CHAPTER FOUR

INTERNAL AFFAIRS

Section 4.01 Registered Agents

Each corporation is required to continuously maintain a registered agent and a registered office within the state of Washington. RCW 23B.05.010(1). The registered agent may be an individual who resides in Washington, a Washington corporation, or a foreign corporation authorized to do business in Washington. RCW 23B.05.010(1)(b). The registered agent must consent in writing to the appointment and that written consent must filed with the Secretary of State. RCW

23B.05.010(2).

A registered agent is deemed to have authority to receive any process, notice, or demand required or permitted by law to be served upon the corporation. RCW 23B.05.040(1).

But the registered agent is not the corporation's exclusive agent for such purposes.

For instance, both RCW 4.28.080(9) and Federal Rule of Civil Procedure 4(h)(1) (in somewhat different language) permit service of process on any one of several persons, including the registered agent, the president, the secretary, and the corporation's managing agent. *United Pacific Insurance Co. v. Discount Co.*, 15 Wash App 559, 550 P2d 699 (1976).

Likewise, if a corporation is dissolved or if it has failed to maintain a registered agent as required by law, service may be made on the Secretary of State. RCW 23B.05.040(2). If a corporation is "without officers in state upon whom process can be served," RCW 4.28.090 describes special rules regarding service for lawsuits filed in the Washington courts.

Section 4.02 Dividends and Other Distributions

A. Definition.

RCW 23B.01.400(6) defines the term "distribution" to mean:

> a direct or indirect transfer of money or other property, except its own shares, or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect of any of its shares. A distribution may be in the form of a declaration or payment of a dividend; a purchase, redemption or other acquisition of shares; a distribution of indebtedness; or otherwise.

Thus, a distribution includes, but is not limited to, the payments commonly referred to as "dividends."

Both distributions and dividends may involve transfers of cash or the transfer of other property. RCW 23B.01.400(6); *Grants Pass Hardware Co. v. Calvert*, 71 Or 103, 142 P 569 (1914).

Corporate "profits" and "dividends" are not synonymous. *Boothe v. Summit Coal Mining Co.*, 55 Wash 167, 104 P 207 (1909)(Rudkin concurring). "It is fundamental that corporate earnings, though amounting to corporate assets, are not the equivalent of dividends until declared such by the directors of the corporation." *In re Clark's Trust*, 29 Misc 2d 253, 217 NYS2d 396, 399 (1961).

B. Power to declare.

A corporation has broad power to distribute its assets. *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 892 P2d 98 (1995). A corporation's board of directors is empowered to authorize the corporation to make distributions of corporate assets to the shareholders. RCW 23B.06.400(1). This is a power which rests with the board alone; the shareholders generally have no right to vote to make distributions to themselves. *Matter of Goerler*, 227 AD2d 479, 642 NYS2d 923 (1996); *Stipe v. First National Bank of Portland*, 208 Or 251, 301 P2d 175 (1956); *Southern Pacific Co. v. Lowe*, 247 US 330, 338 (1918).

> The sole power to declare and pay dividends rests with the board of directors of a corporation. . . . To permit the recovery of an undeclared dividend in an action at law would be the equivalent of allowing the court or jury before whom the case is tried to declare the dividend. "This, of course, is not the law; and, if each stockholder might call in a jury at his pleasure to determine whether a dividend should be declared, corporations would be short-lived affairs and of but little value." *Rubens v. Marion-Washington Realty Corp.*, 116 Ind App 55, 59 NE2d 907, 911 (1945)(quoting from *Knight v. Alamo Mfg. Co.*, 190 Mich 223, 157 NW 24 (1916)).

One early case indicates that where all of the shareholders are also all of the directors, the shareholders may authorize acts normally required to be authorized by the directors. *Steeple v. Max Kuner Co.*, 121 Wash 47, 208 P 44 (1922). Another case, in dicta, states that a distribution need not be authorized by the directors when the shareholders unanimously consent. *Zimmerman v. Kyte*, 53 Wash App 11, 765 P2d 905 (1988). But another early decision states that even a "sole stockholder is not entitled to demand the profits of the corporation until they have been set aside and ordered by the directors to be paid." *Central of Georgia Ry. Co. v. Central Trust Co. of New York*, 135 Ga 472, 491, 69 SE 708, 717 (1910). *See also: Cole Real Estate Corp. v. Peoples Bank & Trust Co.*, 160 Ind App 88, 310 NE2d 275 (1974).

The leading case on whether the shareholders may force the board of directors to declare a dividend is *Dodge v. Ford Motor Co.*, 204 Mich 459, 170 NW 668 (1919) which held that the decision to declare a dividend is normally one of internal corporate management by the board of directors subject to the business judgment rule.

> **NOTE:** RCW 23B.08.010(3) provides that a Washington corporation can be managed by the shareholders, instead of a board of directors. RCW 23B.07.320(1)(d) provides that certain written agreements by and among the shareholders may transfer "to one or more shareholders or other persons all or part of the

authority to exercise the corporate powers or to manage the business and affairs of the corporation." Thus, a written agreement which complies with this statutory provision may alter the usual procedures for declaring distributions. This section has not yet been interpreted by the Washington appellate courts. A discussion of RCW 23B.07.320 appears in Section 4.07 of this book.

C. The right of shareholders to force declaration of distributions.

Although directors generally possess the sole power to declare a distribution, under extraordinary circumstances, the shareholders may bring an action in equity to compel the declaration of a distribution. *Tefft v. Schaeffer*, 136 Wash 302, 239 P 837, *modified*, 239 P 1119 (1925); *United States v. Byrum*, 408 US 125, 142 (1972)(applying Ohio law); *Steele v. Locke Cotton Mills Co.*, 231 NC 636, 58 SE2d 620 (1950); *Kelly v. Galloway*, 156 Or 301, 66 P2d 272, 68 P2d 474 (1937); *Baillie v. Columbia Gold Mining Co.*, 86 Or 1, 166 P 965, 167 P 1167 (1917).

> As a general rule the officials of a corporation are the sole judges as to the propriety of declaring dividends and the courts will not interfere with the proper exercise of that discretion. Yet when the right to a dividend is clear and there are funds from which it can properly be made, a court of equity will interfere to compel a company to declare it. Directors are not allowed to use their power illegally, wantonly, or oppressively. *W. Q. O'Neall Co. v. O'Neall*, 108 Ind App 116, 25 NE2d 656, 659 (1940).

Courts are reluctant to substitute the courts' judgment for the business judgment of the board of directors regarding distributions.

> It is settled law in Delaware, and elsewhere, that the declaration of a dividend rests in the discretion of a corporation's board of directors in the exercise of its business judgment. *Mann-Paller Foundation, Inc. v. Econometric Research, Inc.*, 644 F Supp 92, 96 (1986).

In another decision, the court stated:

> We have recognized that those in control of corporate affairs have fiduciary duties of good faith and fair dealing toward the minority shareholders. Insofar as dividend policy is concerned, however, that duty is discharged if the decision is made in good faith and reflects legitimate business purpose rather than the private interests of those in control. (citations omitted) *Zidell v. Zidell, Inc.*, 277 Or 413, 418, 560 P2d 1086, 1089 (1977).

Courts have held that there are countless reasons for a corporation to retain profits, any one of which will likely defeat a shareholder action to compel the declaration of a distribution.

> Even where there are corporate earnings, the legal power to declare dividends is vested solely in the corporate board. In making decisions with respect to dividends, the board must consider a number of factors. It must balance the expectation of stockholders to reasonable dividends when earned against corporate needs for retention of earnings. The first responsibility of the board is to safeguard corporate financial viability for

> the long term. This means, among other things, the retention of sufficient earnings to assure adequate working capital as well as resources for retirement of debt, for replacement and modernization of plant and equipment, and for growth and expansion. The nature of a corporation's business, as well as the policies and long range plans of management, are also relevant to dividend payment decisions. Directors of a closely hold, small corporation must bear in mind the relatively limited access of such an enterprise to capital markets. This may require a more conservative policy with respect to dividends than would be expected of an established corporation with securities listed on national exchanges. (footnote omitted) *United States v. Byrum*, 408 US 125, 140 (1972)(applying Ohio law).

The bottom line is: courts will generally defer to the business judgment of the board of directors on whether or not a corporation should issue a dividend. Courts will intervene and order a dividend only in extraordinary situations, such as when the directors have acted fraudulently, arbitrarily, or motivated by some improper motive.

D. Shareholder rights after dividend declared.

Once a dividend has been properly authorized by the board of directors, each shareholder has a legal right to receive the declared dividend and each shareholder may sue individually to enforce that right. RCW 23B.06.400(5); *McJannet v. Strehlow Supply Co.*, 25 Wash 2d 468, 171 P2d 684 (1946); *Gellerman v. Atlas Foundry & Machine Co.*, 45 Wash 114, 87 P 1059 (1906).

> When the dividend was declared, the defendant became indebted to each shareholder for his share, and each was in the same position as any other creditor of the corporation and had a right to enforce or assign his demand in like manner. *Steel v. Island Milling Co.*, 47 Or 293, 297, 83 P 783, 785 (1906).

See also: Mann-Paller Foundation, Inc. v. Econometric Research, Inc., 644 F Supp 92, 96 (DDC 1986); *Cole Real Estate Corp. v. Peoples Bank and Trust Co.*, 160 Ind App 88, 310 NE2d 275 (1974); *In re Wilson's Estate*, 85 Or 604, 167 P 580 (1917).

Once the board of directors declares a dividend, the board may not change its mind and rescind the distribution.

> When the dividend was declared, the defendant became indebted to each shareholder for his share, and each was in the same position as any other creditor of the corporation and had a right to enforce or assign his demand in like manner. [A] dividend properly declared by the directors of a corporation cannot subsequently be revoked; and that persons who are shareholders at the time the dividend is declared have a legal claim against the company for the payment of the amount of the dividend; and that, after profits have been set apart and appropriated to the payment of the dividends, they belong to the shareholders, and cannot be recalled, even though the company should suffer losses and become insolvent before the dividend is actually paid. *Albany Fertilizer & Farm Improvement Co. v. Arnold*, 103 Ga 145, 148, 29 SE 695, 696 (1897).

But, the shareholders may unanimously agree to permit the corporation to revoke the dividend. *McJannet v. Strehlow Supply Co.*, 25 Wash 2d 468, 171 P2d 684 (1946).

Once a distribution has been declared, the right to that distribution does not automatically transfer with the transfer of a share. Absent an agreement to the contrary, the right to the distribution remains with the person who owned the share on the record date of the declaration. *McIlvaine v. AmSouth Bank, NA*, 581 So2d 454 (Ala 1991); *In re Wallace's Estate*, 131 Or 597, 282 P 760 (1930); 60 ALR 703. *But see: Drexel Burnham Lambert, Inc. v. Chapman*, 174 Ga App 336, 329 SE2d 595 (1985)(owner of shares on distribution date, not record date, entitled to a stock dividend). However, if the price paid for the shares includes the dividend, the dividend will pass with the shares. *McJannet v. Strehlow Supply Co.*, 25 Wash 2d 468, 171 P2d 684 (1946).

***E. Dividends on preferred shares*.**

The articles of incorporation may authorize one or more classes of shares which have "preference over any other class of shares with respect to distribution, including dividends and distributions upon the dissolution of the corporation." RCW 23B.06.010(3)(d). Shares with such preferences are frequently referred to as "preferred shares."

But the designation of shares as "preferred" has no special legal meaning, rather, such a designation only has the meaning defined for it in the corporation's articles of incorporation. *Waggoner v. Laster*, 588 A2d 1127 (Del Supr 1990); *Gaskill v. Gladys Bell Oil Co.*, 146 A 337 (Del Ch 1929).

Preferred shares may have a right to dividends which is "cumulative, noncumulative or partially cumulative." RCW 23B.06.010(3)(c). A "cumulative" dividend means that dividends for that year and all preceding years are paid on preferred shares before any dividends may be paid to inferior classes for that year. *Arizona Power Co.v. Stuart*, 212 F2d 535, 539 (9th Cir 1954). In order to determine the rights of owners of preferred shares, it is necessary to look at the articles of incorporation and to other contract rights of the shareholders. *Waggoner v. Laster*, 588 A2d 1127 (Del Supr 1990); *Collins v. Portland Electric Power Co.*, 7 F2d 221 (D Or 1925), *affirmed*, 12 F2d 671 (9th Cir 1926).

The owner of preferred shares has the status of a shareholder, not the status of a creditor. An agreement to give preferred shareholders a

higher claim to corporate assets than the claim of general creditors is against public policy and unenforceable. *O'Neal v. Automotive Piston & Parts Co.*, 188 Ga 380, 4 SE2d 40 (1939); *Hewitt v. Linnhaven Orchard Co.*, 90 Or 1, 174 P 616 (1918). As such, dividends are not due the preferred shareholders until declared by the board of directors in their honest discretion. *Treves v. Menzies*, 37 Del Ch 330, 142 A2d 520 (1958); *W. Q. O'Neall Co. v. O'Neall*, 108 Ind App 116, 25 NE2d 656 (1940).

Although some courts are more inclined to intervene to protect the rights of preferred shareholders to dividends, *W. Q. O'Neall Co. v. O'Neall*, 188 Ga 380, 4 SE2d 40 (1939), other courts are not so inclined. *Welch v. Atlantic Gulf & West Indies S.S. Lines*, 101 F Supp 257 (ED NY 1951).

> **NOTE:** If one class of stock is given a preference over another class of stock, the articles of incorporation should specify the nature of the preference (*e.g.*, "$1.00 per share per calendar year before any distributions may be paid on the common shares"); specify whether the preference is cumulative or non-cumulative (*i.e.*, whether or not the right to the distribution carries over to subsequent years and is or is not aggregated with the preference for such years. *See: Collins v. Portland Electric Power Co.*, 7 F2d 221 (D Or 1925), *affirmed*, 12 F2d 671 (9th Cir 1926); *Allied Magnet Wire Corp. v. Tuttle*, 199 Ind 166, 154 NE 480, 156 NE 558 (1926)); and specify whether the preferred shares have the right to additional distributions after receiving the preference distribution (*i.e.*, is a preferred share entitled to any additional sum after receiving its preferred dividend in the event a distribution is later declared for the common shares). The articles of incorporation must also specify the relative rights of the shares upon liquidation. RCW 23B.06.010(3)(d) & RCW 23B.06.020. *See: Haworth v. Hubbard*, 220 Ind 611, 44 NE2d 967 (1942). Keep in mind that the Act's use of the term "distribution" encompass dividends, as well as the purchase or redemption of shares, and many other transfers between the corporation and the shareholder. RCW 23B.01.400(6).

F. When can board of directors declare distributions: early tests.

In the early evolution of corporate law, the shareholders' original capital contributions (*i.e.*, the total amount that all shareholders paid the

corporation for their stock) were considered sacred and untouchable. These original contributions could only be redistributed to the shareholders upon liquidation and after payment of all creditors. Some courts went so far as to describe these original capital contributions as a "trust fund" for the creditors. *Lantz v. Moeller*, 76 Wash 429, 136 P 687 (1913); *McDonald v. Williams*, 174 US 397 (1899).

The "stated capital" of a corporation was the aggregate of all issued shares multiplied by the par value of those shares. The "capital surplus" was the aggregate of all the sums originally paid for all issued shares, less the stated capital. Originally, it was the "stated capital" which was considered the trust fund and out of which dividends could not be paid (as long as the corporation remained a going concern). Many states imposed restrictions on the payment of dividends out of capital surplus as well.

The net worth of a corporation in excess of the capital contributions exchanged for its stock (*i.e.,* its stated capital plus its capital surplus) was referred to by a number of terms including: "earned surplus," "unreserved and unrestricted earned surplus," "profits," "capital surplus," or "net earnings." Until modern times, most state statutes prohibited a corporation from paying a dividend out of this earned surplus (while the corporation remained a going concern). *Northern Bank & Trust Co. v. Day*, 83 Wash 296, 145 P 182 (1915); *Collins v. Portland Electric Power Co.*, 7 F2d 221 (D Or 1925), *affirmed*, 12 F2d 671 (9th Cir 1926); Basye, *Recent Amendments to Certain Financial Provisions of the Oregon Business Corporation Act*, 472 OR L REV 320, 325 (1968).

Over time, this strict limitation on the payment of distributions weakened. One by one, states adopted statutes which permitted some portion of the shareholders' original capital contributions to be redistributed to them even though the corporation continued to be a going concern (so long as the corporation remained solvent).

Prior to the effective date of the present Act, Washington permitted distributions only out of "capital surplus." RCW 23A.08.430. "Capital surplus" meant the "entire surplus" not just the earned surplus. RCW 23A.04.010(13). The corporation could not pay distributions out of stated capital, that is generally, out of the aggregate of the par values of all shares previously issued. RCW 23A.04.010(10), (11), and (12).

For a discussion of permitted distributions under the old law, see Kummert, "State Statutory Restrictions on Financial Distributions by Corporations to Shareholders: Part I," 55 WASH L REV 359 (1980) and

Kummert, "State Statutory Restrictions on Financial Distributions by Corporations to Shareholders: Part II," 59 WASH L REV 185 (1984).

G. Solvency test.

Most states have now adopted a form of "solvency" test. Under a solvency test, distributions may be declared as long as the payment does not render the corporation unable to pay its bills as they come due or as long as the payment does not reduce the corporation's total assets below its total liabilities.

The "solvency" test is the least restrictive test permitted. A distribution which violates the solvency test would likely constitute a fraudulent conveyance as well. Likewise, since directors of an insolvent corporation owe a duty to corporate creditors to prevent the dissipation of corporate assets, a distribution which violates the solvency test would likely constitute a breach of the directors' common law duty to creditors. *See:* Sections 9.08 and 12.07.

H. Washington applies solvency test.

Washington law no longer uses the terms "stated capital," "capital surplus," or "earned surplus". Distributions may now be made out of the original capital contributions of the shareholders.

With the 1990 Act, Washington adopted a modified solvency test for distributions. Pursuant to RCW 23B.06.400(2), which is based upon Revised Model Business Corporation Act § 6.40, no distributions can be made if, after giving effect to the distribution,

> (a) The corporation would not be able to pay its debts as they become due in the usual course of business; or
>
> (b) The corporation's total assets would be less than the sum of its total liabilities plus, unless the articles of incorporation permit otherwise, the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of the shareholders whose preferential rights are superior to those receiving the distribution.

The approach taken by this language is essentially the "solvency" approach. The one deviation from a strict "solvency" approach is that the amount necessary upon dissolution to satisfy shareholders with preferential rights superior to the distributees must be treated as a liability for purposes of determining net worth (*i.e.*, solvency).

The new Act has also simplified the terminology. Dividends, redemptions, partial liquidations, and other such transfer are now all simply referred to as "distributions."

A distribution made while a corporation is insolvent is illegal. Thus,

if a corporation enters into a contract to repurchase some of its shares during a period of insolvency, the contract is illegal and unenforceable against the corporation. *Field v. Haupert*, 58 Or App 117, 647 P2d 952 (1982). However, in determining solvency, the market value of corporate assets (not necessarily its book value), including intangible assets, should be taken into account. *Hansen v. Singmaster Insurance Agency, Inc.*, 80 Or App 329, 722 P2d 1254, *opinion adhered to*, 82 Or App 219, 728 P2d 69 (1986), *rehearing denied*, 302 Or 594, 732 P2d 915 (1987). In the context of a leveraged buyout, the going concern value, rather than the book value, of a corporation's assets may be the appropriate value for determining solvency. *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 892 P2d 98 (1995); *Moody v. Security Pac. Business Credit, Inc.*, 971 F2d 1056 (3d Cir 1992).

***I. Delayed distributions*.**

Not all distributions occur immediately. Under prior law, a corporation had to be solvent not only on the date that the distribution obligation was authorized or incurred, but it had to remain solvent throughout the period over which payments were made. *In the Matter of Poole, McGonigle & Dick, Inc.*, 796 F2d 318 (9th Cir 1986). This posed particular difficulties in a partial liquidation where a former shareholder was to receive payments over several years.

The rule changed. With respect to stock repurchase contracts which call for one or more payments at a later date, RCW 23B.06.400(4) now provides that the effect of the distribution is measured as follows:

> (a) In the case of a distribution of indebtedness, the terms of which provide that payment of principal and interest are made only if and to the extent that payment of a distribution to shareholders could then be made under this section, each payment of principal or interest is treated as a distribution, the effect of which is measured on the date the payment is actually made; or
>
> (b) In the case of any other distribution:
>
> (i) If the distribution is by purchase, redemption or other acquisition of the corporation's shares, the effect of the distribution is measured as of the earlier of the date the money or other property is transferred or debt incurred by the corporation, or the date the shareholder ceases to be a shareholder with respect to the acquired shares;
>
> (ii) If the distribution is of indebtedness other than that described in subsection (4)(a) and (b)(i) of this section, the effect of the distribution is measured as of the date the indebtedness is distributed; and

> (iii) In all other cases, the effect of the distribution is measured as of the date the distribution is authorized if the payment occurs within one hundred and twenty days after the date of authorization, or the date the payment is made if it occurs more than one hundred and twenty days after the date of authorization.

In the context of a leveraged buyout, the going concern value, rather than the book value, of a corporation's assets may be the appropriate value for determining solvency. *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 892 P2d 98 (1995); *Moody v. Security Pac. Business Credit, Inc.*, 971 F2d 1056 (3d Cir 1992); *Hansen v. Singmaster Insurance Agency, Inc.*, 80 Or App 329, 722 P2d 1254, *opinion adhered to*, 82 Or App 219, 728 P2d 69 (1986), *rehearing denied*, 302 Or 594, 732 P2d 915 (1987).

As long as it complies with the above provisions, a corporation's indebtedness to a former shareholder is at parity with its indebtedness to general unsecured creditors, absent an agreement to the contrary. RCW 23B.06.400(5). However, the U.S. Bankruptcy Code provisions regarding insider preferences sometimes supersede this provision. 11 USC § 547.

A more detailed discussion of distributions appears in Peterson & Hawker, *Does Corporate Law Matter? Legal Capital Restrictions on Stock Distributions*, 31 AKRON L REV 17 (1997); Art, *Corporate Shares and Distributions in a System Beyond Par Value: Financial Provisions of Oregon's New Corporation Act*, 24 WILL L REV 203 (1988); McGough, *Statutory Limits on a Corporation's Right to Make Distributions to Shareholders: The Law of Distribution in the 1984 Revised Model Business Corporation Act*, 21 AKRON L REV 27 (1987).

***J. Liability for illegal distributions*.**

Illegal distributions made while a corporation is insolvent are void. *Spokane Merchants' Association v. Lobe*, 13 Wash App 68, 533 P2d 133 (1975).

RCW 23B.08.310(1) provides that a director who votes for an unlawful distribution may be liable to the corporation for that unlawful distribution, unless the director complies with the standards of conduct set out in RCW 23B.08.300. This topic is discussed in Section 9.07 of this book.

A director held liable for an unlawful distribution is entitled to contribution from "each shareholder for the amount the shareholder accepted knowing the distribution was made in violation of RCW 23B.06.400 or the articles of incorporation." RCW 23B.08.310(2)(b). This

topic is discussed in more detail in Section 10.12 of this book.

There is a two-year period for bringing such lawsuits. RCW 23B.08.310(3).

Section 4.03 Share/Stock Dividends

A. Current rule.

A "share dividend" or "stock dividend" is a pro rata dividend which consists of new shares created and issued by a corporation. *Joyce v. Congdon*, 114 Wash 239, 195 P 29 (1921).

Prior to the effective date of the Act, distributions could not be paid out of the stated capital, that is, out of the aggregate of the par values of all issued shares. *See:* Section 4.02 of this book. Thus, the issuance of a stock dividend increased stated capital and was permitted only where there was sufficient surplus earnings available to increase stated capital to include the newly issued shares. *Northern Bank & Trust Co. v. Day*, 83 Wash 296, 145 P 182 (1915); *Lantz v. Moeller*, 76 Wash 429, 136 P 687 (1913).

The present Act no longer contains references to "stated capital" and distributions now may generally be made as long as the corporation is solvent. *See:* Section 4.02 of this book.

In fact, a share dividend is expressly excluded from the definition of the term "distribution" in RCW 23B.01.400(6). Thus, unless the articles of incorporation provide otherwise, a board of directors may authorize the issuance of a pro rata share dividend to the shareholders.

> Unless the articles of incorporation provide otherwise, shares may be issued pro rata and without consideration to the corporation's shareholders or to the shareholders of one or more classes or series. An issuance of shares under this subsection is a share dividend. RCW 23B.06.230(1).

Except under specified circumstances, a corporation may not issue to shareholders of one class or series the shares of a different class or series of shares. RCW 23B.06.230(2).

B. Old rule.

Today, share dividends are not subject to the same restrictions concerning the corporation's financial condition as are cash distributions since share dividends are not a true dividend, but rather, a mere incident in corporate bookkeeping.

For states which still have statutes prohibiting distributions from stated capital, the issuance of a share dividend has the effect of increasing stated capital (since stated capital is determined by multiplying the number of issued shares by their par value). Thus, in some such

jurisdictions, the issuance of a share dividend is only permitted if there are sufficient net earnings available to increase stated capital to include the newly issued shares. *Northern Bank & Trust Co. v. Day*, 83 Wash 296, 145 P 182 (1915); *Lantz v. Moeller*, 76 Wash 429, 136 P 687 (1913); *Anacomp, Inc. v. Wright*, 449 NE2d 610 (Ind App 1983).

In other jurisdictions, courts have held that a share dividend was permitted despite statutes or case law regarding "stated capital."

> A stock dividend takes nothing from the property of the corporation and adds nothing to the interests of the shareholders. The property of the corporation is not diminished. The stockholders' interests are not increased. Their proportional interests remain the same. The only change is in the evidence which represents a given stockholder's interest, that is, the new shares representing the same proportional interest that the original shares represented before the issue of the stock dividend. In short, the corporation is no poorer and the stockholder is no richer than they were before. A stock dividend is, therefore, not in any true sense a dividend at all. Its issuance is, in the last analysis nothing more than an incident or process in corporation bookkeeping. *Stipe v. First National Bank of Portland*, 208 Or 251, 274, 301 P2d 175, 186 (1956).

A share dividend "does not add anything to or take anything away from a shareholder's proportionate interest in the corporation." *English v. United States*, 270 F2d 876, 880 (7th Cir 1959).

> It is somewhat of a misnomer to call it a "dividend" because it is really just a further division of shares in the company's ownership. Nothing concrete is *gained* thereby except that smaller shares, being less costly per share, have a wider market and therefore attract more trading. But when it is issued, the stockholder has the same percentage ownership in the company he had before, relative to all other stockholders. *Drexel Burnham Lambert, Inc. v. Chapman*, 174 Ga App 336, 338, 329 SE2d 595, 598 (1985).

Thus some jurisdictions, but not all, prohibited a stock dividend unless there was sufficient capital surplus.

***C. Share splits*.**

Some courts made a distinction between share dividends and share splits. A share split is a pro rata division of all issued shares into a greater or lesser number of shares. *Anacomp, Inc. v. Wright*, 449 NE2d 610 (Ind App 1983).

> The effect of a stock split is merely to change the form of the stockholder's interest in the company, but not the substance of his property. It simply involves a division of the outstanding shares into more units, each with less value. Each stockholder's proportionate share of ownership, his rights on dissolution, and the total value of his investment in the corporation are maintained intact. The only significant changes are the issuance of a new certificate and a reduction in the market value of each share unit, which usually increase marketability of the shares. *Rogers Walla Walla, Inc. v. Ballard*, 16 Wash App 81, 87, 553 P2d 1372, 1376 (1976).

A stock split does not violate public policy. *Fox v. McKeown*, 154 Wash 34, 280 P 939 (1929).

Like a share dividend, a stock split does not effect the relative ownership of the shareholders since the new shares are issued pro rata. A share dividend has the same effect as would a share split. A stock split is permitted under the current Washington Act without regard to "stated capital."

Section 4.04 Corporate Records

A corporation is required to keep certain records. For instance, a corporation must maintain minutes of corporate meetings, appropriate accounting records, and a list of shareholders in alphabetical order by class. RCW 23B.16.010. *See also:* RCW 23B.07.200.

RCW 23B.16.010(5) requires that the corporation keep a copy of the following records at its principal office or registered office:

(a) Its articles or restated articles of incorporation and all amendments to them currently in effect;

(b) Its bylaws or restated bylaws and all amendments to them currently in effect;

(c) The minutes of all shareholders' meetings, and records of all action taken by shareholders without a meeting, for the past three years;

(d) The financial statements described in RCW 23B.16.200(1), for the past three years;

(e) All written communications to shareholders generally within the past three years;

(f) A list of the names and business addresses of its current directors and officers; and

(g) Its initial report or most recent annual report delivered to the secretary of state under RCW 23B.16.220.

A corporation's records must be maintained either in written form or in a form capable of conversion to written form. RCW 23B.16.010(4).

The right of shareholders to inspect corporate records is discussed in Section 4.06 of this book. Corporate minutes are discussed in Section 5.06 of this book.

Section 4.05 Limited Liability & Indemnity of Officers and Directors

A. Limited liability.

A corporation may include a provision in its articles of incorporation which eliminates or limits the personal liability of directors to the

corporation or to the shareholders. RCW 23B.02.020(5)(j) & RCW 23B.08.320. But a corporation may not so eliminate or limit directors' liability for intentional acts of misconduct, for unlawful distributions, or for any transaction involving improper personal benefit. RCW 23B.08.320. Likewise, a corporation may not retroactively adopt provisions eliminating or limiting liability. *Id*.

***B. Permissive indemnity of directors & officers*.**

A corporation may indemnify a past or present director for his/her good faith acts, except where the individual has been adjudicated liable to the corporation itself or adjudicated liable to anyone on the basis of improper personal benefit. RCW 23B.08.510.

A corporation may indemnify officers, agents, and employees in the same manner. RCW 23B.08.570.

Except as limited by RCW 23B.08.510, a director or officer's right to mandatory indemnity may be expanded by the corporation's articles of incorporation, bylaws, or vote of the shareholders. RCW 23B.08.560.

A bylaw provision concerning the extent of indemnity which conflicts with the terms of the articles of incorporation is void. *Sabre Farms, Inc. v. Jordan*, 78 Or App 323, 717 P2d 156 (1994).

A corporation may advance litigation expenses to directors pending final disposition of the litigation. RCW 23B.08.530. Likewise, a corporation may advance litigation expenses to an officer, agent and employee to the same extent as to a director. RCW 23B.08.530(2).

***C. Mandatory indemnity of directors & officers*.**

Unless limited by its articles of incorporation, a corporation is required to indemnify directors who prevail in any litigation in which the director was a party because he/she was a director. RCW 23B.08.520. This same right is extends to officers. RCW 23B.08.570(1).

RCW 23B.08.540 authorizes a court to order indemnification of a director under two circumstances. First, a court may order a corporation to indemnify a director if it determines the director is entitled to mandatory indemnification under RCW 23B.08.520. Second, a court may order indemnification if it determines the director "is fairly entitled to indemnification in view of all the relevant circumstances, whether or not the director met the standard of conduct set forth in RCW 23B.08.510 or was adjudicated liable as described in RCW 23B.08.510(4)."

An officer is entitled to court ordered indemnification to the same extent as a director. RCW 23B.08.570(1).

One court has held that a board of directors need not comply with the usual conflicts of interest procedures in order to make a good faith advancement of such litigation expenses. *Service Corporation International v. H.M. Patterson & Sons, Inc.*, 263 Ga 412, 434 SE2d 455 (1993).

If a director or officer is entitled to indemnification, the amount due is on par with the debts due other creditors. Upon dissolution, any such indemnity must be paid before distribution of assets to the shareholders. *Crocker v. Stevens*, 210 Ga App 231, 435 SE2d 690 (1993).

A more detailed discussion of the indemnity of directors and officers appears in Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L J 1155 (1990); Roy & Frassetto, *Exculpation and Indemnification of Corporate Directors under Oregon's New Corporation Code*, 24 WILL L REV 257 (1988); *Note*, 17 Val U L Rev 230 (1983).

Section 4.06 Shareholder Right to Inspect Records

A. Statutory right to inspect.

Pursuant to RCW 23B.07.200 and RCW 23B.16.020, shareholders have the right to inspect specified corporate records.

RCW 23B.07.200 grants shareholders the right to inspect the shareholder list from ten days before, and throughout, any shareholder meeting. RCW 23B.16.020 grants shareholders the right to inspect certain other records, records which include meeting minutes and accounting records.

A shareholder may specify the date of inspection; the corporation the location. RCW 23B.16.020(2). A shareholder's demand must be made in good faith and for a proper purpose and the purpose must be set out in the shareholder's demand. RCW 23B.16.020(3).

A shareholder's right to inspect corporate records exists independent of statute and a shareholder's common law right to inspect records may be greater than the right granted by statute.

> But even if the statute has been repealed, the common law right of a stockholder to examine the books and records of the corporation at proper times and for proper purposes remains. And, under the common law rule, as it prevails in most states, . . the burden of showing improper motives on the part of the shareholder in demanding an inspection of the books and records of the corporation is upon the defendant. It is presumed, until the contary (sic) is shown, that the shareholder seeks the information for a proper purpose. This is the rule that prevails in this state. (citations omitted) *State ex rel Grismer v. Merger Mines Corp.*, 3 Wash 2d 417, 420-21, 101 P2d 308, 310 (1940).

See also: Bernert v. Multnomah Lumber & Box Co., 119 Or 44, 247 P 155, 248 P 156 (1926); *but see: Southern Acceptance Corp. v. Nally*, 222 Ga 534, 150 SE2d 653 (1966).

A shareholder's common law right to inspect corporate books and records flows from the shareholder's proprietary interest in the corporation.

> Although there may be reasons of public policy why the stockholders of a corporation should have the right to examine its books and records, the primary basis for that right is not one of public policy, but the private and proprietary interest of stockholders, as owners of the corporation. (footnotes omitted) *Campbell v. Ford Industries, Inc.*, 274 Or 243, 249-50, 546 P2d 141, 145 (1976).

B. Proper purpose.

A shareholder may only inspect records for a proper purpose. RCW 23B.16.020(3).

When the corporation sustains its burden and proves that the shareholder seeks inspection "for her own interests rather than in the best interests of the corporations" and that the shareholder's reasons for inspection "are inimical to the best interests of the trustee and the corporations," the court will uphold the corporation's refusal to permit inspection. *State ex rel Paschall v. Scott*, 41 Wash 2d 71, 74, 247 P2d 543, 545 (1952).

One court has held that "improper purpose" includes inspection for nonderivative litigation and for competitive purposes. *Dynamics Corp. of America v. CTS Corp.*, 479 NE2d 1352, 1355 (Ind App 1985).

C. Court ordered inspection.

RCW 23B.16.040 and 23B.07.200(4) provide that if the corporation refuses to allow inspection, a shareholder may seek a court order requiring inspection. If it orders inspection, the court is also required to award the shareholder his/her costs (including reasonable attorney fees), unless the corporation proves that it acted in good faith. RCW 23B.16.040(3).

The provisions in the Act which give the shareholder the right to inspect records do not limit the power of the court to compel inspection independent of the Act. Thus a court may order inspection of corporate records under the rules of civil procedure pertaining to discovery and may enforce any common law right to inspect. RCW 23B.16.020(5).

RCW 23B.16.040 applies to shareholders; not necessarily former shareholders. *See: Biberstine v. New York Blower Co.*, 625 NE2d 1308 (Ind App 1993).

Section 4.07 Shareholder Agreements in Close Corporations

In 1995, the Legislature adopted which permits a non-public corporation to adopt procedures otherwise inconsistent with the Washington Business Corporation Act by means of a shareholder agreement. Such an agreement may work to change many of the fundamental rules which normally would govern a corporation.

RCW 23B.07.320(1) provides that such an agreement:

> is effective among the shareholders and the corporation even though it is inconsistent with one or more other provisions of this title in that it:
>
> (a) Eliminates the board of directors or restricts the discretion or powers of the board of directors;
>
> (b) Governs the authorization or making of distributions whether or not in proportion to ownership of shares, subject to the limitations in RCW 23B.06.400;
>
> (c) Establishes who shall be directors or officers of the corporation, or their terms of office or manner of selection or removal;
>
> (d) Governs, in general or in regard to specific matters, the exercise or division of voting power by or between the shareholders and directors or by or among any of them, including use of weighted voting rights or director proxies;
>
> (e) Establishes the terms and conditions of any agreement for the transfer or use of property or the provision of services between the corporation and any shareholder, director, officer, or employee of the corporation or among any or them;
>
> (f) Transfers to one or more shareholders or other persons all or part of the authority to exercise the corporate powers or to manage the business and affairs of the corporation;
>
> (g) Provides a process by which a deadlock among directors or shareholders may be resolved;
>
> (h) Requires dissolution of the corporation at the request of one or more shareholders or upon the occurrence of a specified event or contingency; or
>
> (i) Otherwise governs the exercise of the corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors, and the corporation, or among any of them.

For such an agreement to be effective, either: (i) it must be approved in writing by all persons who are shareholders at the time of the agreement and made known to the corporation; (ii) it must be subject to amendment only by all persons who are shareholders at the time of the amendment, unless the agreement provides otherwise; and (iii) it must be valid for ten years or less, unless the agreement provides otherwise.

RCW 23B.07.320(2).

Such a shareholder agreement ceases to be effective if the shares of a corporation's stock become publicly traded on a national exchange or market. RCW 23B.07.320(4).

If such an agreement is adopted, share certificates must conspicuously note the existence of the agreement. RCW 23B.07.320(3). The existence of such an agreement may shift liability for certain discretionary acts from the directors to the shareholders. RCW 23B.07.320(5). RCW 23B.07.320(6) reaffirms the limited liability of shareholders, even though such an agreement has been adopted and/or the shareholders fail to observe usual corporate formalities.

RCW 23B.07.320 is modeled on provisions in a 1983 Close Corporation Supplement to the Revised Model Business Corporation Act which was adopted related to close corporations. This Supplement was substantially revised in 1997 after Washington adopted RCW 23B.07.320.

The 1983 Close Corporation Supplement is discussed in Kessler, *The ABA Close Corporation Statute*, 36 MERCER L REV 661 (1985); *Statutory Needs of Close Corporations - An Empirical Study: Special Close Corporation Legislation or Flexible General Corporation Law*, 10 J CORP L 849 (1985).