Forms of Business Organization

Agency

I. Definition
  A. Fiduciary relationship that arises by the consent of the agent to act for the principal
    1. **Restatement (2d) § 1**
    2. **Restatement (3d) § 1.01**
      a. Fiduciary relationship when a principal manifests assent to an agent that the agent shall act on the principal's behalf and subject to the principal's control, and that the agent manifests assent or otherwise consent to act
  B. Elements
    1. May be terminated by either party at any time
      a. But may be subject to damages, but not specific performance
    2. Generally not required to be in writing
    3. Agent has authority to make contracts for the principal
    4. Principal has the right to control the agent
      a. When principal has close control, agent is an employee/servant
  C. Types of agents
    1. Special – limited to single act
      a. Terminates after act completed or after a reasonable time
    2. General – series of acts
    3. Disclosed – 3d party know the agent is acting on behalf of particular principal
    4. Undisclosed – 3d party thinks agent acting on own behalf
    5. Partially disclosed – 3d party knows agent acting on behalf of principal but doesn't know who principal is

II. Forming an agency relationship
  A. Formed by offer and acceptance
  B. May be implied
  C. Parties' subjective intent / perception doesn't control
  D. *Jensen Farms v. Cargill* (Minnn. 1981) (p 18)
    1. Cargill loaned funds to Warren w/ oversight. Cargill directed Warren to implement its recommendations. Warren falsified financial statements.
    2. Cargill's control enough to establish an agency relationship. Liable to Jensen Farms, innocent 3d party.
    3. Cargill in a better position to stop the fraud than Jensen Farms.

III. Costs and Benefits
  A. Creation of wealth through facilitation of voluntary, ongoing collective action
  B. Reduces transaction costs – Coase
    1. Searching, bargaining, etc.
    2. Information asymmetry
  C. Agency costs
    1. Problems w/ agents managing firm's assets - Adam Smith
    2. Agents as maximizers of own interest
    3. Sources – Jensen ad Meckling
      a. Monitoring costs – principals ensure agent's loyalty

   b. Bonding costs – agents prove reliability to principal
   c. Residual costs – different interests b/t agent and principal

IV. Scope of agent's authority
  A. Actual authority
    1. Based on the words and actions of the principal, the agent reasonably believed that the principal gave the agent the authority
      a. What a reasonable person in the agent's position would infer from the principal's conduct
      b. Not what the principal subjectively intended
    2. Includes incidental/implied authority
      a. Authority to do implementary steps ordinarily done in connection w/ facilitating the authorized act
  B. Apparent authority
    1. Test: 3d person reasonably believes and relies on acts of the principal that the agent has authority
    2. Agent can't establish own authority
      a. *White v. Thomas* (Ark. App. 1991) (p 22)
        i. White gave Simpson authority to bid on land. Simpson purchased land for more than authorized. Simpson sold piece of the land to Thomas. Thomas knew Simpson acting for White. White ratified purchase, but not sale to Thomas.
        ii. Court said that this was 2 different transactions, so Restatement (3d) § 4.07 doesn't apply.
        iii. Thomas only relied on Simpson's word, not on acts of the principal.
  C. Inherent authority / power
    1. Agent's authority to bind principal to contracts
      a. Imposed by law, not by principal conferring authority to agent
    2. In undisclosed transactions
      a. Agent knowingly does something beyond his actual authority and hurts a 3d party, then principal is liable to 3d party
      b. Theory: principal put the 3d party in that position
    3. *Gallant v. Isaac* (Ind. App. 2000) (p 26)
      a. Isaac bought car insurance from Gallant through its agent, Thompson-Harris. Thompson-Harris said covered before completed paperwork. Isaac crashed car in interim. Gallant said not bound b/c didn't fill out paperwork.
      b. Court found Thompson-Harris had inherent authority to bind Gallant.
    4. Court uses this when there's a sympathetic π - not doctrinally sound

V. Law of agency: Liability
  A. Liability of principle to agent
  B. Principal's liabilities to 3rd parties for acts of agent
    1. Principal is liable to 3d party if agent had express authority to enter contract
      a. Principal may be disclosed or undisclosed
    2. Contracts by agent beyond express powers
      a. Ratification
        i. Principal accepts the benefits under an unauthorized contract
        ii. **Restatement (3d) § 4.02**

iii. If the principal ratifies the contract and the 3d party withdraws, 3d party not liable
iv. **Restatement (3d) § 4.07**
- Take it all or leave it all – can't ratify just part of the contract

b. Principal may be bound by estoppel
i. Failure to act when knowledge and opportunity to act arise
ii. Reasonable change in 3d party's position

3. Wrongful acts by agent
a. Agent can bind the principal to torts committed within the scope of the agency
b. Scope of employment
i. **Restatement (2d) § 228**
ii. **Restatement (3d) § 7.07**
iii. "Frolics" are outside the scope of employment

c. Employee v. independent contractor
i. **Restatement (2d) § 220**
ii. Focuses on the degree of principal's control of the agent
- Incentivize the one with control to change behaviors to avoid injury
- Can't punish principal who doesn't have control

iii. *Humble v. Martin* (Tex. 1949) (p 30)
- Car rolled off Schneider's gas station and hit Martin and kids. Humble owned the station and had contract w/ Schneider to run it. Station only sold Humble products.
- Court said Schneider is Humble's agent b/c has financial control and supervision and contract terminable at will.
- Note: court doesn't want a judgment-proof agent to stand between the oil company and all torts

iv. *Hoover v. Sun Oil* (Del. 1965) (p 32)
- Barone operated service station. Fire in π's car. Sun owned service station. Barone allowed to sell competitor products; lots of control over daily operations.
- Court said Barone an independent contractor, so Sun not liable to π.

C. Liability of agent to 3d party
1. Agent who signs a contract for an undisclosed principal is liable to the 3d party for the contract
2. The 3rd party can sue the agent for damages for misrepresentation
a. The agent implicitly represents his own authority

VI. Liability of agent to principle: fiduciary duties
A. Supervised by equity courts
B. Fiduciary duties provide default provisions to fill in gaps in contracts
C. Types of fiduciaries
1. Trustee and trust
2. Guardian and ward
3. Executor of estate
4. Partners, principal/agent, etc.

D. Fiduciary duties
1. **Restatement (2d) §§ 379, 381, 385, 387, 388, 389, 390, 391, 395**

2. Duty of loyalty
    a. The obligation of a fiduciary to exercise the power he has by reason of the fiduciary relationship only in a good faith effort to advance the purposes of the principal/owner or welfare of the relationship
    b. Requires full disclosure
        i. Something more than a seller's duty not to lie
        ii. Informed consent
3. Duty to act with reasonable care
4. Duty to act in fair terms with the principal
    a. Court may find a fair price if agent can show principal gave informed consent
5. Duty to obey
    a. But if the agent in good faith thinks that the principal would want the agent to do something else because of changed circumstances, then agent probably not liable

E. Courts strict about protecting the fiduciary relationship
1. Reduces transaction costs
2. Court will award all damages it can for breaches of fiduciary duties
    a. Unjust enrichment made by agent in the course of the agency belong to the principal.
    b. *Tarnowski v. Resop* (Minn. 1952) (p 36)
        i. Principal hired agent to investigate and negotiate purchase of music machines. Agent relied on false representations of sellers and got commission from sellers. Principal won action against sellers and rescinded contract.
        ii. Commission goes to the principal and is entitled to indemnification by agent.
3. If agent profits because of the fiduciary relationship, liable even if no breach of trust
    a. Restatement (2d) Trusts § 203
    b. *In Re Gleeeson* (Ill. App. 1954) (p. 38)
        i. Gleeson leased land to Curtin. Gleeson died. Curtin was executor and trustee. Curtin leased land to himself at high price w/ the consent of 2 of the beneficiaries. Other beneficiary was incompetent.
        ii. Curtin's profits belong to the beneficiaries.

General Partnership

I. Definition

A. Consensual arrangement where 2+ people agree to operate a business for profit

B. Jointly owned business firm
1. Co-owners have shares in the profits

C. Default: partners are agents of the partnership
1. Form of joint agency w/ fiduciary relationship
2. Opportunities that arise bc of the partnership belong to the partnership
    a. *Meinhard v. Salmon* (NY 1928) (p 45)
        i. Salmon leased premises. Partnership w/ Meinhard. Salmon as manager, Meinhard provided funds. Owner leased larger tract to Salmon.

General Partnership

II. Definition

A. Consensual arrangement where 2+ people agree to operate a business for profit
B. Jointly owned business firm
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C. Default: partners are agents of the partnership
    1. Form of joint agency w/ fiduciary relationship
    2. Opportunities that arise bc of the partnership belong to the partnership
        a. *Meinhard v. Salmon* (NY 1928) (p 45)
            i. Salmon leased premises. Partnership w/ Meinhard. Salmon as manager, Meinhard provided funds. Owner leased larger tract to Salmon.
            ii. Court said Salmon should've disclosed opportunity to Meinhard. Ordered Salmon to allot shares to Meinhard subject to Meinhard contributing pro rata share of capital and Salmon maintaining his management position.
            iii. Court assumes Salmon got info about 2d contract bc of the partnership and not Salmon's management skills
    3. Either partner can bind the partnership
        a. *National Biscuit Co. v. Stroud* (NC 1959) (p 59)
            i. Stroud and Freeman had a partnership. Freeman ordered bread from Nabisco against Stroud's wishes. Dissolution of partnership, w/ assets and liabilities assigned to Stroud.
            ii. Freeman's action bound the partnership and Stroud.

III. Reasons for partnership form
A. Economic
    1. Firm needs more capital as it grows
    2. Financing the business
        a. Debt usually cheaper than equity
        b. When there's too little equity, banks won't lend or will only lend at high rates
            i. Owner has incentive to take big risks b/c gets the profits if it succeeds, but loses bank's money if it fails
B. Share control – intelligence capital

IV. Default terms: usually contracted-around
A. Forms
    1. **UPA § 6**
    2. **RUPA § 101.6**
B. Shared rights
    1. Shared rights of management / control
        a. Not assignable
            i. **RUPA § 504**
            ii. Personal
    2. Shared right of residual return
        a. Residual return: net profit; what's left after costs of doing business are paid
        b. Default: equal shares
        c. **RUPA § 401**
        d. Assignable – **RUPA § 504**
C. Shared liabilities for business obligations
    1. Partners are jointly and serverably liable to 3d parties in torts or contracts
        a. **RUPA § 306**

   b. Partnership entity with unlimited liability
   c. 3d party can sue either partner or the partnership
   d. Unlimited liability offers assurance to the market
2. Partners have indemnity rights against each other
   a. **RUPA § 401(c)-(e)**
   b. Partners are liable for liabilities incurred by the partnership before joining the partnership up to the amount contributed – **UPA § 17**
3. Partners can contract liability among partners
   a. 3d parties w/out notice aren't affected
   b. Firm may file statement of partnership as notice to 3d parties – **RUPA § 303**
4. Questions about partnership liability
   a. Is this a partnership?
      i. **UPA § 7**
   b. Is there partnership liability?
      i. **UPA § 9**
      ii. **UPA § 17**
   c. Does the partner have indemnity rights from other partners?
      i. **RUPA § 401(c)-(e)**
   d. If the partner is retired, what liabilities is he still on the hook for?
      i. **UPA §§ 29-36** - dissolution
   e. If the partner is liable and doesn't have any money, who takes preference to those assets?
5. Limited liability forms
   a. Limited partnerships
      i. Limited partner: investor
         - Contributes capital
         - No management role; maybe rights to appoint/remove a general partner
         - Liability limited to the amount contributed
      ii. General partner: manager
         - Has unlimited liability
         - Can have a general partner that is a corporation without much capital
   b. Limited liability partnership (LLP)
      i. Partners not liable for each other's professional torts (i.e. malpractice)
   c. Limited liability company (LLC)
      i. Membership agreement – complete contractual freedom
      ii. Dominant form when the company is not publically traded
         - Small groups starting a firm
         - 2 entities starting a 3d entity
      iii. Can contract around fiduciary duties
      iv. Can elect to have pass-through taxation
         - Members pay the tax, not the company (no double-taxation)
         - "Check the box" taxation
         - Can't do this if shares are publically traded

D. Partnership property
1. Partnership tenancy under **UPA § 25**
   a. Quasi-entity

b. Partnership creditors can get this
    i. Note: partner's creditors can get the partner's rights to the profits, but not the partnership property itself
c. Stability

2. RUPA moves to recognizing an "entity"
    a. **RUPA § 303**
    b. **RUPA § 201**
    c. **RUPA § 306**
    d. **RUPA § 307**
3. 3d party claims against partnership property
    a. Jingle rule – old common law rule
        i. Partnership creditors have priority over partnership assets
        ii. Personal creditors have priority over personal assets of the partners
    b. Modern rule - Bankruptcy Law of 1978
        i. Partnership creditors have priority over partnership assets
        ii. Personal creditors and partnership creditors have equal rights to the personal assets of the partners
    c. Security interests take priority over all other creditors

E. Governance
1. Equal voice
    a. Usually a management structure is built into contract
    b. But power to withdraw implicit in the background
2. Matters outside ordinary business require unanimity
    a. Incl. admitting new partner, changing the business of the partnership, and doing anything contrary to the agreement

V. Creation
A. Don't need formalities, but usually have them
B. Objective standard, not the subjective intent of the parties
1. **UPA § 7**
2. Factors to help determine if there's a partnership
    a. Interest in net profits – suggests interest in management – suggests partnership
    b. Contribution of labor and skill
    c. Voluntary contract
    d. Intention / consent to do the acts that constitute a partnership
        i. But don't need the intent to establish a partnership
3. *Cohland v. Sweet* (Ind. App. 1982)
    a. Sweet worked at Vohland's Nursery on commission of 20% net profits. Replenished inventory before calculating profits, so Sweet helped finance inventory. Inventory in nursery grew and incr. in value.
    b. Court said that this is a partnership

VI. Withdrawal, Dissolution, and Disassociation
A. Withdrawal
1. Partner always has the power to withdraw at any time, but not always the right (i.e. may be subject to damage)
2. Default is that withdrawal causes dissolution of the partnership
    a. Most contracts say that withdrawal doesn't lead to dissolution

      i. Gives each partner less power
      ii. Partnership is more stable, so more valuable to clients and creditors
  B. Under the **UPA §§ 29- 40**
    1. Requires reorganization and paying off all liabilities
    2. Any partner ceasing to be associated w partnership – **UPA § 29**
    3. The partnership doesn't terminate until wind-up – **UPA § 30**
    4. Dissolution occurs without wrongful termination upon death, withdrawal or expulsion – **UPA § 31**
      a. *Page v. Page* (Cal 1961) (p 71)
        i. Court found the partnership agreement b/t π and Δ to be terminable at will (not for a term)
    5. Dissolution terminates partner's authority to act for the partnership – **UPA § 33**
      a. Interpreted to be subject to a partnership agreement (i.e. can contract out of it)
        i. *Adams v. Jarvis* (Wis. 1964) (p 63)
          - Π withdrew from partnership. Partnership agreement called for no termination upon withdrawal.
          - Court said that **UPA § 33** is a default term and honored the terms in the contract agreement
    6. Dissolution doesn't discharge partner's existing liability – **UPA § 36**
      a. Can contract around this
      b. Generally still liable to 3d parties
      c. Creditors can still require withdrawing partner to pay unless the creditor consents to a material modification
        i. Can be implied
    7. Non-withdrawing partners have the right to continue the partnership for the remainder of the agreed term – **UPA § 38(2)(b)**
    8. Wrongfully withdrawing partner doesn't get his share of goodwill – **UPA § 38(2)(c)**
      a. Goodwill = value not attributable to identifiable assets; difference between value of business and the value of the assets
      b. Justification
        i. Hard to value
        ii. No realization
        iii. Withdrawing partner is a wrongdoer
    9. Distribution – **UPA § 40**
      a. Default: equal shares
      b. *Dreifuerst v. Dreifuerst* (Wis 1979)
        i. Dissolution of a partnership w/ no partnership agreement.
        ii. Court overturned trial court's order of judicial sale and distribution in-kind
  C. Under the **RUPA §§ 601-704**
    1. Disassociation instead of dissolution
    2. Liability
      a. Withdrawing partner is liable for past but not future obligations unless the 3d party reasonably relied on him continuing to be a partner
      b. Like the UPA, withdrawing partner not liable to a creditor if creditor modifies the terms of the agreement

VII. Partnership Accounting

- A. Balance sheet
  - 1. Assets
    - a. Stated at historical cost
  - 2. Liabilities
  - 3. Capital account
    - a. Capital account = assets - liabilities
- B. Accounting methods
  - 1. Cash basis
    - a. Only recognize cash transactions
  - 2. Accrual basis
    - a. Looks for values that change according to markets
    - b. Recognize economic value

The Corporate Form

- I. Economic reasons for the Corporate Form
  - A. Elements
    - 1. An entity separate from the investors and managers
      - a. Stability
    - 2. "Limited liability" for investors
      - a. Investors can only lose what they invest
      - b. No actual liability
      - c. Attracts investors
      - d. Reduces monitoring costs
    - 3. Centralized management
      - a. Managerial expertise – specialization in knowledge
    - 4. Free transferability of shares
      - a. Can transfer the whole interest, incl. the government rights
  - B. Specialization between economic risk and management
    - 1. Investors can invest capital without knowledge
      - a. Cheap diversification
      - b. Makes capital more cheaply available
    - 2. Management can manage without capital
  - C. Types of corporations
    - 1. Public corporations
      - a. Funded through capital markets
      - b. Rational passivity
        - i. Investors don't have incentive to research the firm b/c the number of shares each has isn't enough to make a big difference
    - 2. Close corporations
      - a. Few shareholders
      - b. Differences from public corporations
        - i. Not subject to SEC regulations
        - ii. Less collective action problem
  - D. Capital market centric system
    - 1. Information
      - a. Competitive prices provide signals

      b. Information risks are reduced with more government regulations
   2. Capital market mechanisms
      a. E.g. brokers, insider trading prohibitions
   3. Assurance that managers are competent and honest and investors have the ability to replace/control them if they're not

II. History of incorporation
   A. Early corporations
      1. Created by special acts of the legislature for specific purposes
      2. Financial or transportation companies
   B. General acts of incorporation (1800s)
      1. Free incorporation – available to anyone
      2. Lots of restrictions
   C. 20th Century
      1. Easing of regulations
         a. No minimum or maximum capital requirements
         b. No geographic restraints
         c. Easy to create or merge
         d. Not limited to type of business
      2. Increase in importance of fiduciary duty of loyalty
   D. Usual incorporation process today
      1. Create LLC
      2. Personal capital to angle capital to venture capital
      3. Initial public offering (IPO) or sale to another company

III. Why Delaware?
   A. Del is bad: Columbia story
      1. Favorable to corporate managers who make the decision where to incorporate
      2. Del. gets 28% of its revenue from franchise taxes
      3. Other states follow to try to compete: race to the bottom
   B. Del is good: NYU-Yale story
      1. Del. has incentive to provide high level of shareholder protections, or else they'd insist on incorporation elsewhere
      2. Shareholders only want protections to the point that they can still make money
   C. Delaware Court of Chancery
      1. Only hears corporation cases
      2. Quality, experience
      3. Can get preliminary injunctions quickly
   D. Del. is standard, so the market likes it

IV. General structure
   A. Internal affairs
      1. Relationship between managers, board, and shareholders
      2. Governed by the state of incorporations
   B. Charter / certificate of incorporation / articles of incorporation
      1. Enabling – can create structure best for that business
      2. **DGCL § 102(b)(1)**
      3. Amendments – **DGCL § 241**
         a. Board initiates it

        b. Must be in a way that would've been legal
        c. Shareholder vote
            i. Default: simple majority
    C. Bylaws
        1. Operating rules
        2. **DGCL § 109(b)** grants power to shareholders to adopt bylaws
            a. Can also give the power to the board
    D. Shareholder rights
        1. Right to elect board – **DGCL § 211**
        2. Right to remove directors – **DGCL § 141(k)**
        3. Consent solicitation – **DGCL § 228**
            a. Can act by written consent instead of calling a meeting
        4. Right to vote on
            a. Mergers – **DGCL § 251**
            b. Sale of substantially all assets – **DGCL § 271**
            c. Dissolution – **DGCL § 275**
    E. Board of directors – **DGCL § 141(a)**
        1. Legal right to manage business affairs
            a. Initiates all important things
            b. Designates management
            c. *Automatic Self-Cleansing v. Cunninghame* (Eng 1906) (p 101)
                i. Shareholders passed a resolution to sell company's assets. Board refused.
                ii. This is a board decision; don't have to listen to shareholders if not in corporation's best interest.
        2. Boards increasingly active
        3. Default: elected for 1 year terms
        4. Can have a staggered board
            a. Limits the removal power
            b. 3 terms in Del, 4 terms in NY
    F. Corporate officers
        1. Appointed by board resolution
        2. Agents of the corporation
            a. Subject to apparent authority rules
                i. *Jennings v. Pittsburg Mercantile* (Pa. 1964) (p 107)
                    - Officers asked Jennings to solicit offers for a sale and leaseback w/ no authority from board to do so. Mercantile refused to pay commission.
                    - No apparent authority b/c Jennings relied on agent's actions, not Mercantile's.

Raising Capital

General

I. Capital structure
    A. Debt: bonds
        1. Leverage: amount borrowed

2. Features
    a. Holder has the right to declare default
        i. If the principal isn't paid on maturity date
        ii. If the interest isn't paid and there's an acceleration clause
    b. Stated interest rate or zero-coupon bond
    c. Can be customized by covenants
    d. Can have different seniority levels, which varies risk and price
3. Disadvantages
    a. Cash-flow drain
    b. May be more expensive to refinance
    c. Can declare default if company doesn't pay, which means company might go into bankruptcy or have to borrow from another creditor at high price

B. Equity: common stock
1. Indefinite – no maturity date
2. Right to dividends as declared by the board
    a. No right to declare default if not paid
    b. Dividends paid after company pays expenses and debt interest
3. Unlimited upside as residual owner of cash flows
4. Shareholders have certain control rights [See Shareholder Voting]
5. Preferred stock
    a. Typically has preference over common stock for liquidation and dividends
    b. Usually doesn't vote when dividend is current

C. Debt usually cheaper than equity
1. Bonds are paid before equity in bankruptcy
    a. Less risk = lower price
2. Tax treatment
    a. Payments to bond holders are tax-deductible
    b. Distributions to equity are taxed
3. Implicit cost of equity: people won't give their money without assurance of a return

D. Optimal capital structure is mix of debt and equity

II. Estimating costs

A. Time value of money
1. The value of the use of money
2. PV = (FV) / (1 + r)
    a. Present value (PV) is the value today of the money to be paid at a future point
    b. Discount rate (r) based on time value of money and level of risk
        i. When the investment is risk neutral, this is called the risk-free rate
        ii. When investment is risky, this is called the risk-adjusted rate
    c. Discount factor = 1 + r
    d. FV = future value
    e. [See page 116 for examples]
3. Net present value (NPV): PV of amounts received minus amounts invested
4. Rate of return: % earned if you invest

B. Risk and return
1. Volatility of expected returns
2. Estimating expected return using the weighted average of the value of investments

        a. Sum of all returns/losses each multiplied by their probability of occurring
        b. Discount the expected return to present value
        c. [See pages 118-19 for example]
    3. Types of risks
        a. Systematic – risks for the whole system
        b. Unsystematic – risks for individual firms
    4. Measuring risk premium
        a. Most investors are risk averse, so demand a risk premium
        b. More volatile → more risk → higher risk premium
        c. Risk premium = risk adjusted rate – risk free rate
    5. Investors demand higher risk premium for smaller companies
        a. *Emerging Communications* (Del Ch 2004) (p 126)
            i. Expert used CAPM to calculate cost of equity. Included premium for small company and extra premium for being super-small.
            ii. Court allowed small company premium, not super-small company premium.
  C. Diversification
    1. Can eliminate unsystematic risks through diversification
    2. Diversified portfolio has less total risk than individual components, so investor demands lower risk premium total

III. Valuation of assets: Discounted Cash Flow (DCF) Technique
  A. Estimate all future cash flows
    1. Use a terminal value to calculate for finite number of years
  B. Calculate the discount rate
    1. Weighted-average cost of capital (WACC)
        a. WACC = weighted average cost of debt + weighted average cost of equity
            i. Cost of debt calculated using current yields
                - The interest rate firm would pay today, not the historical interest rate of existing debt
            ii. Cost of equity calculated using one of the methods below
  C. Cost of equity
    1. Capital assets pricing model (CAPM)
        a. Links the asset's risk to the volatility of the asset's price
        b. Cost of equity = risk-less rate + (equity premium)(Beta)
        c. Risk-less rate is traditionally the U.S. Treasury bond rate
        d. Equity premium: historical amount that equity returns on investments above the risk-less rate
        e. Beta: based on the amount that the company's stock varies with the market
            i. If the stock is as risky as the market, Beta = 1
            ii. If the stock is more volatile than the market, Beta > 1
    2. Historical average equity risk premia
        a. Less accurate
    3. Reasonably efficient capital market hypothesis (ECMH)
        a. The stock market rapidly reflects all public information bearing on the expected value of stocks
        b. The market price is close to the asset's value

Balance Sheet

I. Assets
II. Liabilities
    A. Debt
    B. Equity: capital
        1. Stated value
            a. "Permanent" capital
            b. For par value stock, use the stated minimum value
            c. For no par value stock, it's any % of initial cost of capital
        2. Retained earnings
            a. Profits
            b. Managers may put money into retained earnings when it has better investment options than the stockholders or to protect themselves
        3. Excess/surplus
            a. Whatever's left

Assets	Liabilities
Cash	Trade
Inventory	Bonds
Land	**Capital**
Plant	Stated capital
Patents	Excess / surplus capital
	Retained earnings

Protection for Creditors

III. Types of creditors
    A. Commercial creditors
        1. Mostly protected by contract and disclosure
    B. Involuntary creditors
        1. Tort victims
            a. Have to rely on insurance
        2. Shareholders who deal with the company on a small scale
            a. When corporation ignores formalities or implicitly misleads the public
IV. Contractual protections
    A. Most important form of protection for creditors
    B. Information and disclosure
        1. Due diligence
        2. Warranties and disclosures
    C. Covenants
        1. Default term: breach of covenant is treated as a default
        2. Negative covenants: what debtor can't do
        3. Creditor can consent to departing from covenants
        4. Enough covenants/negative covenants may make a court treat the creditor as a principal – *Cargill* [See Agency]
    D. Security interests
        1. Protected in bankruptcy

        a. Given the highest priority
    2. Can get the assets sold

V. Legal protections
  A. Minimum capitalization rules
    1. In U.S., these have been removed for corporations
    2. Can have stock with no par value
    3. Replaced by other protections
        a. Forced disclosure of public companies through SEC filings
        b. Fraud remedy
        c. Contractual protections
    4. "Adequate" capitalization requirements
  B. Dividend protection
    1. **DGCL §§ 174, 244**
    2. Preferred stock
        a. If dividends aren't paid, they accumulate
        b. Have to pay dividends to preferred stock before common stock
    3. Can pay dividends out of
        a. Retained earnings
        b. Excess capital
        c. Reevaluation surplus – **DGCL § 154**
            i. Economic value of assets may be more than the historical price reflected on the balance sheet – reevaluate the asset to reflect the higher value
            ii. Have to disclose the reevaluation
    4. Directors held personally liable if they pay dividends when they shouldn't – **DGCL § 174**
        a. Insurance doesn't cover this
  C. Protection against fraud: Uniform Fraudulent Transfers Act (**UFTA**)
    1. Updates the Uniform Fraudulent Conveyance Act (**UFCA**)
    2. Present or future creditors may void transfers when…
        a. Debtor had actual intent to delay, hinder, or defraud creditors
        b. The transaction makes the debtor insolvent and there was no fair consideration
            i. Insolvency
                - Liabilities > assets at fair market value
                - Liquidity problem: lack of cash to pay liabilities as they come due
                - When the firm is within the zone of insolvency, directors owe a duty of loyalty to the corporation and its creditors
            ii. Fair consideration is bargained for consideration close to what a reasonable person would expect
  D. Protection in dissolution
    1. **DGCL §§ 275-284**
    2. Shareholders are only liable to the extent of the liquidated distribution
    3. Directors only liable to the amount that they wrongfully pay liquidated distributions
    4. Tort victims can get the legislature to revive the company to sue it
        a. Often go after directors for wrongfully paying liquidated distributions
    5. Cut-off of future unknown claimants – **DGCL §§ 281-284**

VI. Equitable remedies

A. Available when…
   1. The π has an equitable (against the fiduciary)
   2. Legal remedies are inadequate
   3. Usually done when there's an abuse of the corporate form
B. Equitable subordination
   1. Rarely done
   2. No legal subordination of debtors, but the court thinks there should be in equity
      a. Test
         i. Consider all relevant factors
         ii. Need a culpable conduct
      b. Usually a fraud is implied
   3. Cases
      a. *Costello v. Fazio* (9th Cir. 1958) (p 145)
         i. Partners formed a corporation that was inadequately capitalized, essentially to protect the capital investments of some of the partners in the original partnership.
         ii. Court subordinated the partners' claims to other creditors' claims in bankruptcy.
      b. *Gannet* (not in book)
         i. Gannet loaned money to its subsidiary. Gannet controlled the management of the subsidiary for its own interests.
         ii. Court subordinated Gannet's debt to debt of other creditors.
C. Piercing the corporate veil
   1. Courts will pierce the corporate veil when there's complete disrespect for corporate formalities
      a. The formalities are the only reason why the corporation is an entity
      b. The corporate form can't be used to commit fraud
      c. *Kinney Shoe v. Polan* (4th Cir. 1991) (p 156)
         i. Polan formed Polan Industries and Industrial. Kinney sublet building to Industrial. Industrial sublet part of building to Polan Industries. Industrial didn't pay rent. Industrial had no assets – a shell to protect Polan from liability.
         ii. Court allowed Kinney to pierce corporate veil because Polan disregarded corporate formalities.
   2. Test
      a. Totality of the circumstances
      b. Must be some wrong done
         i. *Sea-Land v. Pepper Source* (7th Cir 1991) (p 151)
            - Marchese owned 5 businesses, including PS. Comingled funds. Sea Land had judgment against PS. Sea Land tried to pierce corporate veil to get judgment satisfied by Marchese / sibling companies.
            - Unsatisfied judgment no enough to pierce corporate veil.
D. Enterprise liability
   1. Not available in Del.
   2. Make the business as a whole liable on the theory that all of the entities are co-conspirators

3. Unclear where to draw the line

Protection for Equity Investors: Shareholder Litigation

I. Legal Protections: shareholder rights
   A. To sell, vote, or sue
   B. Information rights
   C. [See Shareholder Voting]
II. Types of suits
   A. Class actions (direct)
      1. Π class with a shared important fact or legal issue - FRCP 23(b)(3) (added 1966)
         a. Can bring a class action if things in common to be litigated dominate things not in common
         b. Requirements
            i. Notice requirement
            ii. Opt-out
         c. Nationwide service of process
         d.
      2. Private Securities Litigation Reform Act (PSLRA) attempts to restrain class actions
   B. Derivative suits
      1. 2 suits in one
         a. Suit against the wrongdoer
         b. Suit against the directors for failing to sue the wrongdoer
      2. Π is a fiduciary of the shareholders / company
      3. Classic case: self-dealing between the board and majority shareholder
      4. Benefits
         a. Encourages monitoring
         b. Makes directors' fiduciary duty to shareholders effective for public companies – check on directors
   C. Distinguishing between class actions and derivative suits
      1. Test: *Tooley* (Del 2004) (p 372)
         a. Who suffered the alleged harm?
            i. Individuals got hurt → class action
            ii. The corporation got hurt → derivative suit
         b. Who received the benefit of the remedy?
            i. The corporation → derivative suit
            ii. Individual shareholders → class action
      2. Can be both derivative and direct
         a. *Gentile* (Del. 2006) (p 372)
            i. Injury to shareholders and to the corporation
III. Derivative suits: Requirements
   A. See FRCP 23.1
      1. Del. adopts similar rules
   B. Standing
      1. Must be a shareholder at all times during the suit
      2. Must have been a shareholder at the time of the wrong unless you acquired the shares through the operation of law (i.e. you inherited the stock)

C. Pre-suit demand
   1. Board's decision not to bring a suit is a valid business judgment that is upheld as long as the decision wasn't wrongful
   2. Excused if going to the board would be futile because the board isn't in a position to make a valid business judgment
      a. Entrenchment case
         i. Test: whether the board was in a position to make a valid judgment and whether a majority of directors were in that position
            - *Levine v. Smith* (Del. 1991) (p 383)
   3. Different jurisdictions
      a. In Del, the court assumes that if you make a demand, the board is independent.
      b. ALI requires taking the suit to directors first.
      c. Federal court will probably apply state demand requirements under *Erie*, but unresolved
D. Additional requirements in some jurisdictions (not Del.)
   1. Demand on shareholders in small companies
   2. Bond requirement
E. If a company merges with another company
   1. Cash merger
      a. The π is no longer a shareholder, so no standing
      b. The claim is reflected in the price paid
         i. If it's not, bring an appraisal remedy
   2. Stock merger
      a. Double derivative suit
      b. Π owns shares in the new company. The new company owns the claim against the old company
      c. Look at the board that is in place (new board) when the suit is brought to determine if you have to make a demand on the board
         i. *Rales v. Blasband* (Del. 1993) (p 388)
            - Πs own Danahr stock. Danahar owns Easco.
            - Court found demand was excused bc there was reasonable doubt that the Easco board could act independently.

IV. Attorney's fees
A. Attorneys are the driving force
   1. Solution to the collective action problem
   2. Causes too many suits?
B. Common fund doctrine
   1. All beneficiaries benefit, but all liabilities for attorney fees are on the named π
   2. Solution is to pay the attorney fee out of the common fund
C. Substantial benefit rule
   1. If the settlement created a benefit to the corporation, then the court can award attorney's fees to the π
   2. Governance changes can be enough of a benefit to have the corporation pay attorneys fees
      a. *Fletcher v. A.J. Industries* (Cal App 1968) (p 374)
D. Named π can only get extra damages if the court orders it

      1. Never happens in Del.
   E. Calculation
      1. Percentage of award rule
         a. Look at market rates for a contingency fee
      2. Lodestar / *Lindy* rule
         a. (# of hours) x (level of difficulty)
         b. Incentives for lawyers to run up hours
         c. This rule is receding
         d. Used in federal courts
      3. Auction
         a. Auction the right to represent the class
            i. Incentive to do as little work as possible
         b. Auction the claim
            i. Academic idea only
            ii. Huge discount for risk bc lack of information
      4. All factors test
         a. Del. uses this
         b. Pick a percentage based on time, difficulty, benefit/award, etc.
   F. Must settle the merits before discussing attorney fees
      1. Prevents strike suits
         a. Brought for the purposes of settlement
         b. Defense costs are less than settlement costs

V. Ways for company to deal with a derivative suit
   A. Motion to dismiss
      1. Failure to state a claim –FRCP 12(b)(6)
      2. Failure to make a demand – FRCP 23.1
         a. Did board act in good faith? Disinterested directors?
         b. Π must show reasonable doubt that the board isn't in a position to exercise valid business judgment
            i. Controlling shareholder transaction
            ii. Majority of the board is implicated
      3. Do this for weak claims
   B. Special committee
      1. Committee of independent directors appointed to investigate whether or not to bring suit.
         a. Usually composed of 2 directors not on the board at the time of the transaction.
      2. Delaware
         a. Test - *Zapata v. Maldonado* (Del. 1981) (p 396)
            i. Is the report prepared by independent people? Is it well informed?
            ii. Judge exercises own business judgment
      3. New York
         a. Test: was the committee well informed and independent?
   C. Settlement
      1. Shareholders must have notice and an opportunity to be heard before settlement
      2. If the case makes it past summary judgment, will probably settle
         a. Directors indemnified

      i. Even when there is a very small chance that directors wouldn't be held liable, the risk of having to pay huge sums is enough to settle, e.g., *WorldCom*
    b. Πs get something
    c. Notable exception: Disney case
  3. Must be approved by court
    a. Judge has to determine if it's fair
    b. *Carlton Investments v. TLC Beatrice* (Del. Ch. 1997) (p 418)
      i. Court determined that the settlement was fair and dismissed the case.

Fiduciary Duties of Corporate Directors and Controlling Shareholders

Duty of Attention and Care

I. Directors are required to be informed when they make decisions
  A. "Enough" information
    1. Reasonable person standard
    2. Consider all factors - contextual
      a. Costs of getting more info, including cost of delay
      b. Size of transaction
      c. Significance of unknown
    3. Court considers the process directors took in making the decision
  B. **Model Business Corporation Act § 8.30**
II. Don't want to discourage directors from undertaking risky projects
  A. Want directors to be reasonably careful, but not too careful
  B. Directors aren't liable for losses from a decision made in good faith
    1. Exception: when the decision was egregious that it suggests improper motivation
    2. *Gagliardi v. Trifoods* (Del Ch 1996) (p 243)
    3. Court won't infer negligence from the decision itself
  C. Standard of care different than standard of liability - **Model Business Corporation Act §§ 8.30(b), 8.31**
    1. Standard of care: objective
    2. Liability: subjective standard
      a. Based on director's reasonable belief
III. Methods for ensuring directors act appropriately
  A. Take-over mechanism
  B. Derivative lawsuit
  C. Vote
  D. Non-legal constraints
    1. Reputation
    2. Incentive compensation
    3. Directors want to do the right thing
IV. Problem of director passivity
  A. Duty to monitor management and related duties
    1. Know the company's business
    2. Attend meetings, read and review financial statements
    3. Ask questions

4. Object to illegality
    a. If present and don't consent, presumed to concur

B. Red flag doctrine
    1. Directors are entitled to trust their subordinates unless they are put on reasonable notices otherwise
        a. Recognized in *Grahm v. Allis-Chalmers* (Del. 1963) (p 269)
        b. Applied in *Beam v. Martha Stewart* (Del Ch 2003) (p 273)
    2. Board has a duty to make sure that there's a system in place to give the board this info
        a. *Caremark* (Del Ch 1996) (p 282)
            i. No "red flag" but the wrongdoing was buried in the bowels of the corporation. Adequate info and reporting system. Court found the settlement to be fair.
            ii. Court departed from *Allis-Chalmers* standard to consider the adequacy of the information and reporting system
            iii. This approach affirmed by Del Supreme Ct
        b. **Sarbanes-Oxley § 404**
            i. CEOs and CFOs have to certify that they disclosed all deficiencies or material weaknesses to company's independent auditors
            ii. Applies to officers of companies regulated by the Securities Exchange Act of 1934

C. Cases
    1. *Francis v. United Jersey Bank* (NJ 1981) (p 264)
        a. Mom, dad, and sons directors. Didn't separate operating and client funds. Sons withdrew funds. Mom didn't oversee or stop them, effectively abandoning her position as a director.
        b. Mom held liable for breaching duty to be an active monitor
    2. *Marchese* (SEC 2003) (p 276)
        a. Marchese and outside director. Friend of Adley, controlling shareholder and CEO. Adley fired auditors and hired new ones who approved a consolidation. Marchese signed false statement without asking questions or resigning.
        b. Court issued a cease and desist order against Marchese

V. Duty to Obey Positive Law

A. Directors can't knowingly authorize an illegal act
    1. *Metro Communications* (Del Ch 2004) (p 291)
    2. Business judgment rule doesn't insulate directors, even if the illegal act was done for the benefit of the corporation – *Miller v. AT&T* (3d Cir. 1974) (p 289)
        a. Del. accepts this rule
        b. This is the NY rule – *Roth . Robertoson* (NY 1909) (p 290)

B. Directors conservative about authorizing potential violations of the law
    1. Constraints
        a. Directors can be indemnified for fines only if they had no reason to believe the act was illegal
        b. Reputation
        c. Derivative suits only a weak constraint
        d. Class action if there are tort victims from the violation
    2. Directors probably will authorize it only if there's a very low probability of violation

C. For potential violations, do it openly

1. E.g. alert the EPA
D. Policy question: do we prefer companies to violate the law and pay a small fine or follow the law and lose a lot of money?

Director Protections

I. Indemnification – **DGCL § 145(a)-(e)**
   A. Company can indemnify for losses from actions undertaken on behalf of the corporation in good faith
      1. Criminal liability if the agent had no reason to believe he committed a crime – **DGCL § 145(a)**
      2. Legal fees in derivative lawsuits when the director acted in good faith, unless he's held liable – **DGCL § 145(b)**
         a. Requires court approval
      3. Company can chose to indemnify for other things – **DGCL § 145(f)**
         a. Court interprets this to include a good faith requirement
         b. *Waltuch v. Conticommodity* (2d Cir 1996) (p 245)
            i. Waltuch traded silver for Conticommodity. Suit brought against Waltuch and Conticommodity settled; claims against Waltuch dismissed. Enforcement proceeding against Waltuch settled.
            ii. Conticommodity's indemnification provision invalid bc it would apply even if the agent acted in bad faith
   B. Mandatory indemnification if director is successful on the merits – **DGCL § 145(c)**
      1. Successful includes anything besides a conviction
         a. *Waltuch* dictum
   C. No indemnification for breach of duty of loyalty or gross negligence
      1. Exception: court says that director should be indemnified out of fairness
II. D& O Insurance – **DGCL § 145(g)**
   A. Insurance contract states that a financial restatement doesn't nullify the insurance policy unless the director is actively involved in the fraud
   B. The insurance can be liquidated in bankruptcy to pay off the creditors unless there's a contractual restraint
III. Reliance on experts – **DGCL § 141(e)**
   A. Agent had reasonable grounds to believe the expert has expertise and information
   B. Reasonable reliance on an expert is a defense
IV. Business Judgment Rule
   A. Applied when directors…
      1. Are financially disinterested
      2. Are informed
      3. Exercise their judgment in a good faith effort to advance corporate interests
   B. *Kamin v. American Express* (NY 1976) (p 252)
      1. Amex bought DLJ, which declined in value. Board gave shareholders shares of DLJ in kind. If sold DLJ instead, would've gotten large tax savings.
      2. Theory: corporate waste
         a. Transaction for no consideration or consideration that is so small that it's a deal no reasonable person would make
      3. Court applies business judgment rule

V. Waiver of liability for due care – **DGCL § 102(b)(7)**
   A. Corporation can waive liability for damages for breach of a duty of care when the board acts in good faith
      1. But π can still get an injunction
   B. Statutory response to *Smith v. Van Gorkom* (Del 1985) (p 257), where the court said that the business judgment rule doesn't apply because the board was grossly negligent

Duty of Loyalty

I. Nature of the duty
   A. Directors have a duty to act only in a good faith effort to advance the company's interests
      1. Subjective standard
   B. Controlling shareholder owes a duty of loyalty to the corporation whenever he exerts control
   C. Includes any case where the transaction wasn't motivated by advancing corporate interests
      1. Doesn't have to be financially related
   D. Duty owed to whom?
      1. Two views
         a. Duty owed to the public
            i. Corporations exist only bc states created them
            ii. Can't get limited liability by contract
         b. Duty owed to the shareholders
            i. The corporate form is a private arrangement that fosters private aims
            ii. Advantages
               - Stock price as an objective indicator
               - Right to vote out directors
            iii. Competitive product market makes capital markets more competitive, so companies have focused on making money
      2. Technically, the duty is owed to the corporation
      3. Court deference to directors when directors justify actions based on long-term corporate benefits
         a. *Smith v. Barlow* (NJ 1953) (p 296)
            i. Corporation gave grant to Princeton Univ.
            ii. Court said okay bc it contributed to company's interests.
      4. Constituency statutes
         a. Directors have the power to balance interests of shareholder and non-shareholder constituents
            i. Enabling
         b. Not adopted in the MBCA
         c. Not adopted in Del.

II. Self-Dealing
   A. Evolution of the law of trusts
      1. Classic rule: trustee can't deal with the trust
      2. Trustee can deal with the beneficiary w/ respect to the trust property when…
         a. The beneficiary is competent
         b. Full disclosure to the beneficiary

- c. The transaction is fair
3. Directors with an interest in the transaction don't count towards the quorum
   - a. Problem: if the majority of the board is involved, then no quorum, so the transaction is voidable
   - b. Safe Harbor Statutes
     - i. Validate charter provisions that count interested directors in the quorum
       - **DGCL § 144**
       - **RMBCA § 8.6-8.63**
       - Also in Cal and NY
     - ii. Fairness <u>and</u> full disclosure required [See below]
       - Disclosure is an element of fairness
     - iii. If director/officer does one of the following, then the transaction isn't automatically voidable. But, Δ still has to prove fairness. – **DGCL § 144(a)**
       - Disclosure to the board of material facts and director/officer's interest in the transaction
       - Disclosure to voting shareholders
       - The transaction is fair when approved or ratified by board/committee/shareholders

B. Disclosure requirement
1. Disclosure allows the other party to exercise independent judgment
   - a. Don't want the court to later determine what counts as a fair price
   - b. *Hayes Oyster* (Wash 1964) (p 302)
     - i. Hayes is director and CEO of Oyster Co. Board approved Hayes's plan to sell oyster beds to Keypoint. Hayes didn't disclose his interest in Keypoint.
     - ii. Court (essentially) orders rescission
2. High disclosure requirements
   - a. Have to disclose the top price if it's required out of fairness [See *Weinberger*]
   - b. But parent doesn't always have to disclose top price willing to pay sub in cash merger - *Kahn v. Lynch*
     - i. If sub always got the synergy gains (gains from trade), then parents wouldn't have incentive to merge
   - c. Can't say anything false or misleading

C. Fairness requirement
1. Burden of proof
   - a. Π has initial burden of establishing that the transaction is a conflict of interest
   - b. Burden shift to Δ to prove entire fairness of the transaction [See *Weinberger*]
     - i. Test: entire fairness
   - c. If the transaction is approved by an independent, well informed special committee or ratified by independent shareholders with full information, then the burden shifts back to the π to prove that the transaction was unfair
     - i. Test: business judgment rule
     - ii. [See below]
2. Must be objectively fair
   - a. *Cookies Food Products* (Iowa 1988) (p 312)
     - i. Cookies had exclusive distribution agreement with Herrig's companies. Herrig became majority (controlling) shareholder and replaced 4/5 directors.

Herrig negotiated contracts with his other companies. Business very successful.

ii. Herrig met his burden to show fairness.
- Court easily persuaded by the fact that business was doing well.

3. Entire fairness test
   a. Test
      i. Fair price
      ii. Fair process
   b. Established in *Weinberger v. UOP* (Del 1983) (p 499)
      i. Signal was UOP's majority shareholder and nominated 6/13 directors. Signal acquired UOP in cash merger. $21 suggested to UOP CEO, who said it was generous. Signal imposed time limits. Signal used UOP info in study that showed they could pay $24; didn't disclose this price to UOP. Lehman Brothers said $21 fair in opinion letter they wrote in a hurry; loyal to Signal. UOP minority shareholders and board approved $21.
      ii. Signal had duty to disclose the $24 price bc used UOP info.
      iii. Process was rushed bc Signal put time restrictions on it. Unfair process.
      iv. Court suggests in n.7that this might've been different if there was an independent negotiating team (i.e. special committee)
4. Conflicts that don't trigger a fairness requirement
   a. When everyone, including the self-dealer, is treated equally
      i. *Sinclair v. Levien* (Del 1971) (p 307)
         - Sinclair (parent) had control over Sinven's (sub) board. Sinven paid out dividends instead of expanding operations. Sinclair needed the cash and had other subs take the opportunities.
         - Dividends paid to everyone equally, so no self-dealing issue.
   b. When the conflicts are objectively and subjectively immaterial
      i. *Cede v. Technicolor* (Del 1993) (p 261)
   c. Court's decision to use the entire fairness test instead of business judgment rule is based on the context
      i. Parent/sub merger – entire fairness
      ii. 1 outside, interested director who doesn't originate the transaction; approved by special committee or majority of independent directors – business judgment
      iii. CEO/director initiates the transaction, but isn't a controlling shareholder – unclear
      iv. More willing to defer to defer to board/officers if the process has integrity, e.g. *Cooke v. Oolie* (Del Ch 2000) (p 319)

D. Approval by independent, well informed 3d party
   1. Shift burden back to π and apply business judgment rule
      a. Helps demonstrate fairness of process
   2. Special Committees
      a. Applies to parent/sub mergers, mergers w/ a controlling shareholder, and transactions in which a majority of the board is interested
      b. Requirements in Del.
         i. Independent directors

        ii. Sufficient resources
        iii. Mission is to obtain best available deal
            - Has real bargaining power
    c. Like an arm's length transaction
        i. Committee has the power to say "no"
        ii. Can't be a charade
    d. Committee retains outside bankers and lawyers
    e. Limitations on the committee
        i. Subsidiary can't go to another buyer
        ii. Parent can still do the merger by replacing directors, etc.
        iii. Parent can put pressure on the committee bc can abandon the deal
    f. If the special committee process isn't good, then it has no effect - *Kahn v. Lynch*
        i. Parent threatened to do a tender offer at a lower price if board didn't accept the merger price. Committee recommended the merger knowing this.
        ii. Court said the committee wasn't really independent, thus no burden shifting, i.e. parent still has to prove entire fairness.
3. Ratification by shareholders
    a. *Wheelabrator Technologies* (Del Ch 1995) (p 325)
        i. Waste owned 22% WTI stock and 4/11 of WTI's directors were Waste officers. Waste bought WTI in a merger. Waste interested.
        ii. Shareholder ratification, so business judgment rule.
    b. *Lewis v. Vogelstein* (Del Ch 1997) (p 332):
        i. Shareholder ratification invalid if a majority of voting shareholders interested or the transaction is a corporate waste
            - Exception: can ratify a waste if the vote is unanimous
            - Waste standard: consideration is so small that no reasonable person would be willing to trade
        ii. Shareholders are in a better position to determine fairness than judges.
4. In some jurisdictions, special committee approval and ratification by a majority of disinterested shareholders automatically gives parent/sub mergers business judgment rule. – *Pure Oil*
    a. Del. hasn't adopted this view: still need to show fairness

III. Director & Officer Compensation
  A. Agency problem
    1. Shareholders dispersed – essentially an agent w/out a principal
  B. Inherently a necessary and self-dealing transaction
  C. Business question: Does this align the incentives/economic interests of the director/officer and the company?
    1. Workers
        a. Bargain with a union or bargaining agent
    2. Senior employees / managers
        a. Want to recruit and retain adequate people
        b. Problem of measuring manager's added value
            i. Short v. long term
            ii. Work on a team, buried w/in the company
            iii. Negative evaluations lead to lower productivity

- c. Want to create the right incentives
  - i. Managers start out risk-averse, but shareholders want them to be risk-neutral
- 3. Stock options
  - a. Logistics
    - i. Stock price usually set at the market price at the time the option is granted
    - ii. Usually vests over period of 5-10 years, x% per year
      - Non-vested stocks as motivation for retention
      - All options vest when the company merges and isn't the surviving company – incentive for M&A
  - b. Why give stock options?
    - i. Started as a way to get around wage controls during the Korean War
    - ii. Tax incentive: can't deduct employee compensation above $1 mil for top 5 employees unless the compensation is related to productivity
  - c. One-directional incentives
    - i. Get the upside but don't lose on the downside
    - ii. Preference for volatility
      - Not what shareholders want
  - d. Re-pricing options (to the lower market price)
    - i. When the stock declines below option price, CEO loses incentive to get it back up.
    - ii. Problem: incentive for CEO to have a bad 1st year
    - iii. Instead, company might give CEO new options
  - e. Use of other metrics
    - i. Has been a movement away from stock options
    - ii. CEO is responsible over the whole business, so it makes sense to tie his compensation to stock price. Less sense for others.
    - iii. Things to consider
      - Best marker: how does the company do relative to its industrial peers?
      - Product development
      - Development of the next generation of management / succession plan
    - iv. Don't use indexed options bc of tax purposes

D. Requirements / standards
- 1. Legal standards
  - a. Court is not in a position to judge D&O compensation, so it focuses on protecting the process
    - i. Is the process adequate or corrupt?
    - ii. CEO's used to sit on each other's compensation boards
  - b. Court applies business judgment rule when there is an independent compensation committee and ratification by fully informed shareholders
  - c. Court almost never finds that this is a waste
- 2. **Sarbanes-Oxley § 402**
  - a. Prohibits corporations who trade on NASDAQ and their subsidiaries from extending credit to director/officer.
- 3. NYSE listing standards
  - a. Board approval
  - b. Shareholder ratification

        c. Compensation committee must be entirely comprised of independent directors
            i. Heightened standard of independence
    4. Companies make an effort to separate the compensation committee from the corporation
        a. Compensation consultants are treated like outside auditors
        b. Consultants not hired by the CFO
  E. Policy question: Is CEO compensation out of control?
    1. Arguments that it's not
        a. Skill of the CEO
            i. Rare qualities
            ii. Assumes that CEO's are worth more when they manage bigger assets
        b. Worth it to the shareholders
        c. Huge increase in the ratio of CEO to shop-floor worker's compensation
            i. Large growth in firm size is connected to the skill of the CEO but not of the shop-floor worker
            ii. Globalization constrains shop-floor worker's pay

IV. Corporate Opportunity Doctrine
  A. Fiduciary cannot…
    1. Wrongfully take an opportunity that equitably belongs to the corporation
    2. Compete with the corporation without full disclosure and proper permission from the board
  B. **MBCA §§ 505 and 506**
  C. Tests
    1. Is this a corporate opportunity?
        a. Fairness test, considering all of the factors
            i. Did the fiduciary learn about the opportunity bc of his position as a fiduciary?
            ii. Is the fiduciary an inside or outside director?
    2. If there is a corporate opportunity, did the officer/director violate the corporate opportunity doctrine?
        a. Did the director/officer disclosed the opportunity to the board and the board rejected it in a way that gets business judgment deference?
        b. Would the corporation have been able to take the opportunity if it was presented to the board, given legal, economic, or other constraints?
            i. This standard isn't accepted in all jurisdictions, e.g. NY, bc they want to encourage people to go to the board
  D. Remedy
    1. Corporation takes the opportunity and compensate the officer/director
        a. Constructive trust
    2. Courts will allow parties to deal with this through contract as long as it's fair
    3. *Hollywood Park*
  E. *eBay* case (Del. Ch 2004) (p 353)
    1. Omidyar and Skoll were founder, officers, and directors of eBay. Goldman Sachs offered them IPO shares at the initial offering price (essentially bribing them to use Goldman Sachs as eBay's banker). Never disclosed to eBay's board. eBay would've been able to afford it and was in the business of investing.
    2. Omidyar and Skoll breached their fiduciary duty to disclose the opportunity.

Duty of Good Faith?

I. Breach of duty of care may be so extreme that it constitutes lack of good faith
  A. *Disney* case (Del Ch 2003) (p 339)
    1. Board wanted Eisner (CEO) to have succession plan (#2). Eisner hired Orvitz, who had to walk away from his company to accept. Old board approved w/out question. Orvitz a bad fit. Fired w/out cause, triggering acceleration clause.
    2. Procedural history
      a. Chancellor dismissed. Del SCt reversed.
        i. Breach of duty of care so extreme that it constitutes lack of good faith
      b. Chancellor applied business judgment rule and dismissed. Del SCt reversed.
      c. Chancellor finds allegations that directors were deliberately disinterested
        i. Goes to trial.
        ii. Πs lose at trial.
          - No deliberate indifference.
          - Board's actions not ideal, but legal
    3. Political explanation: Delaware concerned about federalization of the corporate law following Enron.

II. Not a separate duty, but linked to other duties
  A. Del. says there's no separate duty of good faith – *Stone v. Ritter*
  B. *Caremark* ties duty of good faith with the duty of care

Shareholder Voting

Technical issues

I. State Corporate Law – **DGCL §§ 211- 232**
  A. Who votes
    1. Record date – **DGCL § 213**
      a. Whoever is registered on the record date is considered the registered voter
      b. Set by board
      c. Time limits: must be 10-60 days before the meeting
    2. Legal (registered) ownership has the right to vote
      a. CEDE registered owner of most shares of most companies
      b. Complex system of directing votes from beneficial to registered owners to corporation
        i. Proxies try to connect the votes with the cash flow
  B. On what issues do shareholders vote?
    1. Amendment of charter – **DGCL § 242(b)(1)**
    2. Bylaws – **DGCL § 109(a)**
      a. Limited by **DGCL § 144(a),** which gives director power to supervise business and affairs of the corporation
    3. Directors
      a. Election of directors
      b. Removal of directors – **DGCL § 141(k)**
        i. Default: can remove director with or w/out cause

4. Class always has the right to vote if the action is adverse to the class – **DGCL § 242(c)**
    a. Del. court interpreted this to only protect changes to things in the stock certificate
    b. Note: the **MBCA § 1004(a)(3)-(5)** takes a broader view
5. Extraordinary transactions
    a. Mergers – **DGCL § 251(c)**
        i. Target company <u>always</u> votes
        ii. Acquiring company sometimes votes [see Mergers below]
        iii. Class voting in mergers
            - Default rule: all classes of stock vote unless charter says otherwise – **DGCL § 212(1)**
            - Remember that shareholders always vote if the merger is adverse to the class, so might get mandatory class vote even charter says otherwise
    b. Sale of all assets
    c. Dissolution
6. Precatory resolutions when they are permitted to get into company proxy
    a. E.g. "Stop doing business in South Africa" in 1970s
    b. Note: advance notice bylaws require early submission to the company of any shareholder originated agenda item for annual meeting, which limits the time when proxy contests can be mounted.

C. When or how votes are taken
1. At shareholder meetings
    a. Special or annual
    b. Can bring an action to force a meeting if one hasn't been called in 13 months – **DGCL § 211(c)**
2. By consent process – **DGCL § 228**
    a. Can do anything you can do at a meeting
    b. Setting record date in such a situation
3. Voting by giving proxies to vote to an "agent" (usually management) – DGCL § 216
    a. Usually empowered to vote on any matter that may come before the meeting.
    b. Content of proxy materials subject of federal regulation. [See below - § 14(a) of 1934 Act and Rule 14a]

D. How are votes counted
1. Straight voting or cumulative voting. (different effect)
    a. Straight voting
        i. 51% shareholder can elect all board members
    b. Cumulative voting: each shareholder casts total # of votes equal to the # of directors he can vote for, multiplied by # of voting shares
        i. Ensures minority representation
        ii. Expanding the board as a way to dilute voting power of minority block.
    c. Example: A owns 199 shares. B owns 101 shares. 3 directors
        i. With straight voting, A votes for all 3 directors.
        ii. With cumulative voting, B casts 303 votes (101 x 3) and A cast 597 (199 x 3). Each can divide up their votes among any directors. B definitely gets to pick one director.

2. With cumulative voting, either the whole board has to be removed, or a director can only be removed if the amount of votes to remove him is ≥ the amount of votes needed to elect him – **DGCL § 141(k)(1)**
3. Plurality wins a director election unless changed by bylaw – **DGCL § 216**
4. Majority of outstanding shares needed to vote on mergers and charter amendments (if they require a vote)

E. Information available to shareholders
   1. State law generally mandates little disclosure
      a. Theory is market will require it
      b. But see Federal § 14
   2. Shareholder lists – **DGCL § 219**
      a. To refuse, company must demonstrate improper purpose, i.e. one not validly connected to interest as a shareholder
   3. Broad access to company books and records available if shareholder demonstrates a "proper purpose" – **DGCL § 220**
      a. Court will tailor access to the purpose shown

II. Under Federal (SEC) Law and Regulation
   A. Requirements to solicit proxies – **Rule 14(a)**
      1. Broad mandated disclosure by company and anyone soliciting proxies
      2. Exceptions for statements made to shareholders when not seeking a proxy or running for office.
   B. Access to the company proxy – **Rule 14(a)8**
      1. Examples of things that can't be included
         a. Ordinary business
         b. Dealing with election
         c. Inconsistent with company proposal
         d. Invalid under (state) law
      2. Limitations
         a. Only one
         b. Limit of 500 words
      3. Reform efforts to allow access for "short slates" for qualifying shareholders failed (but still on institutional shareholders "wish list")
   C. Process for No Action letters by issuers wanting to exclude shareholder proposals.
   D. Voting fraud – **Rule 14(a)9**
      1. Elements of claim
      2. Possible remedies

Economic Issues

I. Theory of linking voting rights with common shares – one vote one share default.
   A. Reduces agency costs
   B. Special case of dual class voting: a problem or a solution to a problem?
      1. Beneficial for companies that are owned and controlled by their founders, e.g. Google, newspaper companies
         a. Founder adds value
         b. The founder wants to diversify own stock but stay in charge of this company
         c. Can have the high-voting rights be lost when the founder transfers his shares

- C. "Empty voting"
  1. Techniques to decouple votes from cash flow interests through derivatives markets
  2. Examples
     - a. Short sale in which shareholder get to vote, but no longer has an economic investment
       - i. King and Mylan Pharmaceutical (p 207)
     - b. Similarly, a swap transactions where the shareholder maintains some risk
  3. Many people don't direct their brokers to vote, which masks the problem.

- II. Collective action problem
  - A. Rationally apathetic
  - B. System responses to collective action problem, which reduce costs of voting
    1. Voting by proxy
    2. SEC mandated disclosure by issuer in connection with votes
       - a. Reduces information costs
    3. Evolution of "agents" of institutional investors who contract with institutional investors to study company proposals and make recommendations
       - a. Institutional Shareholders Service, Glass Lewis, etc.
    4. Rule on reimbursements of reasonable costs in connection with winning proxy fight for control of board of directors
       - a. *Rosenfeld v. Fairchild* (NY 1955) (p 187)
         - i. Proxy fight winners can get reimbursed for reasonable expenses
         - ii. Has to be ratified by shareholder – always is
       - b. Incumbent managers usually reimbursed whether they win or lose. Insurgents, only if they win.
       - c. Open issue: reimbursements on issue contests where "benefit conferred" other than board control?
         - i. Management will never do it voluntarily
         - ii. Strong arguments that courts should order this, though no court has done so

Some Policy or Political Issues in Corporate Voting

- I. How important is the (flawed and costly) corporate voting process? What reforms are feasible and justified?
- II. Ideological view of voting
  - A. Is the vote important ("the ideological basis for director power") or is it a mistake to analogize it to democratic voting for officials who make law?
    1. Remember that this is an economic thing
  - B. How much should we strive to empower small shareholders to take vote related action?
    1. Broaden reimbursement rights
    2. Make access to common proxy easier
    3. Count votes differently
    4. Prohibit dual class structures
- III. Activist investors (e.g. nelson Peltz of Triarc; Bill Ackman of Pershing Square or Carl Icahn) have met with success in running "short slate" contests.
  - A. Is this a good development or are "hedge funds" interested in finding ways to make personal profit?

Role of Courts

I. Manipulation of the vote
   A. Linked to the entrenchment issue
      1. When directors authorize something bc they are motivated by keeping their own positions
   B. *Schnell v. Chris-Craft* (Del 1971) (p 613)
      1. Management changed the shareholder meeting date as a defensive measure in a proxy fight. Has the legal right to do so under Del. law.
      2. Even though board has the legal power, it is subject to being exercised in an equitable, good faith way.
      3. Court issued injunction.
   C. Management cannot use its legal power for inequitable purposes
      1. Management can use company funds in a way that has the effect of protecting itself as long as that's not the primary purpose
         a. *Cheff v. Mathes* (Del 1964) (p 527)
            i. Holland Furnace owned by a family. Had regional sales reps that sold furnaces. Mormont was director w 10% shares. He wanted to institute a dealer system and fire the sales reps. Family bought Mormont's stock at a reasonable premium.
            ii. Court said this was ok bc the board's primary purpose was to settle a dispute over policy, not to protect itself.
               - Subjective test
      2. Management can't take action intended to interfere unless there's a compelling justification
         a. *Blasius v. Atlas* (Del Ch 1988) (p 615)
            i. Atlantis had 7 board members; charter provided for up to 15. Atlas board added 2 new board seats and nominated 2 new board directors to prevent Blasius from increasing board to 15 and adding 8 of his own.
            ii. Court disallowed this.
      3. [See Court's Review of M&A below]
   D. Management can't vote shares that the company owns
      1. If the parent controls the sub even w/out holding a majority of the sub's shares, still can't vote the sub's shares to elect the sub's directors
         a. *Speiser v. Baker* (Del Ch 1987) (p 195)
         b. Can't invest in another company by using the company funds to control votes

II. Vote "buying"
   A. Should and under what circumstances should courts intervene to prohibit it?
   B. Old rule: buying votes is wrong per se
      1. *Brady v. Bean* (Ill App 1921) (p 205)
         a. Δ told π he would pay him to vote his way. Π did, but Δ didn't pay him.
         b. Court said their contract was unenforceable bc against public policy
      2. Based on the theory that shareholders rely on other shareholders to vote in good faith
         a. This is B.S., since each shareholder can and does vote in his own self-interest
   C. Modern rule
      1. Vote buying isn't invalid per se. Instead, court looks at the process and fairness.
         a. *Schreiber v. Careny* (Del Ch 1982) (p 203)

i. Texas International loaned Jet Capital funds to exercise warrants to prevent voting against (effectively vetoing) merger. Low-interest loan in exchange for approving the merger.
ii. Court said it was a voidable act, but valid bc cured by shareholder approval.

b. Boards buying votes are probably going to be invalid

Insiders' Dealing in the Company's Shares

Common Law: State Law

I. Common law of fraud
   A. Elements
      1. False statement
         a. Can't provide misleading or false information
         b. Omissions don't count
            i. *Caveat emptor*: buyer has the duty to ask
            ii. Exceptions for fiduciary relationships
      2. Material fact
         a. Would a reasonable person take it into consideration?
      3. Scienter
         a. Made with intent to deceive
      4. Reliance
         a. Reasonably and actually relied
      5. Injury related to the falseness
   B. Privity requirement
      1. Must be a face-to-face transaction
   C. Remedies
      1. Recession
      2. Damages
II. Evolution of law re. directors dealing with the company's securities
   A. If dealing on securities exchanges with no face-to-face transactions, couldn't rely on the common law of fraud
   B. Fiduciary relationship modifies the disclosure requirement
      1. Full disclosure and fairness requirements when trustee deals w/ beneficiary [See duty of loyalty above]
         a. Burden on the trustee
      2. Old cases: are directors analogous to trustees?
         a. Minority rule: yes
         b. Majority rule: no
            i. *Goodwin v. Agassiz* (Mass 1933) (p 630)
               - Agassiz president and director of Cliff Mining. Bought shares on Boston stock exchange. Agassiz had inside info, material to the value of the stock, that seller didn't have.
               - Court said this is okay bc Agassiz didn't provide any misleading info.
      3. *Strong v. Repide* (US 1909) (p 630)
         a. Diversity case before *Erie*

   b. Where special facts exist, directors have an obligation to disclose the material facts or refrain from buying/selling corporate stock
      i. Fairness rule
C. Del. expanded scope of state disclosure duties protecting shareholder, e.g. duty to disclose if you ask the shareholders to vote – *Malone v. Brincat* (Delc 1998) (p 640)

III. Evolution of the agency principal
A. CEO as an agent for the corporation (but directors aren't)
   1. Theory: when agent makes a profit bc of the fiduciary relationship, the profit goes to the principal [See agency above]
   2. In this context, the CEO only has the info bc he's an agent. Can only use that for corporate purposes. If he uses it to make a personal profit, has to pay that money back to the corporation.
B. Original common law courts didn't accept the agency principal approach
C. Break with traditional common law approach
   1. *Brophy v. Cities Service* (Del Ch 1949) (p 637)
   2. *Diamond v. Oreamuno* (NY 1969) (p 636)
   3. *Schein v. Chasen* (2d Cir 1973) (p 637)
D. Rejected again after the Federal Courts developed a 10(b)5 remedy [see below], available to class actions under FRCP 12(b)(3) [see above]
   1. *Freeman v. Decio* (7th Cir 1978) (p 636)

IV. Why is insider dealing bad?
A. Does it hurt individual buyers and sellers?
   1. Director buying stock increases demand, which increase price
      a. The seller gets more
      b. Other buyers pay more
   2. Would the seller have sold anyway, or only sell at the increased price?
B. Bad things
   1. Systematic effect: market inefficiency
      a. Higher risk for new companies, where there's naturally more insider (ownership) information
      b. Risk requires an added cost – sell stock at a discount
   2. Not fair
C. Good things
   1. Gets info into the market
      a. Market action as a form of disclosure: people ask questions when they see prices change
      b. People make money when they have info before the market does, which incentivizes people to get that information

Federal Statutory Law

I. 1934 Securities and Exchange Act § 16
A. Provisions
   1. Covered persons required to disclose that you bought/sold stock if you've bought/sold stock within the previous 6 months – **1934 Act § 16(a)**
      a. Disclosure must be within 2 days of the transaction – **Sarbanes-Oxley § 403**

2. A covered person who buys and sells shares within 6 months is presumed to have done so on insider information – **1934 Act § 16(b)**
    a. i.e. if you bought stock and then sold stock within 6 months or you sold stock and then bought stock within 6 months
3. Covered persons – **1934 Act § 16(a)(1)**
    a. Directors
    b. Officers
        i. Some courts have interpreted this to apply to any person with insider information who has some policy making power
    c. Shareholders (beneficial owners) who own 10% of any class of stock

B. Remedy
1. Gives the corporation a right to recovery
2. Pay profits from insider trading to the company
3. Formula: look backwards and forwards 6 months
    a. Pay the highest amount that this generates – inference goes against the insider
    b. Have to match the number of shares

C. What counts as a sale?
1. Includes derivative transactions based on the stock that monetize the asset – **1934 Act § 16(b)**
    a. Swap transactions: swap an equity interest for cash close to the stock amount
    b. Short against the box
2. Executive compensation?
    a. This can destroy company's incentive compensation plans that tie risks to officers/directors
3. Mergers?
    a. Cash mergers probably are; stock-for-stock mergers probably aren't
4. *Kern v. Occidental* (US 1973) (p 642)
    a. Option grant is not a sale of stock bc the option may never be exercised
        i. <u>Overturned</u> by an SEC regulation
    b. Δ not in a position profit from the inside info, so court didn't treat the merger as a sale
        i. No opportunity for Δ to use the inside information bc he didn't control the transaction
        ii. Remains an unclear area of the law

II. 1934 Securities and Exchange Act § 10 and SEC Rule 10b-5

A. **Rule 10b-5** a technique for the SEC to seek injunctions in federal court

B. Anyone with inside information must abstain from trading on that information or must publically disclose the information
1. *Cady, Roberts* (SEC 1961) (p 646)
    a. Policy goal: want public info to be available to the public
    b. People who researched the info can exploit it; people who got the info bc of their role in the company can't
    c. 2d Cir adopts this rule

C. Implied private right of action
1. No explicit private right of action
2. Struggle in the federal judiciary

a. Some courts in favor of finding implied right of action
    i. First recognized by Judge Kirkpatrick in *Kardon v. National Gypsum* (E.D. Pa 1946) (p 645)
    ii. 2d Circuit is the most friendly to finding implied rights of action
    iii. Supreme Court willing to find implied rights of action for a time
b. Other courts more reluctant

3. Supreme Court constraining implied rights of action, in general and under **Rule 10b-5**
    a. Pulled back in *Cort v. Ash* (US 1975) (p 634)
        i. Can only imply private rights of action if Congress intended it
        ii. Must fulfill Congressional purposes
    b. *Blue Chip Stamps* (US 1975) (p 653)
        i. Πs have to be buyers or sellers of stock. Holding stock in reliance of false information isn't enough.
    c. *Santa Fe v. Green* (UA 1977) (p 653)
        i. Santa Fe majority shareholder in Kirby. Did a short-form merger. Kirby minority shareholders claimed Santa Fe breached its fiduciary duty by obtaining a fraudulent appraisal and paid too low of a price. Tried to bring a claim under Rule 10b-5.
        ii. **Rule 10b-5** is an anti-fraud rule, not intended to cover breaches of fiduciary duty
            - Need something more to bring a claim under Rule 10b-5
            - Breach of fiduciary duty cases go back into state courts

D. Misappropriation theory
1. Theory: one who misappropriates material, nonpublic info in breach of a fiduciary duty and trades on that info to his own advantage violates **§ 10(b)** and **Rule 10b-5**.
    a. But, if you don't rely on insider information (and can show it!), then there's no liability – **Rule 10b5-1(c)(1)(i)**
    b. Note: The fiduciary obligation is owed to the employer. If that is breached, it harms the public.
2. Development of the theory
    a. *Chiarella v US* (US 1980) (p 663)
        i. Chiarella printed documents announcing takeover bid and figured out which companies were involved. Bought shares in target without disclosing info.
        ii. Court found that Chiarella didn't have any fiduciary duty owed to the counter-party in the trade, so doesn't fall under *Cady, Roberts* abstain/disclosure rule
        iii. Dissent would use the misappropriation theory
            - Would apply the agency law principal under *Brophy*
            - Profits should go to the corporation
    b. *US v. O'Hagan* (US 1997) (p 681)
        i. O'Hagan a partner at law firm working on potential tender offer to Pillsbury. Bought call options for Pillsbury stock.
        ii. Court adopts *Chiarella*'s dissent and uses the misappropriation theory
3. Open question: what if the employer says it's okay for the fiduciary to trade on insider information?
    a. "Big boy" (see article)
    b. Have to show breach of duty

   c. SEC argument: the employer can't trade on insider info, so can't allocate it
      i. Unclear if court will accept this
4. Tippor / tippee cases
   a. If tippor breached a fiduciary duty by telling tippee, then the breach transfers to the tippee
      i. If this happens, then the tippee has a duty to disclose/abstain
      ii. Tippor (insider) breached duty if he personally benefits, directly or indirectly
      iii. Court more likely to find a personal benefit if it thinks the parties were doing the right thing
   b. *Dirks v. SEC* (US 1983) (p 667)
      i. Dirks is a stock analyst. Secrist, former officer of Equity Funding, told him about suspected fraud. Dirks investigated and found fraud. Dirks disclosed fraud to newspapers and clients.
      ii. Whether or not Dirks is liable depends on whether or not Secrist breached his fiduciary duty. Secrist didn't get any personal benefit from tipping Dirks, so no breach of duty. Thus, Dirks not liable.
   c. *US v. Chestman* (2d Cir, 1991) (p 676)
      i. Ira Waldbaum agreed to sell his company. He told sister Shirley. Shirley told daughter Susan. Susan told husband Keith. Keith told stockbroker Chestman. Chestman bought Waldbaum stock for self and clients.
      ii. Court found no liability bc no fiduciary duty to family members
      iii. SEC's response: **§240.10b5-2(b)(3)**
         - Expands duty of trust/confidence to cover family members in these cases

E. Elements: based on common law of fraud
1. Materiality
   a. Statement must be misleading
      i. Omissions don't count
   b. Fact specific; consider probability and expected magnitude
   c. Would a reasonable person consider this information when deciding whether to buy/sell? – *SEC v. Texas Gulf Sulphur* (2d Cir 1968) (p 647)
      i. Company exploring nearby land to see if it had copper and zinc and was worth acquiring. Exploration not disclosed to the public. Officers/directors bought company stock / calls.
      ii. Officers breached their duty not to trade on insider info.
   d. Would a reasonable investor consider it to significantly alter the total mix of information? – *Basic v. Levinson* (US 1988) (p 686)
      i. Basic and Combustion negotiating merger. Public statements denying negotiations.
      ii. Remands case to apply this test of materiality
2. Reliance
   a. Fraud on the market presumption
      i. Market price depends on all of the available information
      ii. If there was a misstatement, assumes that the market "relied" on it; reflected in the stock price
      iii. Can be disproved, e.g., if the π knew that the statement was false
   b. Adopted in *Basic* [see above]

3. Scienter / intent to defraud
   a. Lower courts disagree on how much you need to prove.
   b. Is gross negligence enough?
4. Loss causation
   a. Have to allege that the loss was caused when you sold the stock at a loss
   b. *Dura Pharmaceuticals v. Broudo* (US 2005) (p 699)
      i. Dura made allegedly false public statements re. likelihood of FDA approval. Announced FDA denied approval and profits low. Stock price fell and recovered w/in a week.
      ii. Court said more facts needed to show that the loss resulted from the disclosure.

III. 1934 Securities and Exchange Act § 14 and SEC Rule 14e-3(a)
   A. SEC's interpretation of **§ 14**
      1. Duty to abstain/disclose if you have material nonpublic information that you know/have reason to know has been acquired directly or indirectly from an insider
      2. 2d Cir upheld this view
         a. *Chestman* [see above]
            i. Court upheld the 14e-3(a) conviction
      3. Other courts have said SEC doesn't have the authority to do this, bc it makes Rule 14e-3 broader than Rule 10b-5

IV. Disgorgement
   A. Provided in **1934 Act § 16(b)**
   B. Adopted in *Elkind v. Liggett & Myers* (2d Cir 1980) (p 700)
   C. Taking away profit potential takes away incentive for insiders to trade
   D. Damages limited to insider's profits

Mergers and Acquisitions

Background

I. History
   A. No mergers allowed
   B. Mergers allowed only with unanimous shareholder consent
   C. Merger with supermajority shareholder consent
   D. Merger with 51% shareholder consent

II. Economic motivations
   A. Good motives
      1. Low cost way to change the ownership structure of productive activity
         a. The structures of economy and technology change, so we should allow markets to change to reflect that
      2. Economies of scale – horizontal mergers
      3. Economies of scope – vertical mergers
      4. Replace under-performing management
         a. Hostile takeovers
         b. Friendly deals with golden parachutes
            i. All options vest when management changes

        ii. If the company is taken over and the officer's responsibilities are reduced or he gets fired, he still has the option to leave and get a termination payment; usually limited to 3 years pay
    5. Merge with a company in a new, foreign market
        a. Enter into new market quickly
- B. Debatable motives
    1. Conglomerate mergers
        a. Merge in a lot of areas
        b. Economies of scale from senior management
            i. Huge failure (GE)
    2. Diversification
        a. Sometimes get economies of scope
        b. So cheap and effective for shareholders to do it themselves
- C. Bad motives
    1. Monopolization
    2. Empire building
        a. Companies grow beyond their efficient size bc managers have incentives to make companies large

III. Ways to acquire (control of) a business
- A. Merger
- B. Sale of all or substantially all of the assets
- C. Acquire a majority of the stock [see Tender Offers below]

Structures of M&A Transactions

I. Process
- A. Starts informally with management
    1. Planned or opportunistic
- B. Bring in the board
- C. Legal steps
    1. Confidentiality and standstill agreements
        a. Acquiring co. wants to do due diligence. Target co. wants to protect the information from competitors and doesn't want Acquiring co. to use the info to price the merge too low.
        b. Confidentiality piece: Acquiring co. will only use the info for evaluating the merger
        c. Standstill: if Target co. and Acquiring co. enter into negotiations and can't work out a deal, Acquiring co. won't do a hostile takeover of T
    2. Exclusivity arrangement for x months
        a. Breach of exclusivity generally means the other party gets out of pocket reliance damages, maybe damages for loss of opportunity
    3. Negotiations
        a. Over the form and price, subject to due diligence

II. Form
- A. Statement of the kind of deal
- B. Representations and warrantees
    1. Representation: statement of fact

2. Warrantee: promise (in response to a question)

C. Covenants and negative covenants
  1. Prevent Target co. from screwing up the business before closing
  2. No shop provisions: the target board won't shop the deal
     a. Includes a fiduciary out: if the board is required by its fiduciary duty to talk to another company who wants to make a superior offer, it can
  3. Affirmative obligation for Target co. to disclose material adverse effects

D. Closing conditions
  1. Bring-down clause: all things in agreement are still true
  2. Government and shareholder approval

E. Termination provisions
  1. Drop-dead date when parties can end negotiations
  2. Termination fees if Target co. takes a better deal
     a. Justification
        i. Cost-reimbursement
        ii. Acquiring co. helped produce the increase in value by negotiating with the target co.
     b. Typically stepped termination fee of 2-4%
        i. Stepped: start at 2%, move towards 4% when close to closing
        ii. Courts don't like 6% fees

F. Deal protections
  1. Examples
     a. Match-rights: if another company offers more $, then acquiring company has the right to match the bid
     b. Asset lock-up: if the deal is terminated, then the would-be acquiring company gets to buy the target company's valuable asset at a discounted price
     c. Lock-up stock option agreement: target co. required to sell 19.9% of its stock to the seller for $x if the target terminates
  2. Must include a fiduciary out
  3. Acquiring co. always has incentive to ask for more protections and higher termination fees. It's reasonable for the target company to agree in order to get a higher price, especially if the merger is going to happen anyway or it's a friendly deal.

III. Statutory mergers – **DGCL § 251**

A. Legal act formally accomplished by filing a certificate of merger with the state

B. 2 enterprises become 1
  1. 1 disappears
  2. The surviving company acquires all of the assets and liabilities of the other company

C. Shareholder vote
  1. Target co.'s shareholders always vote
  2. Acquiring co.'s shareholders
     a. Vote when the transaction changes the board's relationship to the shareholders
     b. Do not vote when
        i. No change in A's charter – **DGCL § 251(f)**
        ii. No change in the characteristics of any of Acquiring co.'s outstanding shares – **DGCL § 251(f)**
        iii. Acquiring co. issues < 20% new stock

        iv. Acquiring co. is substantially larger than Target co. – **DGCL § 251(b)**
  D. Positives and negatives
    1. Acquiring co. acquires everything
    2. Acquiring co. gives up the liability shield of T
      a. Known liabilities are priced in, but still a problem of unknown liabilities
  E. Short-form mergers – **DGCL § 253**
    1. When a shareholder owns 90% stock, no shareholder vote is needed for a merger.

IV. Sale of all assets / Asset acquisition – **DGCL § 271**
  A. Shareholder vote
    1. Acquiring co.'s shareholders never vote
    2. Target co.'s shareholders vote when selling (substantially) all assets
  B. What counts as "substantially all"?
    1. Unclear under **DGCL § 271**
      a. *Katz v. Bregman* (Del Ch 1981) (p 463): 51% assets enough
      b. *Hollinger, Inc. v. Hollinger Intl.* (Del Ch 2004) (p 466): 57% assets not enough
        i. Substantially all ≠ approximately half
    2. **RMBA § 12.02**
      a. Literal interpretation of "substantially all"
  C. Positives and negatives
    1. Acquiring co. retains Target co.'s liability shield
      a. But, some courts apply the successor liability doctrine to impose liability on the buying company when buyer essentially buys a complete business and the selling company dissolves
    2. Takes a long time
    3. High transaction costs

V. Triangular mergers
  A. Process
    1. Acquiring co. creates a wholly owned subsidiary.
    2. 2 step merger
      a. 1st step: Acquiring co. does a friendly tender offer to acquire majority of Target co.'s shares at a negotiated price
        i. No vote is required
      b. 2nd step: Acquiring co.'s sub mergers with T.
        i. Acquiring co. pays cash or stock to Target co.'s shareholders at the same price
        ii. If Acquiring co. survives, it's a triangular merger. If Target co. survives, it's a reverse triangular merger
  B. Voting provisions – **DGCL § 251**
  C. Benefits
    1. Retain Target co.'s liability shield
    2. Relatively quick

VI. De Facto Merger Doctrine
  A. Idea that transactions that have an economic effect the same as a merger should get the same legal rights as a merger
    1. PA uses this doctrine
  B. Del. rejects the this doctrine

1. Takes a formalistic approach (except when it involves self-dealing fiduciaries)
2. Instead, uses the doctrine of independent legal significance

C. Example

1. Company A is larger than Company B.
2. A sells all of its assets to B in exchange for shares of B's stock.
3. A's shareholders vote. B's shareholders vote under NYSE ruled (but not statute).
4. A's shareholders don't get an appraisal right in Del. [see below]

Shareholder Protections in Mergers

I. Appraisal Remedy

A. Developed when there were no cash mergers and no lager capital markets, so shareholders were forced to invest in a new company

B. Exclusive remedy for cash-out mergers is Del. – *Glassman v. Unocal* (Del 1983) (p 487)

C. When is it available?

1. Market-out rule – **DGCL § 262(b)(1)-(2)**
   a. Grants appraisal rights
   b. Denies appraisal when…
      i. Target co's shares are traded on a national security exchange
      ii. Target co's shares are held by 2,ooo registered holders
      iii. Shareholders not required to vote on the merger
   c. If appraisal remedy is denied for above reasons, granted again if shareholders receive any consideration other than…
      i. Stock in the surviving corporation
      ii. Shares traded on the national security exchange
      iii. Cash
      iv. Combination of the above
2. Π must dissent from the merger – **DCGL § 262(d)**
3. Charter can give extra appraisal rights – **DGCL § 262(c)**
   a. No company does: extra cost
   b. Some states always give more appraisal rights
4. Note: only hedge-funds and lunatics use appraisal rights

D. Appraisal remedy isn't really effective

1. Arm's length mergers typically get close to the fair market value.
2. Interested mergers give you an entire fairness (*Weinberger*) claim, which is better for the π than appraisal.

II. Valuation techniques for appraisal remedies and entire fairness cases – **DGCL § 262(h)**

A. Fair going concern value exclusive of the merger

1. In Del, no liquidity discount; no minority discount
2. If the liquidation value > current company value and board decides to do the merger, π can't get the liquidation value
3. Value includes all elements of future value, including the fact that the company may have been a target company in another merger.
4. Value doesn't include value attributed to the merger.

B. Process of measuring value

1. Estimate cash flows of future years, discounted to PV using WAC [see above]

2. Equity value = future cash flows - discount value of debt
    a. Debt based on the market rate of debt: you can refinance on the market
3. Divide the equity value by the # of shares

C. Bankrupt company merger
1. *Vision Hardware* (p 489)
    a. Merger when target co. on brink of bankruptcy. Π brought appraisal action.
    b. No market value of the debt bc company couldn't refinance. Instead, use the creditor's legal claim: the amount the creditor could get in bankruptcy.

D. Valuation for entire fairness cases
1. Valuation for appraisal and for entire fairness are the same. – *Weinberger*
2. Synergy gains > going concern value
    a. Going concern value as the floor price for synergy gains

Tender Offers and Defenses to Them

I. What is a tender offer?

A. Not inherently a corporate act, but defenses to it makes it a corporate matter

B. Gives you legal power to designate the board, which translates into practical control over the board

C. Tests for control (Del.)
1. Own > 51% of the stock
2. Have you controlled the company in the past?
    a. For publically traded companies, you may have practical control even owning 40% stock

D. Positives and negatives
1. Fast
2. Still have a public minority left: hold-out problem

E. SEC factors to help determine what counts as a tender offer
1. Factors
    a. *Active and widespread solicitation of public shareholders
    b. Solicitation is made for a substantial % of the issuer's stock
    c. *Premium over the prevailing market price
    d. Terms of the offer are firm, not negotiable
    e. The offer is contingent on the tender of a fixed # of shares
    f. The offer is open for a limited period of time
    g. The offerees are subjected to pressure to sell their stock
    h. Public announcements of a purchasing program precede or accompany a rapid accumulation
2. * what Allen thinks is important
3. In practice, hard to know how these will come out
    a. *Brascan* (SDNY 1979) (p 455) and *Wellman* (2d Cir 1982) (p 449) were similar cases but came out opposite ways

F. The tender offeror has no obligation to pay a fair price as long as there's no coercion
1. Even if offeror is a controlling shareholder
2. Theory: this is a market transaction

II. 1968 Williams Act (p 403-18, 441-43 of Statutory Supp)

A. Anti-fraud provision - **§ 14(e)**

1. *Virginia Banks*
2. Once the tender offer is commenced, no insider trading - **§ 14e-3**
   a. *O'Hagan*
   b. **Rule 10b-5**

B. Early warning – **§13**
1. Reporting requirement for anyone who owns 5% of the shares

C. Detailed time limits
1. Tender offer has to stay open for a period of at least 20 days
2. If there's an amendment, add 10 days

D. Pro-ration rights
1. If you make a tender offer for x% of the stock and more shares than that are tendered, you have to buy from every shareholder in proportion to the # of shares they tendered
   a. Note: if offeror gets less than x%, then he doesn't have to buy any of the shares

E. Mandatory withdrawal rights

F. Regulation of public announcements

G. All holders / equal price rule – **Rule 14d-10**
1. Have to offer the tender offer to all shareholders at an equal price
2. Moderates the effect of *Unocal* case of discriminatory self-tenders
3. According to an SEC ruling, executive compensation doesn't trigger this rule

III. State Anti-takeover Statutes

A. **DGCL § 203**
1. Mild protection
2. If you do a tender offer and get between 15-85% of the stock without Board approval, then the offeror has to win an enhanced shareholder vote to do a merger (and get rid of the remaining shares)

B. No so important after the development of the poison pill and the Williams Act

IV. Poison Pills

A. Types
1. Flip-over (early version)
   a. Process
      i. Distribute to existing shareholders a right to buy stock at a high price.
      ii. Triggering event: a shareholder acquired x% of the stock.
      iii. The right converts into a right to buy stock in the triggering corporation at a large discount and the right detaches from the stock.
   b. Theory: the director of the target company can't approve a merger agreement that doesn't honor the poison pill rights
2. Flip-in (modern version)
   a. Process
      i. Distribute to existing shareholders a right to buy stock at a high price.
      ii. Triggering event
      iii. The right converts into a right to buy stock in the target corporation at a large discount and the right detaches from the stock. The person/entity who triggered the right is excluded from the right.
   b. Result: dilution of the acquirer's control

B. The pill gives the board power
1. Board as the shareholder's bargaining agent

            a. Problem: agency costs; board protecting itself
        2. Board that issues the poison pill can redeem it
        3. Can acquirer get around the pill without board approval?
            a. The world treats poison pills as complete show stoppers
                i. Theoretically, the acquirer could push through / "swallow" the pill, but it's never happened
            b. The acquirer can run a proxy context tied to a tender offer – higher costs
        4. Shadow pill
            a. Boards can adopt the pill quickly and easily
            b. Treat every company as having the pill
    C. Validity of the poison pill [see *Moran* below]
        1. The poison pill is valid
        2. A company can adopt a poison pill w/out amending the charter
    D. Debate about poison pills
        1. Views
            a. Poison pills are bad - Easterbrook and Forshell
                i. Boards shouldn't be able to protect themselves
                ii. We should support an active market in corporate control so that the highest and best user will buy the company
            b. Moderate view
                i. Boards should have the power to negotiate but not preclude the transactions
            c. Pills are good – Lipton
                i. Boards have better information than the marketplace and shareholders
        2. Empirical evidence
            a. Poison pill prevents 2-tierd hostile takeovers
            b. Targets of hostile takeovers come out the same with or without the pill
            c. Premium over the market is slightly higher with the pill than without it
    E. [See Court's Role in M&A below]
V. Other defenses
    A. Best defense: staggered board + poison pill
        1. Institutional shareholders don't like either, so they get the boards to redeem the pills and de-stagger boards
    B. Increasing debt
        1. Acquiring company often plans to pay for the take-over in large part with the target's assets
        2. If the target increases its debt, it makes it harder for the acquirer to buy it

Court's Review of M&A Transaction

I. Overview of the evolution of the court's role
    A. Business judgment standard
        1. *Johnson v. Trueblood*
        2. Selling the company
            a. The Board must have sufficient information in order to get business judgment rule
                i. Otherwise, the board is grossly negligent, maybe even acting in bad faith
                ii. Ways to get information (about best price)
                    - Do an auction

            - Check the market – *Fort Howard*
        b. *Painter v. Marshall* (7th Cir) (p 526)
    3. *Technicolor*
  B. *Weinberger*
    1. Fair price
    2. Fair process
  C. Court defining a role for itself in arm's length M&A transactions
    1. *Van Gorkom*
        a. Court isn't comfortable with the business judgment rule
    2. *Unocal*
        a. Doctrinal framework in hostile take-over defenses
            i. Is there a legitimate threat?
            ii. Is the board's response reasonable?
    3. *Moran*
        a. Upholds the poison pill, but still subject to *Unocal*
    4. *Revlon*
        a. When the company is being sold, no business judgment deference

II. Enhanced Business Judgment Rule
  A. Two step review
    1. Is there a legitimate threat?
        a. Board has the burden to show that the threat is legitimate
    2. Is the board's action a reasonable response to that threat?
        a. Must be proportional to the threat
  B. *Unocal* (p 529) established this test
    1. Mesa planed a two-tiered tender offer for $54 cash then $54 in subordinate securities. Target company has $60 liquidation price, so the tender offer isn't beneficial to shareholders. Upon recommendation from Goldman Sachs, Board did a self-tender for $72 and excluded Mesa.
    2. Court says the Mesa exclusion was valid
        a. The board has an obligation to protect shareholders, including from other shareholders
        b. Applies *Cheff* test: the Board's principal purpose wasn't entrenchment
    3. What counts as a defensive action under *Unocal*?
        a. Probably depends on the board's subjective intent, but unclear
        b. Is buying another company a defensive action, given that it makes it harder for tender-offerors to take over?
  C. The court applies the *Unocal* enhanced business judgment to poison pills
    1. *Moran v. Household Industries* (p 539)
        a. The target co. had an early flip-over pill in place.
        b. Court said that the poison pill was valid, but subject to a *Unocal* test.
            i. Board can use the poison pill as long as it's proportional to the threat
            ii. Once the board puts the pill in place, it has to redeem it if there's an offer that's not a threat.
    2. Threats that justify the poison pill
        a. Inadequate price
        b. Coercion

        i. Substantive coercion: shareholders don't understand their choices
    c. Timing

III. When the company is being sold: *Revlon* duties

A. *Revlon*

1. Perlman offered $47.50 for Revlon stock. Revlon board adopted a poison pill and put debt on its balance sheet. Perlman raised his bid. Revlon entered merger agreement with Forstman Little ("white knight"), including a lock-up provision, a no-shop provision, and a termination fee.
2. Inducements or deal protectors that end the bidding process when the board is acting as an auctioneer are invalid as violations of the board's fiduciary duty.
    a. Consider whether the board is motivated by entrenchment interests or if it is really acting in the shareholder's self-interest?
        i. If it's in the shareholder interest, the board gets business judgment rule
    b. Deal protectors
        i. It is fair to give some deal protections or companies won't bid
    c. Inducements
        i. Inducements that draw bidders in are good.
        ii. Inducements that push bidders away are bad because they end the auction
2. Allen says this doesn't make sense
    a. Court does an ex-post evaluation
    b. Would be better to allow target to give a lot of inducements at the end in order to get more money for the shareholders.

B. When do *Revlon* duties attach?

1. Cash merger: always triggered
    a. No long-run to consider
    b. Board just has the fiduciary duty to pick the highest deal
2. Stock merger between equal sized companies, both w/ market control: not triggered
    a. The board can make an agreement with a lower economically valued offer if there's no change in control and the board acts in good faith
        i. Board doesn't have an obligation to maximize the current value of the stock
        ii. The board can do things it thinks will increase the long-term price, even if the current market disagrees
    b. *Interco* (Del Ch Ct, late 1980's)
        i. The Rales brothers made a cash offer with a high premium for all shares, to be followed by a merger at the same consideration. Management did a recap transaction to restructure the company. Both increased offers. Rales sued to have board remove poison pill.
        ii. The court said poison pill invalid here.
            - No threat.
            - Shareholders have the right to choose between the Rales brothers' offer and management restructuring.
        iii. **Overturned** by Del Supreme Court in *Time Warner*
    c. *Time-Warner* case (aka *Paramount v. Time*) (Del 1989) (p 559)
        i. Time had long term plan to expand into cable and movies. Announced a Time-Warner merger: stock-for-stock, double-triangular consolidation. Paramount offered cash at a high premium. Time board knew it couldn't get

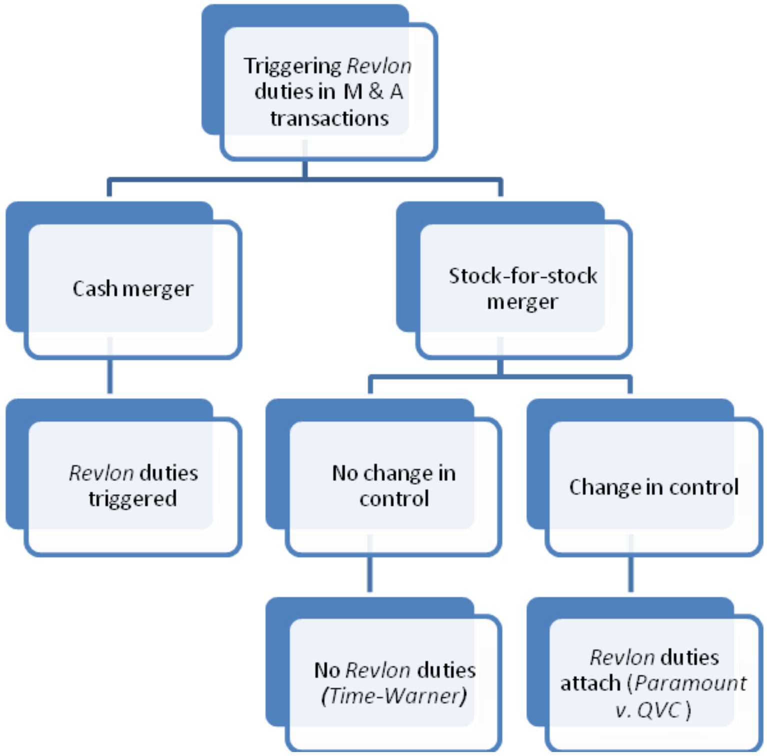
shareholder vote. Restructured the Time-Warner deal: Time did a tender offer for 51% of Warner shares. Paramount sued to stop the deal.

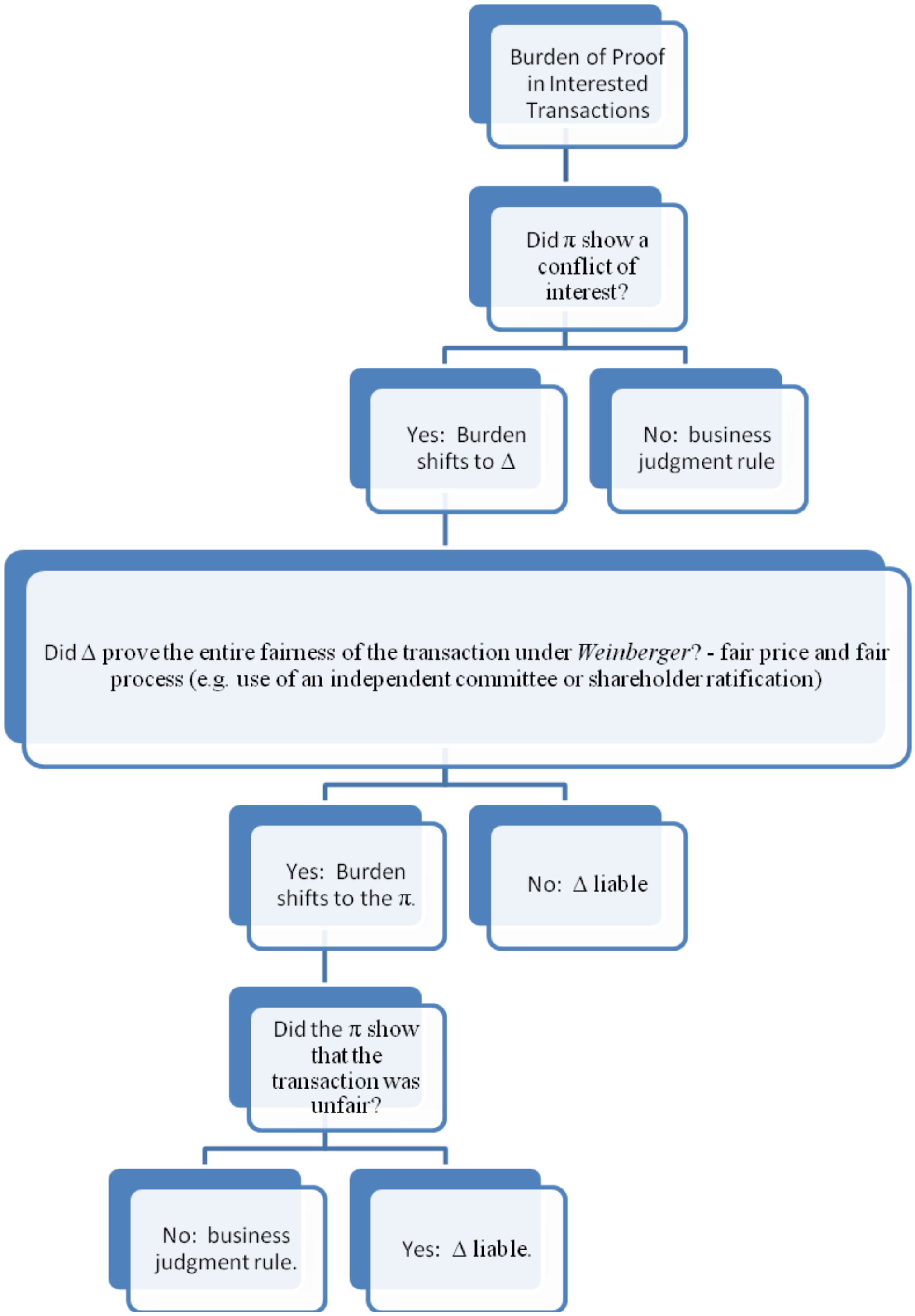
ii. Time-Warner (restructured) deal doesn't trigger *Revlon* duties.
iii. Applied *Unocal* and upheld the deal.

3. Attach when there's a change in control in stock-for-stock mergers, including when the target is market controlled and acquiring co. has a controlling shareholder
    a. *Paramount v. QVC* (Del 1994) (p 567)
        i. Paramount and Viacom had a merger agreement. Paramount had market control; Viacom had a controlling shareholder. QVC makes a stock and cash offer to Paramount. Viacom raised its offer price; new merger agreement w/ little else changed. QVC raised price. QVC brought suit to get Paramount to redeem poison pill.
        ii. Triggers *Revlon* duty
    b. Defining "control"
        i. Owns 51% of the vote
        ii. Has control in fact
            - Factual determination
            - Look at the shareholder's historical control of the firm, etc.

C. When *Revlon* duties attach, apply reasonableness review – *Paramount v. QVC* (Del 1994) (p 567)
    1. Duty to try in good faith to get the best transaction available
    2. Courts can pass upon the reasonableness of the process (under *Unocal*)

II. Short form mergers – **DGCL § 253**
    A. Once the controlling shareholder has 90% shares, he had no obligation to pay a fair price in a short form merger. - *Glassman v. Unocal*
        1. Controlling shareholder (60%) did a tender offer and got 90% shares. Did a short form merger.
        2. Court said that controlling shareholder had no obligation to pay a fair price in the 2nd step short form merger.
    B. Minority stockholders only have an appraisal right.


Triggering *Revlon* duties in M & A transactions
Cash merger
Stock-for-stock merger
Revlon duties triggered
No change in control
Change in control
No *Revlon* duties (*Time-Warner*)
Revlon duties attach (*Paramount v. QVC*)


Burden of Proof in Interested Transactions
Did π show a conflict of interest?
Yes: Burden shifts to Δ
No: business judgment rule
Did Δ prove the entire fairness of the transaction under *Weinberger*? - fair price and fair process (e.g. use of an independent committee or shareholder ratification)
Yes: Burden shifts to the π.
No: Δ liable
Did the π show that the transaction was unfair?
No: business judgment rule.
Yes: Δ liable.