CORPORATIONS

(Prof. Pinto – Fall 2002)

Index

1. AGENCY

(a) Definition: contract under which one (*principal*) engages other (*agent*) to perform services on behalf of principal (some decision making authority is granted).

(b) Form: usually contractual, usually written.

(i) Power of attorney.

(ii) Appointment to a position (*e.g.* general manager of a business).

(c) Authority of the Agent: if *agent* acts with actual authority, *principal* is bound.

(i) *Express Actual Authority*: explicit manifestation.

(ii) *Implied Actual Authority*: authority reasonably or customarily implied from a more general grant of express actual authority. Implication can result from the manager's title or behavior of the *principal*.

(iii) *Apparent Authority*: conduct by the *principal* causes third party reasonably to believe *agent* has actual authority; principal may be bound.

(iv) *Caveat*:

(1) In most cases of *apparent authority*, an *implied authority* coexists. In naming a manager, the *principal* creates *implied authority* to the manager and *apparent authority* to third parties.

(2) Either *actual* or *apparent* authority binds the *principal*.

(3) *Principal* may ratify the authority either expressly or implicitly.

(d) Termination:

(i) at will, by either party;

(ii) death or incapacity, even if neither the *agent* nor third party has knowledge.

(e) Ratification: *principal* may ratify an act executed by *agent* without actual or apparent authority.

(i) need not be communicated to *agent* or third party to be effective; *principal*'s conduct is key;

(ii) may be accomplished by express statement, may result from a *principal*'s acquiescing in the transaction or taking action consistent only with ratification (*e.g.* suing to enforce the unauthorized contract);

(iii) *principal* must have knowledge of the essential facts concerning the transaction;

(iv) usually require the same formality as creation of the authority in the first instance.

(f) Agent's Liability: *agent* may be liable to third party when acting without actual or apparent authority and *principal* does not ratify the act.

(g) Agency Costs: costs incurred by principal to control the agent.

(i) monitoring costs;

(ii) bonding costs (payment to *agent* to expend resources to guarantee against actions that would harm *principal* and to assure loyalty); and

(iii) residual loss (costs associated to divergences between *principal* and *agent*).

(h) Cases:

(i) *Hoddeson* (materials): apparent authority binds the *principal* only if the appearance of authority was created by the manifestations of the *principal* and not alone by proof of those of the supposed *agent*.

(i) Sources: Klein (173); materials.

2. CORPORATE V. PARTNERSHIP FORM

(a) Corporation: list of requirements, including filing of articles of incorporation with the state.

(b) Partnership: association of 2 or more persons to carry on as co–owners a business for profit.

(i) no formal or written agreement required; results from contract expressed or implied.

(ii) profit sharing and control: main elements.

(iii) in the lack of contract, Uniform Partnership Act (UPA or Revised UPA) governs.

(c) Key Considerations (basic legal differences between a corporation and a partnership):

(i) *Limited Liability*:

(1) *Partnership*: generally legally viewed as the aggregate of its owners; each owner is personally liable for the debts of the partnership.

(2) *Corporation*: separate legal entity; shareholders are shielded from personal liability (only lose their investments in the corporation).

(ii) *Free Transferability of Interests*:

(1) *Partnership*: not freely transferable; addition of new partner requires unanimous consent.

(2) *Corporation*: free transferability.

(iv) *Continuity of Existence*:

(1) *Partnership*: change in partnership results in its dissolution; death or bankruptcy of partner causes dissolution; may be terminate by desire of any partner

(2) *Corporation*: not affected by death, bankruptcy or desire of a shareholder to terminate; perpetual existence.

(v) *Centralized Management*:

(1) *Partnership*: all partners participate in the management; each partner may bind the partnership as agent.

(2) *Corporation*: board of directors, elected by shareholders; centralization of management separate from owners.

(vi) *Access to Capital*:

(1) *Partnership*: less access to capital; not attractive to investors.

(2) *Corporation*: basic characteristics listed above are attractive to investors.

(vii) *Taxation*:

(1) *Partnership*: not subject to taxation.

(2) *Corporation*: pay tax as a legal entity; pay on the income received and again when income is distributed to shareholders as dividends.

(I) *S Corporation*: all income is taxed to the shareholders, whether or not such income is actually distributed to them; treated like a partnership for tax purposes.

(d) <u>Limited Partnership</u>: provides partnership–style tax treatment and limited liability for some of the owners; must have at least one partner with unlimited liability; if partner gets involved in the control of the partnership, partner may lose limited liability.

(e) Sources: Pinto (1–8; § 1.06); materials (UPA).

3. WHERE AND HOW TO INCORPORATE

(a) Incorporator: responsible for filing the AoI (Articles of Incorporation, also called charter or certificate of incorporation); must adopt a set of bylaws, hold initial shareholders' and directors' meetings, arrange for election of directors and officers, open bank account, issue shares, other initial acts.

(b) AoI: basic information of the company and must comply with statutory requirements.

(c) Bylaws: internal rules dealing with the governance of the corporation; not publicly filed.

(d) Corporate Existence: begins upon acceptance of the AOI by the state official.

(e) Choice of Law: every state has a corporate statute and common law; state law governs most intra–corporate relationships (*internal affairs doctrine*).

(f) Delaware: dominates; arguably, state laws favor corporate management over shareholders.

(g) Sources: Pinto (11–15); materials.

4. TYPES OF SECURITIES AND CAPITAL STRUCTURE

(a) Capital Structure: amount and type of *debt* and *equity*. Capital is raised by borrowing (*debt*) and investment of owners (*equity*).

  (i) creditors have priority over equity holders and interest must be paid before dividends are paid to shareholders.

  (ii) generally, interest paid to creditors is tax deductible.

  (iii) dividends are paid when there are profits and the board of director so determines.

(b) Securities: common stock, preferred shares and debt, with attributes relating to risk of loss, power to control the business and ability to share in success of the enterprise.

  (i) Investors expect return and compensation for *inflation*, for *risk* (only US government guaranteed securities are risk–free), and for *lost of opportunity* (investment in one business means funds cannot be used for other investments).

  (ii) *Risk* is the primary factor to be weighed against potential return in deciding between investments.

(c) <u>Debt</u>: *bonds* or *debentures* (long term debt instruments, generally 5 years).

(i) *Bonds*: usually secured by specific assets (mortgage on property).

(1) Borrower shall pay a *fixed* amount of *interest* at regular intervals and pay *face value* (or *par value*) at *maturity*.

(2) Total annual interest payment: *nominal interest rate* or *coupon rate* (when expressed as a percentage of *face value*).

(ii) *Debentures*: unsecured debt (holders have a general claim with other creditors).

(iii) If the debt is sold to the public, the contract is called *indenture* and a *trustee* may be selected to represent holders.

(1) *Indenture* contains *covenants* (agreements and obligations of the issuer). Obligations may include maintenance of property, restrictions on dividends, on additional debts, negative pledge clause (issuer may not issue new debt with a security interest in already–owned property), limitations on mergers and changes of control, same business, financial estability.

(iv) Creditors do not receive more money if the business is successful, unless if debt is made *convertible* to common shares (allows for a fixed return but with option on shares if their value increases).

(d) <u>Common Shares</u>: *common* shareholders have a claim to receive the income and assets of the corporation only after all other claims have been satisfied (*residual claim*).

(i) *Common* shareholders usually have significant control of the corporation: voting rights (select the board).

(ii) Lower priority, greater risks of loss but potential for greater return than other investments.

(e) <u>Preferred Shares</u>: equity authorized by statute (usually in the AoI).

(i) In most cases, *preferred* are paid fixed dividends after the creditors are paid their interest, but before *common*.

(ii) *Preferred* are paid when authorized by the board (usually cumulative).

(ii) In liquidations, *preferred* are paid after creditors, but before *common*.

(iii) Lower priority (but greater than *common*), higher risk than creditors in receiving a return and repayment; no vote (no control) and no share in the increased return if the corporation is successful (except if contractually provided for).

(iv) Attract investors because tend to pay higher dividends.

(f) Leveraging: use of *debt* creates *leverage* by allowing debtors to put creditors' funds at risk ("other people's money"), requiring smaller investment of equity by owners.

(i) Problem: failure to pay interest on debt can trigger a default (may lead to bankruptcy).

(g) Sources: Pinto (67–72); Klein (238–46; 273–81; 291–94).

5. ACCOUNTING

(a) Balance Sheet: financial picture of the business on one particular day. Divided in *assets* and *liabilities* and *equity*.

(i) *Assets* (A = L + E): *current assets*, *fixed assets* and *intangibles*.

(1) *Current Assets*: include *cash*, *marketable securities*, *accounts receivable*, *inventories*, *prepaid expenses* (assets that may be turned into cash in the reasonably near future).

(2) *Fixed Assets*: *property*, *plant* and *equipment* (listed at their original cost less depreciation).

(3) *Intangibles*: assets having no physical existence (*e.g.* patent, goodwill).

(ii) *Liabilities* (L = A – E): current liabilities and long–term liabilities.

(1) C*urrent Liabilities*: all debts due within the coming year (accounts payable, notes payable, accrued expenses payable, Federal income tax payable).

(2) *Long–term Liabilities*: debts due after one year from the date of the financial report (deferred income taxes and *debentures*).

(iii) *Equity* (E = A – L): *stated capital*, *capital surplus* and *accumulated retained earnings* (total ownership interest; corporation's net worth).

(1) *Stated Capital*: usually par value of the stock multiplied by the number of issued and outstanding shares (includes *preferred stocks* and *common stocks*).

(2) *Capital Surplus*: amount paid in by shareholders in payment for their shares in excess of the par value.

(3) *Accumulated Retained Earnings*: earnings not distributed as dividends.

(iv) What it shows that is good for analysis: working capital, current ratio, liquidity ratio, inventory turnover, net book value, net asset value, capitalization ratio, bond ratio, preferred stock ratio, common stock ratio.

(b) Income Statement: shows how the company has fared over a period of time, how profitable the company is.

(i) Basically, shows *net sales*, *costs* and *net profit*.

(ii) What it shows that is good for analysis: operating margin of profit, operating cost ratio, net profit ratio.

(c) Sources: materials.

6. VALUATION

(a) Liquidation Value: amount for which assets could be sold minus liabilities. Does not reflect business potential.

(b) Book Value: based on balance sheet. *Equity* may be referred to as the book value. Poor valuation, for the following reasons:

(i) *Cost Based Accounting*: based on cost, not on market; conservative.

(ii) *Depreciation*: fixed assets on the balance sheet may be undervalued and depreciation may make it worst.

(iii) *Intangible Assets*: usually not represented at market value on the balance sheet.

(c) Earnings Approach: takes the future into account and evaluates *inflation*, *opportunity cost* and *risk*; present value of a future return. *Interest rate* reflects the best guess estimate on the prospective *inflation*, *risk* of the debtor paying and *opportunity cost*.

(i) *Capitalization of Earnings*: how much should I invest today (P) to earn a certain amount per year forever (A) at a certain rate (R)?

$P = \frac{A}{R}$, where:

P is present value;

A is annual return; and

R is the rate.

(1) Calculation of the appropriate *rate* depends on *inflation*, *opportunity cost* and *risk*.

(ii) *Cash Flow*: the amount the owner would have for actual use.

(d) Cases:

(i) *Taines* (materials): applying *capitalization of earnings* to evaluate a business.

(e) Sources: Pinto (76–82); materials.

7. Capital Markets and ECMH

(a) Stock Markets: markets for the trading of shares (*secondary markets*); provides *liquidity* and *discipline*.

(i) *Benefits*: numerous investment choices, diversification; capital for modernization or expansion; costs are lower than private sale; liquidity, which lessens the risk to investors.

(ii) *Shareholder Protection*: disclosure, fair–trading, fraud, market manipulation, insider trading.

(b) Efficient Capital Market Hypothesis (ECMH): traders in the stock market react quickly and efficiently to information. New information about a company is immediately reflected in the price of the shares. Stocks move randomly, not irrationally.

(i) *"Weak version"*: past *price* information does not enable one to predict the future price movements.

(ii) *"Semi–strong version"*: market price quickly reflects all publicly available information.

(iii) *"Strong version"*: even non–public information is reflected in price.

(c) Separation of Ownership from Control: beneficial when the managers operate the business in ways that benefit the shareholders; managers are specialists. If not, owners may suffer losses or insufficient gains.

(d) Sources: Pinto (85–90); Klein (385–406).

8. Securities Regulation

(a) Purposes: provide full disclosure when companies sell securities; provide information (enable investors to make well–informed investments decisions) and prohibit misrepresentation, deceit and fraud.

(i) Requires registration: full disclosure (description of business and assets; provisions of the security; management; financial statements).

(ii) Companies seeking to have their securities listed and publicly traded (in the national exchange market, and companies with assets > $ 10MM and at least 500 shareholders, traded over–the–counter, are subject to registration with the SEC (1934 Act).

(iii) SEC role is to protect investors, not shareholders.

(b) Securities Act of 1933: governs initial issuance of securities by corporations.

(c) Securities Exchange Act of 1934: governs, *inter alia*, subsequent trading and other activities respecting securities.

(d) Rule 10b–5: authorizes a defrauded buyer or seller to sue in federal court if a material misstatement or non–disclosure is made in connection with a purchase or sale of security.

(e) Sources: Pinto (133–38); Klein (204–06).

9. STATE LAW REQUIREMENTS ON ISSUANCE OF SHARES AND DIVIDENDS

(a) Issuance of Shares: number of shares authorized (available for sale) must be stated in the AoI; corporations usually have authorized more shares than they plan to sell; shares already authorized but not issued can be issued at the discretion of the board.

(i) *Preemptive Rights*: require that each shareholder be offered the right to purchase a proportionate number of shares in order to maintain the percentage of ownership and voting control. Publicly traded corporations do not provide *preemptive rights*.

(ii) *Par Value*: minimum price for which shares may be sold; today, either *low par* or *no par* shares are usually issued and there is no minimum capital requirement.

(b) Dividends: payments to shareholders which represent a current return on investment. Paid at the discretion of the board.

(i) As a basic principle, *dividends* are not permitted when payment adversely impacts investors or creditors, or when the corporation is *equitably insolvent*.

(ii) In order to distribute dividends, statutes usually require *Earned surplus* (net profits retained), or *earned surplus* and *capital surplus* (stock is issued at a *par value* lower than the price it is sold; company, therefore, has a *stated capital* (*par value* multiplied by the number of stocks) and a *capital surplus* (resulted from the difference between the *par value* and the price the stock was actually sold)).

(iii) The Revision of the Model Business Corporation Act of 1984 (RMBCA) uses a *balance sheet* test to determine whether dividends can be distributed: after a distribution, *assets* must exceed the sum of *liabilities* and the total amount owned to preferred shareholders on a liquidation.

(c) Cases:

(i) *Dodge v. Ford* (Pinto 18, materials): the court held that the powers of directors must be exercised in the benefit of the company and found that directors had no reasons not to pay *dividends*; although normally protected by the *business judgment rule*, the court ordered the payment of *dividends* to the shareholders.

(d) Sources: Pinto (18, 72–76); materials.

10. CORPORATION IN SOCIETY AND *ULTRA VIRES*

(a) Social Responsibility: *profit* is the primary goal of the company.

(i) Most Statutes, as Ohio's (material), protects the jobs of the managers by providing that managers, in taking decisions, may take into account a broad range of aspects, including the interests of the employees, suppliers, creditors and customers, the economy, the community etc.

(b) Cases:

(i) *Shlensky v. Wringley* (Pinto 18, materials): the court held that the decision of the board not to install lights in a baseball stadium was a matter of business policy which was untainted by fraud, illegality or self dealing; courts should not second guess directors because their decisions are presumed to be in good faith.

(1) Directors are given broad discretion in making decisions and may consider interests other than those of the shareholders.

(2) Distinguished from the *Ford* case because the amount of money that was withheld in *Ford* was very large and problem of minority shareholders in a closely held corporation, needing a return on their investments.

(c) Sources: Pinto (16–20); materials.

11. PROMOTERS

(a) Definition: *promoter* is the person that helps creating a business, bringing the parties together, raising capital, making arrangements, promoting; *promoter* acts on behalf of a corporation to be formed or in formation.

(b) Liability: on preincorporation contracts, the *promoter*, instead of the corporation, may be held liable for performance if the contract does not *expressly* provide that the *promoter* will no longer be responsible when the corporation comes into being.

(i) *Strict View*: waiver must expressly mention release of personal liability (*RKO–Stanley v. Graziano*); provision stating that the corporation is *in formation* is not sufficient to release promoter (*Goodman v. Darden*).

(1) The safest course for a promoter, *ex ante*, is expressly to provide in the agreement for a novation *in futuro*. Better yet is to wait until the corporation is formed to enter into any contract.

(c) Cases:

(i) *RKO–Stanley v. Graziano* (Pinto 23): the court held that "[o]ne who acts on behalf of a non–existent principal is himself liable in the absence of an agreement to the contrary." Express mention of release of personal liability is necessary.

(ii) *Goodman v. Darden* (Pinto 23): the court held that although an express provision stating "I agree to release" was not necessary, a provision stating that the corporation was *in formation* was not sufficient to release promoter.

(d) Sources: Pinto (21–23).

12. DEFECTIVE INCORPORATION

(a) Definition: may occur when articles of incorporation are not properly filed. Shareholders act as though the corporation has been formed when it has not. Acts performed, including contracting, are not void, but merely voidable in certain circumstances.

(b) De Facto Corporation: a corporation that made a good faith start toward existence may contend that its existence is good against all the world except the state.

(i) *Elements*: existence is permissible by law, good faith in attempting incorporation, and demonstration of actual use of the corporate powers the participants believe themselves to have (doing business under a corporate name).

(ii) *Caveat*: it is contended whether the *de facto corporation* doctrine can be applied after the enactment of the MBCA and the RMBCA.

(c) Corporation by Estoppel: persons who have dealt with a business as if it was a corporation may not later attempt to hold shareholders individually liable by alleging that the corporation has been defectively formed.

(ii) *Caveat*: it is contended whether the *corporation by estoppel* doctrine can be applied after the enactment of the MBCA and the RMBCA.

(d) Sources: Pinto (28–33).

13. PIERCING THE CORPORATE VEIL

(a) Definition: bypassing the limited liability in a corporation to reach the shareholders' individual pockets (make shareholders personally liable).

(b) Grounds for Piercing: intermixture of affairs, lack of corporate formalities, inadequate capitalization, evasion of a contract (or statute, or with fraud purposes), and instrumentality theories.

(i) *Intermixture of Affairs*: when affairs of owners and the corporation are intermixed and third parties have difficult in separating the interests of the owners from the corporation.

(ii) *Lack of Corporate Formalities*: courts are more likely to pierce the veil of corporations which do not attend to corporate formalities (such as, *inter alia*, issuing stock certificates, holding meetings, electing officers). RMBA requires that at least one more ground be present in order to pierce the veil.

(iii) *Inadequate Capitalization*: if the *capital* is illusory compared with the business and the risks of loss.

(1) *Capital*, for purposes of torts claims, is usually deemed to be *equity* plus insurance coverage.

(2) Courts decisions do not help determine what constitutes adequate *capital*.

(3) Courts are divided on whether *inadequate capitalization* alone is sufficient ground to pierce the veil.

(4) Corporate owners are advised to adequately capitalize the corporation to avoid the risk of personal liability.

(5) Usually, courts do not require owners to update the *capital* as the corporation grows. Analysis is confined in the formative stages of the corporation.

(iv) *Evasion of a Contract*: courts disregard the corporation if they find no reason to its existence other than evasion of a contract or a statute, or incorporated with the sole purpose of perpetrating a fraud.

(v) *Instrumentality Theories*: when a court finds that a corporation exists solely to carry out the owner's agenda, with no reason for its own existence, the corporation is disregarded and the owner held liable. It requires other grounds.

(c) Equitable Subordination: in a bankruptcy or receivership, claims of a *parent corporation* may be asked by creditors to be subordinated to those of outside creditors ("Deep Rock Doctrine"; parent corporation is the last to be paid).

(i) Grounds are similar to those of piercing the veil.

(ii) Too much *debt* in comparison to *equity* increases the risk of application of the doctrine.

(iii) Shareholders lose all their contribution to the corporation, except personal assets.

(d) Cases:

(i) *Walkovszky v. Carlton* (materials): the court held that although grossly inadequate capitalization is a factor in determining whether to pierce the veil, it is not dispositive.

(ii) *Kinney* (Pinto 40, 48 and 50; materials): the court held that the state law (West Virginia) required the presence of two factor: grossly inadequate capitalization and disregard of corporate formalities. The sole purpose of the corporation was found to be to perpetrate a fraud and the court pierced the veil.

(e) Sources: Pinto (35–53); Klein (141–44); materials.

14. THEORIES OF THE FIRM

(a) Regulatory Approach: managers are unaccountable and likely to take advantage of the shareholders; thus, stronger state law protection and increased federal presence are necessary.

(b) Management Approach: managers protect the interest of shareholders due to mutual interest in protecting the corporation; thus, laws should give managers broad latitude in their activities.

(c) Law and Economics Approach: separation of ownership from control is beneficial because passive investors provide capital in return for profits and managers are free to manage and maximize profits; thus, abuse by managers would be controlled privately by the market (poor performance indicates poor management), need to reduce costs (*agency costs*) and private contract (AoI, Bylaws).

(d) Sources: Pinto (83–84, 90–92, 113–19); Klein (172–78).

15. SHAREHOLDERS AND MONITORING

(a) The Legal Model: *directors* and *managers* have the authority to *manage* while *shareholders*, as owners, have some ability to *monitor* the managers' performance.

(b) Shareholders: *common shareholders* are *residual claimants* (claims on assets, upon liquidation, an profits follows creditors and preferred shareholders).

(i) *Election of Directors*: *Common shareholders* select the *directors* and *officers*.

(ii) *Relationship*: relationship between *shareholders* and *managers* is not legally an *agency/principal* relationship; *shareholders* do not control the decisions of the *managers*. *Managers* must act on behalf of the corporation and all of the shareholders, not for the group that elected them.

(iii) *Right to Vote*: shareholders can vote on election of directors, filling of vacancies, and amendments to the bylaws and AoI. Also major structural issues (such as mergers and liquidation and sale of substantially all of the assets). The *board* cannot interfere with voting rights.

(1) *Caveat*: under state statutes, amendments to the bylaws usually do not require board approval, but the AoI do.

(2) Usually, the voting required is a *majority* of the *quorum*, although some states require a *super majority* for certain actions. *Quorum* is established in the Bylaws. AoI can also require a *super majority*.

(3) *Cumulative Voting*: permits shareholders to collect their votes and allocate them any way they choose. Must be set forth in the AoI.

(I) Formula to determine votes necessary to elect one director:

$Sr > \frac{Sv}{D+1}$, where:

Sr is the number of shares (in the *quorum*) required to elect one director;

Sv is the number of shares voting; and

D is the number of directors to be elected.

(II) The lower the number of *directors*, the greater the percentage necessary to elect a *director*; thus, reducing the size of the *board* is a tactic to defeat *cumulative voting*.

(iv) *Proxy Voting*: *proxies* allow shareholders to vote certain matters prior to a meeting or assign the voting right to another person who will be present at the meeting.

(v) *Proxy Fight*: when *managers* send out *proxies* to the shareholders requesting their votes and an *opposite group* sends out its own *proxies*, challenging the request of the *managers*.

(vi) *Shareholder Democracy*: significant case law provides that *managers* cannot act in a way contrary to principles of corporate democracy to perpetuate their offices (*Blausius v. Atlas Corp.*).

(vi) *Vote Buying*: vote under coercion, breach of fiduciary duty, or vote buying is subject to limitations on that right to vote. Voting arrangements among shareholders are usually upheld by the courts, but courts look at the substance of the transaction and its object to find if it defrauds the shareholder.

(vii) *Right of Expression*: significant case law provides *shareholders* with *additional rights* not contained in the statutes, such as the *right to express themselves* and put *directors* on notice of their desires before the next election (*Auer v. Dressel*).

(1) Delaware's courts tend to allow inspection if the primary purpose is to solicit *proxies*.

(2) Delaware statute distinguishes between inspection of the *shareholder list* and of the *corporate books and records*:

(I) *Shareholder list*: defendant corporation has the burden of proof to prove improper purpose.

(II) *Corporate books and records*: plaintiff shareholder has the burden of proof on proper purposes.

(viii) *Right of Information*: *shareholders* are granted the right to receive some *information* (federal securities laws and state law).

(1) Financial statements;

(2) Books and records or list of shareholders, so long as there is a *proper purpose* (*Pillsbury v. Honeywell*).

(c) Cases:

(i) *Blausius v. Atlas Corp.* (Pinto 101–102; materials): the court recognized the importance of protecting shareholder voting and found that the board's action thwarted the shareholders. The action of the board was found not protected by the business judgment rule. A *per se rule* to the effect of prohibiting thwarting shareholder voting was rejected, but the court applied a strict duty of loyalty standard which shifts the burden to the *directors* to demonstrate a compelling justification of their actions.

(ii) *Auer v. Dressel* (Pinto 105; materials): the court (NY Court of Appeals) held that shareholders may express themselves and put on notice the directors who will stand for election at the annual meeting. Shareholders can propound and vote upon resolutions which, even if adopted, would be purely advisory.

(iii) *Pillsbury v. Honeywell* (Pinto 107; materials): the court held that it was an improper purpose the request of the shareholder list by a shareholder wishing to communicate with other shareholders about his opposition to the company's manufacture of munitions used in the Vietnam War. The sole purpose of the shareholder was political, rather than economic. The court applied Delaware law, but Delaware's courts tend to allow inspection if the primary purpose is to solicit *proxies*.

(d) Sources: Pinto (92–108); Klein (120–27); materials.

16. BOARD OF DIRECTORS

(a) Basic Principles: elected by the *shareholders*. *Board* is not legally the *agent* of the *shareholders*. *Board* can act within its power to run the corporation, even if the majority of the *shareholders* disapprove. *Shareholders* may elect different *directors* at the next annual meeting or try to remove *directors* calling a special meeting.

(i) *Directors* act as fiduciaries to the corporation, must serve the best interests of the corporation, including all *shareholders* and not merely the interests of those who elect them.

(b) Board Structure: number of *directors* is usually set out in the bylaws or AoI. The *board* usually takes actions by a majority vote. Individual *directors* who are not *officers* have no authority to act except through the *board*.

(c) Meetings: rules on *voting*, *notice* and *quorums* are usually set out in the bylaws.

(d) Sources: Pinto (108–11); Klein (128–29).

17. OFFICERS

(a) Basic Principles: appointed by the *board*, which may remove *officers* at will. Designation of *officers* is made by the *board* or by the bylaws. *Officers* run the daily operation of business.

(i) *Officers* have a *fiduciary duty* to the corporation since they are corporate *agents*.

(ii) *Officers* that serve also as *directors* are known as "*inside directors*".

(b) Authority: *officers*' power originates from the *board*. *Officers* are *agents* of the corporation.

(i) Three significant ways to an officer (*agent*) bind the corporation (*principal*): *express*, *implied* and *apparent authority* (v. item 1(c)).

(c) Partnership: the UPA (materials) sets forth the authority and limits of the partner to bind the partnership.

(d) Cases:

(i) *Mosell Realty* (materials): the court held that the implied authority of a corporate president is limited to acts within ordinary course of its business, and does not extend to extraordinary and unusual transactions such as the sale and purchase of realty. The authority of corporate directors is conferred upon them as a board, and they can bind corporation only by acting together as an official body, and a majority of them, in their individual names, cannot act for the board itself and bind the corporation. A close corporation's president who had no authority to enter into contract for sale of realty which was corporation's principal asset lacked authority to employ a broker to make such sale.

(e) Sources: Pinto (111–13); Klein (131–35); materials.

18. FEDERAL PROXY RULES

(a) Basic Principles: a *proxy* is a species of *agency* relationship. It allows someone (*agent*, the *proxy holder*) to vote on behalf of a *shareholder* (*principal*, the *proxy giver* or *proxy*).

(i) The agency is revocable.

(ii) The *Proxy* owes a fiduciary duty to the *proxy holder*.

(iii) In publicly held corporations, *proxy voting* is highly regulated (SEC, Securities Exchange Act of 1934, *SEC Rule 14a*).

(b) Proxy Solicitation: any request for a *proxy*, or to execute or not execute, or to revoke, a *proxy*. A *proxy* is every *proxy*, consent or authorization relating to shares.

(c) Proxy Contest: also called *proxy fight*, is an alternative (sometimes more effective) to other more expansive ways (such as suing or purchasing of shares to obtain control; but *proxy fight* is expensive also) to achieve some objective in the corporation, which requires casting of votes.

(i) *Caveat*: any press release, mass mailing, or other communication that may be construed even as conditioning the shareholders group to a forthcoming solicitation is itself a solicitation, subject to compliance with complex SEC's proxy rules. But *SEC Rule 14a–11* allows communication in certain cases (such as election contests) under certain conditions.

(ii) When solicitation materials are completed (including pre–file with the SEC), the corporation shall, within five business days, furnish a copy of the *shareholder list* to the *proxy holder* or offer to may the proxy material (costs by *proxy holder*). Pre–filing may be waived in specific cases (*SEC Rule 14a–12*).

(d) Antifraud Rule: prohibit any statement "which, at the time and under the circumstances under which it is made, is false or misleading with respect to any material fact." (*SEC Rule 14a–9(a)*). General rule, applicable to "any proxy statement, form of proxy, notice of meeting, or other communication, written or oral" in the proxy field. Hard to comply, material omissions or misleading statements are grounds to application of the antifraud rule.

(i) *SEC Rule 14a–9*: in publicly held corporations, *SEC Rule 14a–9*, may be used, *inter alia*, to enjoin a proxy contender from using misleading statements, misrepresentations, nondisclosure or fraud in his proxy solicitation, or, if the proxy has been already obtained, from using the proxy.

(ii) *State Law*: if the corporation is not publicly traded (not a 12(g) corporation under the Securities Exchange Act), claims must be made under state law.

(iii) *Standing to Sue*: *shareholder* whose vote was sought by means of the offending *proxy* or the *tender* of whose shares was sought by the bidder's offer to purchase.

(iv) *Materiality*: not every omission or half–truth is actionable, must be misleading to a hypothetical reasonable investor and propensity to affect his thought process. Must be "*material*".

(v) *State of Mind (Fraud) Required*: under *SEC Rule 14a–9*, the negligence state of mind, or fault, is required. Not strict liability, proof of negligence required.

(vi) *Causation*: under *SEC Rule 14a–9*, plaintiffs need only prove materiality and not reliance. Also, plaintiffs may prove that the solicitation of proxies was an "essential link" in the accomplishment of the defendant's objective, or that the defendant's misleading statements or omissions foreclosed or caused then to forego state law remedies they may otherwise have pursued (v. *Mills*).

(vii) *Remedies*: usually, plaintiff seeks an injunction (against the offending statements, against solicitation of further proxies, and against use of any proxy already obtained.

(e) <u>Cases</u>:

(i) *J.I. Case Co. v. Borak* (Pinto 168–70): the S. Ct. held that Section 14(a) of the Securities Exchange Act, which grants power to SEC to regulate the solicitation of proxies, provides a private right of action for Section 14(a) and *Rule 14a–9* violations.

(ii) *Mills v. Electric Auto–Life Co.* (Pinto 169, 175–177; materials): the S. Ct. held that a plaintiff alleging proxy violations must demonstrate materiality of the omission, need not demonstrate reliance, and, on the remaining causation issue, need only demonstrate that the misleading solicitation was an "essential link" in accomplishing the result about which plaintiff complains. Awards of attorney's fees from the corporate treasury if the plaintiff shareholder has conferred "a substantial benefit" on the corporation and fellow shareholders.

(f) <u>Sources</u>: Pinto (147–54; 165–80); Klein (120–27; 179–82); materials (including § 14a and SEC Proxy Rules and 1992 Revisions).

19. SHAREHOLDER PROPOSALS

(a) <u>SEC Rule 14a–8 Proposal</u>: a single proposal and supporting statement (500 word limit) to be included in corporate management's own annual solicitation. Not a *proxy contest*.

(i) *Types of Proposals*: proposal may usually be a *social responsibility proposal* ("stop advertising cigarettes") or a *governance proposal* (executive compensation, request for secret voting by shareholders, redemption of poison pill).

(ii) *Eligibility and Procedure*: proponent must have been a record or beneficial owner of shares for at least one year, at least $ 2,000 in shares or, if less, at lest 1% of the shares entitled to vote on the proposal (*SEC Rule 14a–8(b)*).

(1) Proponent must continue ownership until the date of the shareholders' meeting. Failure to do so may cause exclusion of the proposal for any meetings in the following two calendar years (*SEC Rule 14a–8(h)(3)*).

(2) Proponent must represent that he will attend the meeting to present the proposal. Failure to do so may cause exclusion of the proposal for any meetings in the following two calendar years (*SEC Rule 14a–8(h)(3)*).

(3) Proponent must provide name, address, number of shares owned, date of acquisition, nomination of the shares, documentation to support ownership, and proposal not less than 120 days before the issuance of the company's proxy statement (*SEC Rule 14a–8(e)(2)*).

(iii) *State Limitations*: under state statutes, *shareholders* have power only with a limited range of matters: amendments to the AoI, mergers, sales of all or substantially all of the assets, dissolution and election and removal of *directors*. Initiative by *shareholder* is even more limited: only for removal of *directors* and nomination and election of *directors*. Other matters are subject to initiative by the *board*.

(1) *Caveat*: however, based on *Auer v. Dressel* (v. item 15), shareholders can propound and vote upon resolutions which, even if adopted, would be purely advisory (*right of expression*, v. item 15(b)(vii)).

(I) When *shareholders* propound a resolution as to a matter they have no power of initiative, language of the resolution must be drafted as a request or recommendation to the *board*. Otherwise, *board* may exclude proposal (*SEC Rule 14a–8(i)(1)*).

(iv) *Proxy Proposal Process*: *shareholder* makes a timely submission of his proposal, duly documented and informed; if the corporation decides to include the proposal in the *proxy statement*, end of the matter. If less than 3% agree with the proposal, corporation may exclude similar proposals for five years. In a second try, if less than 6% agree, exclusion may be for more five years. A third try requires 10% (*SEC Rule 14a–8(i)(12)* and *14a–8(i)(12)(i)*).

(1) To omit the proposal, the corporation must request a "*no–action letter*" from the SEC.

(v) *Ordinary Business Operations Exclusion*: under *SEC Rule 14a–8*, a proposal may be excluded if it deals with a matter relating to the company's ordinary business operations. To avoid exclusion on such ground, proposal must be drafted in the form of a recommendation without narrowly intervening with the day–to–day business activity. A shareholder may propound resolutions that have important social, environmental or political implications but the proposal also must have a significant relationship to the business of the corporation.

(vi) *Other Exclusions*: proposals related to the election to office; proposals that would cause, if implemented, violation of law; proposals aiming mainly personal interest; proposals related to specific amounts of cash or stock dividends; others (*SEC Rule 14a–8(i)(1)–(13)*).

(b) <u>Cases</u>:

(i) *Medical Committee for Human Rights v. SEC* (Pinto 161–63; materials): the court recognized that the corporation was trying to exclude the shareholder's proposal by applying a distorted criteria in considering the proposal interfered with the ordinary business operations. The court held that the general economic and political exclusion required the proposal to also involve a matter with no specific relation to the corporation's business. The proposal was found to relate solely to a matter that was completely within the accepted sphere of corporate activity and control. While decision on what a corporation manufactures are usually ordinary business decisions, napalm's significance to the corporation and its business was relevant and must be taken into account when deciding the exclusion of the proposal. The court held that the action of the SEC was reviewable and that, in view of repeated management statements that its decision to continue manufacturing and marketing napalm was made in spite of business considerations, but that management considered action morally and politically desirable, stockholder's request that it discontinue making napalm must be remanded to SEC so that it might reconsider it within proper limits of its discretionary authority and so that basis for its decision might appear clearly on the record.

(c) <u>Sources</u>: Pinto (154–65); materials (including *SEC Rule 14a–8*).

20. FIDUCIARY DUTIES – OVERVIEW

(a) General: *directors* and *officers* are in a fiduciary relationship to their corporation and to the *shareholders*. *Controlling shareholders* may also be characterized as *fiduciaries*. *Fiduciary duty* serves as a limit on the powers of those in positions of control.

(b) Duty of Care: requires *directors* to perform their duties with diligence of a reasonable person in similar circumstances which may vary depending on the context. Involves poor decision making or lack of attention, but no personal benefit.

(i) *Directors* can be liable for both *malfeasance* (wrongdoing) and *nonfeasance* (failure to act).

(ii) *Judicial Review*: less judicial involvement. Most decisions involving *duty of care* are protected under the *business judgment rule*, which creates a presumption that limits courts in questioning business decisions. Courts will usually focus on the decision making process, not in the decision. Plaintiff usually has the burden of proof and courts rarely look at the substance of the decision.

(1) Rationale for less judicial involvement: protect business decisions that are intended to enhance corporate gain.

(2) Defendants *directors* prefer *duty of care* analysis because of protection of the *business judgment rule* and burden of proof on plaintiff.

(c) Duty of Loyalty: requires a *fiduciary* to act for the best interests of the corporation and in *good faith*. Usually focuses on *conflict of interest* (when personal interest of the *fiduciary* prevails over the corporation). Prevents *directors* from acting against the best interests of the corporation or in such a way as to reap a personal benefit unavailable to other *shareholders*.

(i) *Judicial Review*: more judicial involvement. Courts usually scrutinize a *conflict of interest* transaction to determine if it is fair. Burden of proof may be shifted to *directors* to show fairness and inquiry involves both the process and substance of the decision.

(1) Rationale for more judicial involvement: *directors* may be motivated by personal gain.

(2) Plaintiff *shareholders* prefer *loyalty* analysis because defendants have the burden of proof and judicial scrutiny is active. Also, defendants are not protected by the *business judgment rule*.

(d) Other Standards of Judicial Review: courts developed different levels of scrutiny applicable to resolve situations in which choice for analysis under *duty of care* or under *duty of loyalty* is not clear.

(i) Modified Business Judgment Rule: or *proportionality test*. Burden initially on defendant to justify its actions and some scrutiny is allowed of not only the process but also the substance of the decision (*Unocal Corp. v. Mesa Petroleum*). Delaware decision, generally applied.

(ii) *Waste Standard*: what the corporation received in a transaction was so inadequate in value that no person of ordinary sound business judgment would deem it worth what the corporation paid. To be wasteful, the transaction would have to be a gift, or for no real consideration, or unnecessary. Limited judicial scrutiny. Plaintiff has the burden of proof.

(e) Level of Judicial Scrutiny: level of judicial scrutiny depends on the standard of review, which is influenced by three main factors: the *type of the transaction* (*e.g.* ordinary business decision or self–dealing), the *context of the transaction* (*e.g.* publicly traded company; control group; closely held company), and procedure to either authorize or ratify the transaction (*e.g.* director are interested and voted, shareholders approval required).

(f) Duty of Disclosure: directors have a fiduciary duty to communicate honestly with the shareholders (*Malone v. Brincat*, Del. S. Ct.).

(g) Sources: Pinto (181–84).

21. DUTY OF CARE

(a) Standard of Care: what a reasonable person would do in similar circumstances ("*ordinary prudent person*").

(i) *Directors*: generally should have some understanding of the business, keep informed on activities, perform general monitoring including attendance at meetings, and have some familiarity with the financial status of the business as reflected on the financial statements (*Francis v. United Jersey Bank*, NJ S. Ct.).

(1) Duties of *directors* of *publicly traded corporations* are greater than that of *family–owned closely–held corporations*.

(2) Lack of involvement and failure to monitor managers indicate *negligence*.

(b) Duty to Monitor: directors should implement procedures and programs to assist in their monitoring role.

(c) Business Judgment Rule: limits judicial inquiry into business decisions and protects *directors* who are not negligent in the decision making process. Burden of proof on the plaintiff and judicial scrutiny of the process. Decisions are not reviewed even if they are wrong or poor decisions.

(i) In Delaware: presumption that in making a decision *directors* were informed, acted in good faith and honestly believed that the decision was in the best interests of the corporation.

(ii) Directors must be able to make business decisions without fear of a lawsuit; *directors* are supposed to take *risks*, to produce gain.

(iii) *Caveat*: rule protects mistakes, but not *negligence* in making a decision. Rule is inapplicable in the following cases:

(1) *malfeasance* and (wrongdoing) and *nonfeasance* (failure to act), or prolonged failure to monitor or to act;

(2) decision had no business purpose, was irrational or created a no win situation;

(3) action was *ultra vires* (beyond the powers) or constituted waste (v. item 20(d)(ii));

(4) *directors* had a conflict of interest or there was fraud, bad faith or illegality in the decision.

(iv) Once the *business judgment rule* is rebutted, burden shifts to the defendant to prove entire fairness, and a duty of loyalty standard is applied.

(d) <u>Causation</u>: *negligence* is not enough; the *negligence* must be the *proximate cause* of the loss.

(i) Proof is difficult, specially in *nonfeasance* cases (as it is necessary to prove that if the director had done his duty there would not be damage).

(e) *Duty to Act Lawfully*: public policy requires that the *business judgment rule* does not protect an illegal activity even if such activity is beneficial to the corporation.

(f) *Caveat*: most states, like Delaware (*§ 102(b)(7)*), have passed legislation to protect *directors* and most public companies have placed provisions in the AoI eliminating monetary damages for *duty of care* cases.

(g) <u>Statutes</u>:

(i) *ALI § 4.01*: provides for *duty of care* of *directors* and *officers*, and the *business judgment rule*.

(ii) *Delaware § 102(b)(7)*: provision to protect directors, eliminating monetary damages for *duty of care* cases.

(h) <u>Cases</u>:

(i) *Francis v. United Jersey Bank* (Pinto 188–89, 193; materials): the NJ S. Ct., in a *nonfeasance* case, found that a *director* was *negligent* for failure to monitor the managers or act to stop the managers from looting the company.

(ii) *Smith v. Van Gorkom* (Pinto 194–97; materials): the Del. S. Ct. used to concept of *gross negligence* to conclude that the *directors* breached their *duty of care* at a two–hour meeting in which the sale of the company was initially approved. The court found that the *directors* were uninformed and acted too hastily. Decision was, thus, not protected by the *business judgment rule*. The court also found that a shareholder vote cannot ratify a transaction approved with a lack of information.

(i) <u>Sources</u>: Pinto (181–98); materials (ALI § 4.01, Delaware § 102(b)(7)).

22. DERIVATIVE SUITS

(a) <u>General</u>: corporation litigation can be *direct* or *derivative*.

(b) <u>Direct Action</u>: one or more *shareholders* sue the corporation alleging that the corporation has denied them a right associated with shareholding (*e.g.* rights to dividends or disclosure); action is in the name of the *shareholder*; damages recovered are paid to the *shareholders*.

(c) <u>Derivative Action</u>: *shareholders* sue to vindicate the violation of a duty owned to the corporation, either *fiduciary duties* owned by corporate *directors* or *officers*, or obligations of a third party pursuant to a contract with the corporation. *Shareholders* act on behalf of the corporation. Recovery goes to the corporate treasury. Attorneys' fees are due to the plaintiff winner and are paid by the corporation.

(i) *Requirements to Plaintiffs*:

(1) post security for the defendant's costs;

(2) make a demand on the *directors* to take action (v. item 22(d));

(3) be "record" owners of shares;

(4) verify the truth of pleadings, rather than plead based upon "information and belief";

(5) adequately represent shareholders interests;

(6) own shares contemporaneously with the wrongdoing;

(7) maintain shareholding during the litigation.

(ii) *Caveat 1*: if the allegation is that mismanagement or self dealing has resulted in a decline in the value of one's shares, the action is always derivative.

(iii) *Caveat 2*: in structuring the claim, finding a direct harm to the *shareholder* (*e.g.* denial of rights associated with shareholding; v. *ALI Project § 7.01*, Pinto 392–93) may be a good strategy to qualify the action as *direct* and avoid posting a bond. If there are both *direct* and *derivative* claims, the choice is the plaintiff's.

(iv) *Caveat 3*: closely held corporation, according to the ALI Project, is an exception to the *derivative* action norm. Courts sometimes permit recover to go to plaintiffs (*pro rata*), instead of to the corporate, in closely held corporation.

(d) <u>Demand Rule</u>: means whereby the *board* has an opportunity to manage litigation in the corporation's name or on its behalf. Opportunity for intra–corporate dispute resolution, as by receiving and acting upon a *demand*, the *board* may save the corporation great expense. *Demand* may also filter or stop abusive strike suits. *Demand* is usually made by a letter to the *board* sent by the *shareholder*.

(i) *Demand Refused*: the *board* rejects the *demand* after due deliberation, preceded by investigation of the facts.

(1) Grounds for Refusing: law has not been violated; not in the corporation's best interests.

(I) If *shareholder* files a lawsuit, *board* alleges that it has considered and refused the *demand*, *business judgment rule*. Bad scenario for plaintiff.

(ii) *Demand Accepted*: *board* notifies *shareholder* that the *board* intends to take action on the *demand*. Once *accepted*, *shareholder* no longer has rights in the litigation.

(1) Settlements: settlement may be entered with the alleged wrongdoer (*e.g.* a director) or with the shareholder–plaintiff in the *derivative action* itself.

(iii) *Demand Excused*: *demand* is *excused* (*shareholder* may file a lawsuit without prior demand to the *board*) when the corporation is *threatened with irreparable harm*; when it is a closely held corporation; when the corporation is taking too long to respond; when *demand* was made and the corporation takes no position on the issue; when *demand* is deemed "futile".

(1) *Futility*: *demand* is *futile* if the *board* will not give a fair hearing on the issue. A critical mass of the directors are motivated by an illicit objective (revenge, spite, jealousy), or have a material interest on the claim, or are dominated or controlled by a *director* or *shareholder* who does have a conflict of interest.

(I) Where *officers* and *directors* are under an influence which sterilizes their discretion, they cannot be considered proper persons to conduct litigation on behalf of the corporation. In applying this principle, the court asks if there is a reasonable doubt that the *directors* are disinterested and independent or that the challenged transaction was the product of a valid exercise of business judgment. (*Aronson v. Lewis*, Del S. Ct.; Pinto 413–15).

(II) Delaware: only routes to *demand excused* are financial interests of a critical mass of *directors;* domination and control of a majority of the *directors* by one of the parties to the underlying transaction; or proof that *directors* who had acted at the earlier time of the underlying transaction could not have had the protection of the *business judgment rule*.

(III) New York: more flexible than Delaware.

(e) Cases:

(i) *Marx v. Akers* (Pinto 415–416; materials): the NY Ct. of Appeals held that demand was excused because a majority of the directors were interested in the decision. The trial court, on remand, found that demand was excused because "(1) a majority of the directors are interested in the transaction, or (2) the directors failed to inform themselves to a degree reasonably necessary about the transaction, or (3) the directors failed to exercise their business judgment in approving the transaction." But also found that "a board is not interested 'in voting compensation for one of its members as an executive or in some other nondirectorial capacity, such as a consultant to the corporation'".

(f) Sources: Pinto (385–94; 408–18); materials.

23. DUTY OF LOYALTY

(a) General: requires a *fiduciary* to act in the best interests of the corporation and in good faith (v. item 20(c)).

(b) Interested Director Transactions: a *director* or *officer*, or a *controlling shareholder*, who contracts or transacts with his own corporation, receiving a benefit that is not equally shared with the other *shareholders* and thereby creating a conflict of interest (*self–dealing*).

(i) *Analysis*: three issues should be kept in mind in analyzing an *interested director transaction*:

(1) What are the legal procedural requirements in terms of *voting*, *quorum* and *disclosure*?

(2) How does compliance with those requirements affect the level of judicial scrutiny applied to the transaction (*business judgment rule*, fairness, waste) or the burden of proof?

(3) If there is a failure in the procedure, does that void the contract or have some other effect, such as increasing the level of judicial scrutiny or shifting the burden of proof?

(ii) *California Statute*: became a model for other states. The transaction is not void solely because of a conflict of interest, or the voting and presence of an interested director, if:

(1) the transaction was approved by the disinterested directors with disclosure of the conflicting interest; or

(2) disclosure was followed by shareholder approval; or

(3) the contract was just and reasonable (fair) at the time of approval.

(I) *Weak view*: compliance with the statute was not intended to change common law, which places the burden of proof on the fiduciary and requires fairness. Conflict of interest makes the transaction voidable, but close judicial scrutiny is still required.

(II) *Semi–strong view*: compliance with either disinterested board or disinterested shareholder approval shifts the burden of proof to the plaintiff. Fairness remains an issue, no *business judgment rule* protection.

(III) *Strong view*: compliance with the statute will generally limit judicial scrutiny. Disinterested board or shareholder approval not only shifts the burden of proof to the plaintiff, but removes a fairness inquiry.

(c) <u>Cases</u>:

(i) *Lewis v. S.L. & E., Inc.* (materials): the 2nd Cir. Ct. of Appeals held that: (1) because the directors of plaintiff's corporation were also officers, directors and/or shareholders of the lessee corporation, the burden was on defendant directors to demonstrate that the transactions between the two corporations were fair and reasonable, (2) business judgment rule presupposes that the corporate directors have no conflict of interest; (3) when a shareholder attacks a transaction in which the directors have an interest other than as directors of the corporation, the directors may not escape review of the merits of the transaction; (4) when a corporate transaction is challenged in a derivative action against the interested directors, they have the burden of proving that the transaction was fair and reasonable to the corporation.

(d) <u>Sources</u>: Pinto (199–210); materials.

24. EXECUTIVE COMPENSATION

(a) General: compensation paid to *executives* and *directors* may raise both *duty of care* and *duty of loyalty* issues. There is little judicial scrutiny of salary and bonuses. Differs from other interested transactions because the compensation decision is a necessary ordinary business decision while other conflict of interest transactions are often substitutes for arms length bargain transactions.

(i) *Stock Options*: can result in very high compensation and allow the recipient to buy the shares of the corporation for a period of time at a set price.

(b) Judicial Review: executive compensation cases in publicly traded corporations are rarely successful. The use of *outside directors* in setting compensation will usually mean the *business judgment rule* will apply and *shareholder* approval results in the waste test (exchange of consideration so disproportionately small that a reasonable person would not make the trade). Burden on plaintiff. *Demand* may be required before bringing *derivative suit*.

(c) Sources: Pinto (211–217).

25. CORPORATE OPPORTUNITY

(a) General: if an investment is viewed as belonging to the corporation (a *corporate opportunity*), the corporation should be given the opportunity to invest in it. Legal tests determine which opportunities are *corporate opportunities* and which opportunities the *directors* and *officers* may take advantage of personally.

(b) Legal Tests:

(i) *Interest Test*: or *expectancy test*. Focuses on the circumstances that indicate that the corporation had a special or unique interest in the opportunity. Fact–sensitive and difficult to apply.

(ii) *Line of Business Test*: similar to the *interest test*, but broader. Test looks to how closely related the opportunity is to the existing business. A *director* or *officer* personally taking advantage of the opportunity would be competing with the corporation. Test may be viewed as too restrictive, as it may discard opportunities not closely related but nonetheless of interest to the corporation, or too expansive, as any opportunity may be viewed as an opportunity for expansion.

(iii) *Fairness Test*: looks at the total circumstances to see if there is unfairness and if the interests of the corporation call for a protection. Judicial scrutiny of the process and substance of the transaction, with the burden of proof on the defendants). Some courts combine the *fairness test* with the *line of business test*.

(iv) *The ALI Test*: there is a *corporate opportunity* if the opportunity to engage in a business activity is presented to either the *directors* or *senior executives* under circumstances that (1) would reasonably lead them to believe that the opportunity was intended for the corporation or (2) would require that they use corporate information and it would reasonably be expected to be of interest to the corporation. If the defendant is a senior executive, the corporate opportunity will also include any opportunity that he knows is closely related to the business in which the corporation is engaged or expects to be engaged.

(1) *Directors* must offer the opportunity to the corporation with disclosure as to the conflict and the opportunity. Failure to disclosure creates liability *per se*.

(2) Corporation must reject opportunity before fiduciary may take advantage of it.

(c) Cases:

(i) *Northeast Harbor Golf Club, Inc. v. Harris* (Pinto 220–21; materials): the Maine S. Ct. rejected the *line of business test* as being difficult to apply, rejected the *fairness test* because it is too open–ended and provides no real guidance to fiduciaries, and rejected the combination of both tests because it would just combine the problems of both tests in one. The court held that the *ALI Test* should be applied by the trial court and remanded.

(d) Sources: Pinto (217–24); materials.

26. CONTROLLING SHAREHOLDERS AND SALE OF CONTROL

(a) Controlling Shareholders: shareholder or group acting together owning 51% or more of the voting shares has control of the corporation (control of decisions, including election of directors). Less than a majority may also have control if no other shareholders have a significant ownership interest (*de facto* or *working control*), specially in publicly traded corporations. May create conflict of interest between control group and other shareholders.

(b) Sale of Control: usually buyers pay a premium for control. Raises the issue of whether a equal treatment (*equal opportunity*) should be given to the other shareholders (buyer be obligated to buy the shares *pro rata* or purchase 100% of the business and offer everyone the same price).

(i) *General View*: absent *looting* of corporate assets, conversion of *corporate opportunity*, fraud or bad faith, a *controlling shareholder* is free to sell, and a purchaser is free to buy, the control at a premium price.

(ii) *Looting*: if the only reason for the purchase of control at a premium is to *loot* the business (sell the assets and "dry" the corporation), *directors* or *controlling shareholder* may be held liable.

(c) Cases:

(i) *Perlman v. Feldmann* (Pinto 252–53; materials): explored the idea of *equal opportunity* to share the premium paid to the *controlling shareholders*. The court held that the *shareholders* had an *equal opportunity* in the premium which was allocated *pro rata* to all the *shareholders*, including the *controlling shareholder*. The rule is narrow: *equal opportunity* will be the rule if the seller is in effect selling a corporate asset or opportunity, or acting in a detrimental way toward the corporation or other *shareholders*.

(d) Sources: Pinto (229–30; 248–53); materials.

27. MERGERS AND ACQUISITIONS

(a) General: *merger* is a method of acquisition of another corporation, in which purchaser and purchased companies are combined. Involves exchange of consideration in the form of securities, cash or a combination of consideration. The *merger plan* must be approved by the *board*.

(b) Consolidation: corporations A and B are merged into a new company C.

(c) Triangular Merger: acquiring company A forms a wholly owned subsidiary C and acquired company B mergers into C. Usually used when company A whishes to keep the assets acquired from company B in a separate corporation. Or to avoid contingent liabilities. Shareholders of company B may receive shares of company C. Company A votes in company C, but shareholders of company A vote only in company A.

(d) Reverse Triangular Merger: acquiring company A forms a wholly owned subsidiary C. Company C is then merged into acquired company B, which becomes a wholly owned subsidiary of company A. Usually used when company A whishes to preserve the existence of the acquired company.

(e) Sales of Assets: acquiring company A acquires substantially all of the assets of company B. Both *boards* must approve the transaction.

(f) Tender Offer: or *takeover* bid. Company A makes an offer directly to the *shareholders* of company B to buy their stock. Objective is to acquire at least 51% of the shares. Requires the *board* approval of company A, but requires no *board* approval from company B. *Shareholders* of company B can either accept or reject the offer. Tender is *hostile* if the *board* of company B disapproves or resists the offer.

(g) Appraisal Remedy: shareholders who object to the merger may dissent and seek appraisal as a remedy. Shareholder is then entitled to be paid by the corporation in cash an amount equal to the fair market valu of his shares. Problems and limitations: procedure requirements (*shareholders* must vote against merger and serve notice of their wish to seek appraisal), costs (at the dissenting *shareholders* expense), uncertainty, *freezeouts*.

(i) *Delaware Block Approach*: valuation methodology in which the value of the shares is determined by looking at *market value*, *net asset value* and *earnings value* (*Piemonte v. New Boston Garden Corp.*; Pinto 129–30 and materials).

(ii) *New Methodology*: expanded the *Delaware Block Approach* applying valuation techniques generally acceptable in the financial community (*e.g.* comparative takeover premiums, discounted cash flow) (*Weinberger v. U.O.P. Inc.* (Pinto 240–42; materials).

(h) Defacto Merger: an acquisition structured as an assets sale with the acquiring corporation also assuming the liabilities will not have appraisal rights available in the event valuation is challenged by the shareholders of the selling corporation. In this case, shareholders may argue that the transaction is a *defacto merger* and seek appraisal. Claim would probably not prevail in Delaware if the transaction technically complies with statutory provision.

(i) Cases:

(i) *Piemonte v. New Boston Garden Corp.* (Pinto 129–30; materials): in evaluating a company, the court assigned the components of the appraisal as follows: *market value* (10%), *earnings value* (40%) and *net asset value* (50%). Court did not fully explained why it used the particular weights it did. Highly criticized: limited, too conservative and does not reflect the actual value of the company.

(j) Sources: Pinto (121–32); Klein (209–13); materials.

28. FREEZEOUTS UNDER STATE LAW

(a) Freezeouts: *controlling shareholders* forcing the *minority shareholders* to relinquish their equity position in the corporation. Usually, company A, which controls public company B, sets up a shell corporation C (a wholly owned subsidiary of company A); company A uses its control of the *board* of company B to enter into a merger whereby company B mergers into company C; the merger plan provides that the *minority shareholders* of company B will receive cash or debt securities for their shares, resulting in the elimination of their ownership in company B.

(i) *Two–tier Offer*: a *tender offer* followed by a *freezeout* transaction. Usually when bidder wants 100% ownership but acquires less in the tender offer due to the inevitable holdouts. Control is acquired in the *tender offer* and *freezeout* is intended to acquire the remaining shares. If the price offered to the minority is less than paid to acquire control, this may be unfair.

(ii) *Front–loaded Two–tier Offer*: in a hostile takeover, a higher price is offered in the *tender offer* to the public to gain 51% control but the public was informed that once control was acquired there would be a second step *freezeout* merger at a lower price. Tactic viewed as coercive.

(b) State Law: to perform a freezeout, the *control group* must comply with the state regulation for mergers and fiduciary obligations. For a *merger*, approval by the *board* and *shareholder vote* are required (some statutes require no *shareholder vote* when the *control group* owns a large percentage, usually 90%, of the corporation).

(i) Generally, to avoid *appraisal*, *minority shareholders* use federal securities laws or state fiduciary duty doctrine to enjoin *freezeout* or seek damages.

(ii) Generally, courts will scrutinize *freezeouts* by *control groups* as a *duty of loyalty* issue requiring entire *fairness* (*fair dealing* and *fair price*) and, in some cases, requiring a business purpose for the transaction.

(1) *Fair Dealing* involves full disclosure and procedural fairness issues such as timing, initiation, negotiation and structure;

(2) *Fair Price* relates to all the factors which affect the value of the shares

(c) Shareholder Ratification: in some cases, *shareholder vote* may be sought to ratify a transaction entered by the *board* that may raise issues of conflict of interests. Or to try to reduce the level of judicial scrutiny. To have an effect, shareholder ratification must involve the approval of disinterested shareholders (if there is a *controlling shareholder*, ratification requires approval of a majority of the minority). *Full disclosure* is required, or the vote is inoperative.

(d) Cases:

(i) *Weinberger v. U.O.P. Inc.* (Pinto 240–42; materials): in analyzing a *freezeout* transaction, the Delaware S. Ct. eliminated the requirement of a business purpose and limited the use of equitable relief in *freezeouts*. The court focused on the concept of *fairness* (*fair dealing* and *fair price*). The court found a lack of *fair dealing*. Approval of a majority of the minority shareholders had no effect on entire fairness because the shareholders were not given full disclosure of the bargaining positions of the parent and subsidiary. The *Delaware Block Approach* valuation methodology was expanded to include techniques generally acceptable by the financial community (v. item 27(g)(i)–(ii)). Complex and extensive decision.

(ii) In Re Wheelabrator Technologies Litigation (Pinto 226–27; materials): the Delaware Chancery Court found that the *ratification* of a merger by the majority of the minority fully informed extinguished the *duty of care* claim, because the failure of the *board* to act in an informed and non–negligent manner was a voidable act cured by the *shareholder vote*. The *duty of loyalty* claim was viewed under the *business judgment rule*, as the court found that the acquiring company was not a controlling shareholder and used the following rationale:

(1) in a *duty of loyalty* claim relating to *interested director transactions* where there was no *controlling shareholder*, the issue was subject to the *business judgment rule* and plaintiff had the burden to show that the transaction was wasteful;

(2) in a *duty of loyalty* claim relating to transactions with a *controlling shareholder*, more judicial scrutiny was required and the *ratification* had the effect of shifting the burden of proof to the plaintiff to prove unfairness.

(e) Sources: Pinto (233–47; 224–27); materials.

29. HOSTILE TAKEOVERS

(a) General: a *hostile takeover* takes place when company A (*bidder*) wants to acquire company B (*target*) and the *board* of company B is not in favor of the acquisition. Two means available: *proxy fight* (to try to convince *shareholders* of company B to vote for a new *board* favorable to the acquisition) or *tender offer* (offer is made directly to the *shareholders* of company B, to acquire their stock).

(b) Bidder Tactics: generally, *bidder* acquires a *target* by purchasing control through a *tender offer*.

(i) Tender is made for enough shares to gain *control*.

(ii) All *shareholders* are entitled to an equal opportunity to tender their shares.

(iii) *Bidder* may set conditions to accept tendered shares, such as receipt of a certain number of shares (to avoid owning a large percentage of shares without the benefits of control). If more shares are tendered than the *bidder* wants, shares are purchased on a *pro rata* basis. Cash is often used.

(iv) If *bidder* wants complete control of the target, *bidder* will need to acquire shares not tendered in the offer in a second–step *freezeout* transaction, such as in a *front–loaded two–tier offer* (v. item 28(a)(ii)).

(c) Target Tactics: tactics are aimed to delay a *bidder* from taking immediate control or preclude *bidder* from using certain offensive tactics.

(i) *Shareholder Vote Required*: some tactics require amendments to the AoI and, thus, a *shareholder vote*.

(1) Staggering the terms of the *directors* (some *directors* are elected each year, so immediate control of the *board* by *bidder* is delayed);

(2) *Super–majority* or *disinterested shareholder vote* requirement in selling assets (*bidder* will have problems in paying finance and implementing *freezeout*);

(3) Provision establishing *fair price* for shares or *compulsory redemption* of shares not tendered even if the *bidder* does not want those shares;

(4) Recapitalization and creation of a new class of shares with *supervoting* rights (if *supervoting* class is woned by the managers, hostile tender offer fails).

(ii) *Shareholder Vote Not Required*: some tactics can be implemented without a *shareholder vote*.

(1) "*Crown Jewel Defense*": selling off or option to sell significant assets to a third party (corporation is less appealing to a *bidder*);

(2) Split the corporation to increase overall value;

(3) *Self–tender*: *target* purchases shares from its own *shareholders*;

(4) "*White Knight*": *target* seeks another *bidder* to come to *target*'s rescue;

(5) *Management Buyout*: *managers* takeover the *target*, usually with the use of *debt* (*leveraged buyout*);

(6) Increase *debt* to limit *bidder*'s ability to finance the *tender offer*.

(7) *Poison Pill*: at some triggering event (usually the purchase of a certain percentage of the *target*'s shares), the *target shareholders* are given *rights* to obtain securities (*debt* or *equity*). Securities can be from the *bidder* (*flip over* plan) or from the *target* (*flip in* plan). These *rights* make the *hostile tender offer* more expansive for the *bidder* by adversely affecting either the *target* or the *bidder* itself. Prior to the triggering event, the *target directors* can redeem the *rights*, but after the event the *rights* become non–redeemable.

(d) <u>State Law</u>: actions to defend a corporation from a *takeover* usually are faced with a charge of *breach of fiduciary duty* to the corporation and its *shareholders* under state law. Judicial scrutiny usually applies the *modified business judgment rule* (v. item 20(d)(i)).

(i) *The Unocal Test*: generally applies. In *Unocal Corp. v. Mesa Petroleum* (Pinto 318–20), the Delaware S. Ct. recognized that when *directors* implement a defensive tactics the *board* may be acting primarily in its own interest, and ruled that if a defensive measure is taken within the business judgment rule, it must be reasonable to the threat posed. Concerns of the board may include inadequacy of the price offered, nature and timing of the offer, illegality, impact on creditors, employees and the community, risk of nonconsumption, quality of securities being offered in the exchange. Threat is often based on the belief that the *bidder* has offered insufficient value.

(1) Thus, in enacting a defensive tactic the *board* must prove (I) that it had *reasonable grounds* for believing that a danger to corporate policy and effectiveness existed; (II) that the defensive tactic was *reasonable* to the threat posed.

(2) The presence of a *majority of independent directors* unaffiliated with the *target* enhances the *directors*' proof.

(3) Initial burden on *directors* and some scrutiny of not just the process but also the substance of the decision.

(4) First step focuses on the *directors* acting in good faith after reasonable investigation; the second step allows the court to balance the defensive tactic with the threat.

(5) Gives *directors* significant latitude while allowing some closer judicial scrutiny of the tactics.

(ii) *The Revlon Test*: applies if the sale of the company is inevitable or the control is on sale. In *Revlon, Inc. v. MacAndrews*, the decision of the Delaware S. Ct. indicates that concerns by the *directors* with other constituencies during a *takeover* (such as those permitted within the *Unocal* test) are permissible only if there are rationally related benefits accruing to *shareholders*. But, once there is an auction for the business (more than one *bidder*), such interests are inappropriate. Duties of the *board* change from preservation of the *target* to maximization of value to the shareholders. *Directors* are auctioneers.

(e) <u>Summary</u>: when shareholders challenge the actions of directors, there are generally three levels of review: *business judgment rule*, *Unocal*'s enhanced scrutiny and the *duty of loyalty* (v. Pinto 327–28).

(f) <u>Cases</u>:

(i) *Moran v. Household International, Inc.* (Pinto 314–15; materials): *target* could issue a *right* for every common share if a *bidder* announced a *tender* for 30% of the stock of the *target* or if someone acquired 20% of the stock of the *target*. *Flip over* plan (*target shareholders* who did not tender have the option the *bidder*'s shares at a substantial discount). *Bidder* was only obligated after a *freezeout* merger.

The Delaware S. Ct. upheld the *poison pill* plan. The court found that the Delaware statute permitted issuance of *rights* and preferred shares; that the *poison* *pill* did not preclude an offer since a *bidder* could still buy less than 100% of the corporation and the *pill* would not apply, or try a *proxy fight*.

(ii) *Revlon, Inc. v. MacAndrews* (Pinto 320–21; materials): the Delaware S. Ct. applied the enhance scrutiny of *Unocal* and held that when a target is up for sale the *directors* cannot play favorites (use defensive tactics to choose the *bidder*). Duties of the *board* change from preservation of the *target* to maximization of value to the shareholders. *Directors* are auctioneers, shall seek the highest price for shareholders.

(g) Sources: Pinto (309–37); Klein (182–99); materials.

30. RULE 10B–5

(a) Scope: SEC Rule 10b–5, authorized by Section 10(b) of the Securities Exchange Act of 1934, is the general antifraud rule applicable to "the purchase of any security." Prohibits material omissions or misleading statements, whether oral or written. Rule is not limited to securities of publicly held corporations, misrepresentation in a small or closely held corporation may be actionable.

(i) *Disclosure*: requires full disclosure of information.

(ii) *Insider Trading*: use of nonpublic information by any person "having a relationship [*director*, *officer*, *attorney*] giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone. By use of the information to trade or to tip others who trade, a person makes a gain or avoids a loss by remaining silent when there is a duty to speak.

(b) Private Rights of Action: Rule 10b–5 gives a private right of action; not limited to enforcement by SEC, investors can sue for damages or for injunctive relief based on the rule.

(c) Standing to Sue: only those who have actually purchased or sold the security at issue (*purchaser–seller rule*).

(d) Materiality: the omitted or misstated fact, if known, must be such that it would have assumed actual significance in the deliberations of the reasonable shareholder. One of which the reasonable investor would attach importance in the making of his decision. One which would have a propensity to affect the reasonable investor's thought process. A fact is a *material fact* if there exists substantial likelihood that a reasonable shareholder would consider it important in deciding whether to purchase or sell a security. On materiality, see *Basic, Inc v. Levinson*.

(e) State of Mind: measure of the degree of fault (*scienter*). Courts typically recognize five levels of fault: strict liability, negligence, recklessness (highly unreasonable omission, extreme departure from the standard of ordinary care, danger so obvious that the actor must have been aware of it), knowing conduct, and intentional conduct. But for Section 10(b) purposes, the US S. Ct. held that its language is limited to prevention of knowing, intentional, or possibly reckless conduct, but negligent conduct is not included.

(f) Reliance (Transaction Causation): given proof of *materiality*, *reliance* is presumed. If a reasonable investor would have considered it important if the fact had been disclosed, the courts presume the particular plaintiff would have considered it important.

(i) In cases where the plaintiff is alleging *reliance* on a *misrepresentation*, it is not necessary for the plaintiff actually to have seen the press release, quarterly report, or other document containing the alleged misstatement. Proof of *indirect reliance* is sufficient. If the plaintiff can link his conduct (buying shares) to the defendant's fraud by showing that "the fraud was a 'substantial' or 'significant contributing cause', the plaintiff has shown sufficient reliance to support his 10b–5 claim."

(ii) Plaintiff's reliance must be reasonable. Reasonableness is judged by considering (1) sophistication of the plaintiff; (2) existence of personal relationships; (3) access to relevant information; (4) existence of fiduciary relationship; (5) concealment of the fraud; (6) opportunity to detect the fraud; (7) whether plaintiff initiated the stock transaction or sought to expedite the transaction; (8) generality or specificity of the misrepresentation.

(g) Reliance (Fraud on the Market Theory): may be utilized in cases involving publicly traded securities. Based on the ECMH (v. item 7(b)). If the corporation has issued disclosures that are false or misleading, or which contain material omissions, then market prices will not accurately reflect the state of affairs within the corporation. Investor's reliance on the integrity of the market will have been misplaced. Successful invocation of the fraud on the market theory establishes a presumption, and only a presumption, of reliance (see *Basic, Inc v. Levinson*). Valuable tool for plaintiffs.

(h) Loss Causation: in a Rule 10b–5 case, the plaintiff must establish not only a causal link between the defendant's alleged wrongdoing and the plaintiff's conduct (*transaction causation*), but also a causal link between the defendant's acts and the plaintiff's loss or damages (*loss causation*).

(i) Plaintiff must prove that "but for the defendant's acts (misstatement, omission), the decrease in market price (and loss) would not have occurred. Or prove that the misstatements or omissions were a "substantial factor" in producing the loss the plaintiff as suffered. Proximate causation.

(i) The "In Connection With" Requirement: means of testing whether the connection between securities, or even securities markets generally, and the fraud alleged, is too attenuated.

(j) Privity: Rule 10b–5 has no privity (direct dealings between the plaintiff and the defendant) requirement.

(k) Secondary Liability for Disclosure Violations: plaintiffs often pursue secondary violators (defendants corporate directors and officers, accountants, consultants, attorneys, bankers, celebrities) because the primary violator, often the issuer of the securities, has become judgment–proof (insolvent). After a decision of the S. Ct. in Central Bank of Denver v. First Interstate Bank of Denver, establishing the liability of secondary violators participants in securities transactions is quite difficult under Rule 10b–5.

(l) Freezeouts: in a *freezeout*, a Rule 10b–5 cause of action may arise for the *minority shareholders* if there is a lack of full disclosure that forces the *minority shareholders* to exchange in the merger (that is, sell) their shares. However, use of Rule 10b may be limited by the S. Ct. decision in *Santa Fe v. Green*.

(m) Cases:

(i) *Basic, Inc v. Levinson* (Pinto 345–46; materials): sellers of stock during period prior to formal announcement of merger brought Rule 10b–5 action in which it was alleged that material misrepresentations had been made due to denial of merger negotiations prior to official announcement.

The S. Ct. noted that "it is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant." The court held that: (1) standard of materiality appropriate in § 10(b) and Rule 10b–5 context is: an omitted fact is material if there is a substantial likelihood that its disclosure would have been considered significant by a reasonable investor; (2) materiality in merger context depends on probability that transaction will be consummated, and its significance to issuer of securities (thus, materiality depends on the facts and is to be determined on a case–by–case basis); and (3) presumption of reliance, supported in part by fraud–on–market theory may be applied, but presumption is rebuttable (Rule 10b–5 defendants may attempt to show that the price was not affected by their misrepresentation, or that the plaintiff did not trade in reliance on the integrity of the market price).

(ii) *Santa Fe v. Green* (Pinto 247–48; materials): minority shareholder brought an action against majority shareholders and a firm which had appraised value of the stock for purposes of permitting the company in question to undergo a Delaware short–form merger.

The S. Ct. held that where, on the basis of information provided, the minority shareholders could either accept the price offered for their shares or reject it and seek appraisal in the Delaware court of chancery, their case was fairly presented and the transaction as alleged in the complaint was therefore neither deceptive nor manipulative and therefore did not violate either the Securities Exchange Act provision or SEC rule 10b–5. Mere instances of corporate mismanagement in which essence of the complaint is that shareholders were treated unfairly by a fiduciary are not within the statute or rule.

(iii) *Diamond v. Oreamuno* (Pinto 379; materials): stockholder's derivative action against corporate officers. The NY Ct. of Appeals found that *insider trading* does harm the corporation and violates duties the insider owes to it: "Although the corporation may have little concern with the day–to–day transactions in its shares, it has a great interest in maintaining a reputation of integrity, an image of probity, for its management and in insuring the continued public acceptance and marketability of its stock. When officers and directors abuse their position in order to gain personal profits, the effect may be to cast a cloud on the corporation's name, injure stockholder relations and undermine public regard for the corporation's securities." The court held that, if corporate officers solely by virtue of their position as officers learned of drop in corporate earnings and sold their shares of corporate stock before publishing information as to loss, officers would be liable to corporation for profits resulting from sale. *Diamond* permits a derivative suit for insider trading which allows for a corporate recovery.

(n) Sources: Pinto (247–48; 339–60); materials (including § 10 and Rule 10b–5).

31. INSIDER TRADING

(a) Nature of the Insider Trading Prohibition: the prohibition upon the *insider* is "disclose or abstain". Because the prerogative to disclose usually is the corporation's, and not the insider's, the effective prohibition becomes to "abstain" from trading, or from tipping others to trade.

(b) Who is an Insider?: a person who, because of a *fiduciary duty* or similar relation, is afforded access to *nonpublic investment information* from his corporation. Requires a fiduciary or similar relationship with the other parties to the transaction, that is, the shareholder of the target corporation who sold the shares (see *Chiarella v. United States*). Attorneys, accountants, investment bankers, consultants, may also become *insiders*, or *temporary insiders*, when they learn of nonpublic information during the course of performing services for the corporation. Access to the information has to arise from a *fiduciary relationship*, or similar relation, to those persons who sell shares while the *insider* is buying.

(i) *SEC Rule 14e–3*: prohibits any "person who is in possession of material information relating to [a] tender offer" to trade on that information without any reference to duty.

(c) Tipper–Tippee Liability: an *insider* who passes information to another person knowing that the other person will trade is a *tipper*. Whether he trades or not, *tipper* has the same liability as an insider who actually trades. Recipient of the information is a *tippee*, and also has *insider trading liability*, but only if he trades. Liability of *tippee* is *derivative* of *tipper*; a benefit test applies.

(i) *Benefit Test*: determine whether the *insider*'s tip constituted a breach of the *insider*'s *fiduciary duty*, which depends upon whether the *insider* (*tipper*) will *personally benefit*, directly or indirectly, from his disclosure. Absent some personal gain (tangible or intangible), no *breach of duty*. Because the *tippee*'s duty is *derivative* of the *tipper*'s, the *tippee* cannot be held liable if the *tipper* breached no duty (see *Dirks v. SEC*).

(d) The Misappropriation Theory: developed by courts, "holds that a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b–5, when she misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information", rather than in a breach of a duty to the investor on the opposite side of the trade, as in the "classical" case of insider trading. Someone who steals (or converts) the information in violation of a duty owed to the owner of the information (a misappropriation), or their *tippee* ("fraud on the source"). A thief may be held liable under the *misappropriation theory*.

(i) The S. Ct. upheld the misappropriation theory (see *United States v. O'Hagan*).

(e) Remedies and Enforcement: persons who trade "contemporaneously" with trading by a misappropriator may sue for damages.

(f) Insider Trading Prohibition under State Law: the majority of the states apply the *expanded special facts doctrine*, which claims that an *insider* has the duty to disclose any material facts which *insider* knows a reasonable investor or shareholder would want to know in making the decision to buy or sell.

(g) Cases:

(i) *Chiarella v. United States* (Pinto 362–64; materials): petitioner, who was employed by a financial printer that had been engaged by certain corporations to print corporate takeover bids, deduced the names of the target companies from information contained in documents delivered to the printer by the acquiring companies and, without disclosing his knowledge, purchased stock in the target companies and sold the shares immediately after the takeover attempts were made public.

The S. Ct. held that: (1) employee could not be convicted on theory of failure to disclose his knowledge to stockholders or target companies as he was under no duty to speak, in that he had no prior dealings with the stockholders and was not their agent or fiduciary and was not a person in whom sellers had placed their trust and confidence, but dealt with them only through impersonal market transactions; (2) section 10(b) duty to disclose does not arise from mere possession of nonpublic market information; and (3) court would not decide whether employee breached a duty to acquiring corporation since such theory was not submitted to the jury. Liability is premised upon a duty to disclose (such as that of a corporate insider to shareholders of his corporation) arising from a relationship of trust and confidence between parties to a transaction. Petitioner had no affirmative duty to disclose the information as to the plans of the acquiring companies. He was not a corporate insider, and he received no confidential information from the target companies. Nor could any duty arise from petitioner's relationship with the sellers of the target companies' securities, for he had no prior dealings with them, was not their agent, was not a fiduciary, and was not a person in whom the sellers had placed their trust and confidence. A duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information.

(ii) *Dirks v. SEC* (Pinto 364–66; materials): a former employee exposed a company's ongoing fraud to a securities analyst, who then informed his own clients of the fraud without successfully alerting the public.

The S. Ct. held that unlike insiders who have independent fiduciary duties to both the corporation and its shareholders, the typical tippee has no such relationships. There must be a breach of the insider's fiduciary duty before the tippee inherits the duty to disclose or abstain. A duty to disclose arises from the relationship between parties and not merely from one's ability to acquire information because of his position in the market. Tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them improperly. Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach. In determining whether a tippee is under an obligation to disclose or abstain, it is necessary to determine whether the insider's "tip" constituted a breach of the insider's fiduciary duty. Whether disclosure is a breach of duty depends in large part on the personal benefit the insider receives as a result of the disclosure. Absent an improper purpose, there is no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.

(iii) *United States v. O'Hagan* (Pinto 371–73; materials): after a company retained a law firm to represent it regarding a potential tender offer for another company's common stock, respondent O'Hagan, a partner of the law firm who did no work on the representation, began purchasing call options for the target company, as well as shares of the stock. Following the law's firm withdrawal from the representation, the tender offer was announced and the price of the target stock rose dramatically, and O'Hagan sold his call options and stock at a profit of more than $ 4.3 million.

The S. Ct. held that: (1) criminal liability under § 10(b) of Securities Exchange Act may be predicated on misappropriation theory; (2) defendant who purchased stock in target corporation prior to its being purchased in tender offer, based on inside information he acquired as member of law firm representing tender offeror, could be found guilty of securities fraud in violation of Rule 10b–5 under misappropriation theory; and (3) Securities and Exchange Commission (SEC) did not exceed its rulemaking authority in promulgating rule proscribing transactions in securities on basis of material, nonpublic information in context of tender offers. A corporate "outsider" violates § 10(b) and Rule 10b-5 when he misappropriates confidential information for securities trading purposes, in breach of a fiduciary duty owed to the source of the information, rather than to the persons with whom he trades. Misappropriation, as just defined, is the proper subject of a § 10(b) charge because it meets the statutory requirement that there be "deceptive" conduct "in connection with" a securities transaction. First, misappropriators deal in deception: A fiduciary who pretends loyalty to the principal while secretly converting the principal's information for personal gain dupes or defrauds the principal. A company's confidential information qualifies as property to which the company has a right of exclusive use; the undisclosed misappropriation of such information constitutes fraud akin to embezzlement. § 10(b)'s requirement that the misappropriator's deceptive use of information be "in connection with the purchase or sale of [a] security" is satisfied by the misappropriation theory because the fiduciary's fraud is consummated not when he obtains the confidential information, but when, without disclosure to his principal, he uses the information in purchasing or selling securities.

(h) Sources: Pinto (360–80); materials (including Rule 14e–3).

32. CLOSELY–HELD CORPORATIONS

(a) Devices to Maintain Control: by voting together on a consistent basis or by getting the majority to agree, a group of minority shareholders may be able to elect some directors and then maintain whatever control they possess. Classical devices are *shareholder voting agreement*, *irrevocable proxies*, *voting trusts*, *class voting*, and *cumulative voting*.

(i) *Shareholder Voting Agreement*: all signing shareholders shall vote as they shall agree or, failing agreement, as a designated individual (*e.g.* a lawyer) directs. Alternatively, the agreement may provide that all signatories agree to vote as a majority of the group, or "pool", decides.

(1) Many states provide that a *shareholder voting agreement* shall be specifically enforceable.

(2) To optimize enforcement, *shareholder voting agreement* shall be detailed as to the consequences should one party breach it.

(ii) *Irrevocable Proxies*: allows its holder to vote the shares without needing judicial enforcement (self–executing).

(1) If not expressly revoked, a proxy is considered revoked by a later proxy given to another, by the shareholder's attendance at the meeting, or, in any case, by the passage of eleven month's time.

(2) *Caveat*: irrevocability of a proxy will be upheld when the *agency* is given to protect the interests of the *principal* in addition to protect some independent interest of the *agent*, over and above the normal *agent*'s interests such as employment, compensation and the like (*e.g.* irrevocable proxy given to a bank to vote for shares as guaranty). Agency "coupled with an interest" (or "powers given as securities").

(iii) *Voting Trusts*: shareholders may discuss matters, but the *trustee* has no obligation to listen to them. Complete severance of voting and ownership. All voting rights are in the *trustee*'s hands.

(1) An illegal *voting trust* is simply one that fails to comply with statutory requirements that the *voting trust* be of record at the corporation's principal offices (not secret) and be limited in duration, often ten years.

(2) The *trustee* owes *fiduciary duties of care and loyalty* to the participating *shareholders*.

(3) *Proper purpose doctrine* applies: a *voting trust* will not be upheld if it is found to have fraud, illegality or other improper objective.

(iv) *Class Voting*: *e.g.* AoI providing for two classes of shares, identical in all respects except for voting rights. "A" shares to be held by one group, "B" shares by the other, each group of shares with the right to elect a number of directors.

(v) *Cumulative Voting*: gives a shareholder the right to cast votes equal to the number of shares he holds times the number of director positions standing for election. Shareholder may cumulate his votes on one or two positions rather than vote evenly over all positions up for election (v. item 15(b)(iii)(3)).

(b) <u>Protecting Shareholder Expectations *Ex Ante*</u>: shareholder may be protected by *contract* (*e.g. shareholder agreement*), by *long–term job security* (tenure) and *salary agreement*. Agreements may limit the authority of the *board*. But courts may limit such limitations.

(c) <u>Restrictions on Share Transferability</u>: three basic restrictions: *first refusal*, which prohibit a sale of shares unless the shares are first offered to the corporation, the other shareholders, or both, on the terms the third party has offered; *first options*, which prohibit a sale of shares unless the selling shareholder first offers the shares to the corporation, the other shareholders, or both, at a price fixed under the agreement; and *consent restrains*, which prohibit a transfer of shares without the permission of the corporation's board of directors or other shareholder. Agreements are knows as *buy–sell agreements*.

(i) *Umbrella Test*: in analyzing whether restrain is reasonable, courts search for a determination of whether the agreement has the intent and result of keeping shareholders in (a *restrain on alienation*), or is merely the result of allowing shareholders the opportunity to control who their "partners" will be (*permissible private ordering*).

(d) Protecting Shareholder Expectations *Ex Post*: without contractual protection, participants may face the problem of *illiquidity* (*e.g.* no one to sell shares) and *exploitation* (*e.g.* majority receives high salaries and benefits). In courts, exploited shareholders allege that participants in a close corporation owe fiduciary duties, not only to the corporation, but to one another (a heightened duty), or allege that have been "oppressed" by those in control.

(i) *Summary of Choices*: a minority shareholder oppressed by the control group may have the following choices:

(1) sue for breach of fiduciary duty, requiring the defendants to pay back to the corporation benefits they have received;

(2) invoke the "equal opportunity" rule alleging that he is entitled to benefits parallel to those the controlling faction is receiving;

(3) sue alleging oppression (*e.g.* denial of reasonable expectations, such as dividends, salary, meaningful participation in governance), seeking involuntary dissolution of the corporation if the statute authorizes it; in this suit, plaintiff may seek for alternative relief (*e.g.* appointment of a provisional director).

(e) Cases:

(i) *McQuade v. Stneham* (Pinto 271–72; materials): the NY Ct. of Appeals held that "stockholders may, of course, combine to elect directors." But "a contract is illegal and void so far as it precludes the board of directors… from changing officers, salaries or policies or retaining individuals in office, except by consent of the contracting parties." Contract could be enforced to elect the plaintiff *director*, but not to elect him *officer*.

(ii) *Clark v. Dodge* (Pinto 272–73; materials): the NY Ct. of Appeals held that "[i]f the enforcement of a particular contract damages nobody – not even, in any perceptible degree, the public – one sees no reason for holding it illegal". The court held that a contract requiring the plaintiff to be elected *officer* could be enforced and, according to the contract, he could remain in office only so long as he continued to be "faithful, efficient and competent."

(iii) *Wilkens v. Springside Nursing Home* (Pinto 289–90; materials): the S. Judicial Ct. of MA held that majority shareholders in close corporation owed duty of utmost good faith and loyalty in their dealings with minority shareholder; that majority shareholders did not show legitimate business purpose for removing minority shareholder from the payroll of the corporation, which had never paid dividends, or for refusing to reelect him as a salaried officer and director; and that damages owed to the minority shareholder could not be diminished by claim that duties which had previously been performed by the minority shareholder for his salary had since been performed by other persons.

(iv) *Kemp v. Beatley* (Pinto 297–98; materials): the NY Ct. of Appeals held that: (1) when majority shareholders of close corporation award de facto dividends to all shareholders except class of minority shareholders, such policy may constitute "oppressive actions" and serve as basis for order dissolving the corporation; (2) the provision for involuntary dissolution was properly applied; and (3) change in policy which amounted to nothing less than an attempt to exclude petitioners from regaining any return on their investment through mere recharacterization of distributions of corporate income, constituted oppressive action within meaning of corporate dissolution statute.

(f) Sources: Pinto (259–301; 95–96); materials (including § 18 UPA and §§ of the N.Y.B.C.L.).

The End