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Corporations
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<u>Economic Organization - Background</u>

- necessary ingredients in wealth creation
    - people
    - capital
    - legal/economic/financial systems – facilitate cooperation in wealth-creating activities
- necessary legal regimes in wealth creation
    - property – incentive to property owners because they will get the benefit of improvement/ownership of wealth-creating activities
    - contracts – facilitate bargaining between parties with best information
    - courts – provides order and enforcement
    - **corporate law → reduce transaction costs, agency costs, information asymmetry**
- necessary financial systems in wealth creation
    - capital markets – stock and bond markets – moves money from those who have it (savers) to those that will use it more efficiently (companies)
    - government funding
    - financial institutions – banks, insurance companies
- contracting can be costly, constrained by context, so still need corporate law
    - information asymmetry – info is costly and imperfectly distributed
    - collective action problem – default terms in contracts that can be overcome
    - transaction costs
    - agency costs
- enterprise law
    - enabling – establishes a framework in which to operate with enough freedom for parties to design their own versions
        - few mandatory terms – more equal bargaining power than in employment law
        - default rule – what is most attractive to the most people, and let others contract around it
    - reduce transaction costs
    - system measured by efficiency
        - pareto efficiency – something is efficient only if no one is made worse off – too simplistic
        - Kaldor-Hicks efficiency – something is efficient if the total gains outweigh the total costs
            - Problems: doesn't account for externalities or original distribution of wealth, or require gainers to compensate losers
- Capital markets/wealth generating systems need

- Reliable information, which requires accountants, securities regulators to enforce disclosure, and a fraud remedy
  - To attract investors
  - Information doesn't have to be perfect – bad info will be seen as risky and market will demand a discount; to have efficient market then info needs to be good
- Mechanics – exchanges, honest brokers, rules of trade
  - To guarantee that trade will be executed with integrity
- Assurance that managers of businesses are competent, and if they're not then shareholders have ability to get rid of them
  - Corporation law

<u>Agency</u>

I. Agency, generally

- Rest. (2d) Agency § 1 -- fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act
  - Formation – agreement, usually oral, no writing necessary (§1.03)
  - Can be inferred (*Cargill*) even if parties disagree – objective rather than subjective determination
  - Grants authority to agent to act on principal's behalf
- Kinds of agents' authority
  - Actual authority
    - Rest. (3d) § 2.01 – if the agent reasonably believed that he was authorized based on the words and actions of the principal, courts will recognize authority and bind the principal
    - Scope - what the agent reasonably believed or a similarly situated person would have believed he was authorized to do, NOT subjective intent of the principal (§2.01(3))
    - Includes incidental or implied authority to do those things that a reasonable person would think were part of the primary authority grated by the principal, or necessary to do the thing commanded by the principal (§2.01)
    - Formation by principal's manifestation to agent as reasonably understood by agent (§3.01)
  - Apparent authority
    - Rest. § 2.03 – if a third party reasonably believes the principal authorized the agent to do something and relies on such authority to his detriment, court will recognize authority and bind the principal
    - Third party must rely on action/manifestation of the principal, not just the agent
      - Agent cannot create his own authority
      - In practice, manifestation by principal can be shown by what the agent does/wears (ex: wearing a uniform)

        - Formation by third party seeing the principal's manifestation and understanding it to be authorization for the agent (§3.03)
    - Inherent authority
        - Agent contracts with third party without actual authority, principal is unknown to third party so cannot be apparent authority, but third person harmed – courts create equitable principal to be fair to the third party who detrimentally relies
        - Not formally in Rest. 3d anymore, but reflected in Rest. §§ 2.02, 8
            - General power to bind principal if agent's action would be in ordinary power of agent

II. Liability of Principal to Third Party based on Agent's Conduct

- Parties to contracts made by agents
    - Disclosed principal (§6.01)
        - Principal and third party are parties to K
        - Agent is NOT a party unless otherwise agreed
    - Unidentified principal (§6.02)
        - Principal and third party are parties to K
        - Agent IS a party unless otherwise agreed
    - Undisclosed principal (§6.03)
        - Principal is a party to K unless otherwise excluded
        - Agent and third party are parties to K
        - If principal is a party, then he and third party have same rights, liabilities and defenses as to each other as if principal had made the K personally
- Tort liability
    - principal is liable if tort is committed by agent within scope of agency (Rest. (2d) Agency §219)
    - Actual authority
        - §7.04 - Principal liable to third party harmed by agent when conduct within scope of actual authority or ratified by principal and agent's conduct was tortious or would have subjected principal to tort liability had he done it
    - Apparent authority
        - §7.08 - Principal is subject to vicarious liability for tort committed by agent when his actions were through apparent authority and constituted the tort
- Inherent authority -- §2.01
    - §2.06 – Liability of Undisclosed Principal – if agent of undisclosed principal acts without actual authority and third party is induced to make detrimental change in position, principal with notice of agent's conduct is liable if he did not take reasonable steps to notify the third party of the facts, and cannot just give instructions to agent that he has less authority if a third party would reasonably believe him to have more authority
    - ***Jenson Farms Co. v. Cargill, Inc.***
        - Cargill finances Warren Grain in exchange for many assurances, business management guarantees and financial reporting

requirements; Warren goes bankrupt; farmers sue Warren and Cargill for contract default
        - Court: not a classic agency scenario since Warren didn't entirely obey Cargill, but Cargill had practical and contractual power so established agency relationship, and Cargill can be liable for default
    - ***Gallant Ins. Co. v. Isaac***
        - Insurance broker says new policy is active when it really requires signature, driver gets into accident and insurance company says she wasn't actually covered, agent broker didn't have authority
        - Court: agent had authority to bind principal on new insurance agreements despite explicit instructions because common practice was to recognize verbally binding coverage, action was incidental to usual authority
            - Third party assumed agent had authority based on agent's direct and indirect manifestations
        - Argument for apparent authority? No – no manifestations by principal itself
- *respondeat superior*
    - §2.04 – employer responsible for torts committed by employees within scope of employment
- Estoppel § 2.05 –
    - person is estopped from claiming that there was no agency relationship // is liable to a third party who is justifiably induced to make a detrimental change in position because he thinks the transaction is on the person's account even though the person never manifested that the actor had authority as an agent, if 1) the person intentionally or carelessly caused the third party's belief, or 2) the person had notice of the belief and that it might induce others to change their position but did not take reasonable steps to notify them
- Misrepresentation of Authority §6.11
    - if agent makes a false representation about his authority to a third party, principal is only liable if agent acted with actual or apparent authority in making the representation and the third party had no notice of the falsehood; representations by agent made incident to contract are attributed to principal unless third party knew/should have known it was untrue or without authority
        - ex: *White* (below) – had principal not ratified, then third party could sue for misrepresentation
- Principal's negligence in conducting agency or special relationship (§7.05)

III. Defenses to Principal's Liability

- **Ratification** – Rest. §4.01
    - Ratification affirms a prior act and gives it the effect of being done by an agent acting with actual authority
        - Ratification by manifestation or conduct that justifies a reasonable assumption of consent (§4.01(2))

- Only available if
  - Agent was purporting to act as an agent (§4.03)
  - It occurs before the occurrence of circumstances that would cause the ratification to have adverse and inequitable effects on the rights of third parties (§ 4.05)
  - Encompasses whole transaction, not partial (§4.07)
- Estoppel – if person manifests ratification and a third party detrimentally relies, then estopped from denying ratification (§4.08)
- If agent makes unauthorized contract but principal ratifies it, then third party is bound by contract
  - But courts likely to be sympathetic to third party who doesn't know he can't sue the principal so his action to withdraw from the contract will be viewed as a defense
  - But if not ratified, then third party can sue the agent for false representation of authority (§6.11)
- ***White v. Thomas***
  - Action to enforce contract made by agent without authority; agent exceeded price authority but principal went along with it, commenced second sale to get the price back down
- Court: just because principal ratified the first transaction doesn't mean he ratified the second, cannot be estopped because he didn't know about it → fairness considerations
- Rest. §§ 4.01 – ratification is affirmance of a prior act done by another that gives it the effect of having been done by an agent with actual authority

- **Independent Contractor Doctrine** (Rest. (2d) Agency §220)
  - If agent is an independent contractor then it isn't acting within scope of agency, principal is not liable to third party for torts committed by agent
    - §7.07 – not within scope of employment/agency if occurs as part of independent course of conduct
  - ***Humble Oil & Refining Co. v. Martin***
    - Ps hit by car that rolled into street from gas station, D claims station operator was an independent contractor so it shouldn't be liable
    - Court: despites written agreement, station was not independent contractor because it had no real discretion or power in operating business, lease terminable at will, has to report to Humble – looks like employer/employee, so liable as principal
  - ***Hoover v. Sun Oil Co.***
    - P burnt in back of car, sues gas company rather than franchise operator
    - Court: D is not liable because agent was independent contractor, listed as proprietor of station, bore all risk of profits/losses, no day to day control by Sun Oil, restrictions on ability to terminate lease

IV. Liability of agent to principal – fiduciary duties

- Fiduciary relationship: fiduciary holds legal power over property for the sole purpose of advancing the aim of the fiduciary relationship

- In agency relationship, goal is to advance the purposes of the principal
  - Bound by good-faith judgment
- **Duties**
  - Generally – "act solely for the benefit of the principal in all matters connected with his agency" (§ 387)
  - Obedience – obey principal's commands (§ 385)
  - Loyalty
    - Act loyally for principal's benefit (§8.01, §387), without acquiring any material benefit (§8.02), not for/as an adverse party (§8.03, §389), not in competition (§8.04, §393), without using the principal's property or confidential info for the agent's own purposes (§8.05, §395)
    - Conduct that would otherwise constitute a breach of duty of loyalty is okay if principal gives informed consent after agent discloses all material facts and acts in good faith and with fair terms (§8.06, §390)
  - Care
    - Act with care that is standard in the locality, exercise any special skill (§ 379)
    - act with care, competence and diligence normally exercised by agents in similar circumstances (§8.08)
  - Disclosure
    - Sellers generally don't have obligation to disclose, just obligation not to lie (which is why lawyers have to ask the right questions)
    - But fiduciaries DO have an obligation to be forthcoming → R2A § 381
  - Account for profits arising from the agency (§388)
  - Cannot act adversely to principal without his consent → §389
  - If acting adversely to principal, even with consent, still have to make full disclosure and deal fairly, always on fair terms → §390
- Hypo: agent has duty to obey principal, but gets info that principals plan will not succeed, and agent has opportunity to make contract that is better and will benefit agent too – valid?
  - K would be valid, technically in principal's interests
  - But violates duty of loyalty and obedience → not following orders, and advancing agent's own goals
  - WA: probably okay unless agent knows that the principal's object could not possibly be fulfilled
- ***Tarnowski v. Resop***
  - Agent doesn't properly vet juke box chain business for principal, lies about it, profits from it, principal loses money; P sues sellers and wins, but still sues agent for breach of fiduciary duty of loyalty
  - Court: looks not just for damages, but also unjust enrichment, so agent has to pay legal fees, lost opportunity cost → if you breach a fiduciary duty, the court is going to come down on you really hard

The Partnership Form

I. **The Partnership**

- Contractual form of co-ownership
  - Uniform Partnership Act ("UPA") § 6 – association of two or more persons who carry on a business for profit
  - Revised Uniform Partnership Act ("RUPA") § 101-6 – as co-owners, shared rights to control, shared ownership
  - Governed by partnership agreement (§9)
- Evolution of partnership form
  - Business owner borrows lots of money from bank, incentives to take big risks because if they fail then he'll only lose a little equity
  - So banks stop lending unless owner puts up more equity and gets some skin in the game
  - + creation of shared property gives creditors an entity look to in deciding whether or not to invest, instead of having to rely on the credit of the partners themselves – more stable
- Formation
  - Receipt of share of profits is prima facie evidence of partnership (unless profits received as debt by installments, wages/rent, annuity, interest on a loan, or consideration for sale of good will) (§7(4), §202)
    - Profit sharing shows you have an interest in the whole business – characteristic of a partner
  - ***Vohland v. Sweet***
    - Sweet works for Vohland's dad's nursery, when dad dies he gets 20% of profits as commission, now wants stake in value of inventory b/c company had done a lot of internal investing and profits were low (cash as opposed to accrual accounting – doesn't recognize inventory as asset until it is sold)
    - Court: parties acted like a partnership, so it doesn't matter how they characterized the relationship
      - subjective intent doesn't matter – can't shield yourself from liability by just saying you're not a partnership when you have consensually agreed to act like a partnership
- Partnership property
  - UPA: Quasi-entity → tenancy in partnership (§25(1))
    - Creates shared property, held in common because no single partner can dispose of the property unilaterally, conveyance requires unanimous consent (§25(2)(b))
      - Cf. proprietorship which has no entity characteristic, and corporation which is only an entity, i.e. legal fiction
  - RUPA: entity
    - Partnership is an entity distinct from its partners (§201)
  - Partners' interest in partnership property is share of profits, management rights (§26 , §401)
  - Partners' interest in profits is assignable, but not management rights (§27, §§502-503)

- Governance
    - Partnership is managed by partners for purpose of the business → fiduciary relationship
        - Partners are agents with apparent purpose of carrying on the business (§9(1), §301(1))
        - ***Meinhard v. Salmon***
            - Fiduciary relationship in partnership bears a "punctilio of an honor the most sensitive" – Cardozo
            - Partners in real estate deal, towards end of lease Salmon takes another bigger deal, partner Meinhard claims he should get a cut,
            - Court: if information comes from the fiduciary relationship, one partner cannot exploit it for his own gain alone – he must share it with the other partner; splits proceeds between partners with extra share for Salmon based on position as managing agent, subject to Meinhard continuing to invest
            - Andrews' dissent: this is a contract issue, not fiduciary, since relationship was for 20 years, not indefinite
    - Equal shares (§25), but can create more elaborate management structure by agreement
        - If you do, then can file statement of authority to give notice of change in authority (§303)
            - Binds third parties under certain circumstances, but otherwise third parties are not deemed to know of the limitations on authority just because it's written in a filing (§303(f))
    - Partners have authority to do anything normal to business activities of the partnership unless restricted by agreement (Nabisco v. Stroud)
        - Partners may file these limitations, but third parties are mostly presumed not to know about limitations based solely on filing, so if detrimentally rely partnership can still be bound for unauthorized acts

II. Liability

- Partners are jointly and severally liable for obligations of partnership (§15, §306)
    - Unless otherwise agreed (§306)
- Questions to ask:
    - Is X a partner?
        - § 7 – receipt of profits is prima facie evidence of partnership, but look also at tenancy in common, etc., and sharing of gross returns
        - §16 – partner by estoppel if you hold yourself out to be a partner and third party gives credit to actual or apparent partnership, then you are liable
    - Is the liability a partnership liability, i.e. did partner act with authority to bind the partnership, or should he just be on the hook personally?
        - §9 - Partner acts as agent with binding authority unless

            - he has no authority and third party knows it
            - he is acting not apparently for carrying on of business
            - less than all the partners assign the partnership property in trust for creditors, dispose of goodwill, do anything that would make it impossible to carry on the business, confess a judgment, or submit a partnership claim or liability to arbitration without authorization from remaining partners
            - he acts in contravention of a restriction on his authority
    - What rights does X have to contribution or indemnification from other partners?
        - UPA §18(b) and RUPA § 401 – right to be reimbursed by other partners/partnership if you have to pay for partnership liabilities yourself
    - If X is a new partner, what liability does he have shoulder?
        - UPA § 17 – new partner is liable for all partnership liabilities no matter when they occurred (i.e. before he joined), but limited to partnership property (i.e. contribution of capital to partnership)
        - §306 – new partner is not personally liable for partnership obligations before he joined
    - If X is a retiring partner, what liability does he continue to shoulder?
        - By agreement?
        - If partner withdraws, still liable for all partnership's liabilities
        - Partnership creditors have prior right to any claim of retired partner against the continuing business as against the retired partner's separate creditors (§41(8))
    - If X's liability is greater than his assets, who takes precedence – partnership or personal creditors?
        - Common law: Jingle Rule – partnership creditors have priority over partnership assets, personal creditors have priority over partner's personal assets
        - After Bankruptcy Amendments of 1978 and RUPA § 807(a) = partnership and personal creditors have equal access to personal assets
        - RUPA §504
            - whereas UPA created quasi-entity, RUPA creates an entity
            - if judgment against a partner, creditor can't take the partnership property or throw the partnership into bankruptcy
            - but judgment creditor of partner can attach his partnership interest – partner's future income rights are transferable, can be attached by creditors (management rights aren't, and can't)
- personal creditors – can't take partnership property but can attach the partner's interest in partnership income if the claim was for a partnership obligation (§25)
- partnership creditors
    - first go after partnership property

        - then go to partners' personal property b/c they are jointly and severally liable for obligations of the partnership
            - new partner joins after liability-causing incident
                - UPA §17 – liable, but only for amount of his own partnership property (i.e. capital contribution)
                - RUPA §26(b) – not liable at all
            - If caused by one partner's recklessness, other partners can sue for breach of duty of care to recover their losses (since they have to pay – jointly/severally liable)
- personal and partnership creditors
    - common law jingle rule – partnership creditors have priority over partnership assets, personal creditors have priority over partner's personal assets
    - but after Bankruptcy Amendments and RUPA §807(a) – partnership and personal creditors have equal access to the partner's personal assets
    -

III. Dissolution

- Withdrawal and Dissolution
    - Partner has power to withdraw, but not the right to withdraw
- Partner has power to withdraw, but not the right to withdraw
    - Withdrawal can be wrongful, i.e. breach of contract – can still do it, but may have to pay damages (§31, §602)
- Old rule - UPA: withdrawal by partner causes dissolution (§29), partnership is terminated after winding up of affairs (§30)
- New rule - RUPA: agreements provide that withdrawal will not terminate the business – withdrawal causes dissociation, but not necessarily dissolution (RUPA §601)
    - Less leverage, but more attractive to third parties, shows business is stable
- UPA rules
    - Causes of dissolution (§31)
        - Rightfully – termination of definite term, express will of partner in indefinite term, express will of all partners, expulsion in accordance with agreement
        - Wrongfully – by express will of partner in contravention to partnership agreement
        - By event - that makes it unlawful to carry on the business or for the partners to carry on the business, death, bankruptcy, court decree
    - Effects of dissolution on authority
        - Generally terminates partners' authority except for winding up (§33)
            - But partner can still bind partnership for winding up, for creditors, and third parties who didn't have notice or knowledge of dissolution (§35
    - Effects of dissolution on liability

        - Partner has right to contribution from co-partners for their share of liabilities as if partnership hadn't been dissolved unless he knew about dissolution when he acted (§34)
        - Dissolution does not in effect discharge partners' liabilities, but can be discharged by agreement, or by informed consent (§36)
        - If business continues, old partnership creditors run to new partnership continuing the business, and partnership creditors have prior right to any claim of retired partner against separate creditors (§41)
    - Effects of dissolution on partnership property
        - rightfully – each partner can have partnership property applied to discharge its liabilities and have surplus used to pay **cash** the net amount owing to each partner, or if expelled party gets just cash due from partnership, <u>unless otherwise agreed</u> (§38) (*Adams* and *Dreifuerst*)
        - wrongfully – good partners also get damages; bad partner gets his interest in partnership less damages less value of goodwill (§38)
        - liabilities paid to: creditors → partners → partners (capital) → partners (profits) (§40)
            - if personal assets available too, use Jingle Rule – partnership creditors have priority over partnership property with individual creditors having priority over individual property (§40)
- ***Adams v. Jarvis***
    - Medical partnership, agreement provides that in case of withdrawal partnership won't terminate but will divide profits, partnership will retain accounts receivable; P claims it was a partnership at will so withdrawal created a dissolution (rather than term of years in which withdrawal wouldn't cause dissolution) and property should be sold and divided
    - Court: §38 sale of property "unless otherwise agreed", so since partnership had a contract to keep accounts receivable, contract should govern
- ***Dreifuerst v. Dreifuerst***
    - Brothers have partnership at will (no agreement), own feed mills, dissolve partnership, trial court gives each brother a mill rather than liquidating the assets and splitting the cash
    - Court: statute requires division of assets in cash absent special conditions that trigger partition in kind
    - Partition in kind – allows business to keep running, let one brother buy out the other brother to gain sole control over business; judicial sales don't always draw best/market price
        - Problem – party that wanted to withdraw is stuck with a mill, bears cost of selling; less value b/c have to share customers; not necessarily the value he's entitled to
- RUPA – dissociation, rather than dissolution
    - Causes of dissolution

            - Rightful – express will of partner if partnership has notice or at later date than specified, event or expulsion pursuant to partnership agreement, expulsion by unanimous vote of other partners if unlawful to carry on business with him, he transferred all or substantially all of his transferable interest, by judicial termination, bankruptcy, death, otherwise incapable (§601)
            - Wrongful – by express will/judicial determination/bankruptcy before expiration of term (§602)
        - Effects of dissolution on authority
            - Partner's right to participate in management, duty of loyalty and duty of care terminate, except for matters occurring before his dissociation or if participating in winding up (§603)
        - Effects of dissolution on property
            - If no windup -- Buy out dissociating partner's interest using value based on sale of entire business as a going concern on date of dissociation, less damages for wrongful dissociation (§701)
        - Effects of dissolution on liability
            - Dissociation does not itself discharge the partner's liabilities for partnership obligation incurred before dissociation, but he is not liable for obligations occurred after dissociation (§703)
            - Liable to third party if within 2 years he is liable and other person reasonably believes he is a partner and has no notice/knowledge of dissociation (§703)
            - No liability by agreement, or with creditor's agreement to material alteration (§703)
        - §801 – when dissociation causes winding up of partnership business
- How much should potential partner pay to enter the partnership?
    - In negotiations there will always be a range of prices, so look at what the highest price is that a buyer could rationally pay, and lowest price a seller could rationally take, and the factors affecting their desire for the deal, i.e. alternatives should they walk away → to determine value, look at ranges and alternatives

IV. Modern Forms: LLP and LLC

- Limited liability – only the general partner, not all the partners, is personally liable to business creditors
- limited partnership
    - limited partners – contribute capital, not personally liable, so no management role, sometimes have governance right to remove/appoint general partner
        - makes sense – if no control then shouldn't be liable, not subject to loss beyond their investment
    - general partner – manages the business, personally liable to creditors
        - usually a corporation incorporated for sole purpose of being the general partner, also has limited liability
- LLP – limited liability partnership for professionals
    - Firm itself is liable for partnership assets

    - Partners liable for their own malpractice, only liable for partnership after all partnership assets are gone i.e. bankrupt
- LLC – limited liability company
    - Most popular form today
        - Only use corporate form if you're trying to raise capital by selling stock
    - Complete limited liability
    - Membership agreement can have any governance structure the partnership desires - much more freedom of contract than corporations
        - Can even contract around fiduciary duties
    - Tax benefits
        - Partnership gets pass-through liability (partners pay tax for their share of the entity)
        - But bets corporate-like form without having to pay an entity-level tax – no double tax
- Benefits of limited liability – economically efficient
    - Creditors don't have to investigate or monitor assets and creditworthiness of all the partners, instead can rely on the partnership itself
    - Ease of contracting, much more freedom, so decreases transaction costs
- Benefits of *un*limited liability
    - Shows creditors that you're serious – all partners are personally on the hook for all partnership liabilities (ex: Wachtell Lipton)

<u>The Corporate Form</u>

I. Generally

- Characteristics and benefits of corporate form
    - Creates an <u>entity</u> separate from investors or managers
        - Stable and indefinite – does not change or end each time a partner dies or goes bankrupt
        - Economically valuable – entity can own its own property and enter its own contracts
        - Efficient – creditors don't have to look at participants' credit before investing, look at entity on its own → lowers transaction costs
    - <u>Limited liability</u> for investors (actually no liability beyond original investment)
        - Attractive to investors
    - <u>Centralized management</u> appointed by equity investors
        - Efficient
        - Creates system of professional management and specialization of function
    - <u>Free transferability of shares</u>
        - Shares don't have to be discounted for transfer restrictions (like in partnerships where only income rights are alienable)
- Effects of corporate form
    - Makes capital markets possible, which have social benefits of

        - cheap diversification
        - lowering cost of capital
    - allows managers to specialize in information
- kinds of corporations
    - close corporation – just a few shareholders (typically <40)
    - controlled corporation – one or group of shareholders controls the corporation because they own the majority of shares
    - public corporation – many shareholders, funded through capital markets
        - shareholder pros: cheap diversification of risk, don't have to spend time/money learning business
        - shareholder cons: passive investor, no economic incentive to study business or get involved because shares will never make a difference overall → collective action problem
- problems
    - agency problem between management and shareholders
    - collective action problem – rational passivity of shareholders hampers incentive to monitor managers (one vote won't make a difference; any gain must be shared with all shareholders)
- evolution of corporate form
    - 1800s: corporations created by "special acts" of legislature for projects that required more money than one individual could provide, acts named specific individual for specific purpose, fairly politicized (ex: RRs)
    - 1830: General acts of incorporation passed by states – who you are, what your purpose is, what the charter will contain, what the governance structure will be
        - Minimum and maximum capitalization requirements, geographic limits, can't own stock in other corporations, can't do business *ultra vires* (beyond original scope), mergers only by unanimous consent (hold-up problem so no mergers)
    - 20th cent: loosening of internal constraints (free mergers, no min/max capitalization or par value of stock, no geographic constraint, free to engage in "any lawful business"
        - But still constraints by government (SEC, OSHA, etc.)
        - As internal constraints disappear, fiduciary duty of loyalty becomes more important

II. Formation

- fundraising
    - friend/family capital
    - angel capital
    - venture capital
    - IPO – to get your own money out → create a corporation
- Why incorporate in Delaware
    - Bad story: permissive manager-friendly rules to attract businesses in order to collect franchise taxes which are major part of state budget (high taxes without having to provide services – very attractive), but end up with bad corporate governance ("race to the bottom")

        - Pro-federal government argument: one state shouldn't have this much control over national companies
    - Good story: collect franchise taxes by providing a high level of shareholder protection – shareholders prefer protections that will help managers make money, not leave them hamstrung
        - Pro-state government argument: let the states do what they want
    - WA story: businesses are attracted to Delaware Court of Chancery – quality judges with no distractions, large volume of precedents makes law predictable; market is comfortable with DE because it is commonly used so good for IPOs; mostly big companies able to pay the fee
- Statutes → enabling statutes with few mandatory features, allow businesses to form corporations upon filing charter with state official (DGCL §101)
- Charter
    - Structural, required – includes name, address, nature of business, # of shares (§102(a))
    - Permissive provisions if company chooses to change defaults (§102(b))
        - §102(b)(1) – any provision for management of the business that limit or regulate power of the corporation, directors or stockholders are okay if legal
        - §102(b)(4) – certain corporate actions can require vote of larger group of shareholders
        - §102(b)(6) – shareholders generally not personally liable for corporate debts but can be changed by charter
        - §102(b)(7) – directors' personal liability can be eliminated or limited, except for breaches of duty of loyalty, acts in bad faith or intentional misconduct, and improper self-dealing transactions
            - Response to *Van Gorkum* decision
            - Director protection is for benefit of shareholders → otherwise wouldn't take job, and wouldn't take the risks that are beneficial for shareholders (since they can diversify the risk, better to have bigger gains)
    - DGCL §241 – how to amend the charter
        - Only when board initiates an amendment in way that would have been legal when charter was first created, then majority vote by shareholders (difficult to amend charters)
- Bylaws
    - Operating rules giving certain officers certain powers, creating Board committees, etc.
    - DGCL §109 – shareholders have the power to make bylaws, but corporation may confer that power to directors in charter, while shareholders retain the right to do it (but generally don't act on it) but they may grant that power to the Board to do it for them (which is what always happens); bylaws can be anything legal relating to the business
- Rights of Shareholders
    - Rights can be modified in the charter, but usually aren't – written at IPO phase, company wants it to be attractive to investors so keep default rules

- Right to elect the board → fundamental and important right (§211)
- Shareholders do NOT own the company
  - Corporation is a public form of governance with system of control and management rights, but is not technically "owned" by anybody
- DGCL provisions – default rights for shareholders
  - §109 – right to vote on bylaws
  - §211 – right to elect board, have annual meetings in person or by remote communication
  - §212 – one vote per share of capital stock held, to be exercised at meeting or in writing by proxy
    - §213 – shareholders eligible to vote determined by board's fixing a record date
  - §141(k) – power to remove directors, except when board is staggered
  - §220 – right to inspect books and records, including list of shareholders
  - §222 – right to written notice of shareholder meetings
  - §228 – consent solicitation statute – any action the shareholders can take at a general meeting can also be taken by consent solicitation, i.e. by written consent, so shareholders don't have to attend the actual meeting
    - Important for large institutional investors with big blocks of stock, and for collective action problem
  - §242 – right to vote on amendments to charter
    - Proposed by board, meeting called, approval by majority vote
    - If amendment will change voting power of a class, they are entitled to vote on amendment whether or not they are entitled to under the charter
  - §271 – right to vote (majority) on sale of all or substantially all the corporation's assets
  - §275 – right to vote (majority) on dissolution of company

- Board of Directors
  - Designates management, which often dominates the Board as well (§142)
  - "the boss" – initiates all important decisions and transactions
  - Fiduciary duties to corporation and shareholders
    - Self-dealing transactions not necessarily void if material facts are disclosed and approved by board or shareholders, and on fair terms (§144 – safe harbor statute)
  - Can be indemnified for personal liability suffered as a result of corporate office under certain circumstances (§145)
    - But cannot waive personal liability for breach of duty of loyalty, actions in bad faith/intentional misconduct, or self-dealing transactions (§102(b)(7))
- Corporate Officers
  - Appointed by the board

- Board is principal, officers are agents – apparent authority
- Officers' powers established through formal resolution of the Board
- ***Jennings v. Pittsburgh Mercantile Co.***
  - Company officer (VP and Treasurer-Controller) told Jennings to go through with real estate deal that would sell all the company's assets, Jennings sues for his commission, but company claims officer had no authority to direct him to engage in the transaction
  - Court: no apparent authority for transaction so cannot recover – big transactions like this require formality, board approval
    - When you use the corporate form, you have to follow the rules – gives dignity to the board

III. Raising Capital

- To finance your company, you need
  - Debt → bonds – form of debt, traded on market or privately
    - Maturity date at which firm has legal obligation to repay
    - Stated interest rate that company has to pay
    - Bondholders have right to declare default if interest or principal is not paid when due
    - Advantages of funding through debt
      - Cheaper – tax deductible (treated as expense deductible before taxable profits are calculated), less risky an investment so pay less
    - Disadvantages of funding through debt
      - Cash flow drain because interest must be paid
      - May be more expensive when finally paid back
      - Default can put you into bankruptcy
  - Equity → stock – investment in the company in return for securities
    - Indefinite commitment, no maturity date
    - no right to any return – right to dividends is a discretionary return only when declared by directors
    - no right to declare default and put corporation into bankruptcy to have debt repaid
    - BUT unlimited upside – if business succeeds your return will be greater than bondholder
    - AND certain control rights – right to elect board and consent to fundamental transactions
    - Advantages of funding through equity
      - Control rights
      - Unlimited upside
    - Disadvantages of funding through equity
      - More expensive because not tax deductible – distributions on equity are taxed, so it is more expensive than debt
      - Hard to value
  - Even though debt is cheaper, still want equity
    - The more debt is issued, the riskier the company is willing to act because it doesn't bear the risk itself

        - Then investors will demand a higher interest rate
        - At some point investors will be unwilling to participate without more equity in the firm
    - Goal: lowest cost of capital to run the business
        - optimal capital structure is slightly more equity than debt
        - if debt > equity it is highly levered
        - how do you know what ratio is right?
            - Look at industry – less volatile industry then more debt is okay
            - Senior management has incentive to avoid bankruptcy, so they tend to favor more equity than is probably optimal
- Time value of money – $1 today is worth more than $1 next year because there is value in getting to use it now, and there is a risk the other party won't keep his promise
    - Present value = future value/(1+interest rate)
        - The smaller the discount, the greater the present value
    - Future value = expected value = weighted average of the value of investments
        - = (return if investment is a success x probability of success) + (return if failure x probability of failure) + other weighted data points
- Risk – volatility of expected returns
    - Systematic risk
        - no premium because everything has it, can't be avoided
    - Idiosyncratic risk
        - Adds a premium because not everyone assumes this risk
            - ***In re Emerging Communications Inc. Shareholders Litig.*** – small company premium was inappropriate part of valuation because not generally accepted in the industry
        - Limited by diversification – high risk and low risk investments cancel each other out
    - Capital asset pricing model (CapM)
        - Prices risk – volatility of stock price over some period compared to volatility of the market, measured using Beta (high beta = risky compared to the market)
- Valuation
    - Discounted Cash Flow (DCF)
        - Evaluates company by projecting its value over time, net cash over number of years
        - Net cash flows for each year and a terminal value (since growth won't last forever)
            - Cash flow = profit + non-cash assets
    - Cost of debt = interest rate + difference from market rate
        - Yield
        - Market price is indicative of whether people thing there is greater or less risk

- Cost of equity
  - Riskless rate + equity premium x Beta
    - Riskess rate = Treasury bonds
    - Equity premium = set by economists, amount of return greater than riskless rate that market demands for this kind of investment (uses historical data)
    - Beta – from CapM assessment of risk rate
- Cost of capital = blend cost of debt and cost of equity

- Efficient capital market hypothesis – market is better indicator if stock is widely traded (less value after dot-com bubble bursts)

<u>Protections for Creditors</u>

I. Private Law System = Contracts → negotiated protection

- Required due diligence – supplies information so you can estimate risk
- Warranties and representations – guarantees that the business is as represented to the buyer
- Covenants – affirmative promises to do certain things, i.e. to maintain certain amount of cash, etc.
  - Negative covenant – promise not to do something
- Security interest – interest in assets as form of contract, gives notice to others that you have right of first lien, right to seize property in case of default
- Preferred shares – preferred claim in liquidation, has to be paid out before common stock, accumulates if no dividend paid, but generally don't have voting rights

II. Statutory Protection

- mandatory disclosure for public companies – public law system, enforced by SEC
- no longer in use
  - minimum capitalization requirements
  - par value of stock (i.e. stated minimum stock value)
- <u>Uniform Fraudulent Transfer Act/ Fraudulent Conveyance Act</u>
  - Implicated when person makes voluntary payment or gift to a non-creditor instead of paying existing obligations to creditors
  - Present or future creditors can void a transfer if
    - §4(a)(i) – *actual* intent to hinder, delay or defraud any creditor (subjective intent), OR
    - Transfer was made without receiving fair consideration and
      - §4a(2)(i) - Leaves debtor with assets unreasonably small relative to the business , or
      - §4a(2)(ii) - Debtor intended, believed or reasonably should have believed he would incur debts beyond his ability to pay, or
  - Present creditors can void a transaction if
    - §5a – debtor doesn't receive reasonable consideration and either is or becomes insolvent as a result of the transfer, or

        - §5b – Debtor transfers to an insider for pre-existing debt, was insolvent at the time, and the insider had reasonable cause to believe the debtor was insolvent
    - Insolvency = debtor's debts are greater than assets at fair valuation (§2a)
- Restrictions on dividends
    - Implicated when directors pay dividends instead of paying creditors
    - Board is restricted from paying out dividends that will make the company insolvent
    - Capital Accounts
        - Stated Capital – permanent capital
        - Capital Surplus Account – difference between stated capital and what the company actual gets on the market
            - Dividends are payable
        - Retained Equity – whatever earnings the company retains after paying dividends
            - Dividends are payable
        - Revaluation Surplus -- if there is economic value in the corporation, net of real liability, that is reliable (determined by a third party?), that is not reflected on balance sheet, then Board can revalue the books to create a surplus and pay a dividend from that
            - Cf. "write downs" where company says its assets are worth less than it appears
            - Rarely done, mostly private companies with an interest in paying dividends
    - DGCL (170-1)
        - §154 – allows revaluation, Board can pay dividends from surplus account
        - §174 – directors are personally liable for willful or negligent payment of unauthorized dividends
            - Which is why revaluations aren't that risky – directors don't want to be personally liable
- Insolvency
    - Directors have duty to creditors when corporation is in bankruptcy – in addition to general duty to shareholders (*Geyer v. Ingersoll*)
    - Liabilities > assets at fair market value, or
    - Not enough cash to meet obligations – assets without liquidity
    - When a corporation becomes insolvent, directors' duty runs to the corporation and its creditors, not to the corporation and its shareholders
        - Normally duty is to corporation, which includes shareholders
        - But in insolvency the directors must act to benefit the corporation and the creditors even if the shareholders object – violation of duty to go against creditors' interest

III. Judicial Protection

- Equitable remedies based on court's desire to be fair, not rooted in law

- Available when 1) you have an equitable right (i.e. against a fiduciary), and 2) the legal remedy available is inadequate for full and just recovery
- Rarely used for public companies unless there is an active fraud
- Equitable Subordination
    - Subordinates (i.e. puts below) one creditor's claim to another's based on principles of fairness
    - ***Costello v. Fazio***
        - When partnership is failing the partners form a corporation, pull most of their money out in form of promissory notes leaving very little equity in the company; when company goes bankrupt, trustee wants partners' notes to be subordinated to other creditors because they ran the business into the ground
        - Court: analogous to a fraudulent conveyance because they transferred their capital into an ordinary debt so it would be considered with other creditors when company went under, designed to hinder/delay/defraud creditors, undercapitalized the business, so deserve to be subordinated
    - ***Gannet v. Larry***
        - Newspaper publishing chain tells subsidiary to abandon publishing business and do only newsprint manufacturing so it will have cheap supplier, when subsidiary goes bankrupt Gannet wants its loans repaid
        - Court: Gannet's loans are subordinated because it used its position and loan to control the subsidiary's management for its own business interests, forced subsidiary to incur more risk
- Piercing the Corporate Veil
    - Shareholder becomes personally liable for the corporation's liabilities
    - Severe remedy used mostly when
        - formalities of corporate form haven't been respected
        - corporation serves as a shell for the shareholder himself
        - corporation used to perpetrate a fraud
    - ***Sea-Land Servs., Inc. v. The Pepper Source***
        - D never pays for shipping, shipper sues owner and all the sibling companies
        - Court: disrespect for corporate form so piercing is appropriate
        - Corporate veil piercing test
            - No separation between interest and ownership
            - Upholding corporate form would sanction fraud or promote injustice
        - Factors to consider
            - Lack of corporate records
            - Commingling of individual's and corporation's funds
            - Undercapitalization
            - Corporation using other people's assets as its own
    - ***Kinney Shoe v. Polan***

        - Kinney subleases to Polan's entity which has no money, tries to get Polan to pay since he owned another company that housed all the assets
        - Court: if you don't go through the motions of formality with respect to corporate form, courts will have no pity, corporation was just a shield to keep shareholder away from debts
        - WA: not enough evidence to pierce here, but court probably thought D was bad guy, equitable consideration, undercapitalization isn't enough on its own, can't pull money out of corporation to avoid repayment, assets have to be available to creditors except for reasonable losses

IV. Protections for Involuntary Creditors

- not relying on express statements of the corporation because their involvement is not voluntary – holders of tort judgments, want judgment to be paid
- equitable subordination – possible, but infrequent
- piercing the corporate veil – more common
- ***Walkovszy v. Carlton***
    - P hit by a car, sues company via respondeat superior since tort was committed in course of agency, but D claims that it was a different company since each two cabs form a separate corporation, P says they are functionally one unit so should bear the liabilities (enterprise liability)
    - Court: can't pierce the corporate veil just because one unit's liability makes the whole organization liable (enterprise liability, not shareholder liability); just because corporation is a "dummy" for the individual shareholder doesn't lead to piercing unless some misconduct alleged against that shareholder; since the P didn't allege any misconduct of the shareholder D himself the complaint has to be dismissed
    - Dissent: D clearly using corporate form to avoid liability in cases like this
    - Also: fact that mandatory insurance held by cab drivers doesn't cover judgment is not enough to get piercing
    - Should involuntary creditors like this get more piercing because they weren't in a position to bargain up-front, so need more protection on back-end?

V. Protection upon Dissolution

- when corporation dissolves, directors still run company for purpose of winding down – collect assets, pay debts, pay liquidating dividend to shareholders (DGCL §§ 275-84)
- directors are personally liable to creditors if they pay dividends before debts have been satisfied (DGCL)
- creditors have 3 years to bring a claim against the company
    - involuntary tort creditors can ask Secretary of State to revive company for purpose of suing if statutory limit has passed
- successor liability – tort claimants can sue entity that acquired the company if business is essentially the same but with different ownership
    - successor can protect itself by getting indemnification from seller
- cutting off of future unknown claimants (DGCL §§ 281-84)

<u>Duties of & Protections for Directors → Duty of CAre</u>

I. Duty of Care, Generally

- minimum required of corporate directors
- Board should act as a reasonably prudent person under similar circumstances (DGCL)
    - i.e. appropriately *informed*, and making a *good faith* effort to advance the corporation's interests
- Model Business Corporation Act § 8.30
    - Duty to act (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation
- ALI Corporate Governance Project

II. Protections for Directors for Violations of Duty of Care

- <u>Business Judgment Rule</u>
    - Unless board is impaired/conflicted or there is evidence of bad faith, courts will respect the board's decision to engage in the transaction as part of its ordinary business judgment – board is in a better position to assess reasonableness business decisions than court (*but see* ***Zapata Corp. v. Maldonado*** – business judgment rule + court's own business judgment)
    - In shareholders' and directors' best interests
        - Directors: protects their decisions
        - Shareholders: if not, then directors won't take risks, but high risks offer greater returns for shareholders, and shareholders are able to diversify
    - ***Gagliardi v. TriFoods Int'l, Inc.***
        - CEO pushed out, objects to new board's business decisions, but case is dismissed under business judgment rule
        - Court: suit will be dismissed using business judgment rule if there is no evidence that the board was impaired or acted with bad faith
    - ***Kamin v. American Express Co.***
        - Amex tries to unload bad investment in brokerage house by paying dividend in kind (takes it off income statement), but Ps claim it is corporate waste because it would have been a big tax write-off if sold at a loss
        - Corporate waste = transaction for no consideration or so little consideration that no reasonable mind could consider it a *quid pro quo*, i.e. not in good faith
        - Court: no conflicting interests, no negligence, went through reasonable business process, so apply business judgment rule and find for board
    - ***Smith v. Van Gorkum***
        - Board found to be grossly negligent in violation of duty of care, can't rely on business judgment rule if board chooses a bad deal for shareholders

        - Widely criticized, Del. legislature responds with § 102(b)(7) → any corporation can put provision in its charter saying that directors are not liable for damages in actions brought by or on behalf of the corporation UNLESS they are found to have acted not in good faith or have breached a duty of loyalty (i.e. not personally for breach of duty of care unless acting in bad faith)
    - Model Business Corporation Act → mixes objective standard of conduct with subject standard of liability
        - § 8.30 - directors should act with good faith, in manner reasonably believed to be in corporation's best interests (objective)
            - Reasonable man standard = objective
        - § 8.31 – director will not be held liable unless accused of bad faith, lack of independence, or reasonably believed he was not adequately informed
            - Reasonable director standard = subjective
        - Why?
            - Duty of care is mostly aspirational – good to encourage that aspiration to get involved, but bad to automatically punish people for failing to achieve it because it would chill willingness to be a director and undertake risky transactions that benefit shareholders
- <u>Indemnification</u>
    - Promise that corporation will cover liability costs/expenses incurred by director or officer under certain circumstances
    - DGCL § 145 – corporation has power to indemnify directors, etc., if they acted in ***good faith*** and had no reason to believe he was committing a crime
        - (a) – general indemnification for third party suits
            - Requirements: D sued by reason of his corporate office, acted in good faith and in a way to advance the corporate purpose, and with reasonable belief that he was not committing a crime
            - Indemnification includes attorneys' fees, judgments, etc.
        - (b) – derivative suits
            - Same structure as (a), BUT can only get indemnification upon court approval
        - (c) – mandatory indemnification
            - Corporation must indemnify D who was successful on the merits, got a dismissal, anything other than conviction (***Chapman***)
        - (d) – process
            - Set up disinterested party to make indemnification decisions
        - (e) – advancement of fees
            - Corporation may give $ for expenses incurred in defending the claim in advance of the final disposition, but D has to

sign an undertaking to promise to pay it back if it is found that he is not qualified for indemnification (i.e. loses and court doesn't authorize it under (b))

        - (f) – authorizes D&O insurance
        - (g) – reliance on experts
            - Independent defense if directors had reason to believe that an expert was competent and not misinformed, could reasonably rely on expert opinion
    - ***Waltuch v. Conticommodity Servs., Inc.***
        - Silver trader sued for market manipulation by customers (dismissed but he and corp pay settlement) and by CFTC (pays fine); he wants indemnification because written in charter but corp says he didn't act in good faith so ineligible
        - Court: even though (f) doesn't have an independent good faith requirement, still subject to (a)'s good faith requirement so ineligible for indemnification for CFTC action, but gets mandatory indemnification under (c) for dismissal of the customer suit
            - Always have to act in good faith (otherwise would undermine whole DGCL structure)
    - To determine eligibility, corporation looks at process undertaken, majority vote of uninvolved directors
    - Takes away deterrence for criminal acts?
        - Prosecutors plea bargain with business criminals that they won't pursue jail time if D gives up right of indemnification
- Director & Officer (D&O) Insurance
    - Insurance company stands behind corporation's financial pledge to pay indemnification
    - If you want to be on a board, ask
        - What's their reputation?
        - How is their D&O insurance?
            - Need coverage that is adequate in amount and covers special situations of bad financial statements and bankruptcy
- Liability Waiver

III. Duty of Care – Monitoring

- duty of care can be violated by failures to act or monitor the company
- ***Francis v. United Jersey Bank***
    - Trustee in bankruptcy sues directors mother and sons for breach
    - Court: even though sons were the real bad guys (mismanagement, taking loans from company), mom was director and should have monitored financial statements, no defense that she thought title was honorific and didn't have to attend board meetings
    - Court: director must
        - Acquire rudimentary understanding of business

        - Attend meetings of the board – and ask questions (best defense to claims of lack of due care)
        - Maintain familiarity with company's financial status
        - Review financial statements
        - Object to illegality or step down (otherwise you are presumed to concur)
- ***Graham v. Allis-Chalmers Manufacturing Co.***
    - Antitrust price-fixing violations by company with decentralized management structure, Ps claim that board should have been more vigilant about monitoring because of consent decree for same problem 30 years earlier
    - Court: red flag rule → board is entitled to trust its subordinates unless something happens that would put a reasonable person on notice that something illegal is going on
        - No duty to monitor absent red flat
    - Effect: encourages board passivity, "head in the sand" attitude
- ***Martha Stewart***
    - Board not responsible for monitoring Martha's personal life to prevent adverse impact on company even though her image is closely tied to company's success
- ***In re Caremark Int'l Inc. Derivative Litig.***
    - Settlement hearing for derivative suit after Caremark gave kickbacks to doctors for Medicaid patients in violation of Anti-Referral Payments Law, Ps claim Caremark had obligation to prevent the wrong despite lack of red flag
    - Court: duty to monitor → obligation to create monitoring/information-gathering system that goes up the chain to bard
        - Opposite of *Allis-Chalmers*
    - Similar to §§ 8.30-31 combo – you don't have to have a perfect system but you cannot allow extreme and persistent failure
- ***In re Michael Marchese***
    - Outside director has obligation to monitor losses as part of duty of care – obligation to make due diligence inquiry when he sees auditors were fired, it was unreasonable to rely on the auditor
        - Area in which we want directors to be actively engaged

IV. Duty of Care – Conforming to the Law

- Fiduciary duty of directors to try to cause the corporation to be compliant with law; fiduciary duty not to break the law
- ***Miller v. AT&T***
    - AT&T owed money for phone services during 1968 Democratic Nat'l Convention but un-conflicted board decides not to sue
    - Court: not suing was a violation of statute governing political contributions (creates private obligation to sue, not federal right of action, and no federal enforcement mechanism), so it is not protected by the business judgment rule, at least a triable issue so claim should not be dismissed

- But what if the cost of compliance greatly exceeds the fine for breaking the law? Not necessarily in corporation's best interests to comply
    - Look at probability of violation
        - "more probable than not" – problem
        - 15% - iffy
    - If regulatory fine is small and savings to corporation was big then court likely to say there was no harm to corporation and find for board → cost-benefit analysis
        - Assume relationship between size of fine and gravity of the offense
        - Difference between violating a zoning regulation and an OSHA safety requirement
    - Agency theory – director doesn't want to be sued for knowing violation, so only going to do this when the savings to the company is huge

Duty of Loyalty

I. Duty of Loyalty, Generally

- obligation to advance the purposes of the corporation in good faith
- loyalty to whom
    - public
        - public interest view of corporation: state creates corporations so we can have limited liability because otherwise projects in which the state has an interest (roads, banks) won't be undertaken
    - shareholders
        - private mechanism view of corporation: individuals coming together to foster private aims
    - WA: corporation is too big to ever defer to one interest over the other, so boards are ultimately multi-constituent organizations and shift deference to different factors; but with rise of institutional investors they've become more shareholder-focused

II. Duty of Loyalty – Self-Dealing

- Can directors contract with the company?
    - Originally off limits
    - Now permissible under certain circumstances
- Trust beneficiary rule – if full disclosure and fair terms, then it's okay
    - Fair terms = objective standard
- ***Sinclair v. Levien***
    - Ps claim that company paid too many dividends, would have been better to have them reinvested
    - Court: it is not self-dealing if all the shareholders and the fiduciary get the same benefit
        - Self-dealing = fiduciary gets something but everyone else doesn't
    - Really a corporate opportunity case, but court doesn't go there
- In parent/subsidiary transactions
    - P has initial burden to show conflict
    - Then D has burden to show **entire fairness (fair price + fair process)**

- If ratified by appropriately functioning special committee (independent and informed) then shifts burden back to P to show unfairness (Kahn v. Lynch)
- High duty of disclosure, can't say anything incorrect or misleading
  - but no duty to disclose highest price unless number calculated using target's proprietary info

- In regular transactions
  - Court looks at transaction and conflict to decide whether to use business judgment rule or entire fairness rule - size/consequences of transaction, power/dominance of director, fairness
    - Outside director + small transaction = business judgment rule likely
    - CEO + major improvement = entire fairness likely
    - CEO + minor improvement = business judgment rule likely
    - ***Cooke v. Oolie***
      - Weak conflict + 2 independent directors approved deal = business judgment rule
- Protections for Directors
  - **Safe harbor statutes**
    - Allows director to engage in transaction as long as they follow rules established for trustees and trusts
      - Beneficiary was competent to contract
      - There is full disclosure
      - Transaction is objectively fair
    - Still has to be fair, just not automatically voidable
    - DGCL § 144(a) – interested directors – full disclosure to directors and shareholders, fair terms, approved by shareholder vote
    - Indiana – "not voidable solely for the director's interest in the transaction"
    - Cal. Code § 310 – transaction must be ratified by disinterested shareholders
    - NY § 713
    - Model Business Corporation Act §§ 8.6-8.63 – interested parties cannot approve transaction
      - § 861 – transaction affected by corporation may not be subject to equitable relief in a proceeding that is not a director conflicting transaction. Even a conflict transaction cannot be grounds for relief if a disinterested board or shareholders approved it
      - Not subject to fairness review if set up conditions that make transaction reasonable
    - ***Cookies Food Products v. Lakes Warehouse***
      - Controlling shareholder/director accused of self-dealing because he invented a new product for the company and was compensated for it, but minority shareholder Ps claim

they're not getting dividends and can't trade their stock, so unfair
  - Court: compliance with safe harbor statute and approval by board does not exclude judicial review – burden on self-dealer to demonstrate fairness

- **Disclosure**
  - If you don't make full disclosure then the other side has the right to void the transaction even if you didn't make a profit; if there is a profit, it will be disgorged and given to corporation
  - This way company can act on all pertinent facts
  - Courts use disclosure as proxy for fairness
  - ***Hayes Oyster Co.***
    - Vern is director and part owner of Coast, suggests selling oyster beds, got fair price but didn't disclose self-interest
    - Court: interested parties must disclose interest before the deal or else the deal can be voided even if it was fair
- **Ratification by shareholders**
  - Majority of public shares must vote for the transaction + full disclosure + voluntary vote + disinterested shareholders
  - ***In re Wheelabrator Technologies***
    - Independent and informed ratification of transaction by majority of shareholders
    - Has effect of
      - extinguishing claims of lack of due care
      - if minority of directors - triggers business judgment rule
      - if controlling director – shifts burden of proving entire fairness back to P
  - ***Weinberger v. UOP, Inc.***
    - Signal is parent of UOP, controls 6/13 directors, wants to buy UOP, shareholders accept $21/share
    - Court: even though shareholders voted the directors breached duty of loyalty
      - Breached duty of disclosure – didn't disclose study that said $24 was top price; used UOP info without telling UOP
        - Duty to disclose top price?
          - Kahan: yes
          - WA: no duty to disclose unless you used the target's proprietary info to make the calculation (*Kahn v. Treemont*)
      - Breached duty of loyalty – loyal only to Signal, not to UOP as well, process was too rushed
- **Ratification by special committee**

        - Independent committee of board charged with finding best interest of corporation in deal
        - Independent + good outside advice
        - ***Kahn v. Lynch***
            - Controlling shareholder has burden of proving fairness in conflicted deal
            - Approval by informed and independent special committee shifts burden to P if special committee can negotiate at arms length and conflicted majority shareholder doesn't set deal terms
            - Burden does not shift if special committee dominated by majority shareholder or otherwise controlled by conflicted director

III. Duty of Loyalty – Corporate Opportunity Doctrine

- fiduciary cannot act on a corporate opportunity without first disclosing it to the rest of the disinterested board and the board fairly rejecting (ALI Principles of Corp. Governance §5.05)
    - burden on party challenging the opportunity, unless not properly ratified in which case burden is on board
- what is a corporate opportunity?
    - Legal expectancy test – legal reason to expect that it is the corp's
    - Economic expectancy test – economic reason to expect that it is the corp's
    - Line of business test – opportunity is in a line of business the corp is already in
    - Fairness test – look at all the factors to decide whether in fairness the corp should have first dibs
        - Factors: did the fiduciary learn about the opportunity because of his fiduciary relationship, was it an officer or a director, outside director, etc?
    - ALI Corp. Governance test – director learned about opportunity in connection with his job or under circumstances where he should have realized the offeror expected it to be offered to the corporation, director should have expected it would be of interest to the corporation, or is closely related to corporation's business (§5.05)
- Corporate opportunity can be waived by company
    - Disclosed to board and board passes
    - Ratified after the fact
    - Director can try to show that company wouldn't have been able to pursue it anyway b/c of legal or economic reasons
        - Beyond scope of business in corporate charter?
        - Beyond company's financial capacity
    - DGCL § 122 – under certain circumstances corporate opportunities/self-interested transactions can be waived
- Remedy: corporation takes the opportunity, disgorgement of profit
- ***In re eBay, Inc. Shareholders Litig.***

    - Goldman Sachs allocating IPO shares to directors of eBay, issue is whether directors were taking a corporate opportunity in the profits they made on the stock
    - Court: it was a corporate opportunity b/c eBay did have a business in investing and cash management, opportunity came to them because of their corporate office (looks like a bribe)

IV. Duty of Loyalty – Executive Compensation

- all executive compensation is technically self-dealing, but it is a necessary evil b/c need agents to be energetic and loyal
    - WA: problem is exaggerated – most people do the right thing anyway
    - Motivators
        - Derivative suits – not that effective
        - Align economic interests of company and directors → incentives
- issues
    - Business: are we paying too much and in the right way?
    - Political: are senior officers getting too much?
    - Governance: is the structure of compensation program correct, motivating the right kind of action to advance shareholder interests?
    - Measurement
- Courts don't second guess company's judgment but want to ensure that there is a process used as a proxy for the court's judgment re whether the sum is reasonable
    - Post-Enron NYSE listing standard changes require compensation committees to be totally independent under heightened standards
        - Compensation consultants could be conflicted (hired by CFO to justify big pay), but now treated more like outside auditors where we emphasize independence and regulation
- stock options in response to limiting statute
    - right to buy stock at strike price (time of option) – incentive to drive share price up so you can collect the difference
    - vest upon merger
    - courts: if set up by independent compensation committee and ratified by shareholders its okay
    - root of CEO compensation growth – market capitalization of equity
    - cons: no downside risk, only upside gain if stock goes up, creates preference for volatility
- restricted stock
    - better incentives – get the stock itself so upside and downside risk
- CEO effectiveness measured by stock price? Not really
    - today CEOs effectiveness measured by more than just stock price – success of company relative to industrial peers, positive cash flow growth, development of next generation managers
    - compensation justified because "CEO skill" is rare?
- ***In re Walt Disney Co. Derivative Litig.***
    - Eisner and Disney board hire Ovitz as #2, try to fire him for cause so they don't have to pay termination fee but can't, so end up paying tons of money for only 1 year of work

        - Court: applies business judgment rule - so as long as there were no conflicting interests and the board had a reasonable process, the decision stands
            - Legit business decision: could have saved money by firing him for cause, but better to not have the most powerful man in Hollywood loathe you

<u>Protections for Equity Investors</u>

- **shareholders are protected by the**
    - **right to sell**
    - **right to sue**
    - **right to vote**

<u>Shareholder Suits</u>

I. Direct Suits – Class Actions

- shareholders sue for injuries they've suffered
- made possible by Fed. R. Civ. Pro. 23(b)(3) – if common question of law or fact predominate and class action form is superior to other forms of litigation, then shareholders may aggregate their claims into one class action suit
- recovery goes to the shareholders
- always settled
- pros: overcomes collective action problem for shareholders to encourage claims to be brought that otherwise wouldn't be
- cons: wasteful to pursue claims that are small/insignificant enough that they wouldn't have been brought otherwise; bad incentives for lawyers who drive the litigation themselves in pursuit of fees

II. Derivative Suits

- shareholders sue for injuries the company has suffered
    - classic case: self-dealing transaction by director who controls the board
    - mostly duty of loyalty breaches, not duty of care
- two-part suit
    - against the directors for wrongfully failing to bring the suit themselves → per-suit demand or demand futility
    - against the wrong-doer
- recovery goes to the corporation
- always settled, but only after court hearing
- pros: protection for shareholders, but hard to measure success
- cons: very expensive so possibly wasteful, driven by attorneys fees, possibility of strike suits
- Tooley v. Donaldson Lufkin & Jenrette, Inc.
- ***Gentile v. Rossette***
    - Controlling shareholder gets board to change his convertible debt from \$0.50 per share to \$0.05, which changes ownership stake from 60% to 90%, shareholders approve it but aren't told about ownership change
    - Court: derivative suit because the corporation has been harmed, but also class suit because shareholders have been harmed because their voting rights have been diluted
- <u>Standing</u> (common law rules)

- Have to own stock
  - Guarantees right incentives if you have a stake in the company
- At the time of the wrong
  - Limit # of suits and opportunism
- And for the duration of the action
  - Prevent frivolous or malicious suits, and settling too cheaply

- <u>Pre-suit demand</u>
  - To bring a derivative suit, you have to
    - First go to the board and ask them to bring the suit, and when they don't you go to court and plead that the board *wrongfully* refused, OR
      - If not wrongful, then court applies business judgment rule and respects board's decision
    - Go directly to court and plead demand futility – board is unable to exercise business judgment with respect to this issue so pre-suit demand was pointless
  - ***Levine v. Smith***
    - GM buys back stock from biggest shareholder Ross Perot because he is badmouthing the company, suit claims board was manipulated and misled by managers so unable to act independently in the transaction
    - Court: in demand futility case, if board is informed and not conflicted then court will apply **business judgment rule**, unless plaintiff shows particularized facts that create a reasonable doubt as to the soundness of the challenged transaction
  - **Delaware Rule** – if you make a pre-suit demand then court will assume that the board is independent
    - All derivative suits in Del. go directly to court – demand futility
  - **Universal Demand Rule** (ALI Corp. Governance Project § 7) – shareholder must make pre-suit demand, then court decides whether board's decision was independent, using record of attempted pre-suit demand
  - Other possible hurdle: bond requirement
  - P only has to show reasonable doubt of board's valid judgment in pleading
  - If majority of board is involved in transaction, freeze out merger, or self-dealing issue with parent company, then demand will probably be excused

- <u>Dismissal of suits</u>
  - Fed. R. Civ. P. 12(b)(6) motion to dismiss for failure to state a claim
  - Fed. R. Civ. P. 23.1 motion to dismiss for failure to make a demand
  - Special committee of the board appointed to decide whether to dismiss the claim
  - Merger
    - Cash merger terminates the derivative suit
    - Securities merger = double derivative suit
  - Settlement with attorneys fees
  - Special committees

        - Set up with group of independent directors with special charge to investigate background of the disputed transaction and decide whether corporation should pursue the claim
        - NY Rule – just use business judgment rule
        - ***Auerbach v. Bennet*** – if special committee is truly independent and investigation was reasonable then its decision stands
        - ***Zapata Corp. v. Maldonado***
            - If the report was prepared by independent directors who were well informed, then Del. court will apply its *own* judgment to decide if its decision was reasonable
    - Securities merger
        - Former board wasn't in a position to exercise judgment, but new board has right to claim so need to make demand again
        - ***Rales v. Blasband***
            - Shareholder has stock in parent company, complains about self-interested directors on subsidiary board
            - Court: focus on board and disputed transaction – demand rule excused where board interested in suit and probably couldn't have made an objective decision
- Settlement & Attorney's Fees
    - To get a settlement, you need
        - Best notice practicable
        - Opportunity for other shareholders to appear and be heard
    - Have to settle merits before settlement itself – otherwise looks like strike suit
        - Strike suit – brought for sole purpose of settlement
            - Cost of defense is higher than cost of settlement, so rational defendant will always settle
    - Non-monetary settlements more common
        - Change in deal terms
        - Governance changes
        - Authority restrictions
    - Monetary settlement creates common fund for corporation from which Ps can recover attorneys' fees = common fund doctrine
    - American Rule – each party bears his own fees
        - Exception: common fund doctrine
    - ***Fletcher v. A.J. Indus., Inc.***
        - Derivative suit, claim of self-interested management, remedy is a reorganization of the board and restriction of culpable director's authority, but put off monetary recovery until later date, P wants to recover fees from common fund but it hasn't been created yet
        - Court: judge decides if settlement is fair and reasonable
            - Look at nature of claim and discovery record to determine what claim is "worth"

            - Court: **substantial benefit rule** – attorneys fees can be awarded where suit produced substantial benefits for corporation even if no monetary fund is produced
                - No monetary fund, but benefit was conferred to the corporation – maintaining health of corporation, preventing harm to shareholders' interests, helpful management changes
                - Pros: need to pay attorneys' fees in order to bring derivative suits to court, which enforce otherwise difficult to monitor fiduciary duties – shareholder protection
                - Cons (dissent): encourages people to bring suits that don't have monetary value, will create too much litigation
        - Percentage of the benefit rule – court looks at market for contingency fee cases
        - Lindi Rule – look at time, complexity, difficult, expertise, specialization, lodestar multipler
            - Problem: incentive to drive up hours
        - Delaware Rule – factors without lodestar, role of P in producing the benefit, size of benefit, difficulty of case
        - ***Carlton Investments v. TLC Beatrice Int'l Holdings, Inc.***
            - Breach of fiduciary duty claim regarding board's approval of former CEO's compensation package, Ps claim settlement isn't fair
            - Court: can decide whether settlement is fair, possible because already many hearings and lots of discovery, year of litigation
                - Parties generally in better position to decide fair value of settlement

<u>Voting</u>

I. Shareholder Voting, Generally

- constraints on agency costs
    - shareholders' right to sell their stock
    - fiduciary duties of directors
    - shareholders' ability to sue
    - shareholders' right to vote
- more important with growth of institutional investor blocks

II. Voting Process → DGCL

- Who votes
    - All shareholders
    - Charter creates voting rights for registered owner of stock
        - Now that shares are held by brokers, trusts, institutional investors, use proxies to connect the investor with the voting power
- When do they vote
    - Annual Meeting § 211(b)
        - Board sets record date (§213) to determine shareholders eligible for that year's meeting and vote (§216)

        - Shareholders can sue if board doesn't have a meeting within 13 months, includes expedited hearing, appeals rarely successful
        - Need a quorum §216
    - Special Meeting
        - Called by board or shareholders (some jxs), but mostly to approve mergers
    - By Consent Solicitation §228
        - Anything that could be voted on at the annual meeting can also be voted on by written consent of shareholders §213(b)
        - Originally cost-saving mechanism, now can be used in hostile takeovers
- On what issues do they vote
    - Electing directors §211 → plurality
    - Amending the charter §242(b)
    - Bylaws §109(b)
    - Mergers §251(c) → majority of outstanding shares
        - Only if change of control ➔ target shareholders ALWAYS vote, but acquirer shareholders only vote under certain circumstances (requires change in charter, existing shares won't be the same afterwards, issuing 20% shares)
    - Sale of substantially all assets §271
    - Dissolution §275
    - Ousting directors during their term
        - May be removed by shareholders with or without cause, but staggered boards removed only for cause §141(k)
- How do they vote
    - Kinds of voting
        - Default §151 – 1 share = 1 vote (can be changed in charter)
        - Dual class voting – different classes get different voting power
            - common when company operated by owners (ex: Google)
        - Cumulative voting – each shareholder gets one vote per open seat, can allocate them however they want (i.e. all on one seat)
            - Designed to guarantee minority shareholders some control
        - Class voting – when transaction will affect a certain type of stock, need majority approval by that class of shareholders
        - MBCA §§ 10.04, 10/06
    - Notice & Quorum requirements
    - Counting Standards
    - Plurality for directors; majority for substantive changes
    - By consent solicitation §228, §213(b)
    - By broker – broker votes for company slate if actual shareholders don't surface
    - By proxy – select someone to vote on your behalf
- Information rights
    - Right to list of shareholders and non-objecting beneficial owners upon showing of proper purpose §219

        - Right to any books and records §220
        - Daily transaction "pink sheets"

III. Proxy Voting

- Select and authorize someone to vote on your behalf
- Used to meet quorum requirement for annual and special meetings §211
- Typically used to institute new board of directors
- Process, generally
    - Notice of meeting, issues to be voted on, and proxy solicitation form sent to shareholders
    - Shareholders return proxy card that authorizes management to vote for particular slate
- Technically set up by state law, but really controlled by SEC – 1934 Act §14
    - §14(a) – anyone making a proxy solicitation must first file extensive disclosures (makes proxy contests costly)
    - §14(a)(7) – list or mail rule – corporation must either provide proxy solicitor a list of shareholders and their addresses or mail the proxies itself
    - §14(a)(8) – shareholder access to proxy – regulates what shareholder requests management must include in proxy statements
        - Management does NOT have to include matters that are part of ordinary business judgment of the corporation
    - §14(a)(9) – antifraud rule
- Only significant shareholders ($2000) receive a proxy
- Costly – lengthy filing, all eligible shareholders must be furnished with schedule 14A
- reimbursement for proxy voting – management can recover expenses for soliciting proxies from company after successful proxy contests (like awarding attorneys' fees)
    - ***Rosenfeld v. Fairchild Engine and Airline Corp.***
        - Unsuccessful proxy contests will not be reimbursed, would create too great an incentive, raise transaction costs
        - Only reasonable costs are reimbursed
- Irrevocability
    - Interest sufficient to support irrevocability

IV. Fiduciary Duties in Voting Contests

- Entrenchment – directors try to hold onto their jobs and fend off proxy fights
    - ***Schnell v. Chris-Craft Indus., Inc***.
        - Corporation moves date of annual meeting to undermine an upcoming proxy fight (knew about it because of §14A filed with SEC), P claims this exceeded directors' power because it deprived shareholders of right to run an effective proxy contest
        - Court: directors do hold legal power to change date of annual meeting, but cannot exercise that power inequitably
    - ***Cheff v. Mathes***
        - Board decides to buy out controlling shareholder on board who is trying to change the company at slight premium, shareholder Ps

claim it was corporate waste and not in good faith, just entrenchment

- Court: as long as the inequitable purpose is not their primary purpose, it's okay – if primary purpose is legitimate business decision but secondary result is entrenchment then court won't get involved

- *Alaska Air* case
  - When issuing stock from which directors will get voting rights, be careful about establishing clear evidence that this was a valid business decision and not an invalid entrenchment move
- ***Blasius Indus., Inc. v. Atlas, Corp.***
  - Blasius is 9% shareholder in Atlas, tries to increase size of board and put its own people in seats so it can succeed in its thus far unsuccessful effort to restructure the company
  - Court: actions of management that would ordinarily get business judgment rule protection can lose that protection if its transaction is designed to thwart or impede shareholder voting rights and there aren't compelling circumstances to justify it = **compelling justification test**
    - board shouldn't be allowed to override shareholders' decision
    - if shareholders have been misled or manipulated then board could step in (substantive coercion test from *Time Warner*)

- Voting the company shares
  - DGCL § 160(c) prohibits company from voting its own stock
    - Treasury stock (i.e. held by company itself) cannot be voted
    - Subsidiary controlled by parent cannot vote its shares → can't use sub to control the parent
    - These shares cannot be counted for the quorum
  - ***Speiser v. Baker***
    - Circular control structure that allows parties to control HealthChem with only minimal equity ownership in lieu of public shareholder block, subsidiary controlled by two directors of larger company; Baker sues when Speiser throw him out
    - Court: structure violates §160(c) and general prohibition against manipulating company structure to interfere with voting rights – used company's own money to control the voting of the company's shares
      - Victim = public whose voice has been diluted
- Vote buying
  - Old rule: buying votes is per se wrong
  - WA's rule: can be inequitable under certain circumstances, i.e. if consideration is not paid to all voters, or payoff designed to push voter in a certain direction
  - Subject to intrinsic fairness evaluation
    - Can be ratified by shareholder vote

- ***Brady v. Been***
  - Buying votes is against public policy – corrupts the voting process and does indirectly what the court said you couldn't do (i.e. vote your own shares – using company money to pay off shareholders)
- ***Schreiber v. Carney***
  - Company volunteers to give low-interest loan to shareholder so he can exercise his warrants and approve the merger (otherwise would have lost the warrants), shareholders approved it, but looks suspect because this consideration isn't paid to everyone
  - Court: deal was a result of good arms-length negotiation in response to legitimate business problem for corporate benefit, he didn't benefit (left in same position as he would be without the deal), so court looks to fairness standard and then applies business judgment rule

<u>Fraud & Insider Trading</u>

I. Elements of Fraud

- common law – no general duty to disclose (caveat emptor), but if you start talking, you cannot speak falsely or mislead people
  - false statement (no omissions at common law, except for fiduciaries)
  - materiality
  - scienter (fraudulent intent, or negligent misrepresentation for fiduciaries)
  - reasonable reliance
  - loss causation
- common law modification of disclosure obligation for fiduciaries
  - director of trust cannot deal with trustee unless he makes full disclosure and proceeds with fair terms
    - extended to corporate directors when they deal in their own stock
- §10b5 – SEC anti-fraud provision, "disclose or abstain" rule for trading with insider information
- Remedy – rescission (equitable), damages

II. Common Law Fraud – Dealing in Company Shares

- Trustee rule: directors have obligation to affirmatively disclose all material information and can only deal on fair terms
- Application to markets doesn't work well
  - Seller makes up his own mind, so unless buyer made false statement, doesn't seem like fraud
  - ***Goodwin v. Aggasiz***
    - CEO of mining company has info about value of minerals on company's land, removes exploratory equipment from land, buys shares, and seller of shares sues since he wouldn't have sold at such a low price had he known
    - Court: corporate director is not a fiduciary for the shareholders, but for the corporation, so since CEO didn't owe a duty to the shareholder this isn't fraud

        - WA: probably could have argued agency rule (below) but didn't see information as a corporate asset and didn't argue for corporate recovery
- If seller isn't hurt, then who is the victim?
    - Other shareholders?
    - Integrity of the market (SEC's primary concern)
    - Company
- Maybe this kind of transaction is actually good
    - Signal to the market that the director has faith in the company, better way of getting best information disseminated to the market
- Agency rule: profits made by agency in course of the agency go to the principal unless the principal consents on full information, so if director makes a profit baesd on insider information without disclosing it first then profits should go to the company
    - Pros: destroys incentive for insider trading
    - Cons: takes away mechanism for enforcement, directors aren't technically agents unless written in charters
    - ***Brophy v. City Service***
        - CEO makes profit trading company stock ("front running" before price goes up after company stock purchase announcement)
        - Court: since agent acquired the information as a result of the agency relationship, he can only use it to benefit the firm, not himself – profits must be disgorged and paid back to the company
    - ***Diamond*** – same theory – fiduciary who profits from insider info is subject to disgorgement to the corporation
    - Shine v. Chasen
    - ***Freeman v. Decio*** – does not apply the agency theory, prefers federal regulation and doesn't want to confuse that system by adding a state theory and remedy at common law
    - state common law remedy used infrequently – class action plaintiffs' lawyers prefer to be in federal court
- alternative theory: whenever directors make disclosures to shareholders, they have an obligation to do so based on true and accurate information

III. Federal Regulation

- 1934 Securities & Exchange Act §16 – recognizes right of company and remedy to protect insider information → officer is subject to disgorgement of proceeds of insider trading (= *Brophy*)
    - §16(a) – information gathering mechanism – reporting form
    - §16(b) – officers defined as those with significant policymaking power for the company or corporate division (so that corporations can't avoid regulation with creative titles)
    - If you are a covered person and buy or sell shares within six months then you are conclusively presumed to have done so on insider information
        - Measured by looking six months forward and backward (Learned Hand method)
- Application to mergers

  - *Occidental* – selling stock options to another company wasn't a "sale" because they couldn't be sure it would happen, and stock merger wasn't a sale because it wasn't in control of the transaction and therefore didn't have an opportunity to use insider info
  - SEC's response – passes regulation holding that stock options are sales → if you monetize an investment it will count as a sale
- §10b5 – principle anti-fraud remedy
  - Cannot make false or misleading statements or omissions in securities transactions
    - Includes omissions, "misdiclosure," and misappropriation theory
  - not a private remedy, but enforcement mechanism (injunctions) for SEC to promote its vision that markets only function properly upon full disclosure
  - rule: disclose or abstain (Cady Roberts Rule)
    - justified by policy goal of having full disclosure for properly functioning markets, not by traditional notion that fraud causes an injury to a victim
    - but questionable whether these directors are actually doing anything "wrong," and can be good way of getting info to market
  - ***SEC v. Texas Gulf Sulphur***
    - Mining company's exploration looks positive, news gets out and executives buy stock, press release that they haven't found anything definitively, stock goes up, SEC enforcement action for disgorgement
    - Court: officers have an obligation to disclosure or abstain from trading; technically true but misleading info is not enough
  - ***Santa Fe Indus. Inc. v. Green***
    - Majority shareholder engages in short form cash-out merger (to get rid of minority shareholders), subsidiary thinks its stock is undervalued as part of fraudulent scheme to get rid of shareholders
    - Court: §10b5 has to be about fraud or falseness, limits federal implied right of action under §10b5 because there are state remedies available for M&A – appraisal remedy
- Who has a duty to disclose
  - Three theories
    - Equal Access – everyone in market should have the same information so trading is fair and market functions properly (Cady Roberts Rule, *Texas Gulf Sulphur*)
    - Fiduciary Duty – violation stems from breach of fiduciary duty to seller or shareholder (*Chiarella*, *Dirks*)
    - Misappropriation – trading on nonpublic information is a breach of duty to the source of the information (*Chiarella* dissent, *O'Hagan*, same as *Brophy*)
  - ***Chiarella v. United States***
    - Employee at business printing press figures out merger parties from forms he's printing, buys up a bunch of stock

        - Court: no duty to disclose that runs to the seller, so no breach of any fiduciary obligation and therefore not criminally liable
        - Dissent: misappropriation theory – fiduciary obligation to his employer that he breached by wrongfully taking its information and using it for his own benefit – any profit should go to the employer (i.e. *Brophy*)
    - ***Dirks v. SEC***
        - "tipping" case - analyst uncovers fraud and tells his clients who then sell their stock, SEC censures him
        - D says there is no duty, but SEC says the guy who gave him the info (former employee) had a duty to his employer, and since D knew it came from a confidential source, it made him a "tippee" with the same obligations to the source as the "tipper"
        - Court: breach depends on the purpose of the disclosure, so since he wasn't trying to benefit from the information (was trying to do the right thing) there is no breach
    - ***United States v. Chestman***
        - Founder and CEO of Waldbaums tells his wife insider info about sale of company to A&P, gets passed through the family to granddaughter's husband who tells his broker who tells his clients, and they all buy stock
        - Court: no liability, does not extend fiduciary obligation to family members
    - SEC's response is §10b5(2) – non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the misappropriation theory of insider trading under §10b5
        - Whenever a person agrees to maintain information in confidence
        - History of sharing confidence such that recipient knows or reasonably should know that the info provider expects it to be kept a secret
        - Info received from spouse, parent, child or sibling, but can rebut presumption by showing that no one thought it was meant to be confidential
- §14e – anti-fraud provision for tender offers
    - §14e3 – disclose or abstain
    - *Chestman* – claims that §14e3 can't be broader than §10b5, has to be read the same way, some courts agree but 2nd Cir. said it was valid
    - ***United States v. O'Hagan***
        - Lawyer knows about client's upcoming merger, buys a lot of stock (not his client's stock, but the acquirer), convicted of violating §§10b5, 14e3
        - Court: misappropriation theory – violated fiduciary duty to client and firm by taking the private info and using it for his own person benefit instead of just the principal (= *Chiarella* dissent)
            - Duty and cause of action run to different players
- §10b5 elements

- In connection with sale of security
  - ***Blue Chip Stamp***
    - Misstatement has to be "in connection with" sale of security, can't just rely on misstatement to your detriment
- False statement or omission
  - Duty to disclose arises from fiduciary relationship in misappropriation theory
  - No general duty to market
- Materiality
  - Something is material if there is a substantial likelihood that a reasonable person would find it important, and would have been viewed by an investor as having significantly altered his behavior
  - *Texas Gulf Sulphur* – importance of something discounted by its probability
  - *Basic v. Levinson* – mergers are significant to market and company, material misstatement
- Reliance
  - *Basic v. Levinson* – hard to show reliance when people aren't trading face to face, so assume markets are efficient, stock price incorporates all relevant information, and purchasers rely on that price when they buy stock, so material misstatements are incorporated into market price, which the purchaser than detrimentally relies on
  - If D can show that the purchaser actually knew about the misstatement, hard to argue that you relied on the market
- Scienter
  - Actual knowledge
  - Recklessness or gross negligence
- Loss Causation
  - Dura Pharmaceuticals – confirms that causation is important, show the investment and loss
- Damages – disgorgement of profits (*Elkind v. Liggett & Myers*)

<u>Mergers & Acquisitions</u>

I. M&A, background

- history
  - 19^{th} cent.: unanimity rule to approve mergers (no one should have to invest in something they don't want) so very few mergers
  - 1890: mergers possible with supermajority shareholder vote
  - Mid-20^{th} cent.: relaxing of voting rules, just need simple 51% majority
- Purpose – low-cost, quick way to change the ownership structure of productive assets, bring assets together under common management
- Economic drivers of M&A
  - Economies of scale – reduces costs by spreading cost over a larger output load (ex: horizontal mergers in banking and finance spread high cost of computerization over larger customer base)

    - Economies of scope – makes it cheaper to expand into related business areas then it would be normally (ex: vertical mergers between manufacturers and suppliers)
    - Replacement of under-performing management – efficiency gains by getting better managers, can be friendly (golden parachutes) or hostile
    - Speed – mergers are done as soon as the shareholders vote, saves costs
- Questionable motives for M&A
    - Conglomerate mergers – economies of scale by leveraging senior management skill over many different business areas (ex: GE)
        - But easy to get overextended
    - Diversification – in different business areas
        - But shareholders can diversify so cheaply and effectively that it's unnecessary, and better for investors to have company that takes risks (bigger payout)
- Bad motives for M&A
    - Monopolization
    - "empire" purposes – end up exceeding efficient size of company for personal interests
- Process
    - Management approaches merger target
    - Confidentiality and standstill agreements
        - Confidentiality – promise not to disclose confidential business info
        - Standstill – promise not to acquire anymore stock, but if the deal falls through and acquirer buys someone else, target has right to enter target offer for acquirer's new shares
    - Exclusivity agreement – promise not to negotiate with anyone else, but if not a binding contract yet can only sue for out-of-pocket reliance damages (ex: Wachovia/Citigroup)
    - Due diligence
    - Agreement
        - Art. I: statement about kind of deal, parties, basic economic terms, structure, closing date
        - Art. II: reps & warranties → info gathering technique
            - Representations – facts
            - Warranties – promises
        - Art. III: covenants
            - Promises designed to take deal from signing to closing, protect buyer from the seller adversely changing the business
        - Closing conditions – must be satisfied in order for deal to be valid
    - Drop dead-date – if deal doesn't close by then, both parties can walk away
- Protections for parties
    - No-shop provision – promise not to shop for alternative deals
    - Fiduciary out – but can enter another deal if required to by fiduciary duties (i.e. for shareholders' best interests)

    - Match right – if target has to take fiduciary out, acquirer has right of first refusal/3 days to match the offer to keep the deal (bad for competition, discourages other offers)
    - Termination fee – if deal doesn't close, then target has to pay a fee to acquirer (can also have reverse break-up fee)

II. Types of M&A – Mergers, Acquisitions and Stock Purchases

- merger §251
    - one company buys another company
    - legal act, formally accomplished by board action and shareholder vote, filing certificate with state official
    - one company becomes surviving entity with all the assets and liabilities of target company, which ceases to exist
    - board approves deal, recommends it to shareholders, requires approval by majority of outstanding shares
    - shareholder voting
        - target shareholders always vote – fundamental change to corporation
        - acquirer shareholders sometimes vote
            - will vote if
                - issuing 20% of their stock as part of deal
                - if they have to change charter as part of the merger (per §241)
                - if characteristics of existing shares are changed at all
            - will not vote if
                - transaction is small
    - §253 – short form merger
        - Majority shareholder owns at least 90% of stock, can buy remaining shares without shareholder vote, just has to send notice and give chance to ask for appraisal remedy
    - pros: acquire everything, quick and easy
    - cons: no liability shield so on the hook for the target's problems
- acquisition → asset purchase §271
    - acquisition = non-technical term for getting control of another business by any method other than a merger, i.e. buying assets or business, but not the whole corporation
    - requires contract that identifies all the assets you're acquiring – time consuming and costly
    - shareholder voting
        - target shareholders vote if selling "all or substantially all" of the company's assets
            - *Katz v. Bregman* – judge sensitive to shareholder fairness so requires vote for sale of significantly less than all the assets
            - MBCA tries to get closer to "substantially all"
        - Acquirer shareholders only vote if it's a significant transaction

        - Pros: liability shield – you buy assets but target continues to operate so keeps its own liabilities
        - Cons: slow and costly, and can lose liability shield of target goes out of business
            - Solution: triangular merger – put acquired business in a separate subsidiary in order to preserve the liability shield
                - If subsidiary survives = forward triangular merger
                - If target business survives = reverse triangular merger
                - Ideal model → preserves liability shield, relatively quick, not as complicated as asset purchase
    - stock purchase / tender offer
        - buy stock on market in effort to gain practical control over the board, though not legal control (power to appoint majority of the board, so lots of influence)
            - Delaware recognizes
                - Control as a matter of law: 51%
                - Control as a practical matter: look at context, how board has been controlled in the past (40% probably looks like control)
        - Not a corporate act – just one person offering to buy shareholders' shares
        - Regulated by federal law
        - Filing requirements, but less extensive than other forms
        - No shareholder voting, just individual decision to sell stock
        - Directors are not involved, and they don't like it, so look for ways to protect against hostile tender offers
            - Poison pill
        - Pros: fast (20 days)
        - Cons: left with minority public shareholders, so need to get rid of them using second stage merger; possibility of poison pills

III. Appraisal Remedy & Entire Fairness Doctrine

- if shareholder objects to a merger and it passes anyway, then he has the right to ask the company to buy out his shares at a fair price = appraisal
    - remnant from original unanimity rule for mergers – no investor should be forced to hold stock in company he didn't choose to invest in
- used mostly by institutional investors and hedge funds – everyone else would just sell their stock before the merger was consummated
- DGCL §262
    - (b) "market out" -- appraisal is available if the merger gives you anything other than stock in a well-traded security or cash
    - (c) appraisals available for mergers [but in some jurisdictions can also be for sale of substantially all assets]
    - (d) to get an appraisal you have to dissent from the merger
    - (e)-(g) procedural rules for who is eligible
    - (h) how you measure what you get = fair value
        - Fair value exclusive of any value or expectation arising out of the merger = "going concern value"

    - Other jurisdictions also use minority discount for minority shareholders and liquidity discounts for companies whose securities aren't worth much on market, but Del. doesn't
- Going concern value – uses discounted cash flows
  - Estimate future cash flows
  - Discounted to the future using weighted average cost of capital
    - Debt – current yield for publicly traded debt
    - Equity – look at comparable companies, cost of riskless capital, risk premium (beta), risk rate for comparable companies
  - Discount value of debt
    - Debt has to be paid first, then what is left is equity that is paid as appraisal
  - ***Vision Hardware***
    - appraisal remedy when vulture company buys up the debt of an almost bankrupt company and does cash out merger, Ps claim shares were worth more, should have calculated by deducting market value of debt rather than legal obligation of debt
    - Court: although ordinarily you'd use market value, this is special situation of bankruptcy so use legal obligation
    - Equity has a hold-up position in bankruptcy proceedings so court could have recognized that
- <u>In parent/subsidiary mergers</u>
  - Can bring appraisal remedy or entire fairness self-dealing transaction fiduciary shareholder suit
    - Mostly choose shareholder suit – bigger block of clients with bigger possible gains, attorneys' fees
    - Whereas appraisal you only get fair value of your puny # of shares, no fees
  - ***Weinberger v. UOP***
    - **Entire fairness test** for self-interested transaction in parent/subsidiary merger – fair process and fair price
    - Court: uses same valuation technique for entire fairness and appraisal
      - Lower courts reluctant to depart from going concern valuation
- De facto mergers
  - Doctrine of independent legal significance – if you do something that is permitted under Del. statute, it doesn't have to satisfy other techniques that you might have used instead
    - *Arco v. Harrington* – transaction didn't require a vote, but even though they could have structured it a different way that would have required a vote, they still don't

IV. Tender Offers

- Subject to federal law
- Williams Act §§13-14 – management protection for directors in tender offers
  - Substantive regulations

        - Tender offer must be open for at least 20 days, but can be extended unilaterally by the company
        - Right of proration: if you make a tender offer for less than all shares, then you have to accept only that percentage of those who tender until you reach the desired number
            - Equitable provision – that way shareholders have time to think about it, don't have to rush to tender
        - (d)(7) - withdrawal rights
        - (d)(10) – all holders rule & equal price rule – tender must be extended to everyone and all at the same price
        - Antifraud provision §14e (*O'Hagan*)
    - § 13 – investors must file notification form when they reach 5% ownership
        - (e)(3) – disclosure requirements for going private transactions
        - (e)(4) – special requirements when the issuer does a self-tender
        - (d) – when you buy securities you have to file information about who you are, what you own, and what your business plan is
        - (g) – less burdensome filing requirements for financial institutions with no intention of affecting control
    - § 14
        - (d) – give details about sources of financing, plans for company (more detail required if you're also selling stock)
        - (d)(2) – date of commencement, access to stock list under state or securities law (so you can send out tender offer to everybody)
- To determine what constitutes a tender offer, use SEC factors (*Brascan*)
    - Active solicitation
    - Substantial number of shares
    - At a premium price over the market
    - On firm terms (i.e. not negotiated)
    - Contingent upon some minimum acceptance
    - Open for a limited time

V. Director Defenses in Control Contests

- Board has no role in tender offers, so needs a way to protect its company and its job
    - Williams Act
    - State takeover statutes
    - Poison pill
    - Business Judgment Rule
        - Eroded by *Unocal* and *Revlon*
- State takeover statute → DGCL § 203
    - If you get more than 15% but less than 80% of stock without board approval and then you attempt a second-step merger, then you have to get an enhanced shareholder vote (mild form of protection)
- Poison Pills
    - "flip over" pill (*Moran* – poison pills are valid)

        - Right to buy stock at ridiculously low price when triggered is distributed to shareholders as dividend
        - If someone makes tender offer for 30% of stock, then the rights detach from the shares and trade separately, so wouldn't be acquired in the tender offer
        - If acquirer who triggered the pill attempts a second-step merger, then the right is triggered and those shareholders can buy stock at half-price
            - Dilutes the acquirer's holding
            - And director can't consent to the second step merger if the acquirer won't honor this crazy deal
            - → designed not to work
        - But ultimately ineffective – investor did the tender offer but never went to second step, just replaced the board
    - "flip in" pill
        - If someone makes tender offer for 10% without board approval, then shareholders have a right to buy the acquirer's stock at half-price
            - Designed to fail
    - Justification – board will act as loyal bargaining agent for shareholders (Marty Lipton view)
    - Cons – we shouldn't care about the shareholders in these transactions because they would benefit more from having a market for corporate control (Easterbrook view); boards aren't necessarily comprised of totally selfless and independent individuals so pills can be used for wrong reasons and therefore raise transaction costs
    - 1980s studies show that companies with pills tend to get a slightly higher premium, but that they are no less likely to be subject to hostile takeovers
    - "shadow pills" – investors should operate like everyone has a pill since companies can adopt them quickly
- Business Judgment Rule
    - Old rule: courts use business judgment rule to evaluate defensive moves in M&A, very permissive to boards
    - New rule: *Van Gorkum*, *Unocal*, and *Revlon* → when change of control is an issue, the court will look at what is reasonable → duty to try in good faith to get the best transaction through a good process, and courts will be more active in review process
        - *Van Gorkum* – board liable for gross negligence in breaching duty of care where otherwise court would have applied BJR
        - *Unocal* – <u>defensive actions</u> must be 1) in response to a legitimate threat and 2) reasonable in relation to that threat
            - *Interco* – boards may have to redeem their poison pills if there is no remaining legitimate threat and there has been enough time to find alternatives for shareholders – shareholders get to choose preferred deal

            - *Revlon* – response to <u>sale of company</u> – BJR for whether it is appropriate to try to raise the bidder's offer, but then cannot use inducements (i.e. lock-ups) that have the effect of ending the auction process
                - *Time Warner* – *Revlon* duties triggered when company is 1) put up for auction, or 2) broken up; do not have to redeem poison pill under *Unocal*
                - *QVC* – Revlon duties triggered when the deal involves a controlling shareholder
                    - *Time Warner* list was not exhaustive
                    - Stock-for-stock merger doesn't involve a change of control so no *Revlon* duties

VI. More on Control Contests

I. pre-Unocal/1985
- attacks by shareholders reviewed by court under
    - no conflict → business judgment rule, or
        - barring conflict of interest, courts don't intervene – would create chaos where business can't rely on their own decisions
    - conflict → entire fairness rule
        - for fiduciary self-dealing cases where controlling parent decides terms of parent/subsidiary merger (*Weinberger*)
        - fair process + fair price
        - control – 51% or actual control
        - can avoid rule by showing truly independent directors or special committee – shifts burden to P to show why deal was unfair
            - but if not truly independent, their significance drops out and still have to use entire fairness (*Kahn v. Lynch*)
- defensive cases
    - *Cheff v. Mathes* – as long as primary purpose of board's action is not to keep the directors in office, then court will use BJR and not review the decision → subjective test, director discretion
    - *Schnell v. Criss Craft* – directors have legal power to change date of annual meeting but can't use that power inequitably, i.e. to deprive shareholders of ability to run proxy contest
    - *Smith v. Van Gorkum* – courts will get more involved

II. *Unocal* (1985)
- Shareholder Mesa makes tender offer to become controlling shareholder with plan for second step merger paid by subordinated bonds with questionable liquidity – shareholders will have to tender if they want guarantee of getting paid
- So board decides to self-tender at higher price if Mesa
    - Closes its tender offer (designed to stop the deal but institutional investors complain so board drops condition)
    - and is also excluded from the self-tender offer
- Mesa sues, claims board cannot discriminate against one shareholder
- Court: in defensive actions, if board can show that it was responding to a legitimate threat, and that the response was reasonable in relation to the threat,

then courts will okay it → takes subjective *Mathes* test and makes it an objective test of reasonableness to be decided by the court
    - Threat – Mesa's tender offer was structurally coercive
- Defensive actions
    - Intentional: i.e. in Unocal, defending against hostile takeover
    - Unintentional: changing from cash to stock (also implicates §160(c) – board cannot vote the company stock)
    - Also buying another company, selling a division, or issuing notes (Revlon)

III. Revlon v. MacAndrews & Forbes Holding, Inc.

- Perelman wants to buy the company, Revlon responds with flip-in poison pill with repurchase of stock with unsecured debt (raises company debt which restricts Perelman's ability to sell assets once he acquires company), issues notes to shareholders with dividend with covenant on management changes (like self-tender), but Perelman just keeps raising his bid, so Revlon recruits competing bidder (white knight) Forstmann Little with lock-up deal protections (asset lock-up of fragrance division, termination fee, no-shop agreement with fiduciary out)
- Court
    - Notes issued to shareholders – defensive measure judged under Unocal reasonable defense standard
        - Reasonable for board to want to protect its long-term corporate strategy
    - Second step was an auction in which board had duty to sell to the highest bidder
        - Lock-up provisions are okay when they draw bidders into auction, but are not allowed when they have the effect of ending the auction??
            - WA disagrees – board should be able to lock in its bidder

IV. Post-*Unocal/Revlon*

- *Interco*
    - Rales brothers want to restructure company by selling off its assets and raising the price of equity, board defends itself by restructuring itself – stub share – and tendering for higher price, didn't require shareholder vote
    - Court: all share/all cash deal so not obviously coercive like in *Unocal*, so now that there is no threat the shareholders should decide whether they prefer the Rales brothers' deal or the company recapitalization deal
        - Company is using the pill to force the shareholders to take the company's preferred offer instead of letting them choose → *Unocal* may be used to mandate redemption of a poison pill
- *Paramount Communications Inc. v. Time Inc.* ("Time Warner")
    - Time and Warner announce stock for stock merger, Paramount offers better alternative bid, so companies defend deal (won't be approved by shareholders) by turning it into a Time tender offer for 52% of Warner's shares which doesn't require a shareholder vote but does require borrowing a lot of money, so Paramount won't be interested now that Time has so much debt, Paramount sues to enjoin the deal

- Court of Chancery – doesn't trigger *Revlon* because no change in corporate control
  - Control is in the market because there is no single controlling shareholder of the companies
    - So deal should get BJR under *Unocal*
- Supreme Court of DE – right result but wrong test – *Revlon* duties triggered when company is 1) put up for auction, or 2) broken up (=sale)
  - Since this is neither, it isn't subject to higher scrutiny under *Revlon*
  - Response to threat was not motivated by self-interest or entrenchment, okay under *Unocal*

- *Paramount Communications Inc. v. QVC Network*
  - Paramount and Viacom have deal with defensive lock-up provisions (no-shop with fiduciary out, high termination fee (could argue it interferes with vote?), and stock option plan that has no good basis for price since so early in process,), QVC offers tender and second step merger at higher price, renegotiate to raise price but keeps lock-up terms, QVC raises offer again, Paramount's lawyers claim they do not fit into Revlon categories under Time Warner
  - Court: stock for stock merger will lead to a change of control, making Viacom the controlling shareholder of Paramount, so triggers *Revlon* (Time Warner Chancery Court formulation – change of control is trigger)
    - Time Warner list wasn't exclusive
    - ***Revlon* = triggered by change of control, board has duty to secure transaction that will offer best value to shareholders reasonably available**
  - Unocal + Revlon in QVC → when control is at issue, the court will look at what is objectively reasonable and take a more active role in review, board has duty to try in good faith and with a good process to get the best transaction,
- What kinds of asset sales trigger *Revlon*
  - Cash merger – no opportunity to get a better price later, so duty to get best price now
  - Stock for stock merger – no duty because no change of control (*QVC*)
    - But if 1 big company and 1 tiny company, raises question of whether the small company really has best information about the future of the combined entity and can properly value what is the
  - Mixed consideration – pressure to take best deal if mostly cash, but otherwise no clear guidance
    - *RJR Nabisco* – started as management buyout then opened for bidding process, court said didn't have Revlon duty to choose higher bid since special committee gave an explanation for the choice and ran a good process, and deal was not all cash so gets discretion in choosing which option is best
- In asset sales, board needs good information on the alternatives and available prices, or can be found to be grossly negligent or acting in bad faith
  - Auction with best price

        - Negotiate a deal that you find is acceptable and then check the market
            - *Fort Howard* – company can negotiate and use reasonable protection terms that aren't preclusive of other offers, have fair opportunity for someone else to pay a higher price before closing – gets BJR
- No obligation to get fair price
    - Tender offers by controlling shareholders
    - Short form mergers under §253 (*Glassman v. Unocal*)
- Defensive moves (Unocal)
    - Acquire another company
    - Sell off division (crown jewel)
    - Issue notes to increase debt
    - Put covenants or events of default into notes (Revlon)
    - Issue shares to dilute raiders stock (poison pill)
- Defensive strategies when board prefers one deal over another
    - Lockup of assets
    - Deal protections
        - No shop
        - Termination fees
- Board can always just say no