing the shares, that present or prior shareholders do not have the right to present their shares to the Company and be cashed out, and that the shares were not issued in violation of shareholders' preemptive rights. The question of adequate consideration

is relevant to the determination of valid issuance primarily because many state corporation laws provide that stock may not issue until the full amount of the consideration therefor has been paid.<sup>33</sup> Thus, if issued shares are not "fully paid," they generally cannot be "validly issued." Proper execution and delivery of certificates for issued shares may be investigated by examining and comparing the stock described in the minute books with the stock ledger and by confirming that the issuance of stock was properly recorded in the stock ledger. An examination of applicable state law and the Bylaws of the Company will disclose which officers may properly execute issued certificates. There is, however, no way to check proper execution other than obtaining a certificate of a witness to the signing, or by examining a photocopy of the issued share certificate. Finally, although a right of rescission or other equitable remedy may be available, violation of federal or state securities laws does not affect the valid issuance of securities.<sup>34</sup> The purchase transaction is merely voidable at the option of the purchaser.

#### c. Fully Paid and Nonassessable

The term "fully paid" is generally understood to mean that (1) the Company received at least the amount of consideration required by its Certificate or Articles of Incorporation and state law on the date of issuance (this usually means the par value for par stock); (2) the consideration given was of a type permitted under the applicable state law at the time of issuance (usually cash, property, or past services); (3) the directors valued the consideration if it was not cash; and (4) the recited consideration was actually received by the Company. When these factors are present, stock may generally be characterized as "fully paid and nonassessable" under applicable state law.<sup>35</sup>

Every state corporation law addresses what types of consideration are acceptable as payment for shares.<sup>36</sup> Permissible consideration normally consists of cash, labor already performed, personal property, or real property. Mere promises to pay or to perform services in the future do not normally constitute proper consideration, although state corporation laws do occasionally permit shares to be issued that are only partly paid.<sup>37</sup> When property or services rendered constitute the sole consideration given for shares, counsel must examine the valuation of such consideration, as determined by the board of directors, in the context of the requirements of receiving a minimum consideration as prescribed by applicable law for shares, and the actual receipt of such consideration.<sup>38</sup> Most state corporation laws provide that the valuation made by the board of directors is conclusive as to value in the absence of fraud.<sup>39</sup> With respect to actual receipt of the consideration, counsel may generally rely "on a certificate of a responsible officer of the Company or an independent accountant to the effect that, after due examination including inspection of the books and records of the Company, it was determined that the consideration recited in the minutes was, in fact, received by the Company."<sup>40</sup> Shares issued in

connection with mergers, consolidations, reorganizations, conversions, or the like, become "fully paid" as a matter of law, which obviously requires the examination of the applicable state law.

The term "nonassessable," which almost always appears in connection with the term "fully paid," generally means that stock in the hands of a shareholder is not subject to call or any future monetary assessment by the Company or its creditors except in the case of partly paid shares. Counsel may determine whether this element is present by comparing applicable state law with the Company's stock and minute books. This designation, however, has been construed to apply only to assessments relating to the purchase price of shares, and not other types of shareholder assessments that could be exercised under the authority of the Company's Certificate or Articles of Incorporation.<sup>41</sup> It should be noted that applicable law is usually different with respect to the capital stock of banks or insurance companies.<sup>42</sup> In these circumstances, the ability to assess against shareholders is a technical and specialized concern.

#### d. Preemptive Rights and Other Agreements

Preemptive rights represent the right of a shareholder to maintain a proportionate share of ownership in a corporation by purchasing a proportionate share of any new stock issues.<sup>43</sup> The first step in this connection is to ascertain whether preemptive rights exist. Most state corporation statutes provide either that such rights must be set out in the Certificate or Articles of Incorporation or they are waived,<sup>44</sup> or that if such rights are not specifically denied in the Certificate or Articles of Incorporation they are available.<sup>45</sup> Therefore, an examination of the Articles or Charter and applicable state law will usually disclose the presence or absence of preemptive rights. If it is discovered that preemptive rights exist, counsel should first confer with the purchaser about the potential reasons for preserving or abolishing such rights in the post-acquisition context.

There is little case law dealing with securities issued in derogation of preemptive rights; however, at least one court has held that shares so issued were not thereby voided. Instead, the purchaser of the shares might be required to sell back to the Company sufficient shares to permit holders of the right to be satisfied, should they choose to execute their preemptive option.<sup>46</sup> Conversely, shares issued in violation of preemptive rights could result in cancellation of the shares.<sup>47</sup> Counsel must consider the existence of preemptive rights in concluding that previous issuances of shares were validly issued or not in the context of applicable state law and court decisions.

If it is discovered that present shareholders are entitled to preemptive rights, and further, that shares previously issued were in violation of such rights, the question is whether some portion of this previously issued stock is voidable or subject to rescission. Counsel may wish to amend the Company's Certificate or Articles to eliminate preemptive rights before

they can be exercised.<sup>48</sup> Alternatively, counsel may obtain a signed waiver of preemptive rights from such shareholders. Obtaining such a waiver, however, may prove to be impracticable if there are numerous shareholders or if the Company has had a long prior existence. Preemptive rights may also be limited by the time allowed for exercise by the provisions in the Certificate or Articles of the Company. In such cases, the right may have lapsed by its own terms.

Counsel must also examine the terms of any preferred shares of the Company, as well as any shareholder agreements, that purport to limit the rights of the Company to issue shares. In this connection, counsel should review the minutes of all directors' meetings and the Certificate or Articles of Incorporation for references to either preferred shares or shareholder agreements. Occasionally, the latter will not be filed with the Company, but only referenced in the minutes.<sup>49</sup> To the extent that most state corporation laws permit an almost unlimited range of preferred share terms or shareholder agreements, this examination should proceed on a facts-and-circumstances basis at the discretion of counsel.

#### NOTES

1. Fitzgibbon & Glazer, *Legal Opinions on Incorporation, Good Standing, and Qualification to Do Business*, 41 BUS. LAW. 461, 461-62 (1986) [hereinafter *Legal Opinions*].

2. See *Gow v. Consolidated Coppermines Corp.*, 19 Del. Ch. 172, 165 A. 136, 139-40 (1933); see also *Leise v. Jupiter Corp.*, 241 A.2d 492, 497 (Del. Ch. 1968).

3. See, e.g., *Special Committee on Legal Opinions in Commercial Transactions*, New York County Lawyers Association, in cooperation with Corporation Law Committee, Association of the Bar of the City of New York, and Corporation Law Committee of the Banking, Corporation, and Business Law Section, New York State Bar Association, *Legal Opinions to Third Parties: An Easier Path*, 34 BUS. LAW. 1981, 1905-06 (1979) [hereinafter *Special Committee*].

4. See, e.g., DEL. CODE ANN. tit. 8, § 106 (1983); CAL CORP. CODE § 209 (West 1977 & Supp. 1990); TEX. BUS. CORP. ACT ANN. art. 3.04 (West 1980).

5. Babb, Barnes, Gordon & Kjollenberg, *Legal Opinions to Third Parties in Corporate Transactions*, 32 BUS. LAW. 553, 557 (1977) [hereinafter *Babb*]. A de facto corporation is "[o]ne existing under color of law and in pursuance of an effort made in good faith to organize a corporation under the [applicable] statute. . . ." BLACK'S LAW DICTIONARY 308 (5th ed. 1979).

6. Fitzgibbon & Glazer, *supra* note 1, at 467:

[D]e facto corporations and corporations by estoppel [are not] treated as corporations for all purposes; for example, their charters may be subject to successful challenge by the state in quo warranto proceedings; their officers, directors and shareholders may not be shielded from liability by the corporate form; and their assets may be vulnerable to the claims of creditors of the owners . . . . Opinion recipients seek assurance against

just this sort of uncertainty. For example, when a bank requests an opinion that its borrower is a corporation, it wants to know not only that a court would enforce the entity's obligation but also that, under corporate law, the entity's assets will be insulated from claims that might be brought against stockholders by their personal creditors.

7. See Special Committee, *supra* note 3, at 1906; Babb et al., *supra* note 5, at 558.

8. See notes 5-6, *supra*.

9. See *Geisenhoff v. Mabrey*, 58 CAL. APP. 2d 481, 137 P.2d 36, 40-41 (1943).

10. See *Gossett v. Schabelitz*, 74 CAL. APP. 2d 854, 169 P.2d 684, 687-88 (1946).

11. *Fitzgibbon & Glazer*, *supra* note 1, at 463.

12. There are, however, some items that mere examination of the Bylaws will not disclose. See *In Re Ivey & Ellington, Inc.*, 28 Del. Ch. 298, 42 A.2d 508, 508-10 (1945) (bylaw may be amended by implication without any formal action where a course of conduct is relied upon to effect the change and has continued for a period long enough to justify the inference that shareholders knew and consented).

13. See, e.g., *Belle Isle Corp. v. MacBean*, 29 Del. Ch. 261, 49 A.2d 5, 8-10 (1946) (resolution authorizing the issue of stock at a director's meeting where no quorum was present was illegal and the stock may be cancelled unless the action is later ratified at a meeting at which a quorum is present, but the subsequent approval of the minutes of an illegal meeting is not sufficient to be a ratification of such an unauthorized act).

14. See, e.g., *Young v. Janas*, 34 Del. Ch. 287, 103 A.2d 299, 300-302 (1954) (election of president of a corporation was invalid when it preceded his election as a director, even though both elections took place at the same meeting).

15. See generally WHAT CONSTITUTES DOING BUSINESS, CT CORPORATION SYSTEM (1985).

16. See *id.* at 10-11 (citing Alabama, Arkansas, Mississippi, and Vermont).

17. See, e.g., MAINE REV. STAT. ANN. tit. 13-A, § 1214(2) (West 1981 & Supp. 1990); S.C. CODE ANN. § 33-23-140(B) (Law Co-op. 1987). But see DEL. CODE ANN. tit. 8, § 383(a) (1983).

18. See *What Constitutes Doing Business, CT Corporation System* 19-25 (1985).

19. Compare W. VA. CODE § 31-1-49 (Michie 1988 & Supp. 1989) with VT. STAT. ANN., tit. 11, § 2101 (1984). See generally *Eli Lilly & Co. v. Sav-on-Drugs, Inc.*, 366 U.S. 276 (1961) (constitutional limitations on state qualification requirements).

20. See, e.g., CAL. CORP. CODE 703(b), (c) (West 1977 & Supp. 1990); *Italo Petroleum Corp. of America v. Producers' Oil Corp. of America*, 20 Del. Ch. 283, 174 A. 276, 279 (1934) (subsidiary barred from voting parent's shares for the election of directors).

21. W. Wynne, Jr., *Corporate Review in Connection with Mergers and Acquisitions*, ACQUIRING OR SELLING THE PRIVATELY HELD COMPANY 1989 (PLI, B4-6876).
22. See, e.g., *In the Matter of Farm Industries, Inc.*, 41 Del. Ch. 379, 196 A.2d 582, 590-92 (1963) (voting trustee can enforce an agreement even though he never filed the agreement or had the shares deposited as state statutes required since failure to do so did not affect any parties outside the agreement).
23. For example, as to shares pledged to secure a debt, see *Banker's Mortgage Co. v. Sohland*, 33 Del. Ch. 331, 138 A. 361, 361-62 (1927) (no record in the corporation's books is necessary to vest title in a pledgee).
24. See, e.g., *In re Giant Portland Cement Co.*, 26 Del. Ch. 32, 21 A.2d 697, 702-704 (1941) (stock held in the name of two persons who are also husband and wife, although the certificate does not disclose that, is held in tenancy by the entirety; and shares could not be voted by proxy signed by only one of the two).
25. See, e.g., *Investment Associates, Inc. v. Standard Power & Light Corp.*, 29 Del. Ch. 225, 48 A.2d 501, 516 (1946) (stock registered in name of decedent may be voted by an executor or administrator), *aff'd* 29 Del Ch. 593, 51 A.2d 572 (1947).
26. See, e.g., *Special Committee*, *supra* note 3, at 1909; *Babb et al.*, *supra* note 5, at 567. See also *Standard Scale & Supply Corp. v. Chappel*, 16 Del. Ch. 331, 141 A. 191, 195-97 (1928) (restrictions placed on stock without authority in statute or organizational documents are invalid).
27. *Special Committee*, *supra* note 3, at 1909.
28. See, e.g., *Pierce v. Guaranty Laundry, Inc.*, 200 Okla. 395, 194 P.2d 875, 876-77 (1948) (shares held not duly authorized).
29. See, e.g., *Scovill v. Thayer*, 105 U.S. 143, 148-50 (1881) (shares held not duly authorized).
30. See, e.g., *Triplex Shoe Co. v. Rice & Hutchins, Inc.*, 17 Del. Ch. 356, 152 A. 342, 345-46 (Del. 1930) (shares held not duly authorized).
31. See, e.g., notes 28-30, *supra*.
32. See, e.g., *Special Committee*, *supra* note 4, at 1910; *Babb et al.*, *supra* note 5, at 567.
33. See, e.g., N.Y. BUS. CORP. LAW 504(a) (McKinney 1983); TEX. BUS. CORP. ACT ANN. art. 2.16 (West 1980 & Supp. 1990). The Delaware statute is slightly different in that Delaware recognizes partly paid shares as validly issued, but subject to call for the remaining consideration. DEL. CODE ANN. tit. 8, §§ 152, 153, 156 (1983 & Supp. 1988). See generally *Highlights for Children, Inc. v. Crown*, 43 Del. Ch. 323, 227 A.2d 118 (1966).
34. See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 387 (1970); *Special Committee*, *supra* note 3, at 1910-11.
35. See, e.g. DEL. CODE ANN. tit. 8, § 152 (1983 & Supp. 1988); TEX. BUS. CORP. ACT Art. 2.16 (West 1980 & Supp. 1990).
36. See *id.*; CAL. CORP. CODE § 409 (West 1977 & Supp. 1990).

37. See *supra* note 33 and accompanying text.
38. See, e.g., *Bennett v. Breuil Petroleum Corp.*, 34 Del. Ch. 6, 99 A.2d 236, 240-41 (1953) (shareholder may maintain an action for the cancellation of a third-party shareholder's stock when the corporation did not receive the agreed consideration).
39. See, e.g., *Butler v. New Keystone Copper Co.*, 10 Del. Ch. 371, 93 A. 380, 382-84 (1915) (in the absence of fraud, directors' valuation of labor done or property received for stock issued is conclusive).
40. *Babb et al.*, *supra* note 5, at 568.
41. See, e.g., *Brown v. Portneuf-Marsh Valley Irr. Co.*, 299 F. 338, 348-50 (D. Idaho 1924) (although shares were nonassessable, corporation could assess part of the operating costs of the corporation from shareholders), *aff'd*, 274 U.S. 630 (1927).
42. *Babb et al.*, *supra* note 5, at 568-69.
43. BLACK'S LAW DICTIONARY 1060 (5th ed. 1979).
44. See, e.g., CAL. CORP. CODE § 406 (West 1977 & Supp. 1990); DEL. CORP. CODE § 102(b)(3) (1983 & Supp. 1988).
45. See, e.g., TEX. BUS. CORP. ACT art. 2.22-1 (West 1980 & Supp. 1990).
46. See *Barsan v. Pioneer Savings & Loan Co.*, 163 Ohio St. 424, 433-37, 127 N.E.2d 614 (1955); see also *Henn, CORPORATIONS* 263-64 (1961).
47. See, e.g., *Rowland v. Times Pub. Co.*, 160 Fla. 465, 35 So. 2d 399, 400-402 (1948) (cancellation of shares issued in violation of preemptive rights when sale was made to minority shareholders with the intent to dilute another majority shareholder).
48. See, e.g., *Gottlieb v. Heyden Chemical Corp.*, 32 Del. Ch. 231, 83 A.2d 595, 596-97, (1951) (amendment to certificate can eliminate accrued preemptive rights and is effective as long as no shareholder objects), *rev'd on other grounds*, 90 A.2d 660 (Del. 1952).
49. See *supra* note 22.