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RAW CAPITALISM

Allen Greenspan declared before Congress last October:

The [economic] crisis, however, has turned out to be much broader than anything I could have imagined. . . .

. . .

. . . [T]hose of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself specially) are in a state of shocked disbelief. Such counterparty surveillance is a central pillar of our financial markets' state of balance.

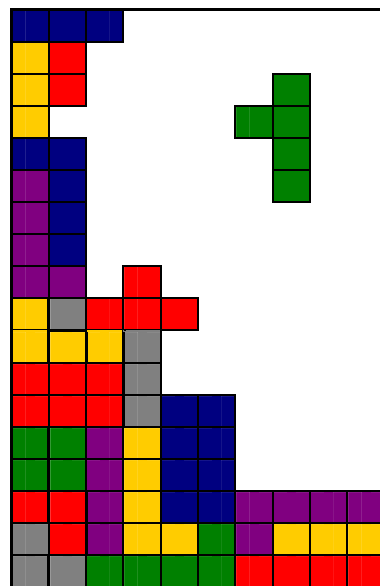
If it fails, as occurred this year, market stability is undermined.¹

In questioning by committee members, Greenspan said further, “[Y]es, I found a flaw [in my ideology], I don’t know how significant or permanent it is, but I have been very distressed by that fact.”²

What does this mean for businesses that are seeking investment, particularly small and closely-held ones? Currently, there is a significant freeze on new business investment. Before that freeze thaws, change is likely.

Investors’ Rights

Greenspan hints at a fundamental, broader flaw in our current capital markets that is now being closely examined. For years, the market has relied on a company’s board of directors and management, and to some extent on those with whom a company does business, to police stakeholders’ interests. Delaware, the state that leads the country in corporate law and governance, epitomizes the idea of board and management ascendancy.



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¹ *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight and Gov’t Reform*, 110th Cong. 15-17 (2008) (testimony of Alan Greenspan) (preliminary transcript), <http://oversight.house.gov/documents/20081024163819.pdf> (last visited Feb. 5, 2009).

² *Id.* at 36.

Section 141(a) of the Delaware General Corporation Law says, “[t]he business and affairs of every corporation organized under [Delaware law] shall be managed by or under the direction of a board of directors . . .”³ Stockholders’ powers, however, are not as clear. They do have the right to vote for directors at the company’s annual meeting,⁴ and each share of stock typically carries the power of one vote.⁵ Stockholders also have the power to adopt and amend bylaws.⁶ But, what these statutes really mean in practice is much less than what appears.

The Delaware Supreme Court has limited stockholders’ powers by emphasizing those of the board of directors:

No such broad management power [as that set forth in Section 141(a)] is statutorily allocated to the shareholders. Indeed, it is well-established that stockholders of a corporation subject to the [Delaware General Corporation Law] may not directly manage the business and affairs of the corporation, at least without specific authorization in either the statute or the certificate of incorporation.⁷

In reality, stockholders’ only effective rights are to “vote with their feet.” Thus, Delaware corporation law (and the laws of other states, most of which follow Delaware’s lead) leaves little if any check on the ideological flaw that Greenspan now finds in our market-based economic model.

Private Equity Model

The long-standing notion that stockholders, at least in large, publicly-held companies, are meant to be silent investors, just along for the ride and trusting that management and the board will look out after their interests, has been shaken to its foundations by the current economic crisis. In advance of the World Economic Forum in Davos, Switzerland, some predicted that “capitalism [may be] widely viewed as a failure, rather than something to be admired.”⁸

Private equity firms (PEs), which typically invest in a company before it goes public, do not subscribe to the “silent partner” model. Of course, many of the companies in which they invest are either start-ups or move-ups (that is, they are seeking capital to move beyond their current products or markets), and PEs recognize that close watch is needed to protect their funds’ investments in such companies. Thus, they often take a controlling interest in a company, board

³ Del. Code Ann., tit. 8, § 141(a) (2008).

⁴ *Id.*, § 211(b).

⁵ *Id.*, § 212(a).

⁶ *Id.*, § 109(a).

⁷ *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 277 (Del. 2008) (answering questions certified by the SEC) (citing *McMullin v. Beran*, 765 A.2d 910 (Del. 2000) (“One of the fundamental principles of the Delaware General Corporation Law statute is that the business affairs of a corporation are managed by or under the direction of its board of directors.”); *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998) (“One of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation. . . . Section 141(a) . . . confers upon any newly elected board of directors full power to manage and direct the business and affairs of a Delaware corporation.”) (emphasis in original) (citations omitted); *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (“A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation.”)).

⁸ Marc Champion, *World’s Elite Visit Davos in Doubt: Leaders, CEOs Seek New Model at Forum, as IMF Prepares to Lower Growth Forecast*, WALL ST. J., Jan. 26, 2009, at A6.

seats or consent rights to significant corporate events any one of which effectively puts the PE in the driver's seat.⁹

Changing Landscape

The U.S. Securities and Exchange Commission amended, in 1998, Rule 14a-8 that addresses stockholders' rights to propose their own ideas for a stockholder vote at a public company's annual meeting.¹⁰ The revised Rule 14a-8 focused on "mak[ing] it easier for shareholders to include a broader range of proposals in companies' proxy materials."¹¹ The rule would allow stockholders greater input in the corporate governance process. Nevertheless, state law still blocks broad stockholder involvement in substantive decisions.¹²

But, investors are getting more and more concerned about whether and how management and the board of directors, and those with whom they deal, are fulfilling their fiduciary duties to all stakeholders. Dillard's Inc. is a prime example.

Activist investors in Dillard's Inc. demanded to see corporate records involving board members' use of corporate jets and vacation homes as well as a full list of business relationships, among other things, between Dillard family members and the department store chain's independent directors.

The move . . . underscores how the recession is throwing corporate governance into the spotlight . . .

Representatives of the investors, New York hedge funds Barington Capital and Clinton Capital . . . have been pressing Dillard's for change for more than a year.¹³

There are new legislative proposals at the state level to broaden stockholder involvement in corporate decision-making.

A new front in the battle over corporate governance is emerging in an unlikely place: North Dakota.

. . . last year lawmakers there – prodded by out-of-state activists including Carl Icahn – enacted the nation's most shareholder friendly corporate governance law.

The law prescribes rules that companies incorporating in North Dakota can adopt as a package, including requiring an annual shareholder advisory vote on executive pay and the naming of a chairman who isn't an executive. The rules also provide for the annual election of directors and make it easier for shareholders to nominate their own director candidates.¹⁴

⁹ JACK S. LEVIN, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS ¶ 103 (Martin D. Ginsburg & Donald E. Rocard sp. eds., 2005).

¹⁰ 17 C.F.R. § 240.14a-8 (2008).

¹¹ Amendments to Rules on Shareholder Proposals, 56 Fed. Reg. 50,682 (proposed Sep. 26, 1997) (to be codified in 17 C.F.R. pt. 240).

¹² See, e.g., 953 A.2d 277 (“the proposed Bylaw, as written, would violate Delaware law if enacted by CA's shareholders . . . because the Bylaw contains no language or provision that would reserve to CA's directors their full power to exercise their fiduciary duty to decide whether or not it would be appropriate, in a specific case, to award reimbursement [for proxy expenses]”).

¹³ Rachel Dodes, *Dillard's Investors Press Further on Records*, WALL ST. J., Dec. 9, 2008, at B3.

¹⁴ Cari Tuna, *Shareholders Ponder North Dakota Law*, WALL ST. J., Dec. 8, 2008, at B6.

Emerging Investor Demands

Before Alan Greenspan had even spoken to Congress, Treasury Secretary Hank Paulson had already announced the results of what had shocked Greenspan: “Raw capitalism is dead.”¹⁵ Paulson was declaring that an undisciplined free market – one without effective regulation or active participation by stakeholders, particularly investors and creditors, had come to its end. The new economic model will not entirely abandon capitalism, but it will certainly throttle it. It will replace free market forces – the ones on which Greenspan had completely relied for marketplace discipline – with external controls.

There will be new regulations. But, stockholders and other company stakeholders are likely to demand more monitoring, oversight and control when they invest. This force is making itself known and felt today to those seeking capital for their businesses. And, small and closely-held businesses are no exception.

But, they can effectively respond to these increasing demands. The corporate form of organization, common to larger businesses, presents a slightly more complex framework in which to allow stockholders more substantive participation in corporate affairs. Tailored articles of incorporation and corporate bylaws, however, can check the almost plenary power of the corporation’s management and board.

The limited liability company and the limited partnership, more common and suitable forms of organization for the small and closely-held business, offer even greater flexibility.¹⁶ The checks and balances in a limited liability company agreement (often called the operating agreement) or in a limited partnership agreement are largely limited only by the creativity of the drafter.

“Mom and pop” businesses – the small and closely-held business space – is a unique investor market. Founders and owners, who often work in their businesses, possess a unique affinity for their businesses and often react strongly to investor demands for checks and balances on their management and control. Nevertheless, experience in 2008 shows that such checks and balances, and rights to advise and consent to important decisions, will continue and grow as a feature of small business investment, particularly as the current economic crisis heightens concern over business health.

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¹⁵ Andy Serwer & Allan Sloan, *How Financial Madness Overtook Wall Street*, TIME, Sep. 18, 2008, <http://www.time.com/time/business/article/0,8599,1842123,00.html>.

¹⁶ See generally Delaware Limited Liability Company Act, Del. Code Ann., tit. 6, §§ 18-101 – 18-1109 (2008) and Delaware Revised Uniform Limited Partnership Act, *id.*, §§ 17-101 – 17-1111.