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Neal R. Pandozzi
Adler Pollock & Sheehan

David R. Werbel
Adler Pollock & Sheehan

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Practice Guide

Getting Down to Business: A Pocket Guide to the Revised Rhode Island Business Corporation Act

Neal R. Pandozzi* and David R. Werbel**

INTRODUCTION

Effective July 1, 2005, chapter 216/274 of the Rhode Island Public Laws of 2004 (Revised Business Corporation Act) deletes title 7, chapter 1.1 of the Rhode Island General Laws in its entirety and replaces it with title 7, chapter 1.2.¹ Adopting many of the corporate law principles found in the Model Business Corporation Act² and the Delaware Code,³ the Revised Business Corporation Act modernizes the corporate laws formerly found in title 7, chapter 1.1 of the Rhode Island General Laws, providing greater flexibility and clarity for corporations and their shareholders, directors and officers. A comprehensive discussion of the Revised

* Associate with the Business and Corporate Law Group, Adler Pollock & Sheehan P.C. B.A. 1995, Providence College; J.D. 1999, Roger Williams University School of Law; LL.M. 2000, Boston University School of Law.

** Associate with the Business and Corporate Law Group, Adler Pollock & Sheehan P.C. B.A. 1991, Hobart College; M.A. 1994, The American University; J.D. 1997, New York Law School. The theories and opinions expressed in this practice guide do not necessarily reflect those of Adler Pollock & Sheehan P.C., or its attorneys.

1. R.I. GEN. LAWS § 7-1.2-101 (Supp. 2004).
2. See generally MODEL BUS. CORP. ACT (1984) (Supp. 1998-99).
3. See generally DEL. CODE ANN. tit. 8, § 1-101, *et seq.* (2005).

Business Corporation Act's impact on Rhode Island's corporate law is beyond the scope of this practice guide. Therefore, this practice guide highlights certain significant changes.

I. FILING REQUIREMENTS GENERALLY

The Revised Business Corporation Act simplifies the filing requirements for domestic and foreign corporations.⁴ For example, the Revised Business Corporation Act no longer requires duplicate filings or notarization of signatures, and permits facsimile and "electronically transmitted" signatures.⁵ The Revised Business Corporation Act also affirms that the secretary of state is not liable to any individual for either pre-clearing or accepting a filing, or filing and indexing an instrument.⁶

II. CORPORATE NAME

Under title 7, chapter 1.1 of the Rhode Island General Laws as well as the Revised Business Corporation Act, a corporate name may not be the same as or deceptively similar to the name of any other entity on file with the secretary of state.⁷ However, an amendment to the Revised Business Corporation Act, which, as of the writing of this practice guide has not been enacted into law, provides that a corporate name may be used if it is "distinguishable upon the records" of the secretary of state.⁸

III. ARTICLES OF INCORPORATION

The Revised Business Corporation Act reduces the number of required statements to be included in a corporation's articles of incorporation.⁹ A corporation may include additional provisions so

4. R.I. GEN. LAWS § 7-1.2-105.

5. *Id.*

6. *Id.* § 7-1.2-105(g).

7. *Id.* § 7-1.2-401.

8. H.R. 5750, 2005-2006 Leg., Jan. Sess. (R.I. 2005). The "distinguishable" standard is similar to the standard used under the Delaware Code. *See* DEL. CODE ANN. tit. 8, § 1-102(a) (2005).

9. R.I. GEN LAWS §7-1.2-202(a). Section 7-1.2-202(a) provides that the articles of incorporation must state:

- (1) A corporate name that satisfies the requirements of §7-1.2-401;
- (2) The total number of shares which the corporation has authority to issue, and if the corporation is to be authorized to issue more than one class of shares: (i) the total number of shares of each class; and

long as such provisions are not inconsistent with the law.¹⁰

IV. SHARES

A. *Par Value*

Under the Revised Business Corporation Act, unless otherwise provided in the corporation's articles of incorporation, shares in the corporation that are silent as to par value are presumed to have a par value of one cent per share solely for the purpose of calculating a tax or fee on the corporation's capital.¹¹ For purposes of calculating a corporation's capital, par value shares are valued at their par value, and shares with no par value are valued at their actual value (i.e., the consideration paid for the shares).¹² Thus, for shares that are silent as to par value, a nominal par value of one cent per share simplifies the method for calculating the silent share's contribution to the corporation's capital and, thus, the tax or fee on the corporation's capital.

B. *Consideration*

Although the corporation's board of directors must first determine the adequacy of consideration before a corporation issues shares, the Revised Business Corporation Act permits a corporation to issue shares for consideration consisting of promissory notes and contracts for future services.¹³ Thus, the risk of non-payment associated with promissory notes and the uncertainty of valuation associated with contracts for future services are now

(ii) a statement of all or any of the designations and the powers, preferences, and rights, including voting rights, and the qualifications, limitations, or restrictions of them, which are permitted by the provisions of this chapter in respect of any class or classes of shares of the corporation and the fixing of which by the articles of association is desired, and an express grant of the authority as it may then be desired to grant to the board of directors to fix by vote or votes any of them that may be desired but which is not fixed by the articles; (3) The address of its initial registered office, and the name of its initial registered agent at the address; and (4) The name and address of each incorporator.

Id.

10. *Id.* § 7-1.2-202(b).

11. *Id.* § 7-1.2-605.

12. See generally MODEL BUS. CORP. ACT § 6.21 (1984) (Supp. 1998-99).

13. R.I. GEN. LAWS § 7-1.2-604(c) & (d).

outweighed by greater faith and confidence in the board's business judgment regarding the adequacy of consideration.¹⁴ To further reduce the risks associated with accepting promissory notes and contracts for future services as consideration for shares, a corporation may escrow the shares until the note is paid or the services are performed.¹⁵ If the note is not paid or if the services are not performed, then the corporation may cancel the escrowed shares.¹⁶

C. Fees

Prior to the effective date of the 2003 amendments to title 7, chapter 1.1 (2003 Amendments), license fees due upon the number of authorized shares by domestic or foreign corporations were calculated on a per share basis, with an eighty dollar minimum fee.¹⁷ The 2003 Amendments, as restated by the Revised Business Corporation Act, provide for a license fee of \$160 when the number of authorized shares is less than 75,000,000.¹⁸ When the number of authorized shares is 75,000,000 or greater, the fee is calculated at one-fifth of a cent per share.¹⁹

Domestic and foreign corporations are also subject to an annual franchise tax.²⁰ Such tax is calculated based upon the number of shares and par value.²¹ Specifically, the franchise tax is calculated as the greater of either (1) \$2.50 for each \$10,000.00 (or fraction thereof) of par value, or (2) \$500.00.²² Shares with no par value shall be deemed to have par value of \$100.00 per share for purposes of this calculation.²³

14. See, e.g., *Public Investment Ltd. v. Bandeirante Corp.*, 740 F.2d 1222, 1232-33 (D.C. Cir. 1984) (discussing the risks associated with accepting promissory notes and contracts for future services as consideration for stock); Gayle J. Mayfield & Michael W. Newcomb, *How to Avoid the 10 Biggest Legal Mistakes Businesses Make*, at <http://www.mayfield-law.com/Articles/10mistake.htm> (last visited May 27, 2005); MODEL BUS. CORP. ACT § 6.21 (discussing the use of promissory notes and contracts for future services as consideration for shares).

15. R.I. GEN. LAWS §7-1.2-604(f).

16. *Id.*

17. 2003 R.I. Pub. Laws 376, art. 29, § 1.

18. R.I. GEN. LAWS § 7-1.2-1602(c).

19. *Id.*

20. *Id.* § 44-12-1.

21. *Id.*

22. *Id.* § 44-12-1(a).

23. *Id.* § 44-12-3.

V. PREEMPTIVE RIGHTS

Under the Revised Business Corporation Act shareholders of a corporation incorporated on or after July 1, 2005 will no longer have a preemptive right to acquire either (1) unissued shares, or (2) securities convertible into shares or carrying a right to subscribe to or acquire shares, unless the corporation provides for preemptive rights in its articles of incorporation.²⁴ Previously, shareholders possessed automatic preemptive rights unless the corporation elected to “opt out” of such rights in its articles.²⁵ The new “opt in” approach gives deference to the corporation’s board of directors by allowing the corporation’s articles to define the terms and conditions of preemptive rights.²⁶

VI. DISTRIBUTIONS

Eliminating the distinction between paying dividends and making distributions from capital surplus, and abandoning the antiquated “stated capital” and “capital surplus” mechanism for a more streamlined approach, the Revised Business Corporation Act simplifies the method by which a corporation distributes its assets.²⁷ Corporations are prohibited from redeeming shares or distributing assets other than shares if (1) the corporation is insolvent, or (2) the distribution will render the corporation insol-

24. *Id.* § 7-1.2-613(a).

25. *Id.* § 7-1.1-24. See generally MODEL BUS. CORP. ACT § 6.30 (1984) (Supp. 1998-99) (comparing the former “opt out” approach to the new “opt in” approach for preemptive rights). Preemptive rights place corporations with complicated capital structures in the difficult, if not impossible, position of having to allocate additional new shares that preserve the rights of various classes of existing shares. See *id.* Further, because preemptive rights require a publicly-held corporation to make a prior offering of shares to its existing shareholders, the “opt out” approach can delay a corporation’s access to the national markets to raise equity capital. See *id.*

26. *Id.* To assist corporations desiring to “opt in,” section 7-1.2-613(b) of the Rhode Island General Laws provides a standard clause for inclusion in the corporation’s articles granting preemptive rights to the shareholders, as well as interpretive principles for when a shareholder exercises such rights. R.I. GEN. LAWS § 7-1.2-613(b).

27. R.I. GEN. LAWS § 7-1.2-614. Given the exceedingly complicated statutory rules and related loopholes governing capitalization, corporate creditors lacked meaningful protection against distributions to shareholders that could impair the security of their position. See MODEL BUS. CORP. ACT § 6.30. As a result, sophisticated creditors negotiated contractual restrictions on distribution of assets to shareholders. See *id.*

vent.²⁸ Share distributions are not subject to the insolvency test because a share distribution will not affect the amount or type of the corporation's assets or liabilities and, thus, will not render the corporation insolvent.²⁹ However, a corporation may set forth limitations on share distributions in its articles of incorporation.³⁰

VII. INDEMNIFICATION

As clarified by the Revised Business Corporation Act, even if an officer or director of a corporation is not entitled to indemnification as provided under section 7-1.2-814(b) of the Revised Business Corporation Act or the corporation's articles of incorporation, a court may nevertheless order indemnification upon application of the affected officer or director.³¹

Furthermore, in contrast to title 7, chapter 1.1 of the Rhode Island General Laws, officers and directors of a corporation are entitled to broader indemnification than is provided by the Revised Business Corporation Act to the extent that broader indemnification provisions are included in the corporation's articles of incorporation.³²

VIII. MERGER/RIGHT TO DISSENT

Unless required by the articles of incorporation, no shareholder approval or notice of the merger is required if: (1) the plan of merger does not amend the articles of incorporation of the corporation; (2) each shareholder immediately prior to the merger will hold the same number of shares with identical preferences, limitations and relative rights immediately after the effective date of the merger; and (3) the securities issued in connection with the merger represent less than 20% of the total voting power of all outstanding shares entitled to vote for directors of the corporation after the merger.³³

The Revised Business Corporation Act narrows a share-

28. R.I. GEN. LAWS § 7-1.2-614(a)(iii).

29. See Craig A. Peterson & Norman W. Hawker, *Does Corporate Law Matter? Legal Capital Restrictions on Stock Distributions*, 31 AKRON L. REV. 175 (1997).

30. R.I. GEN. LAWS § 7-1.2-614(b)(i) & (ii).

31. *Id.* §7-1.2-814(d).

32. *Id.* §7-1.2-814(b)(1)(iv); MODEL BUS. CORP. ACT § 8.51.

33. R.I. GEN. LAWS §7-1.2-1002(c)(1).

holder's right to challenge a merger. In particular, a shareholder may not challenge a merger where the right to dissent is available unless such corporate action: (1) was not done in accordance with statute, articles of incorporation, bylaws or board of directors' resolution authorizing the action; or (2) was procured as a result of fraud or material misrepresentation.³⁴ The appraisal process is the exclusive remedy for corporate action except under exceptional circumstances when judicial review of a completed transaction is warranted.³⁵

IX. DERIVATIVE ACTIONS

As set forth below, the Revised Business Corporation Act has modernized the prior law governing shareholder derivative suits by adopting the provisions of the Model Business Corporation Act.

A. *Standing*

An additional requirement for standing, that the shareholder fairly and adequately represent the corporation's interests, tracks Rule 23.1 of the Federal Rules of Civil Procedure with one exception: the plaintiff must fairly and adequately represent the interests of the corporation rather than similarly situated shareholders.³⁶ This exception is meant to more properly reflect the nature of a derivative suit as an action brought by a shareholder to enforce the corporation's rights.³⁷

B. *Demand*

In general, a shareholder may not commence a derivative action until he or she has made a written demand on the corporation to take suitable action and ninety (90) days has elapsed.³⁸ This requirement: (1) eliminates the excessive time and expense for both litigants and the court in litigating the question of whether demand is required; (2) gives the board of directors the opportunity to reexamine the act complained of in light of a potential lawsuit;

34. *Id.* §7-1.2-1201(d).

35. MODEL BUS. CORP. ACT § 13.02(d).

36. R.I. GEN. LAWS § 7-1.2-711(b)(ii); *see* Model Bus. Corp. Act § 7.41 (discussing the standing requirement for derivative actions).

37. *See* MODEL BUS. CORP. ACT § 7.41; FED. R. CIV. P. 23.1.

38. R.I. GEN. LAWS § 7-1.2-711(c).

and (3) will not unduly restrict a legitimate derivative suit because of the relatively short waiting period.³⁹

C. *Stay of Proceeding*

The court may stay a derivative proceeding if the corporation commences an inquiry into the allegations made in the demand or complaint.⁴⁰ It is expected that the court will monitor the course of the inquiry to ensure that it is proceeding expeditiously and in good faith.⁴¹

D. *Dismissal*

On motion of the corporation, the court will dismiss a derivative proceeding upon: (1) a majority vote of independent directors if the independent directors constitute a quorum; or (2) a majority vote of a committee of at least two or more independent directors appointed by a majority vote of independent directors, whether or not such independent directors constitute a quorum; or (3) a decision by a panel of independent persons appointed by the court upon motion of the corporation after such independent directors, committee or panel has determined in good faith, and after reasonable inquiry upon which its conclusions are based, that the derivative proceeding is not in the corporation's best interests.⁴²

Because a derivative suit is an action brought on behalf of the corporation, it should be controlled by those directors who can exercise independent judgment with respect to its continuance.⁴³ At the same time, the court is required to assess the independence and good faith of the directors and the reasonableness of their inquiry.⁴⁴ Thus, in (1) or (2) above, if a majority of the directors is

39. MODEL BUS. CORP. ACT § 7.42. The ninety (90) day waiting period may be waived if the corporation will otherwise suffer irreparable injury. *Id.*

40. R.I. GEN. LAWS § 7-1.2-711(d).

41. MODEL BUS. CORP. ACT § 7.43.

42. R.I. GEN. LAWS § 7-1.2-711(e)(1). "Inquiry" is used rather than "investigation" to clarify that the inquiry's scope will depend on the issues raised and the knowledge of the group. MODEL BUS. CORP. ACT § 7.44. The phrase "upon which its conclusions are based" requires that the conclusion follow logically from the inquiry. *Id.* Significantly, the court's review is limited to whether the determination is supported by the inquiry's findings, as opposed to the reasonableness of the determination. *Id.*

43. MODEL BUS. CORP. ACT § 7.44.

44. *Id.*

independent then the burden of proof is on the plaintiff-shareholder.⁴⁵ If, however, the plaintiff-shareholder proves that the majority of directors in (1) or (2) above were not independent, then the burden shifts to the defendant-directors to prove the independence of the decision-makers and the propriety of the inquiry and the final determination.⁴⁶ If the court-appointed panel makes the determination, the burden of proof is on the plaintiff that the requirement for a good faith determination after reasonable inquiry has not been met.⁴⁷

E. *Discontinuance or Settlement*

Since a derivative suit is brought for the benefit of all shareholders it may not be discontinued or settled without the court's approval.⁴⁸ Furthermore, if the court determines that the discontinuance or settlement will substantially affect shareholders' interests, the court will direct that notice be given to the affected shareholders.⁴⁹

F. *Payment of Expenses*

To address abuses that may occur during a derivative proceeding, the court can order a party to pay the opposing party's reasonable expenses (including counsel fees) incurred because of the filing of a pleading, motion or other paper that was not well grounded in fact or warranted by existing law and was interposed for an improper purpose.⁵⁰

X. DUTY OF CARE FOR DIRECTORS

Under section 7-1.1-33 of the Rhode Island General Laws, directors were required to discharge their duties "with the care an ordinarily prudent person in a like position would exercise under

45. *Id.*

46. *Id.*

47. *Id.*

48. R.I. GEN. LAWS § 7-1.2-711(f) (Supp. 2004); *see* MODEL BUS. CORP. ACT § 7.45 (discussing the court's role in approving the proposed discontinuance or settlement of a derivative action).

49. R.I. GEN. LAWS § 7-1.2-711(f).

50. R.I. GEN. LAWS § 7-1.2-711(g)(3); *see* MODEL BUS. CORP. ACT § 7.46 (comparing the payment of such fees and expenses with Rule 11 sanctions under the Federal Rules of Civil Procedure).

similar circumstances.”⁵¹ This language, which suggests a tort law negligence standard as the proper measure for determining deficient conduct, has obscured the relationship between the statutory duty of care and the common law Business Judgment Rule.⁵² On the contrary, when adjudicating claims of liability based on a director’s breach of his or her fiduciary duty to the corporation, Rhode Island courts have interpreted the statutory duty of care using the common law Business Judgment Rule.⁵³ The new standard of care set forth in the Revised Business Corporation Act, requiring directors to discharge their duties “with the care that a person in a like position would reasonably believe appropriate under similar circumstances,” follows this trend, aligning the language of the statutory duty of care with the concepts set forth in the common law Business Judgment Rule.⁵⁴ The resulting objective standard replaces the former subjective standard.⁵⁵

51. R.I. GEN. LAWS § 7-1.1-33 (1999 Reenactment).

52. MODEL BUS. CORP. ACT § 8.30(b); see James MacDonald, *Corporate Code Revision*, 46-NOV Advocate (Idaho) 29 (discussing the change in the standard of conduct required for directors from a tort negligence standard to a standard based on the Business Judgment Rule).

53. See *Adams v. Providence Athenaeum*, No. C.A. 03-4513, 2004 WL 2075128 (R.I. Super. 2004); *Heritage Healthcare Servs. v. Beacon Mut. Ins. Co.*, No. C.A. 02-7016, 2004 WL 253547 (R.I. Super. 2004).

54. See MODEL BUS. CORP. ACT § 8.30(b). The Business Judgment Rule is essentially a rebuttable presumption that, in making a business decision, the corporation’s directors acted in good faith, on an informed basis, and with the honest belief that they were acting in the corporation’s best interests. See *Adams*, 2004 WL 2075128 (citing *Emerald Partners v. Berlin*, 787 A.2d 85, 90-91 (Del. 2001) (citations omitted)), and discussing the Business Judgment Rule); *Heritage*, 2004 WL 253547 (same). The Business Judgment Rule places the initial burden on the plaintiff to prove that the board of directors, in reaching the challenged decision, acted fraudulently, illegally or without becoming sufficiently informed to make an independent business decision, thus violating any one of its three fiduciary duties: due care, loyalty or good faith. *Id.* If the plaintiff fails to meet this burden, then the Business Judgment Rule provides substantive protection for directors and their decisions. *Id.* However, if the plaintiff rebuts the presumption, then the burden shifts to the defendants to prove that the challenged action was entirely fair to the plaintiff. *Id.*

55. R.I. GEN. LAWS § 7-1.2-801; MODEL BUS. CORP. ACT § 8.30(b). “The standard is not what care a particular director might believe appropriate in the circumstances but what a person – in a like position and acting under similar circumstances – would reasonably believe to be appropriate.” *Id.* Even though the new standard takes into consideration the special background, qualifications and management responsibilities of the particular director, the standard does not excuse a director who lacks business experience or a particular expertise from exhibiting the basic director attributes of practical wis-

CONCLUSION

As stated above, the Revised Business Corporation Act provides today's corporation with an updated approach for conducting its business and affairs. As a result, the Revised Business Corporation Act places Rhode Island on an equal footing with other jurisdictions having modern corporate laws.

