**CORPORATIONS (PROF. R. BUBB)[[1]](#footnote--1)**

**2. LAW OF AGENCY**

Jenson Farms Co. V Cargill, Inc.

* Warren Grain & Seed Co. was sued by its creditors who also sued Cargill.
* Cargill financed Warren, authorized Warren to act as its agent in certain transactions, oversaw Warren’s business and exercised control and decisions over Warren (more than nominal control).
* Considering these facts, Warren was found to be Cargill’s agent despite the fact that no contract was entered but an agreement was clear among the parties.

RoL: Agency is created through course of conduct where facts evidence that the principal has consented to the agent to be its agent, the agent acts on behalf of the principal, and the principal exercises control over the agent.

**Liability in Contract**

*Actual and Apparent Authority*

White V Thomas

* White authorized Simpson to buy a piece of land in an auction limited to certain amount and when Simpson exceeded such amount sold a part of the land to Thomas, who believed Simpson was authorized to sell despite such authority was not evidenced but only asserted by Simpson and no effort was made to contact White.
* White repudiated the transaction and succeeded since Simpson’s authority was specific and there was no evidence that White authorized her to sell in any manner whatsoever, and no third party can reasonably believe that she was authorized to sell only because she was authorized to buy.

RoL: If the principal is absent and there is no evidence that the agent has specific authority, the agent has no apparent authority to carry engage in such specific actions merely because the agent asserts to have such authority.

Actual Authority: Authority that the agent reasonably believes to have or the principal whishes the agent so to act, pursuant to principal’s manifestations to the agent. (2.01 3rd Rest.)

Apparent Authority: That which can a 3rd party reasonably infer from the actions or statements of the principal, not those of the agent.

Authority inferred from the conduct of the principal and the agent.

Inherent Authority: That inferred by a 3rd party since a general agent would ordinarily have such authority and said 3rd party in not on notice that agent is not so authorized.

|  |  |  |  |
| --- | --- | --- | --- |
| →Actual→ | | →Inherent→ | |
| ↑ | ↓ | ↑ | ↓ |
| Principal | Agent | | 3rd |
| ↓ |  | | ↑ |
| →Apparent→ | | | |

*Inherent Authority*

Gallant Ins. Co. V Isaac

* Thompson-Harris was Gallant’s agent and was authorized to bind Gallant on new and interim insurance coverage.
* Isaac reasonably believed that T-H had authority to orally bind coverage since Isaac has always dealt with T-H and all paperwork was handled through T-H.
* Despite the fact that T-H was not expressly authorized to do so, it was inherent to renew insurance policies within its authority and it was a common practice of Gallant with T-H (thus being in the usual and ordinary scope of T-H’s authority), Gallant was therefore bound.

RoL: Agent has inherent authority if it acts within the usual and ordinary scope of its authority, and a 3rd party reasonably believes the agent has such authority and is not on notice that the agent is not so authorized.

**Liability in Tort**

Humble Oil & Refining Co. V Martin

* Martin family was injured by a car owned by Ms. Love and on service in the facilities of a Humble Gas station operated by Schneider.
* Since Humble did not owned the gas station but exercised substantial control over Schneider’s day to day business and operations, the independent contractor relationships is converted to a master-servant relationship, and thus Humbles is liable, as master, for the tortuous acts of its servant, Schneider.

RoL: Liability arises for a principal for its contractor’s torts if he exercises substantial control over the contractor’s operations.

**Duties of Agency**

Agency is a fiduciary relationship: power of fiduciary (agent) is for the sole purpose of advancing the purposes of its principal.

Duty of obedience: obey principal’s commands

Duty of loyalty: always exercise authority in such a manner that believing in good faith is in the best interest to advance the purposes of the principal and never for personal benefit.

Duty of care: to act in good faith in such a manner believing a reasonable person would act under similar circumstances.

*Duty of Loyalty*

Tarnowski V Resop

* Tarnowski retained the services of Resop to investigate and negotiate the purchase of a business from Loechler and Mayer. Investigation was superficial and was misrepresented by Resop who additionally received a secret commission from sellers.
* Tarnowski bought business relying on Resop’s work and discovered business was inadequate and he has been misled due to Resop’s misrepresentations. Tarnowski then sued for recovery of the secret commission as well as all direct and consequential damages and expenses.
* Tarnowski succeeded since an agent is liable for the profits made in representation of the principal, and an agent is also liable for all damages caused to the principal by the agent’s breach of duties.

RoL: Agent is liable i) for any profits made during the agency, and ii) for all damages caused to the principal by the agent’s breach of duties.

*Trustee’s duties*

In re Gleeson

* Gleeson appointed Colbrook as trustee of her property after disease for the benefit of her children. Colbrook leased the land and with his co-tenant held the land and farmed it for a year after Gleeson’s death.
* Colbrook failed to account for profits made as co-tenant and was sued by Gleeson’s children.
* Since a trustee cannot deal in his individual capacity, and Colbrook chose to be the trustee instead of continuing to be a co-tenant, no exception can be alleged and as a general rule the trustee must account for all profits.

RoL: Trustee of real estate being also the tenant must account to the trust for all profits made in his capacity as tenant.

**3. PARTNERSHIPS**

**Agency conflict**

Meinhard V Salmon

* Louisa Gerry leased a hotel to Walter Salmon who then entered into a joint venture with Meinhard to reconstruct and operate the hotel. Meinhard contributed 50% of the money and Salmon managed the business until the lease was to expire when the hotel was then leased to Midpoint Realty Company, owned and controlled by Salmon.
* Salmon failed to disclose this fact to Meinhard breaching his duty of loyalty since joint adventurers, as partners, owe to each other the duty of finest loyalty and those transactions normally allowed to those acting at arm’s length transactions are forbidden to those bound by fiduciary duties.
* Meinhard was excluded by Salmon, his co-adventurer, from any possibility to compete and any chance to enjoy the opportunity to benefit.

Dissent: This was not a general partnership but rather a venture for limited purposes and there was no interest to renew.

RoL: Joint adventurers owe to each other, while the enterprise continues, the duty of finest loyalty.

**Partnership formation**

Vohland V Sweet

* Sweet used to work for Vohland’s father and after his dead, Sweet and Vohland reached an agreement to continue the business. Sweet will receive a part of the business returns as a commission.
* Sweet succeeded proving that a partnership existed since his “commission” was structured more as a profit-sharing structure and he contributed labor and expertise.
* A partnership involves mutual contribution and mutual share of profits and if a contribution other than capital is integral to the business such contribution is sufficient to create a partnership.

RoL: Labor and expertise area contributions of a partner for purposes of the creation of a partnership. Intention to create is not necessary but rather intention to engage in acts that create a partnership is the general rule.

**Relations with 3rd parties – Claims of creditors**

Jingle rule: Evolved in 19th century and gave creditors of the partnership priority in all assets of the partnership, and gave first priority to the creditors of individual partners in the individual assets of partners.

New Rule: Creditors of partnerships have first priority in the assets of the partnership, but are placed on parity with individual creditors in the assets of individual partners when partnership is in Chapter 7 or if RUPA 807.

**Governance and Issues of Authority**

National Biscuit Co. V Stroud

* Stroud and Freeman created an equal partnership that bought bread from Nabisco until Stroud notified not to be responsible for more bread. However, Freeman ordered more bread and then they dissolved their partnership with most assets remaining with Stroud. Nabisco then sued payment.
* Stroud was compelled to pay Nabisco since Freeman’s last order was entered on behalf of the partnership and within its ordinary business and since all partners are jointly and severally liable, and in this case no partner had veto power over the other, Stroud former notice denying responsibility is of no effect.

RoL: Acts of any partner bound all co-partners if performed on behalf of the partnership within its scope of business.

**Termination**

Page V Page

* Page and Page entered into a oral unprofitable partnership and since one of the two partner was the owner of a corporation which is the largest creditor of the partnership, he whishes to terminate the partnership.
* Since partnerships may be solved by the express will of any partner when no definite term or undertaking is specified, the dissolving partner has the power to dissolve by express notice. Dissolution must be made on good faith without intention to appropriate the business without compensation to the co-partner.

RoL: Partnerships can be dissolved by the express will of any partner on good faith when no specific term is set.

**Limited Liability**

Business creditors cannot proceed against the personal assets of some or all equity investors.

Limited Partnership: Limited partners who do not manage business but share profits without incurring personal liability for business’ debts, and general partners who manage and are personally liable as in a normal partnership.

Limited Liability Partnership: All partners retain limited liability; used by professionals such as accountants and lawyers. Limited liability only to negligence, malpractice, wrongful act or misconduct of other partners or agents.

Limited Liability Company: All members enjoy limited liability; centralized management; freely transferable ownership interests; continuing life.

**4. CORPORATE FORM**

1) Legal personality with indefinite life; 2) limited liability for investors; 3) free transferability of shares; 4) centralized management, 5) appointed by investors.

**Centralized Management**

*Legal Construction of BoD – Holder of primary power*

Automatic Self-Cleansing Filter Syndicate Co. Ltd. V Cunninghame

* 55% majority shareholders wanted to sell company’s assets and the BoD opposed.
* Since the charter provides that the management and business remain on the BoD subject to any resolution of 75% shareholders, the mere 55% majority cannot override the resolution of the BoD opposing the sale of assets.
* Statute gives precedence to BoD and absolute power to do all things except for those reserved to shareholders subject to the provisions of the charter.

RoL: If the charter provides of a 75% vote of shareholders to override the decisions of the BoD, a mere majority may not override any resolution of the BoD.

**Corporate Officers: Agents of the corporation**

Jennings V Pittsburgh Mercantile Co.

* Pittsburgh’s VP, Egmore, met with Jennings, a realtor, to retain his services an obtain sale & leaseback proposals. Egmore represented that a committee controlled the company and was responsible for accepting offer and thereafter BoD approval was automatic. Jennings obtained several proposals but were rejected and his commission was denied.
* Egmore’s representations cannot give raise to apparent authority, which can only be inferred from actions of the principal and not of the agent, and since this was an extraordinary transaction, Jennings, an experienced realtor, should have reasonably inquired as to Egmore’s authority.

RoL: An executive officer does not have apparent authority to accept an extraordinary transaction.

**6. PROTECTION OF CREDITORS**

**Capital Regulation**

Stockholders equity: 1) stated/legal capital: capital stock, portion of value contributed by original shareholders, product of value of stock times the number of issued outstanding shares or discretionary portion of stock sale price;

2) capital surplus: difference between par value of stock and its sale price;

3) accumulated retained earnings/earned surplus: undistributed amounts of net profit.

Nimble dividend test: Dividends may be paid either out of: capital surplus and accumulated retained earnings, and if no capital surplus, out of net profits of current and preceding fiscal year.

Reducing stated/legal capital with par value requires amendment of charter by shareholder vote. BoD can transfer stated/legal capital within no par value on its own decision.

**BoD Liability**

Delaware Chancery Court (as well as Bankruptcy Courts) has held that when a firm is insolvent (even if no one has moved for bankruptcy protection), its BoD owes now a duty to consider the interests of the creditors of the corporations (since shareholders are residual creditors).

**Shareholder Liability**

*Equitable subordination*

Costello V Fazio

* Fazio, Ambrose and Leonard formed a partnership later incorporated and withdrew almost all their capital contributions left assumed as liabilities for the company, which operated with losses until it filed for bankruptcy.
* Since the partner left the company grossly undercapitalized, for the personal benefit of the shareholders acting as creditors who also acted as directors, taking advantage of said position and thus mismanaged the company to prejudice other creditors, claims of controlling shareholders must be subordinated to outside creditors.

RoL: It is inequitable to allow shareholders-creditors to share into the assets of a bankrupt company in the same parity with unsecured creditors, since they would receive a portion of the capital invested which should have been used to satisfy the claims of corporate creditors before any capital contribution could be returned to the shareholders.

*Piercing the corporate veil*

Sea-Land Services, Inc. V Pepper Source

* Ocean carrier Sea-Land shipped peppers to Pepper Source, which later dissolved and Sea-Land was unable to collect its bill. Sea-Land sued and was unable to recover judgment since PS had no assets and therefore sought to pierce the corporate veil and hold sole shareholder Marchese and related companies liable.
* Corporate veil will only be pierced where: i) a unity of interest and ownership is evidenced that separate existence between a corporation and an individual or other corporation no longer exist, and ii) circumstances are such that holding separate corporate existence would result in the sanction of a fraud or promote injustice.
* Since Sea-Land evidenced that i) no corporate records and formalities were not maintained by PS, ii) its funds and assets were commingled with those of Marchese and other related companies, iii) PS was undercapitalized and iv) corporate assets were shifted to other companies, but failed to evidence the intention and wrong-doing of PS of such conduct resulting in its unsatisfied judgment, corporate veil cannot be pierced because only one of the two prongs of the test was proven.

RoL: Corporate veil will only be pierced if: i) unity of interest and ownership between corporation and individual or other corporation exist, and ii) holding otherwise (the separate corporate existence), would sanction fraud or promote injustice.

Kinney Shoe Corp. V Polan

* Kinney entered a sublease with Industrial Realty Company, which sole shareholder is Polan, and which corporation had no paid-in capital and failed to observe any corporate formalities. Industrial further subleased a part of the building to Polan Industries, Inc., which sole shareholder was also Polan.
* Polan made no investment in Industrial, which was only a shell and had no assets or income beside the Polan Industries sublease, albeit the first payment to Kinney was made directly by Polan’s personal funds and no other payments were made.
* Kinney sued to pierce the corporate veil and hold Polan personally liable and succeeded since in a breach of contract plaintiff must assert i) unity of interest and ownership such that separate personalities no longer exist, and ii) an inequitable act results if acts are treated as those of a separate corporate existence.

RoL: In a breach of contract, corporate veil is pierced if i) unity of interest and ownership is such that separate personalities are lost, and ii) considering the acts of the corporation alone would produce an inequitable result.

*Veil Piercing for Involuntary Creditors (Torts)*

Walkovzky V Carlton

* Walkovzky was hit by a taxicab operated by Seon Cab Corporation, in which Carlton was a shareholder as well as in other 10 corporations which sole asset is 2 taxicabs.
* Walkovzky fell short to adequately state a cause of action against Carlton since he did not evidenced that shareholder Carlton was acting in his individual capacity commingling their funds with those of the corporations.

Dissent: Corporations were intentionally undercapitalized to avoid liability.

RoL: If a corporation is part of larger corporate entity that actually runs the business, veil will not be pierced to hold individual shareholders liable, despite that they will be liable to contract and tort creditors if they used the corporation to further their personal business rather than the corporation’s business.

Note: Walkovzky amended complaint to state a cause of action and Carlton was then held liable.

**7. VOTING SYSTEM**

Right to vote, right to sell and right to sue. Issue for corporations: collective action problem and costs in large companies.

Cumulative voting: number of votes times number of directors, thus minorities will guarantee at least to elect one director. E.g.: 300 shares, shareholder A 199 shares, shareholder B 101 shares, 3 directors, A will have 199X3=597 votes to allocate in 3 positions, B will have 101X3=303 votes to allocate in 3 positions and thus can use all such 303 in one position to defeat A which cannot allocate all its vote to win 303.

Staggered BoD: classified directors are successively elected in different periods. E.g.: class A directors are elected in year 1, class B in year 2, and class C in year 3. Gaining control of the BoD by a single shareholder is difficult since needs to win at least 2 elections deferred in time.

**Proxy voting**

Rosenfeld V Fairchild Engine & Airplane Corp.

* An amount of money was paid from corporation to reimburse both sides on a proxy contest: old BoD spent o defend their positions and new BoD gave additional amount, and new BoD, as ratified by the shareholders, was paid expenses too. Shareholder Rosenfeld sued although the new BoD resolved these reimbursements were reasonable and acted in good faith.
* Rosenfeld did not succeed since BoD is allowed to make expenditures to persuade shareholders and solicit vote, otherwise, incumbent BoD will be unable to defend their position and shareholders have the right to reimburse new BoD for their expenses to contest for their position.

RoL: When BoD acts in good faith in a contest over certain corporate policy, they have the right to incur reasonable and proper expenses for solicitation of proxies in defense of their policies.

**Separating Control from Cash Flows**

*Circular control structures*

Speiser V Baker

* Speiser (50% shareholder of Health Med Corporation, one of its two directors and its president) sought judgment to require holding a shareholders meeting to elect directors. Baker (50% shareholder of Med and the other director) counterclaimed that Speiser is calling the meeting only to remove him of the BoD and that Med is not allowed to vote its 42% shares in Health Chem at such shareholders meeting pursuant to the statutory provision (DGCL 160 (c)) prohibiting to vote shares that “belong” to the issuer corporation (Chem).
* Chem’s stock was held: i) 42 % by Med, ii) 40% by the public, iii) 10% by Speiser, and iv) 8% by Baker.
* Med’s stock was held: i) 50% common stock by Speiser, ii) 50% common stock by Baker, and iii) Medallion Corp. (“Medallion”) owned convertible preferred stock representing: a) unconverted, 9% voting power, and b) converted, 95% of voting power.
* Medallion stock was entirely held (100%) by Chem.
* This structure allowed Speiser and Baker to control all entities. Conversion of preferred stock of Medallion (indirectly Chem) in Med will destroy control.
* A shareholders meeting must be met if it has not been met in contravention to statute, even if one of two directors will be removed.
* Stock hold by a subsidiary may “belong” to the issuing corporation controlling said subsidiary and thus shall not be voted. Despite that Chem (through Medallion) does not hold a majority entitled to elect directors in Med, historic common law analysis of former like statutory provisions and case law (Italo Petroleum Corp v. Producers Oil Corporation) set forth that where the effect of this structure is to harm the vote of the public shareholders, the prohibiting rule (DGCL 160 (c)) is applicable.

RoL: A corporation failing to hold a shareholders meeting to elect directors in contravention of statute must do so even if it means that a directors shall be replaced. Prohibition to vote stock by a corporation “belonging” to the same corporation, is applicable where such stuck is held by a subsidiary even if the majority of shares to elect the BoD is not held in such subsidiary.

*Vote buying*

Schreiber V Carney

* Jet Capital, a shareholder of Texas International Airlines, Inc. agreed not to exercise its veto voting rights to oppose a merger of TIA upon receiving a loan by TIA as consideration. Merger of TIA would have tax and financial adverse effects on Jet unless it exercised several warrants (options for shares) held in TIA. Jet lacked necessary funds and found a third part loan too expensive.
* A loan from TIA to Jet was suggested and since several directors were shared by TIA and Jet, a des-interested committe, based on external independent counsel advice, agreed a loan plan approved by TIA’s shareholders.
* Schreiber, a dissenting shareholder, brought action to void transaction based on vote-buying prohibitions and did not succeed since court considered that i) vote-buying is uniformly sanctioned in case law (Cone v. Russell and Brady v. Bean) only where a fraudulent animus is present harming the rights of other shareholders, and that, ii) present law is much more lenient towards these type of transactions, especially considering the approval of voting trusts (Ocean Exploration Co. v. Grynberg), and agreements should thus be examined in light of its object or purpose. Furthermore, since in this case TIA’s shareholders approved the transaction, which was mainly entered into to further their interests, vote-buying is not prohibited per se.

RoL: Vote-buying is permissible if it does not harm other shareholders.

**Federal Proxy Rules**

Section 14: Prohibition to solicit proxies or consent in contravention to SEC rules.

R14a-1 –

14a-2: Definitions, applicability and exceptions.

R14a-3: No one may be solicited for a proxy unless they are or have been furnished with a proxy statement containing information specified in Schedule 14A.

R14a-4 –

14a-5: Regulate the form and requirements of the proxy and the proxy statement, respectively.

R14a-6: Provides for the requirements of the formal filing with SEC.

R14a-7: Sets forth the list-or-mail rule for dissident shareholders to be provided by the corporation.

R14a-8: Provides for shareholders proposals to include their suggestions in the proxy materials. Section (i) provides for such proposals that can be excluded from the materials. Proposals may be on corporate governance or corporate social responsibility.

CA, Inc. V AFSCME Employees Pension Plan

* + - Certification of questions sought by the SEC from the DSC. AFSCME proposed to include in the proxy materials of the CA annual shareholders meeting an amendment to by-laws to reimburse expenses incurred by shareholders. CA sought a no-action letter from SEC and AFSCME responded.
    - DSC held as RoL that: i) a proposal seeking to amend by-laws to require reimbursement of expenses incurred in election of directors is proper to be included in a proxy statement; and ii) that such a proposal, if adopted, would contravene Delaware law since would prevent BoD to exercise their fiduciary duties if so required to deny reimbursement.

R14a-9: Prohibition against false or misleading proxy solicitations. Fraud SCOTUS elements: i) materiality, it is material only if there is substantial likelihood that a reasonable shareholder would consider it important; ii) culpability, no standard defined yet but proof of scienter (intention or extreme recklessness) has been required; iii) causation and reliance, causation need to be proved but can be presumed if misrepresentation was material and proxy solicitation was essential to accomplish transaction; iv) remedies, injunctive relief, rescission or monetary damages.

Virginia Bankshares, Inc. V Sandberg

* + - 1st American Bank merged with VBI on a freeze out merger based on a price determined by an investment banker, and pursuant to a shareholder approval recommended by the proxy solicitation of the BoD. Shareholder Sandberg sued alleging violation of Section 14 and R14a-9 alleging she would have received a higher price.
    - Court concluded, that i) a higher price was evidenced and never disclosed and thus the proxy statement was misleading as to the suggested price; and ii) that regardless of the foregoing, there was no causation since the vote of the minority shareholders were not required to approve the transaction and thus the “essential link” test is not met.

Dissent: There are no ground to limit Section 14 to those situations where the minority has enough vote to oppose a proposal, such Section is designed to protect all investors through adequate disclosures thus the minority can participate.

RoL: Individuals are permitted to prove misleading or false statements in proxy statements. And causation can not be alleged by minority shareholders whose vote is not required to authorize the transaction.

**8. DUTY OF CARE**

ALI principles of Corporate Governance: D&O are required to perform their functions i) in good faith, ii) in a manner they reasonably believe to be in the best interests of the corporation, and iii) with such care that an ordinary and prudent person would reasonably be expected to exercise in a like position under similar circumstances.

Gagliardi V Trifoods International, Inc.

* Shareholders of Trifoods sued BoD for losses allegedly caused due to mismanagement.
* Recovery was denied since shareholder failed to prove BoD did not act in good faith and/or failed to act as an ordinarily prudent person would have acted under similar circumstances. Absent a financial conflict, D&O are not liable for corporate losses and are protected by the business judgment rule. This makes sense since shareholders would not want D&O to be risk averse and it is in the best interest of shareholders to protect D&O so as to be confident that if they act in good faith and meet minimal standards of attention will not be held liable for a business loss.

RoL: Shareholders must evidence that D&O did not act in good faith and/or failed to act as an ordinarily person would have acted under similar circumstances, in order to recover damages from mismanagement.

**Indemnification**

Waltuch V Conticommodity Services, Inc.

* Waltuch traded silver for Conti until market fell and clients sued both for fraud and antitrust acts. Conti settled all claims and Waltuch claimed reimbursement of expenses under Art. 9 of by-laws and Conti claimed that DGCL 145(a) bars indemnification to the extent D&O acted in good faith which was not evidenced; Waltuch further claimed DGCL 145(f) allows corporations to indemnify outside the good faith limit of DGCL 145(a) as Art. 9 did.
* Court held that i) Art. 9 of the by-laws contravene DGCL 145(a) permitting indemnification only on a good faith basis and therefore Waltuch was not entitled to indemnification; however, ii) if D&O are successful on the merits or otherwise in their defense, as Waltuch did by settling, they are entitled to indemnification under DGCL 145(c).

RoL: No provision in corporate documents can indemnify D&O without including a good faith limitation as provided for in applicable statute even if the same statute allows for additional indemnification rights. If D&O are successful on the merits or otherwise on their defense, they shall be indemnified.

**Business Judgment Rule**

Kamin V American Express Co.

* Amex spent $30M acquiring stock in Donaldson, Lufken and Jenrette and further decided to pay a dividend in kind with such shares. Minority shareholder Kamin claimed that such a decision was a negligent violation of their duties since value of the shares was lower and they could have sold and gain a taxable loss resulting in tax savings.
* Court held that such a decision is of exclusive to the business judgment rule of the BoD and judiciary shall not interfere as long as made in good faith.

RoL: Business judgment rule cover decisions whether to pay dividends and courts will not scrutinize unless bad faiths is involved.

Business judgment rule (ABA Corporate Director’s Guidebook): a decision constitutes a valid business judgment (and gives raise to no liability) when it i) is made by financially disinterested D&O, ii) who are duly informed before exercising judgment, and iii) who exercise such judgment in a good faith effort to advance corporate interests.

**Duty to monitor: Losses resulting from passivity of the BoD**

Francis V United Jersey Bank

* Mrs. Pritchard inherited an interest in Pritchard & Baird after her husband death. Shes and her two sons were directors and hers sons withdrew money from clients account until bankruptcy. Bankruptcy trustee sued her liable for the clients losses.
* Court found her liable despite the fact that she was a heavy drinker and under psychological effects of her husband’s death, since inherent to her role was the duty to acquire a basic business understanding and keeping her informed on the business activities and overall monitoring reviewing financials; her negligent failure to do so contributed to clients losses since she could have noticed such misappropriations.

RoL: D&O liability to its clients requires to prove that i) a duty existed, ii) D&O breached such duty, and iii) such a breach contributed to clients losses.

Graham V Allis-Chamber Manufacturing Co.

* Allis’ BoD was sued by its shareholders since Allis was indicted and it pleaded guilty for antitrust violations. BoD was not aware of the antitrust conduct and had no suspicion of knowledge of any acts that put them on notice.
* Action did not prosper since the court concluded that D&O can not be liable if they have no knowledge or suspicion of wrongdoings and absent such cause they have no duty to impose any espionage system; it was impossible for them to know every employee and they focused on policy matters.

RoL: D&O who have no knowledge or suspicions of wrongdoings by employees are not liable.

Red flag doctrine: D&O rely on integrity of subordinates until a red flag appears.

In re Caremark International Inc. Derivative Litigation

* Caremark entered into several contracts with physicians that prescribed their products, which were monitored internally by the BoD and in response made structural changes, however it was indicted for violations to Anti-referral payments Law and shareholder sued and Caremark agreed to settle. Settlement agreement was submitted to court for review.
* Court concluded that the settlement was fair since BoD has an affirmative duty to try in good faith to assure that monitoring systems exist and are adequate, which the BoD appears to have done, and that derivative litigation was unlikely to success but Caremark was concessional.

RoL: BoD has an affirmative duty to make good faith efforts to assure corporate monitoring systems and information exist and are adequate.

Caremark standard: Red flag approach is sufficient; effort to have an adequate information and reporting system.

In re Citigroup Inc. Derivative Litigation

* Shareholders of Citi sued its current and former D&O of breaching their fiduciary duties since they failed to properly manage and disclose risks of Citi in subprime mortgage market. Alledgldey “red flags” should have put them on notice but they ignored them.
* Citi’s D&O were not held liable since the discretion granted to them allows them to maximize value by taking risks without fearing to be held liable for any business losses.

RoL: D&O do not breach their fiduciary duties failing to oversee company’s risk exposure.

Adjustment to Caremark standard: duty to monitor does not apply to monitor risk.

**“Knowing” Violations of Law**

Miller V AT&T

* Democratic National Convention owed AT&T millions, which AT&T’s officer failed to try to collect and the shareholders sued based on breach of fiduciary duties since such a debt relief was in violation of illegal campaign contribution laws.
* D&O were found liable since the business judgment rule cannot operate in their defense where they have acted in bad faith influenced by personal considerations and incurring in illegal acts.

RoL: Business judgment rule does not hold D&O free of liability if they have committed illegal or immoral acts.

**9. DUTY OF LOYALTY**

Requires D&O and controlling shareholders to exercise their institutional power over corporate processes and property (including information) in a good faith effort to advance the interests of the corporation. Duty is owed to the corporation itself as a legal entity; ultimately, to equity investors.

A.P. Smith Manufacturing Co. V Barlow

* Smith made a contribution to Princeton University and shareholders sued, claiming i) it was not expressly authorized in the charter for Smith to do so, and ii) NJ laws expressly authorizing the donation do not apply to Smith since it was incorporated before enactment of said law.
* Court held that a law enacted in the public interest can be validly applied to preexisting entities under reversed power since NJ courts have confirmed such reversed power even if it affects contractual relationships and thus Smith’s lawfully exercised its powers under common law.

RoL: Laws applied in the public interest can be applied to preexisting corporation under reversed power.

**Self-dealing Transactions**

*Disclosure*

State ex rel. Hayes Oyster Co. V Keypoint Oyster Co.

* Verne Hayes was CEO, director and 23% shareholder of Coast Oyster Co. and negotiated a sell of oyster beds to Keypoint Oyster, a company incorporated by Engman and that would be 50% owned by Hayes Oyster. Coast’s BoD and shareholders approved the transaction, Hayes voting his shares and other proxies for a majority and two years later Hayes left Coast and new management sued on breach of fiduciary duties.
* Hayes was held liable and Keypoint was order to cancel its shares owned by Hayes Oyster and issue them to Coast, since Hayes did breach his fiduciary duties failing to disclose the conflict of interest, the interest he had on the transaction and the advantage he took out of it. It is irrelevant it Coast was damaged or it Hayes intended to defraud, it only matters that Hayes was not loyal to Coast.

RoL: D&O breach their fiduciary duties if they fail to disclose any conflict of interest or personal advantage they would obtain in a transaction involving the corporation they owe said duties to.

*Controlling Shareholders and Fairness Standard*

Sinclair Oil Corp. V Levien

* Sinclair was majority shareholder and effectively controlled Sinclair Venezuelan Oil and its BoD. Minority shareholder Levien sued alleging excessive payment of dividends, denying business opportunities to SinVen, and harm to SinVen through breach of contract between SinVen and Sinclair International Oil, wholly owned subsidiary of Sinclair.
* Court held that i) all SinVen shareholders benefited from the dividends and Levien failed to prove denial of business opportunities belonging to SinVen thus no self-dealing was demonstrated and the business judgment rule shall apply; and ii) that since Sinclair did engage in self-dealing when the contract between SinVen and Sinclair Int’l was entered and Sinclair failed to prove that the contact was fair to SinVen, Sinclair should be held liable in that part.

RoL: Intrinsic fairness test is only applied where fiduciary duties exist accompanied by self-dealing business transactions. Absent self-dealing, the business judgment rule should be applied.

Intrinsic Fairness Test: shifts burden of proof to the defendant to demonstrate the fairness of any specific transaction. Plaintiff must first prove the existence of fiduciary duties and self-dealing by the defendant.

**Approval by Disinterested Parties**

*Safe harbors*

Cookies Food Products V Lakes Warehouse

* Financially distressed Cookies engaged with Duane “Speed” Herrig owner of Lakes Warehouse to distribute its products at Herrig’s own costs. Herrig’s success led him to purchase Cookies majority shares and gain control of it, replace its BoD, extend exclusivity terms and with Lakes and increase compensations for him and Lakes. No dividends were paid to Cookies shareholders and they sued on breach of duty of loyalty.
* Court held that since Herrig’s services were neither unfairly priced nor contrary to Cookies’ corporate interests, Cookies profited under Herrig’s control, and Herrig produced sufficient information to Cookies BoD to make prudent decisions and all members were aware of Herrig’s interests in the transactions with Lakes, Herrig did not breached his duties to Cookies.
* Moreover, statute provided that no transaction with D&O shall be void if any of the following occur: i) conflict of interest is disclosed or known to the BoD and BoD authorizes without votes of interested members, ii) conflict or interest is disclosed or known to shareholders and they authorize, or iii) transaction is fair and reasonable to the corporation.

Dissent: Decision is blinded by Cookies success and failed to assess that Herrig failed on his burden of proof to evidence that all self-dealing transactions were fair.

RoL: D&O engaged in self-dealing transactions must prove that they acted in good faith, honesty and fairness.

*Approval by Disinterested BoD*

Cooke V Oolie

* Sam Oolie and Morton Salkind were TNN’s directors and creditors and approved a transaction that allegedly favored them as creditors which was approved by disinterested directors, but shareholders still sued.
* Court presumed that the business judgment rule applied to Oolie and Salkind and that shareholders had the burden of proof to rebut it, and since the disinterested directors approved the transaction having no incentive to act disloyally, the Court further concluded that such an approval evidenced that the interested transaction furthered the best interests of the corporation.

RoL: Interested D&O approval of an interested transaction is protected with the business judgment rules if disinterested D&O ratify or approve said interested transaction.

*Approval by Disinterested Special Committees of Independent members of BoD*

Such Committee must negotiate a fear deal and obtain the best deal available advancing corporate interests. Such approval, even with a due process of the Committee, only shifts burden of proof from defendant to plaintiff to show unfairness, which is a substantial burden.

*Shareholder Ratification of Interested Transactions*

Lewis V Vogelstein

* Since this case involves a waste of assets, court concluded that unanimous shareholder approval has the effect of protecting the transaction because no one can be forced against their will to make a gift of their property.

RoL: Unanimous shareholder approval is required to ratify a conflicted transaction involving corporate waste.

In re Wheelabrator Technologies, Inc.

* WTI was bought by Waste Management Inc., as approved by WTI’s BoD including 4 interested directors that were also Waste’s directors, and further shareholders approval which included a 22% of Waste. Others shareholders sued alleging breach of duty of loyalty.
* Court held that shareholder ratification does not automatically extinguishes claims but rather only shifts the burden of proof to the plaintiffs (shareholders), the business judgment rule being applicable. Here the shareholder plaintiffs have such burden of proof.
* Court considered two types or ratification of transactions involving breach of duties: i) director-interested transactions, in which case if approved by informed shareholders the business judgment rules becomes applicable (the plaintiff shareholders having the burden to proof violation), and ii) controlling shareholder-interested transactions, which are normally conditioned to approval of a majority of the minority, in which case if approved by such shareholders, the standard of entire fairness remains applicable but the burden shifts to the plaintiff to show the transaction was unfair (conversely to the general rule under the entire fairness standard in which the defendant BoD must show that the transaction was fair).

RoL: Informed shareholders ratification of interested transactions subjects a claim of breach of fiduciary duties to the business judgment rule.

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| **Standard of Review for interested director transaction**  **Non-controlling SH transaction**  (if controlling SH transaction: entire fairness – Cookie) | | |
| Standard of Review + burden of proof | DGCL §144 | ALI §5.02 |
| Neither board nor SH approve | Entire Fairness, with burden on defendant (as in Cookie) | Entire fairness, burden on defendant |
| Disinterested directors approve | BJR, with burden on plaintiff (Cooke v. Olie) | §5.02(a)(2)(B): Reasonable belief in fairness, burden on plaintiff |
| SH ratify | BJR/Corporate Waste, burden on plaintiff (Lewis + Wheelabrator) | §5.02(a)(2)(D): Corporate Waste, burden on plaintiff |

**Management Compensation**

Lewis V Vogelstein

* In this case the grant of options to the BoD was sufficiently unusual in order to require further inquiry whether it constituted waste, thus shareholder ratification should be substantially considered.

RoL: A court should grant substantial effect to shareholders ratification to grant options to BoD in assessing whether such a grant constitutes a waste.

In re The Walt Disney Company Derivative Litigation

* Disney’s CEO Michael Eisner suggested hiring his friend Michael Ovitz placing significant pressure on the BoD for such purposes making press releases and negotiating on his own. The compensation committee of the BoD approved the employment agreement and the BoD was aware that if Ovitz was terminated without a cause he could receive hundreds of millions. When Eisner could not work with Ovitz and was let go, the shareholders sued claiming breach of fiduciary duties, good faith and/or corporate waste.
* Court held that: i) the BoD did not act in bad faith, at most with ordinary negligence, hiring Ovitz, and since under the business judgment rule ordinary negligence does not represent violation of duties, breach was committed, ii) Eisner had no obligation to inform the BoD of everything and regardless of such fact he acted in good faith believing it was in the best interest of the corporation to hire Ovitz, iii) since the BoD has the right but not the duty to fire officers and since the CEO was in charge of day to day management, they believed Eisner had authority to do so and thus were not required to act therefore not breaching any duties nor acting in bad faith, and iv) Eisner assessed the alternatives to fire Ovitz and considered in good faith without violating his duties that letting him go despite the high cost was the best alternative.

RoL: In order to determine whether fiduciary duties have been violated by failure of the directors to act in good faith, evidencing (by the plaintiffs) that a conscious and intentional disregard of one’s responsibilities (intentional dereliction) is an appropriate standard to prove bad faith.

Legacy:

1. Plaintiffs must prove that the presumption of the business judgment rule does not apply, either because i) D&O breached their fiduciary duties, ii) acted in bad faith, or iii) made an unintelligent, unadvised decision failing to inform themselves before deciding;
2. If plaintiffs fail to rebut the business judgment rule presumption, defendants will prevail.
3. If plaintiffs succeed to rebut the business judgment rule presumption, burden shifts to defendants to prove that the transaction was entirely fair.
4. Mere negligence (lacking degree of attention that a reasonable person in similar situation would) does not give raise to liability since the business judgment rule prevails (possibility to dismiss).
5. Gross negligence may be the basis for a breach of fiduciary duties resulting in liability; however, such gross negligence can be waived through waivers in charter provisions (waive-able gross negligence).
6. Such waivers of liability under gross negligence may not waive liability for breaching the duty of loyalty acting in bad faith (a profound inattention that lacks of any good faith – non waive-able gross negligence involving breach of duty of loyalty not in good faith: abandonment of office).

**Corporate opportunities**

1. “Expectancy test” that gives the narrowest protection to the corporation applying in which an expectancy or interest must grow out of an existing legal interest and the appropriation will in some degree balk the corporation in effecting the purpose of its creation.
2. “Line of business test” that classifies any opportunity falling within a company’s line of business as its corporate opportunity.
3. “Fairness test” taking unto consideration factors like how a manger learned of the opportunity, whether corporate assets were used to exploit it and other specific facts evidencing good faith and loyalty to the corporation.

When can fiduciary take it: full disclosure of opportunity, and BoD decides in good –faith not to take advantage of it.

**Loyalty in Close Corporations**

Donahue V Rodd Electrotype Co.

* Harry Rodd, controlling shareholder of Rodd, caused the corporation to repurchase his shares and then distributed the rest of his investment with his family. Euphemia Donahue, a minority shareholder refused to ratify transaction and was denied the offer to sell her shares at the same price and the sued.
* The court found that this was a close corporation since there was i) a small number of shareholders, ii) no ready market for tock, and iii) substantial majority shareholder participation in management, and thus resembled it with a partnership where the relationship among stockholders must be of trust, confidence and absolute loyalty (“the duty of finest loyalty”). Thus the court concluded that the controlling group may not use its control to obtain special advantages and must cause the corporation to offer the same opportunity to all shareholders at identical price.

RoL: Controlling shareholders in a close corporation breaches its fiduciary duty of loyalty to the other shareholders if he does not cause the corporation to offer the other shareholders the same opportunities to repurchase its shares.

Smith V Atlantic Properties, Inc.

* Louis Wolfson purchased a piece of land and then offered a 25% interest to Paul Smith, Abraham Zimble and William Burke. Atlantic was further incorporated to operate the land and each received 25% shares. Bylaws required 80% voting for any resolution. After years accumulated earning accrued to an amount, which incurred in penalties by the IRS due to the denial of Wolfson to vote for the payment of dividends.
* The court found that since Wolfson was warned of the penalty and he still denied, he unreasonably used a provision of the by-laws designed to protect minorities to the detriment of other shareholders committing a breach of his fiduciary duties.

RoL: Minority protective provisions in corporate documents create a fiduciary duty on minority stockholders to use them reasonably without harming corporate interests or other shareholders.

**10. SHAREHOLDER LAWSUITS**

Direct actions: Normally brought as class actions, gathering together many individual direct claims that share common aspects and seek to recover damages suffered individually.

Derivative actions: Assertion of corporate claim against D&O alleging a wrongdoing to the corporation which indirectly (derivatively) damaged the shareholders though recovery is sought for the corporation and not individually.

Plaintiff must remain being a shareholder during the whole action, he must have been a shareholder at the time of the alleged act, and must lack any conflict of interest.

Demand rule: Right of shareholder to bring a derivative suit is limited to situations where the stockholder has first demanded the BoD to pursue the clam and they have wrongfully refused to do so or where the demand is excused because BoD is incapable to make and impartial decision regarding such litigation.

**Attorney’s fees and Incentives to Sue**

Fletcher V A.J. Industries, Inc.

* Fletcher brought derivate suit alleging Ver Halen dominated the company and that Malone, the treasurer, received excessive salary, thus causing harms to the corporation. A settlement was reached and Ver Halen’s authority was restricted, Malone removed from the treasury and new members were appointed to the BoD. Monetary claims were referred to future arbitration, as well as attorney’s fees.
* General rule is that party prevailing may not recover attorney’s fees unless statute expressly allows so. An exemption is the common fund rule where if a party sues to protect a common fund he is entitled to attorney’s fees.
* Court held that the common fund has been applied to actions where the corporation receives a monetary judgment like the one to be awarded in future arbitration and that in this case another exemption was created where the corporation received a substantial benefit from the management reorganization achieved. Attorney’s fees were awarded.

Dissent: This new rule exemption should be created by the legislature where statutes specifically limit attorney’s fees.

RoL: Attorney’s fees are properly awarded if the corporation has substantially benefited from the action, even if the corporation receives no monetary awards (“Substantial benefit” rule).

**Demand Requirement**

Levine V Smith

* GM’s largest shareholder, Ross Perot, and other shareholders sold back their shares in response to disagreement with senior management. Shareholders sued alleging that Perot was paid a premium in order to stop his criticism against GM. Shareholders claim demand futility and wrongful refusal of their demand by the BoD.
* Court held that i) when lack of independence is charge, plaintiff must show that the BoD is either dominated by a director who is proposing the challenged transaction, or that the BoD is under his influence that discretion is sterilized, and ii) a plaintiff in a demand in futility must argue specific facts creating reasonable doubts as to the soundness of the challenges transaction sufficient to rebut the business judgment rule presumption that attaches the transaction. Therefore the court solved that independent directors were capable of impartially consider a demand and thus plaintiffs failed to plea facts sufficient to raise a doubt that a majority of the BoD acted so uninformed as to fail to exercise due care.

RoL: In order to dismiss their action, plaintiffs claiming demand futility or wrongful refusal of demand must allege particular facts sufficient to overcome the business judgment rule presumption. BoD decision to refuse shareholders demand is protected by the business judgment rule and it is the burden of the plaintiffs to rebut it.

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| Summary:  Rule 23.1 = the Pre-suit Demand Rule: before starting a derivative suit, shareholders have to “demand” to the BoD  There are 2 possibilities that may be problematic: either the shareholders demanded but their demand was refused (=demand refused), or they didn’t demand because of the futility of the demand (=demand excused).  Issue: If shareholders bring a derivative suit in both a “demand excused” and a “demand refused” context, the BoD will file a motion to dismiss based on Rule 23.1, which requires a pre-suit demand. To determine the sufficiency of a complaint to survive dismissal under Rule 23.1, there is a 2-prong test (Arinson-Levine Test).  In case of demand futility/demand excused: this 2-prong test applies. The shareholders will survive the motion to dismiss (and will thus be able to bring their derivative claim) if they prove:  That board was not independent or disinterested, OR (if they fail to prove this)  That the challenged transaction was in bad faith or gross negligence (Business Judgment Rule).  In case of demand refused (demand made but refused):  The Delaware Supreme Court infers that the plaintiffs concede that board is independent and disinterested. Thus, the 1st prong of the test is not satisfied.  The only possibility is the 2nd prong of the test: Transaction was not exercise of valid Business judgment (May bad faith or gross negligence be inferred from the challenged transaction?).  🡪 Conclusion: In Delaware, Universal Non-Demand: SH will never “demand” to the board because demanding would suppress the SH’s ability to claim the absence of interest of the Board. SH just can prove gross negligence or bad faith, which is very difficult. SH will thus never survive motion to dismiss if they make a “demand”. |

Rales V Blasband

* Blasband, stockholder of Danaher Corp., was also stockholder of Easco Hand Tools, Inc., which was acquired by Danaher. Rales brothers have been directors, officers and shareholders of both companies. Blasband alleged misuse by Easco’s BoD of the process of the sale of notes to buy junk bonds instead of buying government securities or invest in corporate purposes and outstanding debt; it was also alleged that such junk bonds were only bought to help Rales brothers’ friend Drexel, seller of the junk bonds.
* Since all members of Easco BoD were found either financially interested or incapable to act independently, Blasbnad allegations establish that demand is excused on the BoD.

RoL: The standard for determining demand excusal is whether the BoD was capable of impartially consider the action without being influenced by improper considerations.

*Special Litigation Committees*

Zapata Corp. V Maldonado

* Maldonado, shareholder of Zapata, sued Zapata’s BoD and was excused to make prior demand since all the BoD members were being sued. BoD has now changed and appointed a “special litigation committee” that recommended to dismiss the action.
* Court held that an independent committee such as that involved in this case, could properly act for the corporation to dismiss the action believing it is detrimental to the corporation’s best interests, and that the courts should apply a two-step test to assess their motion to dismiss.

RoL: When a demand is excused and derivative action is initiated, the BoD (or special committee) can move to dismiss and the court should apply a two-step test in order to: i) inquire about the independence and good faith of the special committee and the basis of their conclusion, and if satisfied, ii) in its discretion may apply its own independent business judgment to determine whether the motion to dismiss should be granted.

In re Oracle Corp. Derivative Litigation

* Shareholders of Oracle sued alleging insider trading by four members of the BoD, which created a special committee concluding, based on extensive investigation, that action should not proceed.
* Court found that since two members of the committee were professors at Stanford University, which was strongly linked to Oracle due to large donations from the company, the committee can not be considered independent. Law should take into account human factors and motivations.

RoL: A special litigation committee does not meet its burden to prove its independence where its members are professors at a university that has ties to the corporation.

Joy V North

* Special litigation committee of Citytrust recommended dismissing action brought in federal court under diversity jurisdiction.
* Federal court found that state law would require judicial review of the decision of the committee and they would have to prove that continuing the litigation would very likely be against the corporate interests.

RoL: Special litigation committee recommendation to dismiss derivative action must also prove that the derivative action is likely to be against corporate interests. Under Zapata, the committee must persuade the court that i) they were independent, ii) they acted in good faith, and iii) they had reasonable basis for their recommendation to dismiss, and if so evidenced, the court may in its discretion undertake its own examination.

*Settlement by Special Committee*

Carlton Investments V TLC Beatrice International Holdings, Inc.

* Carlton brought derivative action alleging breach of fiduciary duties by BoD of TLC Beatrice in connection with compensation of former CEO. After disputes the BoD added two new directors to integrate a special committee, which after investigation suggested settling the case. Carlton claimed settle was inadequate.
* Court held that the two steps in Zapata to i) review committee’s independence, good faith and reasonableness, and ii) apply their own business judgment, are necessary and found that the committee was independent and acted in good faith and well informed proposing reasonable solutions, which shall be enough to support, but notwithstanding, it further held that in applying its own business judgment, it was a reasonable settlement.

RoL: A settlement proposal negotiated by a special committee must be review under the two-step test in Zapata.

**11. TRANSACTIONS IN CONTROL**

**Control Premium**

Zetlin V Hanson Holdings, Inc.

* Zetlin was a 2% shareholders in Gable Industries together with Hanson Holdings and the Sylvestri family who were the controlling shareholders and sols their controlling shares at a premium price to Flintkote Co. when the share was trading at the open market at a lower price. Zetlin sued alleging all shareholders required to have the same opportunity.
* Court held that claim can not be held since it would require that a controlling interest be transferred only by means of an offer to all shareholders (a tender offer), meaning such a radical change that only the legislature can command.

RoL: Absent looting of a corporate asset, conversion of a corporate opportunity, fraud of other act of bad faith, a controlling shareholder is free to sell and purchaser free to buy a controlling interest at a premium price.

Perlman V Feldmann

* Russell Feldmann dominant shareholder and chairman of the BoD of Newport Steel Corporation sold his controlling interest to a syndicate of competitors, Wilport Company, together with the power of the company to allocate their product in a time of short supply, which was considered looting of a corporate asset and thus Perlman and minority shareholders sued.
* Court found that since the sale resulted in a sacrifice of and element of corporation’s good will and consequent unusual profit to the fiduciary that caused such sacrifice he should be accountable for his gains.

Dissent: Feldmann had no duty as controlling shareholder-fiduciary to refrain from selling. If the implication is that in particular market conditions controlling shareholders have a fiduciary duty not to sell, it cannot be agreed. Feldmann did not receive excessive price since his stock was also worth more than a non-controlling block. If a corporate asset was sold, the corporation should receive the consideration not the other shareholders.

RoL: Majority shareholders can sell their controlling interest without having to account to the corporation for any profits but when such sale involves the sacrifice of corporate good will and a consequential unusual profit to the selling fiduciary, he should account for his gains.

**Sale of Corporate Office**

Carter V Muscat: BoD of Republic Corporation appointed new BoD as part of a transaction in which they sold their controlling stock slightly above market; Court upheld.

Brecher V Gregg: Gregg, CEO, received a 35% control premium on his stock in exchange to secure appointment of buyers candidate CEO and two members to the BoD; he accomplished but BoD fired new CEO. Buyers unsuccessfully sued Gregg on premium, but shareholder succeeded on disgorgement.

**Looting**

Harris V Carter

* Carter Group controlled Atlas Energy Corp. and sold such controlling interest to Mascolo and accepted the resignation to the BoD of Atlas in return for stock in Insuranshares of America, Inc. Mascolo took control of Atlas and allegedly looted Atlas transferring much of its value to Mascolo and increasing their controlling interest. Harris and minority shareholder of Atlas sued Carter and Mascolo alleging that Carter knew intentions of Mascolo and thus breached their fiduciary duties.
* The Court held that when a shareholder pressumes to exercise control of a corporation he assumes a fiduciary duty of the same kind owed by the BoD to the corporation and when an action of the fiduciaries may forseeably harm the corporation, his negligent acts causing such harm are compensable.

RoL: Majority shareholders may be liable if they negligently sell their controlling interest and such sales causes damage to the corporation.

**Tender Offers: Duties of Buyers**

Brascan Ltd. V Edper Equities Ltd.

* Edper bought shares of Brascan and attempted to buy more shares contacting more shareholders and acquired them through its broker at slightly higher prices. Brascan sued seeking Edper to divest the shares bought alleging failure to announce it was making a tender offer and violated Section 14(e) of the Williams Act.
* Court held that Edper’s acts did not constitute a tender offer under the Williams Act; it only fully met one of the eight criteria listed by SEC in amicus curiae to determine whether acquisitions constitute a tender offer under Williams Act: i) active wide spread solicitation of public shareholders, ii) large accumulation of stock (met), iii) premium over the prevailing market price (slightly met), iv) firm offer terms rather than negotiable, v) offer contingent on the tender of a fixed number of shares (slightly met), vi) offer open only for a limited time, vii) offerees subject to pressure to sell, and viii) public announcements of a purchasing program preceding or following rapid accumulation.

RoL: Mere acquisition of large portion of company’s stock itself does not constitute a tender offer under Section 14(e) of the Williams Act.

Tender offer Rules: Williams Act

R14e-1: Tender offers must be open for 20 business days.

R14d-10: Tender offers must be made to all holders and all purchases must be done at the same price.

R14d-7: Shareholders who tender can withdraw while tender offer is open.

14e-5: Buyer/bidder cannot buy outside the tender offer.

**12. M&A**

**Transactional Form**

1) Acquirer can buy Target’s assets, 2) Acquirer can bull all of the Target’s stock from its shareholders, 3) Acquirer can merge itself or a subsidiary corporation with the Target in terms ensuring control of the surviving entity.

*Asset Acquisition*

Katz V Bregman

* Plant Industries, led by its CEO Bregman, sold operations in USA and aimed to dispose of its Canadian assets, which constituted more than 50% of its assets and more than 40% of its income. Shareholder Katz brought an action seeking to enjoin sale of alleged substantially all assets, which required shareholder approval.
* Since it was evidenced that the proposed sale would constitute a sale of substantially all of Plant’s assets, injunction should be granted until shareholder approval is obtained.

RoL: Sale of substantially all assets requires approval not only of the BoD but of the majority of the shareholders.

Consider i) Thorpe V CERBCO where sale of CERBCO’s subsidiary representing 68% was determined to be subject to shareholder approval being “measured not by the size but also on the qualitative effect of the corporation, whether transaction was out of the ordinary course of business and affects the existence and purpose of the corporation,” and ii) Hollinger, Inc. V Hollinger Intl. where sale of a subsidiary accounting for 56-57% did not constituted “substantially all” of the assets of the corporation since “a fair and succinct equivalent to [that] term would therefore by “essentially everything.”

**Mergers**

Target or collapsed corporation’s shareholders always have voting rights. Voting stock of the surviving corporation is generally afforded voting rights except where three conditions are met: i) surviving corporation’s charter is not modified, ii) security held by the surviving corporation’s shareholders will not be exchanged or modified, and iii) surviving corporation’s outstanding stock will not be increased by more than 20%.

Triangular merger: Aquirer forms a new subsidiary (NewCo) and transfers the merger consideration to NewCo in exchange for its stock, Target merges into NewCo (or NewCo merges into Target), the merger consideration is distributed to Target’s shareholders and Target’s stock is cancelled, stock of Acquirer in Target (if any) will also be canceled, and Acquirer thus will hold all of NewCo’s stock who now owns all assets of liabilities of Target.

Forward Triangular Merger: If NewCo survives.

Reverse Triangular Merger: If Target survives (nonetheless having all its s tock converted into the merger consideration).

**Appraisal Remedy**

Right for shareholders who dissent from mergers or sales of substantially all assets. Works as a put option, an opportunity to sell shares back to the corporation at a price equal to their fair value immediately prior to the merger (but including all elements of future value that were present at the time of the merger excluding the speculative elements of the merger itself). DGCL 262(c) allows appraisals when the corporation’s charter is amended or when substantially all assets are sold.

Market-out rule: Appraisal remedy is granted if Target shareholders receive as merger consideration anything other than: i) stock in the surviving corporation, ii) any other shares traded on a national exchange, iii) cash in lieu of fractional shares, or iv) combination of such items.

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|  | **Statutory merger DGCL 251** | **Asset Acquisition DGCL 271.** |
| **T Voting Rights** | Yes-need majority of shares outstanding 251.c. | Yes if all or substantially all assets are being sold 271.a |
| **A Voting Rights** | Yes- unless less than 20% being issued 251.f. | No (though stock exchange rules might require vote to issue new shares) |
| **Appraisal Rights** | Yes if T shareholders vote, unless market-out exception 262. | No unless provided in charter 262.c. |

**De Facto Mergers**

Hariton V Arco Electronics, Inc.

* Loral entered into a purchase agreement with Arco to buy all of Arco’s assets and assume and pay all of its debts and liabilities in exchange to one share of Loral for each three shares of Arco. Arco would then dissolve and distribute Arco’s shares to its shareholders. Shareholder Hariton sued after closing alleging this was a de facto merger and that statutory provisions were not complied with.
* Court held that if all provisions are complied with a corporation may achieve a result in a manner, which would be illegal under another statute and since there is no interaction between statutes and the sale of assets was followed correctly the provisions of the merger are of no relevance.

RoL: Corporation may sell its assets to another corporation resulting in the same as merger without following the merger statutory requirements.

**Duty of Loyalty in Controlled Mergers**

*Cash Mergers of Freeze-outs*

Weinberger V UOP, Inc.

* Signal was a 50% shareholder of UOP and two directors of the former were also directors of the latter and suggested for Signal to acquire all other shares of UOP in a cash-out merger at $24 per share. Signal offered $21 per share, which was approved by the BoD, backed with an investment banker fairness opinion letter, and further approved by the majority of the minority (the other) shareholders. Shareholder Weinberger sued alleging unfair to UOP other shareholders.
* Court held that since Signal failed to disclose to the other UOP directors and the minority shareholders the report on the $24 price, UOP was misled by the fairness opinion which was not prudently prepared by the investment banker, the $21 price was not fair and a minority shareholder can thus challenge the transaction.
* Court made a realistic approach to valuation using a new method to determine a fair price, which considers all relevant non-speculative factors, consistent with the method used in determining appraisal remedies. Discounted cash flow is the most common technique nowadays.

RoL: Corporations involves in a cash-out merger must comply with the fairness test: i) fair dealing imposes a duty on the corporation to disclose all material information of the merger, and ii) obtaining a fair price requires it to be equivalent to a price determined using an appraisal method where all relevant non-speculative factors are considered.

*Control and Exercise of Control*

Kahn V Lynch Communication Systems, Inc.

* Alactel was a large shareholder of Lynch and opposed Lynch’s intention to buy Telco suggesting instead to buy Alcatel’s subsidiary Celwave. Celwave’s acquisition was rejected and Alcatel offered to acquire all Lynch and offer was approved. Minority shareholder Kahn sued.
* Since Court found that Alcatel exercised control of Lynch with only a 43.3% thus stood on both sides of the transaction, it bear the burden to prove the transaction’s entire fairness. Record failed to show this and the lower court erred to shift the burden of proof of entire fairness to plaintiff Kahn.

RoL: Shareholder owes fiduciary duties if it owns a majority interest or exercises control over the business affairs of the corporation.

*Controlling Shareholders Fiduciary Duties*

In re Pure Resources, Inc. Shareholders Litigation

* Unocal owned 65% of Pure and offered significant premium over price. Pure’s committee suggested rejecting the offer and Pure shareholders sued for preliminary injunction to block Unocal’s offer, alleging it was inadequate and coercive because of the power of Unocal over Pure and its BoD, and that not adequate and non-misleading disclosure of material facts was made.
* Court held that an acquisition tender offer by a controlling tender offer is not coercive only when i) it contains a non waiveable majority of the minority provision, ii) a short-form merger will take place immediately after the controlling shareholder obtains +90%, and iii) controlling shareholder has made no retributive threats, and thus found Unocal’s offer coercive since is included a definition of “majority of the minority” that included shareholders affiliated with Unocal under such “minority” as well as Pure management whose incentives were biased by their employment and compensation. Otherwise the offer was non-coercive.
* Court further held that material information was not disclosed and granted the preliminary injunction.

RoL: When a controlling shareholder makes a tender offer (to be followed by a short-form merger), such offer is coercive if it provides in its definition of “majority of the minority” that such minority includes i) other shareholders affiliated with the controlling shareholders and ii) management with incentives different to those of the minority shareholders, but the offer is not subject to the entire fairness review if other aspects of the offer are non-coercive and full disclosure have been made.

E.g.: an offer would be coercive for example if the controlling shareholder threatened to discontinue paying dividends. A non-coercive offer would leave the shareholders free to voluntary accept it; if they do not like it will remain as shareholders forcing the bidder to cash them out having the protection of an appraisal right.

**13. PUBLIC CONTESTS FOR CONTROL**

**Defending against Hostile Tender Offers**

Unocal Corp. V Mesa Petroleum Co.

* Mesa 13% shareholder of Unocal made a two-step tender offer including junk bonds. Unocal BoD rejected offer and responded with a self tender at higher price, to be paid with debt, conditioned to Mesa’s offer success, Unocal would repurchase for non-junk bonds; Mesa was specifically excluded from the offer, who then obtained an injunction.
* Court held that it will not substitute the business judgment of Unocal’s BoD unless it is shown that their decision was made to perpetuate their position in office or breaching their fiduciary duties, lacking good faith, defrauding or being uninformed. This defense was reasonable to the threat posed where Mesa’s offer was coercive since was aimed to force shareholders to tender at first step avoiding junk bonds in second step. Unocal’s BoD objective was in the best interest of the corporation and all shareholders since Mesa was a corporate raider and BoD aimed to either defeat Mesa or at least, if Mesa succeeded, offer the other shareholders (under Mesa’s offer forced to accept junk bonds) some valuable senior debt. Exclusive and selective self-offer was reasonably related to threat posed and fits within their duty to ensure minority shareholders receive equal vale. Business judgment rule is upheld; reversed.

RoL: Court will not substitute the business judgment of the BoD of a corporation that has fought back a shareholder’s attempt to take over if no breach of duty of BoD is evidenced.

Consider Unitirin V American General Corp. where Unitrin’s BoD implemented a poison pill and a self-tender offer to repurchase shares (excluding BoD’s shares) in response to AGC’s offer, and the court, applying Unocal, held that the pill was proportional as well as the repurchase which was within a range of reasonableness (“they were not “draconian”). 1) Under Unocal/Unitrin the BoD of Target has the burden to proof that defensive action was proportional to threat, 2) defense action that is preclusive or coercive will fail to satisfy Unocal test, 3) assuming that defensive action passes the preclusive/coercive test (it is not “draconian”), it will be valid inasmuch it is “within a range of reasonableness.” Therefore, an action will be sustained it is attributable to ant reasonable judgment.

**Poison Pill**

Moran V Household International, Inc.

* Household’s BoD adopted a poison pill plan concerned by the general takeover climate. Moran’s company DKM, which was Household’s largest shareholder, had already considered a buy out, and when the plan was adopted by Household’s BoD, he sued.
* Court held that since the BoD of Household had reasonable grounds to believe a threat existed, the adoption of a defensive mechanism was reasonable to such a threat and thus business judgment rule should be applied. Whether the response is to a particular specific threat or to a general concern is of no relevance. The poison plan is affirmed.

RoL: A corporation may adopt a poison pill as a general anti-takeover defensive plan rather than in response to a particular threat.

**Choosing a Merger or Buyout Partner**

Smith V Van Gorkom

* Van Gorkom was CEO and director of TransUnion, which received a buyout offer by Pritzker. Van Gorkom knew of this offer and failed to disclose it to the BoD until Pritzker imposed a deadline to accept. The BoD approved based on a very short presentation of Van Gorkom and submitted to shareholder approval, which was further obtained. Smith and other shareholders sued breach of fiduciary duties.
* Court found the BoD liable since they acted in a grossly negligent manner and owed a duty to the corporation and shareholders to make informed business decisions, and breached such duty failing to further investigate on the proposal and submitting it to shareholder approval without providing sufficient material information. The shareholder ratification does not relieve the BoD from such duty.

RoL: Business judgment rule shields D&O only if a business decision was made on an informed basis relying on all material information reasonably available.

Revlon, Inc. V MacAndrews and Forbes Holdings, Inc.

* Pantry Pride made a tender offer for Revlon, which in turn adopted a poison pill and issued debt in form of notes making it less attractive. However, Pantry raised offer and Revlon negotiated with a “white knight” Forstmann Little, and Pantry then raised offer again, which caused Forstmann’s offer to be further raised. Revlon’s BoD granted a “lock-up” provision to Forstmann making Pantry’s offer financially impracticable. Pantry sued to enjoin lock-up.
* Court held that the while lock-up was not illegal per se here it had no other effect but to prevent a competitive bidding, depressing the stock price and thus not working to the benefit of the shareholders. Court thus held that when it appeared that an active bidding contest will ultimately result in an inevitable sale (change of control) of the corporation, the BoD’s duties shifted to makes its best efforts to maximize the sale price for the benefit of the shareholders.

RoL: A “lock-up” cannot be granted if it prevents competitive bidding for the corporation.

**Pulling together Unocal and Revlon**

Paramount Communications, Inc. V Time, Inc.

* Time and Warner Communications, Inc. had been considering a merger resulting in long-term enrichment and shared ownership and control. BoD solicited shareholder approval and before voting Paramount made a tender offer. Time’s BoD concluded that price was inadequate and that the Warner deal was a better long-term opportunity and thus adopted defense mechanisms which were sued to be enjoined by Paramount.
* Court found that since Time’s BoD did not make breakup inevitable and Time was thus not the object of a biding war, Revlon duties were not triggered. The Court held that the business judgment rules applied under the Unocal test where a BoD may oppose a takeover if i) there are reasonable grounds of danger to corporation, which factor was considered by the Time’s BoD founding that the Warner deal was the best alternative, and ii) the defensive measures adopted are reasonable, which in this case were since the plan was only designed to carry forward the preexisting transaction in a different manner.

RoL: Efforts of a BoD to prevent a takeover tender offer are not invalid merely because the tender offer price was actual market value (as that offered in short-term value by Paramount).

Paramount Communications, Inc. V QVC Network, Inc.

* Viacom and Paramount were discussing a merger, which was approved by Paramount’s BoD having Paramount merged into Viacom and shareholders receiving nonvoting shares in the new company. Merger agreement included: i) no shop provision unless unsolicited offers not subject to material financing contingencies, or unless the BoD determines third party negotiations were required to comply with their fiduciary duties, ii) a $100 million break-up fee, and ii) an option for Viacom to purchase 20% stock of Paramount at a low price.
* QVC offered a merger proposal at a higher price, Viacom raised its offer and the QVC raised again, and when the BoD of Paramount decided the merger with QVC was not in the best interest of the corporation, QVC sued.
* Court found that i) when shareholders controlling power is substantially changed, the BoD acts are subject to enhanced scrutiny and their fiduciary duties require them to assure that the shareholders receive the greatest value possible, and ii) such a duty is breached since Paramount entered into highly restrictive agreements that impeded to solicit competing bids as an adequate mean to ensure the best value for shareholders.

RoL: i) a change on corporate control subjects the BoD to enhanced judicial scrutiny and requires them pursue the best value for shareholders; ii) a BoD breaches it fiduciary duty if it contractually restricts its rights to solicit and obtain competing bids (thus failing to ensure best value for the shareholders).

Lyondell Chemical Co. V Ryan

* Blavatnik, who controlled Basell made and oral offer to buy Lyondell, whose BoD slightly negotiating reducing break-up fee and then recommended shareholders to approve, which actually occurred.
* Court found that there is only one Revlon duty (to obtain the best available price) and held that the judiciary cannot determine how to comply with such duty. Failure of the BoD to take any specific action on the sale process does not show a conscious disregard of their duties and thus Lyondell’s BoD did not breach their duties by failing to act in good faith.

RoL: There are no legally prescribed steps for the BoD to follow in order to satisfy their Revlon duties such that failure to follow such steps results in a conscious disregard of their duties.

**Protecting the Deal**

“No shop/No talk:” covenants from the seller to protect deal in favor of acquirer i) not to shop for alternative transactions of provide confidential information to other buyers, ii) to submit the transaction to the shareholders, and iii) recommend it for shareholder approval.

DSC held in Smith V Van Gorkom that the BoD of Target has no fiduciary right to breach a contract (like a no shop covenant) even if their fiduciary duties requires them to do so, the corporation itself has no such privilege and will be liable. Thus:

“Fiduciary out:” provisions that specify that upon a particular event (e.g.: receiving a better offer or outside counsel suggests fiduciary duties to abandon deal), the BoD of the Target can void the contract without breaching it.

**Shareholder Lock-ups**

Omnicare, Inc. V NCS Healthcare, Inc.

* NCS in financial distress received several offers for all their assets in bankruptcy by Omnicare, which were rejected. Genesis made further offers conditioned to shareholder approval by requiring the two controlling shareholders-directors to vote in favor of the merger, and to exclude any fiduciary out provisions.
* Omnicare learned and made another offer, which was not accepted by NCS but used by it to negotiate and improve terms with Genesis, who conditioned new offer to immediate approval, which under the agreement with shareholders would not be possibly rejected. Omnicare sued to enjoin and launched a tender offer for more than twice market value.
* Before shareholder approval, NCS’ BoD suggested shareholders to vote for the Omnicare deal.
* Court held that pursuant to the enhanced judicial scrutiny required under Unocal NCS BoD must prove i) reasonable grounds for danger, and ii) that their defensive response was reasonable in relation to the threat posed, for which BoD must also prove defensive devices were not coercive or preclusive and then that response was within a range of reasonableness.
* Court found that NCS defense devices were coercive and preclusive since they deprived shareholders to receive another bidder by restricting proxy contests or otherwise, and thus are draconian and impermissible and are not within a range of reasonableness. Therefore, since the agreement required the NCS BoD to act or not in certain manner and thus limit the exercise of their fiduciary duties, it is invalid and unenforceable. To work otherwise it required an effective “fiduciary out” provision to be included.

Dissent: Since minority shareholders were deemed to know that such controlling shareholders-directors could approve the merger by themselves without a need for minority votes, there is non-minority vote to coerce.

RoL: Lock-up deal devices that all together are coercive and preclusive are invalid and unenforceable in the absence of a fiduciary out clause.

**State Anti-Takeover Statutes**

CTS Corp. V Dynamics Corp. of America

* Laws of Indiana require public corporations to require an entity acquiring 20%, 33% or 50% interests to be subject to shareholder referendum without the vote f such interests.
* Dynamics already held almost 10% and announced a tender offer to grow to 27% and challenged the statute as unconstitutional under the Commerce Clause.
* Court held as RoL that since this law applies to both Indiana and non-Indiana to be acquirer, a law allowing in-state corporations to require shareholder approval prior to significant shifts in corporate control is constitutional.

**Proxy Contests for Control**

Schnell V Chris-Craft Industries, Inc.

* Dissident group of shareholders of Chris-Craft attempted to waive a proxy fight, to give them less time, the incumbent BoD reset the date of the annual meeting and Schnell and other dissidents sought injunction.
* Court held that since there was no prior indication of warning to change the date of the annual meeting they did so in order to obtain an inequitable advantage in the contest.

RoL: Inequitable action does not become permissible just because it is legally permissible.

Blasius Industries, Inc. V Atlas Corp.

* Blasius acquired less than 10% and suggested to the BoD of Atlas a plan to incur in leverage that was not accepted by the BoD of Atlas. In response Blasius began soliciting shareholders to approve modify the BoD from 7 to 15, 8 to be appointed by them and thus gain control. BoD suggested to increase to 9 chosen by them.
* Court held that since this was an effort by the BoD to frustrate the will of the shareholders it should fail. It was an invalid attempt to thwart shareholder voting power.

RoL: BoD may not enlarge its size to prevent a majority shareholder to vote to expand to give control to an insurgent group.

Unisuper V News Corp.

* News BoD adopted a policy that any poison pills will expire after a year unless shareholders granted extension. BoD failed to comply and shareholders sued.
* Court held that since the agreement in question gave power to shareholders and not to a third party, the BoD as agent of the principals, shareholders, must give way.

RoL: Contract between corporation’s shareholders and its BoD to permit a vote in defensive mechanism is not invalid as a matter of law (DGCL 141(a)).

**14. TRADING IN SECURITIES OF THE CORPORATION**

**Common Law of Duties of the BoD**

Goodwin V Agassiz

* Agassiz and other insider of Cliff Minig Co acquired shares of Goodwin in a stock exchange knowing that a geological theory could lead to discover minerals but decided not to disclose so that another company in which they invested acquired rights on adjacent land. Goodwin sued on breach of duty by failing to disclose.
* Court found that here fraud was not proved since i) Agassiz did not personally solicit Goodwin rather bought on the open market, ii) Agassiz was an experienced stock dealer and made a voluntary decision to sell, iii) at the time of the sale the undisclosed geological theory has nit been proven, and iv) had they disclosed the theory prematurely they would have been exposed to litigation if proved to be false.

RoL: D&O may not personally solicit shareholders to buy his shares without disclosing material facts of his knowledge as D&O and not known to the shareholder; but the fiduciary duties of D&O does not require precluding all their dealings on corporate stock where there is no fraud.

**Corporate Recovery from Insider Trading**

Freeman V Decio

* Skyline Corporation reported a significant drop in earnings and was suspended form trading by NYSE losing over 30% value. Arthur Decio, largest shareholder, chairman of the BoD and president of Skyline and other insiders sold stock based on this information and shareholder Marcia Freeman sued demanding disgorgement of profits to the corporation.
* Courts held as RoL that insider trading on the basis of material information does not constitute a breach of fiduciary duties to the corporation and remedies for insider trading under the federal securities laws now constitute a more effective deterrent than the Diamond V Oreamuno case that held the opposite result here.

**Exchange Act Section 16(b) and Rule 16**

Designated persons (D&O and 10% shareholders) to file public reports of any transactions on the corporation’s securities.

In calculating the profit realized from a sale (or purchase), a covered person must first look back six months and match the number of shares sold (or purchased) with the same number of shares purchased (or sold). Process is repeated looking forward six months. One then deducts the lower total purchase price from the amount realized o the reportable sale to determine the profit, if any, that is payable to the corporation.

**Exchange Act Section 10(b) and Rule 10b-5**

*Elements of a 10b-5 claim: False or Misleading Statement or Omission*

SEC V Texas Gulf Sulphur Co.

* TGS’ employees discovered unusual mining deposits but decided not to disclose. Several employees bought TGS stock or calls and TGS issued options. The BoD did not know about the discovery and rumors were denied on press releases. When discovery was finally confirmed employees and officers acquired stock. Since the price increased substantially, SEC investigated and sued.
* Court held as RoL that anyone in possession of material inside information must either disclose it to the investing public or, if obliged not to disclose it to protect corporate confidence, abstain from trading, where material information include all that which, may affect the decision of investors whether to buy, sell or hold. In this case, the mining discovery represented a material fact and therefore all transaction by individuals knowing the mining results were in violation of R10b-5.

Santa Fe Industries Inc. V Green

* Santa Fe owned 90% of Kirby Lumber and merged with Kirby under state statute that does not require prior notice and could pay minority shareholders fair market value. Green and other shareholders sued alleging merger lacked a business purposes, no prior notice was given and price, based on appraisal was substantially higher.
* Court found that full disclosure was made, and neither notice nor a business purpose were required by applicable statute and if minority shareholders were dissatisfied with prices should seek a court appraisal under state statute.

RoL: In order to bring a claim under Section 10(b) or R10b-5, there must be a showing of manipulation or deception.

*Elements of a 10b-5 claim: Equal Access Theory*

Consider Cady, Roberts & Co., a SEC decision assessing insider trading on the open market. SEC application rested on i) existence of a relationship giving access to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and ii) the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those he deal with.

*Elements of a 10b-5 claim: Fiduciary Duty Theory*

Chiarella V USA

* Chiarella, an employee at Pandick Press was exposed to documents involving two corporations about to merge; although not identified, Chiarella deduced the identities and bought stock of the target corporation realizing a gain when stock was sold after the takeover closed. SEC investigated, he was fired and convicted.
* Court found that liability can only be presumed from a duty to disclose arising in a relationship or trust and confidence (ReTaC) between two parties to a transaction, and since there is no evidence that Chiarella had such a relationship with the sellers, no duty raised to provide a basis for his conviction.

RoL: Purchaser of stock who has no duty to the seller of said stock since he is neither an insider nor a fiduciary, has no obligation to disclose material information of his knowledge; failure to disclose said information does not constitute a violation of Section 10(b).

Dirks V SEC

* Dirks, a stock broker, received information from Secrist, former employee of Equity Funding of America, that said company was involved in reinsurance fraud. Dirks personally made an extensive investigation and revealed information to investors who sold stock and caused its price to drop. Based on Dirks investigation, SEC convicted EFA officers and the sued Dirks for his disclosure of non-public information to his clients.
* Court found that mere receipt of information by a tippee (Dirks) does not itself carry with the fiduciary duty of the insider (tipper); here, Secrist the tipper and insider did not receive a benefit for his disclosure and thus did not breach his duty to the shareholders of EFA, hence there was no derivative breach of Dirks.

Dissent: All that is necessary is that the shareholders (in this case those of EFA) suffer an injury and since here Secrist’s disclosure resulted in Dirk’s clients trading based on such information.

RoL: A tippee (recipients of insider information) is liable for openly disclosing material information received from a tipper (disclosing party of information), if the tippee knows or should know that the insider-tipper will benefit from such disclosure to tippee. Holding is consistent with Chiarella, duty to disclose arises only from the existence of a ReTaC.

USA V Chestman

* Waldbaum, controlling shareholder of Waldbaum told his family that Waldbaum will be sold. Loeb was married to Walbaum’s niece and told his broker, Chestman, who then purchased Waldbaum stock for himself, Loeb and other clients. SEC sued based on R14e-3.
* R14e-3 provides that a person engages in illegal conduct if he trades on the basis of material nonpublic information concerning a pending tender offer that he knows that has been acquired from an insider of the offeror of the tender offer.
* Court found that SEC not exceeded its rulemaking authority promulgating R14e-3, even if it omits the elements of breach of fiduciary duty or fraud.
* Court further held that here the evidence is insufficient to establish a ReTaC between Loeb and the Waldbaum family and such cannot be imposed unilaterally by Loeb’s wife requiring secrecy nor on a mere kinship which does not establish a confidence relationship. Thus, absent a fraud by Loeb, there is no basis to hold Chestman liable.

RoL: SEC did not exceed its authority enacting R14e-3 even if it omits the breach of fiduciary duty or fraud element. One who misappropriates material non-public information in breach of his fiduciary duty or similar ReTaC and uses that information to trade on securities, commits a violation to R10b-5.

USA V O’Hagan

* O’Hagan was a partner in a law firm that represented Grand Met in a tender offer for Pillsbury. O’Hagan did not work on the deal but learned on the information and bought calls that sold when deal closed and made a huge profit. SEC then investigated and convicted O’Hagan.
* Court found that O’Hagan owed a duty of loyalty and confidentiality (a ReTaC) to his law firm and the firm’s client, thus O’Hagan breached his duty and misappropriated the information this being sufficient for his conviction. Court further found that SEC did not exceed on his authority to promulgate R14e-3(a) that provides as illegal to trade securities based on undisclosed information in tender offers even in the absence of a duty to disclose.

RoL: Person who trades securities based on confidential information that he misappropriated in breach of a fiduciary duty (or ReTaC) to the source of the information, is guilty of violating Section 10(b) and R10b-5.

SEC did not exceed his authority to enact R14e-3(a) proscribing trading on undisclosed information even in the absence of a duty to disclose.

*Elements of a 10b-5 claim: Materiality*

Basic Inc. V Levinson

* Combustion Engineering Inc. demonstrated an interest in merging with Basic. BoD of Basic denied rumor several times until confirmed, driving up price of stock. Shareholders brought class action since they sold before confirmation based upon Basic’s BoD denial of the merger.
* Court found that disclosed information must be material and that materiality should be considered as a information that would tend to influence a shareholders decision requiring a deep investigation on total facts, and thus held that lower court failed to consider all fact and case was remanded.

RoL: A misstatement regarding merger negotiations is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding whether to buy or sell.

*Elements of a 10b-5 claim: Scienter (Intention)*

Consider Ernst & Ernst V Hochfelder where gross negligence was not consider sufficient to hold liable, conversely R10b-5 requires specific intent to deceive, manipulate or defraud.

*Elements of a 10b-5 claim: Standing*

Consider Blue Chip Stamps et. al. V Manor Drugs where it was made clear that a plaintiff must have been a buyer or seller of stock in order to have standing to bring a complaint about a violation of R10b-5.

*Elements of a 10b-5 claim: Reliance*

Basic Inc. V Levinson

* Court found that misleading material information in the open market will affect the price of stock (fraud-on-the-market theory), and thus a presumption exists that shareholders traded in reliance of Basic depressed price and that because the BoD made a material misrepresentation (denying the merger plans) the price was fraudulently depressed. Court thus held that since the material representation was shown and thus shareholders established their injury, the burden of proof shifts to Basic’s BoD to rebut and Basic failed to rebut.

RoL: Reliance on materially misleading statements by a corporation will be presumed where a class of shareholders-plaintiffs asserts a R10b-5 claim where they relied on the integrity of the price set by the market.

*Elements of a 10b-5 claim: Causation*

Misrepresentation must be relied on and reliance must cause a loss.

*Remedies of 10b-5 Violations*

Elkind V Ligget & Myers, Inc.

* Shareholders of L&M were told that Ligget would announce a decline in earnings and they sold. The decline was released and stock price fell. Purchasing shareholder sued contending that sellers benefited on inside information.
* The Court held a RoL that the preferred measure of damages (when inside information regarding a stock decline is involved) is the decline in the purchasers stock up to the amount of benefit of the tippee.
* Court considered that this is the best formula since plaintiff would simply need to prove i) time, amount and price of his purchase, ii) that a reasonable investor would not have paid a high price or made the purchase if he knew the information on the tippee’s possession, and iii) the price to which the security had declined by the time he learned of the tipped information or at a reasonable time after it became public, whatever occurs first.

False/misleading statement or omission: Chiarella, Dirks, O’Hagan

Materiality: “What a reasonable shareholder will consider important.” (Basic (probability X magnitude test))

Scienter (Intention): Intention to deceive, manipulate or defraud (Ernst & Ernst), but may be inferred from reckless or gross negligence. For omissions, 10b5-1 says: knowing possession but allows for pre-existing trading plan defense.

Standing: Must be a purchase or sale of securities (Blue Chip Stamps).

Reliance/causation: Presumption on reliance on the integrity of market price (Basic).

Injury/damages: Disgorgement rule (Liggert).

1. These outlines are keyed to the syllabus prepared by Prof. Bubb for the Fall 2011 course and contain mainly a summary of all cases reviewed in class pursuant to the reading assignments (*Commentaries and Cases on the Law of Business Organization*, Allen, Kraakman and Subramanian, Aspen, 3rd Ed., 2009), and additional limited information. [↑](#footnote-ref--1)