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Quarterly State Compliance Review

By Sandra Feldman

This edition of the Quarterly State Compliance Review looks at some legislation of interest to corporate lawyers that went into effect Jan. 1, 2017. It also looks at recent decisions of interest from the courts of Delaware, New York, California and Pennsylvania.

IN THE STATE LEGISLATURES

Legislative activity was fairly light during the last quarter of 2016. However, some significant amendments to business entity statutes did go into effect on Jan. 1, 2017. Highlights from around the country include the following:

In Alabama, House Bill 202 enacted a new limited partnership act, providing mandatory and default rules regarding formation, dissolution, limited and general partners, economic and management rights and other provisions governing limited partnerships. In California, Assembly Bill 1722 amended the LLC law to require the vote of 50% or more of members to dissolve an LLC and the vote of 50% or more of members, managers, or persons signing the articles of organization to cancel the articles of an LLC that conducted no business.

In Indiana, House Bill 1336 authorized the formation of series LLCs. A series LLC’s articles of organization must authorize the designation of one or more series, the operating agreement must establish the series, and articles of designation must be filed for each series. There is also provision for the registration of foreign series LLCs and foreign series.

In New York, the Not-For-Profit Corporation Law was amended by Assembly Bills 8072 and 7641 (Laws of 2013 and 2015) to provide that no employee of the corporation shall serve as chair of the board or hold any other title with similar responsibilities. And in Nebraska, a new business corporation law went into effect. Originally enacted in 2014 by Legislative Bill 749, and amended in 2016 by Legislative Bill 794, the new law is based on the Model Business Corporations Act and enacts changes to various provisions including those governing shares and distributions, shareholder meetings, consents and voting, electronic communications, officer duties, and dissolution.

IN THE STATE COURTS

DE Supreme Court Rules on Setoff and Recoupment Defenses

In Finger Lakes Capital Partners, LLC v. Honeoye Lake Acquisition, LLC, No. 42, 2016 (Delaware Supreme Court) decided Nov. 14, 2016, the plaintiffs formed an investment vehicle to own several portfolio companies. They contacted the defendant to be the money partner. The parties signed a term sheet that required them to split the management fees. A dispute arose over about how to distribute the proceeds from the sale of one of the portfolio companies. The plaintiffs filed suit and the defendant counterclaimed seeking to recover management fees. The plantiffs argued that laches prevented the defendant from recovering fees earned earlier than three years before filing its counterclaim. The Chancery Court rejected that argument, ruling that the defendant could rely on the earlier amounts to support its recoupment and setoff defenses, which were not subject to the three year statute of limitations. The plaintiff appealed.

The Delaware Supreme Court reversed the Chancery Court's ruling. The court noted that setoff, being a defense arising out of a claim unrelated to the suit being brought by the plaintiff, is subject to the three-year statute of limitations. However, time-barred claims can be considered for recoupment when they arise out of the same transaction as the plaintiff's claim. In this case, the defendant's attempt to use the fees arising from the management of multiple portfolios was not factually related to the plaintiffs' claim for a distribution of proceeds from the sale of one company. Thus, the defendant could only assert the earlier amounts as a setoff, which was time barred.

DE Chancery Court Appraises Fair Value of Regional Bank

Dunmire v. Farmers & Merchants Bancorp of Western Pennsylvania, Inc., C.A. No. 10589 (Delaware Chancery Court) decided Nov. 10, 2016, was an appraisal action brought by a shareholder of a regional bank that merged into another bank in an exchange that valued the regional bank at $83 per share.

The Delaware Chancery Court noted that the merger price is the best evidence of fair value where the transaction results from a competitive and fair auction, followed by a more than adequate sales price, and the dissemination of information to a large number of prospective buyers. However, that was not the case here, as the same family owned both banks, there was no auction, and no evidence the negotiations were arm's length.

The court then evaluated, and rejected, the appraisals of each side's expert. The petitioner's expert valued the shares at $137.97 but, according to the court, overstated the bank's going concern value. The respondent's expert valued the shares at $76.45, but the court doubted the appropriateness of the banks used as comparables. Instead, the court performed its own discounted net income analysis and concluded the bank's shares were worth $91.90.

NY Appellate Court Dismisses Claims Arising from Madoff Scheme

New Greenwich Litigation Trustee, LLC v. Citcofund Services (Europe), 2016 NY Slip Op 06796 (New York Supreme Court, A.D. 1st Dept.) decided Oct. 18, 2016, was a derivative suit brought on behalf of feeder funds that suffered losses in the Bernie Madoff ponzi scheme. The defendants, administrators of the funds and outside accountants, moved to dismiss on grounds of in pari delicto — the doctrine mandating that courts will not intercede to resolve disputes between two wrongdoers. The trial court granted the motion and the plaintiff appealed.

The New York Supreme Court, Appellate Division, first held that the trial court correctly applied New York law. The court rejected the defendants' argument that under the internal affairs doctrine Delaware law should have been applied because the funds were Delaware limited partnerships. The court noted that the internal affairs doctrine does not apply in cases such as this where the rights of third parties — in this case, fund administrators and accountants — are at issue. The court then affirmed dismissal under New York's in pari delicto doctrine, noting that the complaint pleaded extensive wrongdoing on the part of the funds' management, including issuing false reports to investors and failing to perform even minimal due diligence and oversight.

CA Appellate Court Rejects Reverse Agency Theory of General Jurisdiction

In Strasner v. Touchstone Wireless Repair and Logistics, LP, D068865 (California Court of Appeal, 4th Dist.) decided Nov. 4, 2016, the plaintiff sued out-of-state entities in California. The defendants moved to quash service of process for lack of personal jurisdiction.

The California Court of Appeal affirmed. Among other arguments, the plaintiff sought to assert general jurisdiction over the out-of-state entities based on their being indirect wholly owned subsidiaries of a California corporation. The plaintiff did not try to establish an alter ego relationship. Instead, she argued, general jurisdiction was appropriate because each entity was an agent of the California corporation. The court noted that there was no California case in which a "reverse agency" theory has been used to impute a California parent's forum contacts to an out-of-state subsidiary. In addition, such a theory would be at odds with the underlying principle of imputation through agency — which relies on the resident exerting power over the day to day operations of the resident corporation.

PA Supreme Court Rules on Nonprofit's Authority to Act

Zampogna v. Law Enforcement Health Benefits, Inc., No. 40 EAP 2014 (Pennsylvania Supreme Court) decided Nov. 22, 2016, involved a Pennsylvania nonprofit corporation whose purpose, as set forth in its articles of incorporation, was to administer health and welfare benefits to the members of a police officers' union. The corporation mailed postcards to union members endorsing a candidate for election as union president. Another candidate sought a declaratory judgment, claiming that the corporation's sending the postcard violated the Nonprofit Corporation Law and its articles of incorporation. The trial court denied relief, but the Commonwealth Court reversed, finding that endorsing a candidate was not a direct administration of benefits and therefore unauthorized.

On appeal, the Pennsylvania Supreme Court reversed. The court stated that a nonprofit corporation's action is authorized when the action is not prohibited by the corporation law or the articles of incorporation and is not clearly unrelated to the corporation's purpose. Here, there was no language in either the law or articles prohibiting the endorsing of a candidate in a union election. In addition, because the union president has a direct impact on the corporation's ability to function, endorsing a candidate the corporation believes will best serve its members is not unrelated to its corporate purpose of administering benefits for its members. Accordingly, the action was authorized.

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