WASHINGTON'S NEW PROVISIONS ON PREEMPTIVE RIGHTS, CUMULATIVE VOTING, AND SHAREHOLDER APPROVAL ON A SALE OF ASSETS

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Corporate/M&A Alert

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Governor Jay Inslee recently signed Senate Bill 5003 ("SB 5003") into law, which amends the Washington Business Corporation Act ("WBCA") to (1) change the default rule relating to preemptive rights; (2) change the default rule relating to cumulative voting; and (3) adopt an objective test for when the sale of all or substantially all of a corporation's assets is taking place and thus requires shareholder approval. For corporations formed on or after January 1, 2020, SB 5003 reverses the presumption in the WBCA that shareholders' have preemptive rights and cumulative voting rights, unless the articles of incorporation provide otherwise. SB 5003 further amended the WBCA to revise and clarify the standards governing when shareholder approval is required for a sale or other disposition of a Washington corporation's property and assets other than in the usual and regular course of business.

PREEMPTIVE RIGHTS

Prior to SB 5003's amendment of the WBCA's preemptive rights provision, unless the articles of incorporation provided otherwise, the shareholders of a Washington corporation had a preemptive right to acquire proportional amounts of the corporation's unissued shares or any security convertible into shares on the decision of the board of directors to issue those shares unless the shares were issued: (a) as compensation to employees and certain other service providers; (b) to satisfy conversion or option rights created to provide compensation to employees and certain other service providers; (c) pursuant to the corporation's initial plan of financing; or (d) issued for consideration other than money.

SB 5003 reverses the default rule applicable to preemptive rights for corporations formed on or after January 1, 2020, from the current "opt out" approach to an "opt in" approach. Under the new law, shareholders of Washington corporations formed on or after January 1, 2020, will only have preemptive rights if the articles of incorporation so provide. This amendment makes the WBCA consistent with the approach taken in the Model Business Corporation Act ("MBCA") and in the corporate statutes of over 40 states, including Delaware. The amendment will remove a potential trap for companies that raise multiple rounds of capital but inadvertently fail to offer the preemptive right to (or obtain a waiver from) shareholders in connection with each securities issuance, resulting in the expenditure of additional time, effort and money by the company to address the issue when discovered later.

Recognizing that a number of Washington corporations may have based their control structure on the prior statutory provision, the default rule with respect to corporations formed before January 1, 2020, remains unchanged.

CUMULATIVE VOTING

Prior to SB 5003's amendment of the WBCA's cumulative voting provision, unless the articles of incorporation provided otherwise, the shareholders of a Washington corporation entitled to vote at any election of directors were entitled to cumulate votes by multiplying the number of votes they were entitled to cast by the number of directors for whom they were entitled to vote and to cast the product for a single candidate or distribute the product among two or more candidates.

SB 5003 reverses the default rule applicable to cumulative voting for corporations formed on or after January 1, 2020, from the current "opt out" approach to an "opt in" approach. Under the new law, shareholders of Washington corporations formed on or after January 1, 2020, will only be able to cumulate votes in a director election if the articles of incorporation authorize cumulative voting. For authorized cumulative voting to occur, the meeting notice must conspicuously state that cumulative voting is authorized at the meeting, or a shareholder with the right to cumulate votes must give notice to the corporation at least 72-hours before the meeting that such holder intends to cumulate votes. If one shareholder gives this notice, the other shareholders in the voting group may also cumulate their votes without giving further notice.

Washington's new approach to cumulative voting closely mirrors the MBCA approach and brings Washington in line with the majority of the states on default rules applicable to director elections. Thirty-eight states, including Delaware, have adopted straight (non-cumulative) voting as the default rule. SB 5003 better aligns Washington corporate law with current practice regarding corporate director elections.

As with the preemptive rights amendment, the cumulative voting default rule with respect to corporations formed before January 1, 2020, remains unchanged, thereby allowing Washington to revise its corporate code without impacting those corporations that may have relied on the prior statutory presumption in their control structures.

OBJECTIVE TEST FOR DETERMINING WHETHER A SALE OF ASSETS REQUIRES SHAREHOLDER APPROVAL

Washington's current statute governing shareholder approval for the sale of assets, Chapter 23B.12 of the WBCA, requires shareholder approval of all transactions involving the sale, lease, exchange, or other disposition of "all or substantially all" of a corporation's property and assets "other than in the usual and regular course of business." The phrase "all or substantially all" has not been defined in the WBCA, nor has it been the subject of judicial interpretation in any opinion by a Washington court. Washington's current approach for determining when a sale of assets requires shareholder approval largely reflects the 1984 version of the MBCA, which has subsequently been amended to provide better clarity.

In 1999, the MBCA was revised to add an objective test and safe harbor for determining when a transaction involving a sale of assets must be submitted to shareholders for approval. These revisions were carried forward to the 2016 Revision to the Model Business Corporation Act ("RMBCA"). Under Chapter 12 of the RMBCA, shareholder approval is required for any sale of assets if the disposition would leave the corporation without a "significant continuing business activity."

In line with the RMBCA, SB 5003 provides that a sale, lease, exchange, or other disposition of a corporation's property and assets, other than in the usual and regular course of its business, would require approval of the corporation's shareholders if the disposition would leave the corporation without a "significant continuing business activity." A corporation will conclusively be deemed to have retained a significant continuing business activity if the corporation retains a business activity that represents at least:

1. 25% of the total assets at the end of the most recently completed fiscal year; and
2. either (a) 25% of income from continuing operations for that fiscal year or (b) 25% of revenues from continuing operations for that fiscal year.

The determination of whether a continuing business activity constitutes a "significant continuing business activity" may be based either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or, in the case of item (1) above, on a fair valuation or other method that is reasonable in the circumstances.
SB 5003 provides much-needed clarity to Washington corporations and their advisors seeking to determine whether a transaction involving the disposition of less than all of a corporation's assets must be submitted to shareholders for approval by modifying RCW 23B.12 to include this objective test and safe harbor.

IMPACT ON WASHINGTON CORPORATE LAW

The amendments contained in SB 5003 modernize Washington's corporate law on preemptive rights and cumulative voting with respect to corporations formed on or after January 1, 2020. These changes better align Washington corporate law with current practice under the MBCA and the approach taken by a majority of states, and remove a potential trap for unwary companies. SB 5003 also provides clarity on when a sale of corporate assets does not require shareholder approval. Washington corporations and their advisors will benefit in particular from the safe harbor for determining when a transaction involving the disposition of less than all of a corporation's assets need not be submitted to shareholders for approval because the corporation retains a significant continuing business activity.

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