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CORPORATION

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Corporate Citizenship Simplified: *The Hertz Corporation v. Friend* © [¶7.1]

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The U.S. Supreme Court has brought clarity and predictability to an area of law that historically has enjoyed neither. For more than 50 years, litigants have found it difficult to predict where a corporation's "principal place of business" was for purposes of 28 U.S.C. §1332(c)(1), and have been obliged to engage in costly collateral litigation concerning not the merits of the case, but where it belonged. That ended Feb. 23, 2010, when Justice Stephen Breyer, delivering the unanimous opinion of the Court, boiled the former grocery list of ingredients that determine a corporation's principal place of business down to just one—its headquarters. *See Hertz Corp. v. Friend*, No. 08-1107, slip op. (U.S. Feb. 23, 2010).

Divergent and Increasingly Complex Interpretations

Since 1958, corporations have been deemed citizens of their state (or states) of incorporation and the state where they have their "principal place of business." 28 U.S.C. §1332(c)(1); *see* 28 U.S.C. §1332(d)(10) (applying same test to unincorporated associations under the Class Action Fairness Act). While determining the former had been a relatively straightforward matter, determining the latter had been anything but. Courts applying

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Section 1332(c)(1) had generally applied one (or a combination) of three tests: (1) the nerve center test; (2) the locus of the operations test; and (3) the center of corporate activities test. *See* 15 James Wm. Moore et al., Moore's Federal Practice §102.54 (3d ed. 2005). The first focused on a corporation's center of control in a particular location in a state, whereas the second and third focused on a corporation's aggregate physical presence or production activities throughout an entire state. Most circuits had adopted their own variation or combination of the second and third tests, whereas only the Seventh Circuit had adopted a variation of the nerve center test. *Hertz*, slip op. at 14. In short, no test was applied uniformly throughout or even within the circuits, causing a lamentable lack of predictability and consistency in an area of law in which both are of paramount importance. As commentators predicted, *Hertz* served as the vehicle for the Court to reconcile the "divergent and increasingly complex interpretations" that had been given to Section 1332(c)(1). *Id.* at 13-14.

Administrative Simplicity Is a Major Virtue

The *Hertz* story is unremarkable. The plaintiffs alleged violations of California state employment law on behalf of a putative class of California citizens. Hertz removed the action to federal court, invoking federal diversity jurisdiction under the Class Action Fairness Act and asserting that diversity existed because it was a citizen of New Jersey or Oklahoma—but not California. The Northern District of California applied the Ninth Circuit test, compared Hertz's business activities state-by-state, concluded that Hertz had its principal place of business in California because the majority of its business took place there and remanded the action to state court. The Ninth Circuit affirmed and the Supreme Court granted Hertz's petition for certiorari.

The Court vacated the remand order, finding that the "nerve center" test is the most consistent with the plain language and legislative history of Section 1332(c)(1) and, perhaps more importantly, is the only rule that is simple, predictable and administrable.

First, the Court found that the nerve center test is consistent with the plain language of Section 1332(c)(1) because it focuses on a single "place of business" (the corporation's headquarters) rather than multiple places of business possibly spread throughout an entire state. Because the plain meaning of the statute requires identification of a single "place of business," and because a state as a whole cannot be a "place of business," any test that aggregates multiple locations is inconsistent with that plain meaning. *Id.* at 14-15.

Second, the Court found that the legislative history to Section 1332(c)(1) weighed in favor of adopting a "simplicity-related . . . benchmark." *Id.* at 16. Until the mid-fifties, corporations were simply citizens of their places of incorporation. *Id.* at 8. Because that test was easily manipulated, the Judicial Conference considered various amendments, initially proposing a numerical test based on the quantum of income earned in a given state, specifically the state in which a corporation earned "half its gross of income." *Id.* at 16. The Conference eventually abandoned that quantitative approach for a qualitative one that would, it was thought, be easier to apply, namely the "principal place of business" language in the current version of Section 1332(c)(1). *Id.* at 14. Adopting the nerve center approach was consistent with that desire for simplicity and predictability reflected in the legislative history.

Third, and most importantly, the Court found that the alternatives to the nerve center test are "unusually difficult to apply" and are "at war with administrative simplicity" because "corporations come in many different forms, involve many different kinds of business activities, and locate offices and plants for different reasons . . . ." *Id.* at 11, 13. In rejecting those alternate approaches, the Court "place[d] primary weight upon the need for judicial administration of a jurisdictional statute to remain as simple as possible" in order to avoid collateral litigation that wastes time and money on matters unrelated to the merits of a dispute. *Id.* at 7.

The Court settled on an admittedly imperfect but easily administered bright line rule, defining the principal place of business as "the place where the corporation's high level officers direct, control and coordinate the corporation's activities," more commonly referred to as the corporation's "nerve center." The Court left little room for confusion, however, stating that the "nerve center" will be a corporation's headquarters absent evidence of jurisdictional gaming such as the maintenance of a sham office. *Id.* at 1, 14, 18. It also acknowledged that "counterintuitive results" might occasionally occur under the "nerve center" test, but found that risk was outweighed by the benefits of an easily administered, "more uniform" rule. *Id.* at 18.

The Road Ahead

Although the Court noted that jurisdiction must still be established through competent evidence, the burden of doing so just became lighter. In *Hertz*, despite remanding the issue for determination by the lower court, the Court acknowledged that Hertz had provided an unchallenged declaration from an employee relations manager regarding the location of its "corporate headquarters," its "core executive and administrative functions" and its "administrative operations." *Id.* at 2. This evidence should be sufficient to establish Hertz's "nerve center" on remand. Given the importance the Court placed on the ease of administration and the avoidance of collateral litigation on jurisdictional issues, corporations invoking federal jurisdiction may rely on *Hertz* to argue that the quantity of evidence required to establish the existence of diversity jurisdiction is now greatly reduced.

The Court's new principal place of business test also counsels in favor of increased consideration of litigation and risk management among the law-related factors (such as reducing tax liabilities and finding a jurisdiction with a well-settled body of corporate law) considered when locating (or relocating) corporate headquarters. Because corporations continue to have potentially significant exposure to state court litigation in their states of incorporation and principal place of business, corporations can and should consider locating their headquarters in states with fairer courts, better laws, smaller populations, and correspondingly reduced state court risk exposure. In any event, corporations would be wise to deputize in-house counsel responsible for ensuring a uniform presentation as to the corporation's "nerve center" in those cases where jurisdiction is contested.

OTHER CORPORATE DEVELOPMENTS

[¶7.2] Record holder—Del.—"Stockholders of record" include the Depository Trust Company (DTC) participant banks and brokers listed on the "Cede & Co."

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(Cede) breakdown for purposes of determining the stockholders entitled to vote or act by written consent, thereby eliminating the need for a DTC omnibus proxy in such circumstances.

The board of directors of EMAK Worldwide, Inc. (EMAK) had five members and two vacancies. An insurgent faction, Take Back EMAK, LLC (TBE), sought to remove two directors and fill three of the four resulting vacancies so as to establish an insurgent majority. Donald Kurz, a member of TBE who was also a director, purchased the voting and economic rights in enough stock to ensure that TBE's solicitation would have sufficient votes. TBE also obtained consents from the holders of a majority in voting power of the corporation's stock in favor of its insurgent slate, but the inspector of elections subsequently invalidated consents representing more than 1,000,000 shares of stock that were held in "street name" for failure to obtain an omnibus proxy from the Depository Trust Company (DTC). Unsurprisingly for a corporation that was publicly traded for some fourteen years, a significant number of EMAK stockholders owned their shares in street name. The vast majority of publicly traded shares in the United States are registered on the companies' books not in the name of beneficial owners—i.e., those investors who paid for, and have the right to vote and dispose of, the shares—but rather in the name of "Cede & Co." (Cede), the name used by DTC. A "Cede breakdown" is the informal name for the participant listing DTC provides when requested to do so by a corporation that identifies as of a particular date the name of each bank or broker that holds shares with DTC as of that date and the number of shares held. Additionally, the Investor Communications Solutions Division of Broadridge Financial Services, Inc. (Broadridge) provides proxy processing services to the majority of brokerages and banks. Thus, Broadridge's bank and broker clients formally transfer to Broadridge the proxy authority they receive from DTC (via the DTC Omnibus Proxy) via written powers of attorney. On behalf of the brokers and banks, Broadridge delivers directly to each beneficial owner a proxy statement and a voting instruction form. For the TBE consent solicitation, Broadridge collected, recorded, and totaled the voting instructions it received from the beneficial owners of EMAK shares held in street name. There was no dispute that the banks and brokers properly authorized Broadridge to vote the EMAK shares held on their behalf at DTC. TBE filed suit, primarily under 8 Del. C. §225, challenging, among several things, the invalidation of the consents as to the shares held in "street name."

The Delaware Chancery Court held for TBE on its claim, finding that the "street name" consents, which evidenced authority from the participating banks and brokers who appeared on the DTC participant listing, but omitted the omnibus proxy from DTC, had validly effected corporate action. In doing so, the court redefined "stockholders of record" to include the DTC participant banks and brokers listed on the Cede breakdown for purposes of determining the stockholders entitled to vote or act by written consent, thereby eliminating the need for a DTC omnibus proxy in such circumstances. The court also held that the Cede breakdown is part of a corporation's stock ledger for purposes of 8 Del. C. §219(c), thus, aligning Delaware law's definition of record holders with federal regulations under which the participant banks and brokers are recognized as the record holders of the shares held by DTC. In reaching its decision, the court observed that there was no legal precedent on point as to this issue, saying: "there is no legal authority—*none*—addressing this subject." DTC itself did not appear to have any written policies or procedures governing the matter. While holding that only stockholders

of record can execute a written consent, the court reasoned that the DGCL recognizes the power of a proxy holder to execute a written consent on behalf of a record holder, 8 Del. C. §212(b), and that because the broker ownership was apparent from the Cede breakdown, the omnibus consents provided by Broadridge were valid to vote the brokerage and bank shares held at DTC. The court noted that the reality is that DTC inevitably transfers voting authority to its participant member banks and brokers, making it unnecessary to provide specific evidence of proxy authority at the time the broker consent is delivered, and that this is already the practice for the powers of attorney by which the banks and brokers transfer their voting authority to Broadridge. For these reasons, the court held that the Broadridge omnibus consents validly voted the street name shares. Finally, the court expressly held that the banks and brokers on the Cede breakdown were stockholders of record under section 219(c). Finding that TBE's consents validly effected corporate action, the court ruled that the EMAK board consisted of the three newly elected directors, the two incumbents, and one vacancy [*Kurz v. Holbrook*, 2010 Del. Ch. LEXIS 24 (Del. Ch. Ct. 2010); ¶84,999.82].

Board shrinkage through bylaw amendment—Del.—As a matter of first impression in Delaware, a bylaw amendment that purports to shrink the number of board seats below the number of sitting directors is void, as is a bylaw that purports to a establish qualifications for directorships that would disqualify a sitting director and terminate his service.

The board of directors of EMAK Worldwide, Inc. (EMAK) had five members and two vacancies. An insurgent faction, Take Back EMAK, LLC (TBE), sought to remove two directors and fill three of the four resulting vacancies so as to establish an insurgent majority. Donald Kurz, a member of TBE who was also a director, purchased the voting and economic rights in enough stock to ensure that TBE's solicitation would have sufficient votes. TBE also obtained consents from the holders of a majority in voting power of the corporation's stock in favor of its insurgent slate. Crown EMAK Partners, LLC (Crown), a large preferred shareholder, contended that it had delivered sufficient consents (the "Crown Consents") to amend EMAK's bylaws in two important ways. First, the Crown Consents purportedly amended the bylaws to reduce the size of the board to three directors. Because Crown had the right to appoint two directors under the terms of EMAK's preferred stock, reducing the board to three, if valid, would give Crown a board majority. Second, the Crown Consents purportedly added a new section to the bylaws providing that if the number of sitting directors were to exceed three, then the EMAK CEO would call a special meeting of stockholders to elect the third director, who would take office as the singular successor to his multiple predecessors. Crown contended that the bylaw amendments were valid and that the next step was for the EMAK CEO to call a special meeting. TBE challenged, inter alia, the validity of the bylaw amendments.

The Delaware Chancery Court held, as a matter of first impression, that the bylaw amendments adopted through the Crown Consents conflicted with the DGCL and were void. No authority had previously addressed what happens when a bylaw amendment would shrink the number of board seats below the number of sitting directors. The court reasoned that the outcome of the amendments would be either that the surplus directorships would terminate or would hold office without official seats, and that such outcomes conflicted with 8 Del. C. §§141(b) and 141(k), so that

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the bylaws would be void as contrary to Delaware law. The court found that the notion that the terms of the extra directors would end conflicted with Section 141(b)'s mandate that "[e]ach director shall hold office until such director's successor is elected and qualified or until such director's earlier resignation or removal." The court cited the three procedural means by which the term of a sitting director can be brought to a close and emphasized that shrinkage of the board was not among them. Also, under Section 141(k), shares only can vote to remove directors if they can vote to elect directors. Thus, the specific references to removal in Sections 141(b) and (k), the absence of any comparable provision addressing board shrinkage, and the background common law expectation that a director otherwise would serve out a full term absent cause for removal reinforced the court's view that eliminating directorships through board shrinkage is not permitted. The court added that its reading of Section 141(b) was not affected by the possibility that a corporation might establish qualifications for directorship and provide that a director who ceased to meet them could no longer serve. The court reasoned that a bylaw provision that established qualifications for directorships that would disqualify a sitting director and terminate his service would likewise violate Sections 141(b) and (k) and thus be void. The court observed that if a bylaw amendment reducing the size of a board could eliminate sitting directors, then directors suddenly would have the power to remove other directors, which was, by negative implication, prohibited by Section 141(k). The court also rejected the possibility that excess directors might continue on, bereft of their board seats, until their own terms ended through removal, resignation, or the election and qualification of a successor. First, Delaware law does not contemplate a liminal state in which suddenly surplus directors might continue to exist, untethered from the statute or any constitutive corporate document. Moreover, the lingering presence of directors without board seats would create a direct conflict between the number of directors in office and the number of directors provided for in the bylaws, as well as conflicting with the statutory quorum requirement for board action. Finally, permitting such a scenario would conflict with the concept of an *annual meeting* at which directors are elected under Section 211(b). For these and other reasons, the court held that the bylaw amendments were invalid [*Kurz v. Holbrook*, 2010 Del. Ch. LEXIS 24 (Del. Ch. Ct. 2010); ¶84,999.83].

Sealed instruments—Del.—In the case of an individual, in contrast to a corporation, the presence of the word "seal" next to an individual's signature is all that is necessary to create a sealed instrument (sometimes referred to as a "specialty contract"), irrespective of whether there is any indication in the body of the obligation itself that it was intended to be a sealed instrument.

Frank C. Whittington, II (Frank), brought suit in 2006 to enforce his rights as an alleged member of Dragon Group, L.L.C. (Dragon Group). In 2001, Frank and the other members of Dragon Group had signed an Agreement in Principle (the "AIP"), which constituted a global settlement of prior litigation among the parties. The word "seal" appeared in typed letters beside the signature line for each signatory of the AIP. Frank claimed that the defendants had breached the AIP, among other things, and sought various forms of relief. The defendants claimed that Frank was precluded from obtaining such relief because he failed to bring his claims within the applicable statute of limitations, which they asserted was three years—the limitations period for actions based on a promise. However, one exception to the three-year statute of limitations for contract actions is

for contracts under seal, for which the common law twenty-year period applies. In the Court of Chancery, Frank argued that the AIP was a contract under seal because the word "seal" appeared in typed letters beside the signature line for each signatory of the AIP. The Chancery Court rejected Frank's argument because there was no evidence of a clear intent to enter into a contract under seal, and dismissed his claims on the ground of laches. The court, therefore, did not address the merits of Frank's claims.

On appeal, the Delaware Supreme Court, noting that there was a split of authority in the Delaware trial courts as to what constitutes a sealed instrument, other than a mortgage or deed, reversed. The court, in a divided decision, resolved the split in authority in favor of a bright line rule that eliminated the need for evidence of intent in the case of a contract signed by an individual. The court thus overruled precedent that had held that for an instrument other than a mortgage to be under seal, it must contain language in the body of the contract, a recital affixing the seal, and extrinsic evidence showing the parties' intent to conclude a sealed contract. Because the Chancery Court had relied on the now-overruled precedent in rejecting Frank's limitations argument, the Supreme Court remanded the case to the Chancery Court for reconsideration of its laches holding by applying a twenty-year statute of limitations for purposes of analogy. Justice Jacobs, noting that "[s]ealed instruments are an artifact of a period of history that has, by and large, long passed into obscurity," dissented, arguing that the majority's bright-line approach represented an "inadvisable policy choice that would frustrate the reasonable expectations of parties to many commercial contracts." In his view, it would be an inadvisable policy to subject parties to commercial contracts to the risk of litigation for twenty years without requiring at least minimally persuasive evidence that the parties intended that result [*Whittington v. Dragon Group, L.L.C.,* 2009 Del. LEXIS 654 (Del. 2009); ¶84,999.84].

Oppression; statute of limitations—Iowa—Where a minority shareholder claims oppression, his claim will not be barred by the statute of limitations where acts of oppression taken together create a continuing wrong that occurs within the limitations period.

John Baur, a minority shareholder in Baur Farms, Inc., (BFI), a closely held family corporation, sought dissolution of the company on the grounds that the majority owner, Bob Baur, had acted to freeze John out and had breached his fiduciary duties to John by engaging in oppressive conduct. When John approached Bob about purchasing his shares, Bob insisted on applying a minority discount to arrive at the price—and repeatedly continued to do so. John claimed this was oppressive. He also claimed that Bob "misapplied, misused and wasted corporate assets," thereby breaching a fiduciary duty owed to a minority shareholder by a majority shareholder. Bob and BFI asserted a five-year statute of limitations based on the alleged conduct that occurred before the limitations cut off. The trial court ruled that even if it accepted John's argument that the continuous wrong doctrine was applicable to his claims, the claims were barred by the five-year statute of limitations. The court concluded that the only conduct complained of that fell within the limitations period was Bob Baur's vote to reimburse legal fees to defend this action, which occurred after the filing of the suit, and thus could not be the basis for the suit. The trial court, therefore, granted summary judgment to the defendants.

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On appeal, the Iowa Court of Appeals noted that a corporation may be judicially dissolved in a proceeding brought by a shareholder if it is established that the directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent. Canvassing cases that addressed the statute of limitations issue, both from Iowa and other jurisdictions, the court found that if the acts John complained of were looked at in isolation, it would agree that his claims were time-barred. While some of the acts about which he complained were discrete acts that he could have challenged when they occurred, the court observed that those same acts could be viewed as specific and supportive evidence of the alleged plan by Bob to freeze out John. Here, the core of John's claims of oppressive conduct related to his inability to receive any return on his interest in the corporation and, more importantly, his inability to sell his stock other than at a low price determined by Bob. To the extent that Bob's insistence on a minority discount was a continuing wrong or a wrong that had reoccurred within the statute of limitations period, the court found the limitations period would not apply, especially since the state's Supreme Court and the legislature indicated that fair value does not include a discount for minority status. Thus, the court concluded that any insistence by Bob that a minority discount be imposed could be found to be oppressive and a continuing wrong when coupled with the other evidence presented by John—and raised a genuine issue of material fact concerning whether the statute of limitation barred the action. Accordingly, the court reversed the grant of summary judgment on this issue to Bob and BFI, and remanded the case [*Baur v. Baur Farms, Inc.,* 2010 Iowa App. LEXIS 117 (Iowa Ct. App. 2010); ¶84,999.85].

LEGISLATIVE NEWS

[¶7.3] Here is a list of statutes appearing in this report that have been amended or added.

NEBRASKA

RS amended

45-101.04	General interest rate; maximum; when not applicable

SOUTH DAKOTA

Model Registered Agents Act amended

59-11-2	[Definitions]

Model Registered Agents Act added (uncodified sections)

2 [S.B. 51, L. '10]	[Executing false material; penalty]
3 [S.B. 51, L. '10]	[Electronic transmission]

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