FUNDAMENTAL BYLAWS – Note on CCWG-Accountability proposal

The proposed measure of Fundamental Bylaws refers to dividing existing bylaws into two categories: fundamental, and regular. Bylaws in the 'Fundamental' category would be harder to change. Normally, amending the bylaws requires a two-thirds (2/3) vote of the Board. This proposal suggests that changes in Fundamental Bylaws require a higher vote of 3/4 members of the Board, and final approval of the Community. As far as Community approval superseding Board decisions is concerned, it must be noted that the California Corporate Code requires the Board to have final approval. Even though delegation of Board activities is permitted, the Board is the ultimate oversight authority. Therefore, in any situation, decisions are subject to the "ultimate direction of the board". [§5210] Another important point to be noted is that members have the right to prospectively approve or veto certain board actions. The bylaws can confer these rights of a member on any person. [§5056] So, while the Community cannot be the final oversight authority, or alter Board decisions, they can be vested with the powers of the Members, and prospectively approve or veto certain board actions.

Coming to the Fundamental Bylaws aspect: Nothing in the Code indicates whether there can be a classification within the bylaws wherein certain bylaws will be considered 'fundamental' with respect to others. §7151(e) permits requiring the vote of a larger proportion of the directors for certain corporate actions. This provision would need to be included in the bylaws, and cannot be amended, except by this greater vote. Within the existing legal framework, the best way to incorporate what is being sought to be introduced through 'fundamental bylaws', is to require a greater vote (e.g. 3/4, instead of the usual 2/3) for certain actions. So, instead of creating 'fundamental' bylaws, one would have to create 'fundamental' actions that require a greater vote than other actions or issues.

On the other hand, the Delaware Corporate Code does not seem to place as high a value on the final say of the Board. From a limited perusal of the law, it would appear that a corporation has the *discretion* to confer the power to amend bylaws on the Board of Directors, by providing as such in the certificate of incorporation. [§ 109] A corporation also has the option of conferring the power to adopt, amend or repeal bylaws on the governing body, by whatever name designated. Therefore, if the Community could be established as a governing body, it seems possible that they have a final say in amending bylaws.

LIFTING THE CORPORATE VEIL

California courts have placed the burden of proof on the party attempting to pierce the corporate veil to justify doing so. The test laid down by the California Supreme Court[1] has two requirements: (1) that there is a unity of interest and ownership to the extent that the parent and its subsidiary no longer exist as separate personalities; and (2) that if the acts of the subsidiary are treated as the acts of the parent, an equitable result will follow. These two requirements have come to be known as the "formalities requirement" and the "fairness requirement". The application of these requirements has differed from court to court. Some have been used just one requirement to justify piercing the veil,[2] while others have required additional factors be proved.[3]

<u>Parent-subsidiary context:</u>

In cases of parent-subsidiary relationships, the two prong test of formalities and fairness remain the same.[4] The Formalities requirement will involve looking at the degree of control the parent exercises over the subsidiary, in order to determine whether the subsidiary is a mere instrumentality of the parent corporation. While some courts have allowed piercing the veil even in the absence of fulfilling the fairness requirement,[5] California courts require ***both*** control and unfairness to be proved in order to pierce the veil between a parent and subsidiary, and have been strict about this.[6] So mere inter-corporate connections between a parent and its subsidiary in the absence of proof of manipulative control by the parent, will not justify lifting of the corporate veil.

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[1] *Automotriz del Golfo de Cal. v. Resnick*, 47 Cal. 2d 792.
[2] *Anderson v. Abbott,* 321 U.S. 349 (1944), where the unfairness requirement alone was considered sufficient.
[3] *Berger v. Columbia Broadcasting Sys*., 453 F.2d 991, 995 (5th Cir. 1972), which required proof of fraud.
[4] *McLaughlin v. L. Bloom Sons Co.,* 206 Cal. App. 2d 848 (1962).
[5] *Chatterly v. Omnico, Inc.*, 26 Utah 2d 88.
[6] *United States v. Dean Van Lines*, *Inc*., 521 F.2d 289, 291 (5th Cir. 1976); *Schlecht v. Equitable Builders*, *Inc*., 272 Or. 92, 96, 535 P.2d 86, 88 (1975) and *Institute of Veterinary Pathology, Inc. v. California Health Laboratories, Inc*., 116 Cal. App. 3d 111, 119-20.

Additional information about the first factor:

In *Associated Vendors, Inc., v. Oakland Meat Company*,[7] the court provided a list of factors that help establish unity of interest:

"Failure to segregate funds, Diversion of funds or assets, Treatment by shareholder of corporate assets as own, Failure to maintain minutes, Identical equitable ownership in two entities, Officers and Directors of one entity same as controlled corporation, Use of the same office or business location, Employment of same employees, Total absence of corporate assets, Under-capitalization, Use of Corporation as mere shell, Instrumentality or conduit for single venture of another corporation, Concealment or misrepresentation of the responsible ownership, management and financial interests, Concealment or misrepresentation of personal business activities, Disregard of legal formalities, Failure to maintain arms length relationships among related equities, The use of the corporate identity to procure labor, services or merchandise for another entity, The Diversion of assets from a corporation by or to a stockholder or other person or entity to the detriment of creditors, The manipulation of corporate assets and liabilities in entities so as to concentrate the assets in one and the liabilities in another, The contracting with another with the intent to avoid performance by use of the corporation entity as a shield against personal liability, The use of the corporation as subterfuge for illegal transactions and The formation and use of a corporation to transfer to it the existing liability."

Courts have the discretion to consider these factors, or add new ones when arriving at a decision.[8] Not all factors need to necessarily be present.[9]

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[7] (1962) 210 Cal App. 2d, 825.
[8] *Arnold v Browne* (1972) 27 Cal App 3d 386.
[9] *United Community Church v. Garcin*, 231 Cal. App.3d 327.