**SPRING 2016 MILLER CORPORATIONS OUTLINE**

**Grade: A-**

**AGENCY:**

In order for liability to be imposed, there needs to be an *agency relationship* and the action in question needs to be *within the scope* of the agency relationship

**Agency Relationship (Restatement (3rd) § 1):** the fiduciary relationship that arises when (1) one person (a “principal”) **manifests assent** to another person (an “agent”) that (2) the agent shall **act on the principal’s behalf** and (3) **subject to the principal’s control**, and (4) the **agent manifests assent or otherwise consents** so to act

* **Formation of Agency Relationship:**
  + manifestation of assent by the principal
    - principal has great exposure to liability so must manifest assent
    - manifestation = objective, observable action
  + manifestation of assent or consent by the agent
    - agent has less exposure to liability so has broader range of actions he can take to assume agency relationship
* **Duties of Agency Relationship:**
  + agent acts on principal’s behalf
    - *Gordon v. Doty:* teacher let coach use her car to drive students to soccer game; accident occurred
      * coach was agent of teacher (teacher liable since tort was within scope of agency)
        + **“on behalf” doesn’t need to involve business**
        + **no contract or compensation necessary**
      * *policy:* court wants injured ppl to be compensated; neither coach nor teacher can pay themselves but teacher’s insurance will only pay if she’s found liable as principal
    - *Gay Jenson Farms Co. v. Cargill, Inc.*: Cargill financed operations of grain elevator before it went bankrupt and couldn’t pay the farmers it bought grain from
      * Cargill was principal of grain elevator (liable since contract is within the scope of agency)
        + grain elevator acted on Cargill’s behalf because **sold most of its grain to Cargill**
      * *policy:* court wants to find someone to pay back the farmers since grain elevator can’t
  + agent is subject to principal’s control
    - *Gordon v. Doty:* teacher’s **condition that only the coach drive** the car was enough to establish control
      * even though didn’t give any other instructions (route to take, speed, etc.)
    - *Gay Jenson Farms Co. v. Cargill, Inc:* Cargill **interfered with internal operations** of grain elevator enough to establish control
      * **mere fact of being “creditor” doesn’t establish control** 
        + but Cargill made grain elevator implement certain policies, approved spending, etc.

**Liability of Principal to Third Parties in Contract:** principals are liable to third parties who are injured by breaches of contract entered into by an agent acting *within the scope of his agency* (authority)

* **Actual Authority**
  + Restatement (3rd) § 2.01: an agent acts with actual authority when at the time of taking an action that has legal consequences for the principal, the agent reasonably believes, in accordance with the principal’s manifestations to the agent, that the principal wishes the agent so to act
  + express authority: principal has explicitly given agent authority
  + implied authority: principal has impliedly given agent authority
    - *Mill Street Church of Christ v. Hogan:* church hired Hogan to paint building; decided that another man would help if he needed it; church let Hogan hire his brother in the past; Hogan hired his brother this time
      * Hogan had implied authority as agent of the church to hire his brother (had to pay workers’ comp for brother’s injury since he’s considered an employee)
        + **implied authority is circumstantially proven by considering (a) agent’s understanding of his authority, (b) nature of task/job, (c) existence of prior similar circumstances**
        + **implied authority includes such powers as are practically necessary to carry out the duties actually delegated**
      * *policy:* church was member of workers’ comp. and wanted to apply policy to pay for brother’s injury
* **Incidental Authority** 
  + Restatement § 35: unless otherwise agreed, the authority to conduct a transaction includes authority to do acts with are incidental to it, usually accompany it, or are necessary to accomplish it
* **Apparent Authority** 
  + Restatement (3rd) § 2.03: contracts entered into with a third party on a principal’s behalf by an agent lacking actual authority can still be binding on the principal if the third party reasonably believes the agent has authority to act on behalf of the principal and that belief is traceable to the principal’s manifestations
  + *370 Leasing Corp. v. Ampex Corp.:* 370 entered into negotiations w/ Ampex to purchase memory units; purchase order was never signed by Ampex; intra-office memo from Ampex stated that salesman Kays would handle agreement btwn 370 & Ampex; Kays sent letter to 370 confirming delivery
    - Kays had **apparent authority** to bind Ampex to the contract with 370
      * **agent has apparent authority to bind principal when *principal acts* in such a manner as would lead a reasonably prudent person to suppose the agent had the authority he purports to exercise** (manifestation by principal required)
        + Ampex did nothing to dispel inference of authority, sent memo suggesting Kays had authority
      * absent knowledge of third parties to the contrary, **agent has the apparent authority to do those things which are usual and proper to the conduct of the business he is employed to conduct** 
        + reasonable for third party (370) to conclude that salesman (Kays) has authority to make sale on behalf of his employer (Ampex)
    - *policy:* Ampex is cheapest cost avoider (can easily put policies to dispel assumptions)
* **Undisclosed Principal**
  + Restatement (3rd) § 2.06: an undisclosed principal is liable for the acts of an agent on the principal’s behalf without actual authority if the principal, *having notice* of the agent’s conduct and that it might induce third parties to change their position, didn’t take reasonable steps to notify third parties of this
    - *note:* compare Restatement to common law, which doesn’t require principal to have notice of agent’s behavior
  + *Watteau v. Fenwick:* Humble sold pub but stayed on as manager; only had authority from new owners to purchase certain items but purchased others on owners’ credit; third party he purchased from didn’t know he was an agent (thought he still owned pub)
    - new owners are still liable for the acts of Humble, even though they were contrary to his authority
      * there was no *apparent authority* because apparent authority has to somehow be traced back to principal’s manifestations and third party here didn’t even know principal existed
      * **liability of undisclosed principal is limited to actions that are within the usual course of business in this type of relationship** 
        + reasonable for suppliers to think that pub owner had authority to buy anything
    - *policy:* if something is not within ordinary course of business, third parties are more on notice to think something is wrong; but would impose too high monitoring cost to make undisclosed principal liable for all actions of agent
* **Ratification**
  + Restatement (3rd) § 4.01:
    - (1) ratification is the affirmation of a prior act done by another, whereby the act is given effect as if done by an agent acting with actual authority
    - (2) a person ratifies an act by:
      * (a) manifesting assent that the act shall effect the person’s legal relations, or
      * (b) conduct that justifies a reasonable assumption that the person so consents
  + *Botticello v. Stefanovicz:* husband & wife owned farm; husband executed agreement w/ Botticello to lease farm w/ option to purchase; when B tried to exercise his right to purchase, wife wouldn’t allow because she owned 50% of land and never agreed to contract
    - husband was not acting as wife’s agent during contract execution and **wife did not ratify contract**
      * neither marriage nor joint ownership automatically prove agency relationship (no other evidence)
      * **ratification requires acceptance of results of the act with an intent to ratify and full knowledge of all material circumstances**
        + no evidence that wife had intent to ratify nor knowledge of all material circumstances
      * **ratification requires that the action be purported to be done on the account of the principal** 
        + husband never said he was acting on behalf of his wife, so she couldn’t have ratified the agreement by accepting lease payments
* **Estoppel**
  + Restatement (3rd) § 2.05: a person who has not made a manifestation that an actor has authority as an agent and who is not otherwise liable as a party to a transaction purportedly done by the actor on that person’s behalf is subject to liability to a third party who justifiably is induced to make a detrimental change in position because the transaction is believe to be on the person’s behalf if:
    - (1) the person intentionally or carelessly caused such belief, or
    - (2) having notice of such belief and that it might induce others to change their positions the person did not take reasonable steps to notify them of the facts
  + *Hoddenson v. Koos Bros.:* woman went into dept. store to buy furniture and was “assisted” by fake salesman who took her cash; she never got the furniture
    - the store is liable for the acts of the fake salesman through estoppel
      * no actual or apparent authority, no ratification, no undisclosed principal
      * **estoppel prevents proprietor from denying liability bc of lack of authority when their *dereliction of duty* enabled situation to happen** 
        + solely through lack of store’s reasonable surveillance and supervision, an imposter falsely impersonated himself as an agent of the store

*Koos* *Bros.* acted in a way that allowed plaintiff to be fooled

* + - * + duty of proprietor includes exercise of reasonable care and vigilance
    - *policy:* store is in better position to protect against these risks than customer (store is lowest cost avoider)
      * easier to prevent confusion by having employees wear name tags/supervise than for customer to investigate every employee

**Liability of Agent to Third Parties in Contract:**

* **Fully Disclosed Principal:** third party knows agent is acting on behalf of principal and knows identity of principal
  + Restatement § 320: unless otherwise agreed, a person making or purporting to make a contract with another as an agent for a disclosed principal is not a party to the contract (agent not liable)
* **Partially Disclosed Principal:** third party knows agent is acting on behalf of *some principal*, but doesn’t know identity of principal
  + Restatement § 321: unless otherwise agreed, a person making or purporting to make a contract with another as an agent for a partially disclosed principal is a party to the contract (agent is liable)
  + *Atlantic Salmon A/S v. Curran:* man was conducting business, representing he was marketing director for a corporation that didn’t exist, and then created separate, unrelated corporation; owed money to suppliers, but claimed not personally liable because was acting as agent for new corporation
    - man is personally liable to suppliers
      * **it is the duty of the agent, if he wants to avoid liability on a contract entered into by him on behalf of his principal, to disclose not only that he is acting in a representative capacity, but also the identity of his principal**
    - *policy:* no hardship for agent to disclose; harder for third parties to know who to go after otherwise in case of a breach
* **Undisclosed Principal:** third party doesn’t know a person is someone’s agent (acting on someone else’s behalf)
  + Restatement § 322: an agent purporting to act on his own account, but in fact making a contract on behalf of an undisclosed principal is a party to the contract

**Liability of Principal to Third Parties in Tort:**

* **Servant vs. Independent Contractor**
  + Restatement § 219(1): a *master* is subject to liability for the torts of his *servants* committed while acting *within the scope of employment*, but is generally not liable for torts of *independent contractors*
    - **servant:** agrees to (a) work on behalf of master and (b) be subject to master’s control or right to control the “physical conduct” of the servant (manner in which job is performed)
    - **independent contractor:** not subject to master’s control of “physical conduct” (hired to get a result done, but not told how to do it)
  + note: look at who was in **best position to prevent accident** to make case for liability
  + *Humble Oil & Refining Co. v. Martin:* family was hit by car that rolled off gas station lot; gas station company (Humble) claimed not responsible bc gas station was franchise operated by independent contractor (not servant/employee)
    - gas station operator was servant (agent)
      * **whether master-servant (agency) relationship exists is highly fact-based inquiry based on amount of control exercised by alleged master over alleged servant** (enough control exists in this case to impose liability)
        + facts *for* Humble as master:

Humble owns gas station

Humble can fire gas station operator at any time

Humble controls hours of operation

Station sells only Humble tires, batteries, accessories, etc.

Humble pays most of gas station expenses

* + - * + facts *against* Humble as master:

gas station operator hires & fires workers

gas station operator sets workers’ salaries

neither consider each other to be employee/employer

agreement expressly repudiates Humble’s authority over workers

* + - *policy:* accident happened because gas station was on a hill (Humble’s decision, gas station operator not in control of this)
  + *Hoover v. Sun Oil Company:* fire at gas station owned by Sun Oil caused by negligence of employee; Sun Oil claimed no liability because gas station was franchise and operator was independent contractor (not servant/employee)
    - gas station operator was independent contractor (no master-servant relationship)
      * **the test for whether a master-servant (agency) or independent contractor relationship exists is whether “master” has retained right to control the details of the day-to-day operation**
        + facts *for* Sun Oil as master:

employees of gas station wore Sun Oil uniforms

gas station advertised under Sun Oil name

gas station operator had weekly visits from Sun Oil sales rep who would make various business suggestions and discuss any issues w/ gas station operator

gas station operator attended Sun Oil training

gas station equipment was to be used only for Sun Oil products

* + - * + facts *against* Sun Oil as master:

gas station operator wasn’t required to follow advice of sales rep

gas station operator set hours, pay scale, conditions, etc. of employees

gas station operator assumed all risk of profit or loss from operations

gas station operator was listed as proprietor

lease was subject to termination of either party

* + - *policy:* accident was caused by negligence of employee (part of operator’s duty, not in Sun Oil’s control)
      * note: compare this case to *Humble* (facts very similar but different outcome)
  + *Murphy v. Holiday Inns, Inc.:* woman sued Holiday Inn, Inc. when she slipped at a hotel as a result of employee’s negligence; Holiday Inn claimed no liability because hotel was franchise operated by independent contractor (not servant/employee)
    - hotel operator was independent contractor (no master-servant relationship)
      * **the critical test for whether an agency relationship exists is the extent of the control agreed-upon**
        + facts *for* Holiday Inn as master:

operator had to construct hotel according to plans and specifications approved by Holiday Inn

hotel had to use Holiday Inn branding

training was provided by Holiday Inn to hotel employees

* + - * + facts *against* Holiday Inn as master:

franchise agreement didn’t give Holiday Inn any right to control the methods or details of the day-to-day operations

Holiday Inn had no power to control rates, fire employees, determine wages/working conditions, demand share of profits, etc.

* + - *policy:* accident was caused by negligence of employee (within hotel operator’s control, not Holiday Inn’s control)
  + note: overlying policy consideration in all these cases if whether franchisor had ability to prevent or control the risk (if yes 🡪 more reason to hold franchisor liable)
* **Tort Liability & Apparent Agency** 
  + Restatement § 267: one who represents that another is his servant and thereby causes a third person justifiably to rely upon the care or skills of such apparent agent is subject to liability to the third party for harm caused by the lack of care or skills of the one appearing to be a servant or other agent as if he were such
  + *Miller v. McDonald’s Corp:* woman sued McDonalds when she bit into Big Mac with stone in it; McDonalds Corp. claimed no responsibility because store was owned and operated by franchise that was independent contractor (not employee/servant)
    - McDonald’s Corp. is liable via apparent agency
      * even if McDonald’s Corp. didn’t exercise enough control over store to be considered master, can still be liable via apparent agency (*but note* that court says there is evidence that McDonald’s Corp. actually did control food handling part of business and thus can be liable as master)
        + **apparent agency creates an agency relationship that does not otherwise exist**

centrally imposed uniformity of McDonald’s stores and no indication that store is independently operated shows that McDonald’s Corp. held itself out as master

note: court extended Restatement 267 here because it wasn’t proven that woman *relied* on McDonald’s manifestations when choosing to eat there

if this decision is followed, then imposing liability on franchises is very easy via *apparent agency*

* **Scope of Employment** 
  + Restatement § 228(1): conduct of a servant is within the scope of employment if, but only if:
    - (a) it is of the kind he is employed to perform;
    - (b) it occurs substantially within the authorized time and space limits;
    - (c) it is actuated, at least in part, by a purpose to serve the master;
    - (d) if force is intentionally used by the servant against another, the use of force is not unexpectable to the master
  + Restatement (3rd) § 707: an employee acts within the scope of employment when performing work assigned by the employer or engaging in a course of conduct subject to the employer’s control. An employee’s act is *not* within the scope of employment when it occurs within an independent course of conduct not intended by the employee to serve any purpose of the employer
  + *Ira S. Bushey & Sons, Inc. v. United States:* seaman on Coast Guard vessel was drunk on his way back to ship while it was docked; turned ship wheels & damaged dock; Coast Guard claimed no responsibility bc seaman wasn’t acting within scope of his employment when turning the wheels
    - Coast Guard is liable for seaman’s actions (within scope of employment)
      * **conduct of the seaman is not so unforeseeable as to make in unfair to charge the Coast Guard w/ responsibility** 
        + **the employer should be held to expect risks which arise out of and in the course of his employment of labor**
      * court made decision based on *fairness* (not economic efficiency), employed **strict liability** standard on Coast Guard
        + “a business enterprise cannot justly disclaim responsibility for accidents which may fairly be said to be characteristic of its activities”
        + note: Coast Guard is *not* cheapest cost avoider in this case (cheaper for dock to put locks on ships than for Coast Guard to keep watch on its employees 24/7)
  + *Manning v. Grimsley:* baseball player was warming up before game, was being heckled by fans of opposing team; threw ball in their direction & hit plaintiff in the face; baseball team claims no responsibility because player was not acting within scope of employment when throwing ball
    - Baseball team is liable for player’s actions (within scope of employment)
      * **where a plaintiff seeks to recover damages from an employer for injuries resulting from an employee’s assault, it must be shown that the employee’s assault was in response to plaintiff’s conduct which was presently interfering with the employee’s ability to perform his duties successfully**
        + heckling served purpose of rattling baseball player so he couldn’t play game as well, so it did presently interfere with his ability to perform duties
    - note: court uses own common law here, *not* Restatement § 228(1)(d)
      * under Restatement § 228(1)(d), team probably *wouldn’t* be liable because it is very uncommon for players to throw balls at fans and thus unexpectable
  + *Arguello v. Conoco, Inc.:* woman & her father were racially discriminated against in Conoco-owned store when trying to buy gas & being asked for ID to make purchase; Conoco, Inc. claimed no responsibility because cashier was not acting within scope of her employment
    - Conoco, Inc. is liable for actions of cashier (was within scope of employment)
      * **factors used when considering whether employee’s acts are within scope of employment:**
        + **time, place and purpose of the act**
        + **its similarity to acts which the servant is authorized to perform**
        + **whether the act is commonly performed by servants**
        + **the extent of departure from normal methods**
        + **whether the master would reasonably expect such act would be performed**
* **Principal’s Liability for Torts of Independent Contractors** 
  + An employer is generally *not liable* for the torts/negligent acts of independent contractors committed within the scope of the contract, unless:
    - (a) the employer retains control of the manner and means of doing the work that is the subject of the contract
    - (b) the employer engages an incompetent contractor
    - (c) the activity contracted for constitutes a “nuisance per se”
      * “nuisance per se” = inherently dangerous activity
        + *policy:* creates incentive for employer to be careful; ensures there is a solvent defendant in case of accident (dangerous activity = accidents more likely)
  + *Majestic Realty Associates, Inc. v. Toti Contracting Co.*: independent contractor accidentally damaged neighboring building while working on demolition project; employer claimed no responsibility because demolition company was independent contractor
    - employer is liable for negligence of independent contractor (nuisance per se exception)
      * current tort rules characterize this type of demolition as inherently dangerous activity and demolition company acted negligently because didn’t follow protocol

**Liability of Agent to Third Parties in Tort:**

* Agent is liable for his own negligent actions (chooses to take the risk)

**Liability of Agent to Principal (Fiduciary Obligation of Agents):**

* **Contractual Liability of Agent to Principal**
  + Restatement (2nd) § 379: a person who makes a contract with another to perform services as an agent for him is subject to a duty to act in accordance with his promise
* **Tort Liability of Agent to Principal** (Fiduciary Duty)
  + Restatement (2nd) § 379-383; 387-396:
    - **Duty to Exercise Care** (can’t act negligently): an agent must
      * (a) act with care and skill
      * (b) not bring disrepute on the principal
      * (c) keep the principal reasonably informed
      * (d) keep and render accounts
      * (e) not act beyond the scope of his agency
    - **Duty to Exercise Loyalty** (can’t favor own interests over principal’s): an agent must
      * (a) give profits to the principal
      * (b) not act for an adverse party
      * (c) not compete with the principal
      * (d) not use or disclose confidences (confidentiality)
  + **Duties During Agency**
    - Business Opportunity Doctrine (part of duty of loyalty): an agent shall not misappropriate a business opportunity belonging to the principal
      * *Reading v. Regem:* British soldier made extra money by accompanying smugglers while wearing his army uniform (so wouldn’t seem suspicious)
        + England is entitled to the money the soldier made while smuggling

**if a servant takes advantage of his service and violates his duty of honesty and good faith to make a profit for himself (in the sense that his employment is the *real cause* of his obtaining money as distinct from *merely affording the opportunity for getting it*) then he owes that money to his master because *he got that money solely by reason of the position that he occupied as a servant to his master***

**doesn’t matter that the master didn’t lose any money or suffer any damages**

**doesn’t matter that the master couldn’t have done the act himself**

* + - * *Rash v. J.V. Intermediate, Ltd.*: Rash hired to start & manage division of JVIC; while working there he also owned 4 other businesses w/out telling JVIC & gave JVIC contracts to his businesses; used own scaffolding business even when JVIC started a scaffolding service
        + Rash breached his fiduciary duty to JVIC

**an employee has a duty to deal openly with the employer and to fully disclose to the employer information about matters affecting the company’s business**

at the very least an employee’s independent enterprise cannot compete or contract with the employer without the employer’s full knowledge

**it is the duty of an agent to disclose to the principal what the principal should rightly know** (what is relevant to principal’s business)

* + - * + *policy:* very low cost to agent to disclose info
  + **Duties During and After Termination of Agency** 
    - *Town & Country House & Home Services, Inc. v. Newbery:* employees left and started competing home cleaning agency w/ customer list from old employer
      * Newbery breached his obligation to former employer
        + ex-employee may not solicit his former employer’s customers who are not openly engaged in business in advertised locations or whose availability as customers cannot readily be ascertained

Newbery couldn’t have obtained customer list any other way, old employer spent a lot of time and money creating the customer list

* + - * *policy*: tradeoff between freedom of competition, employee mobility vs. employers being willing to train employees & give them access to info necessary to do their job

**PARTNERSHIPS:**

**Partnership (UPA §6(1)):** A **partnership** is an association of two or more persons to carry on as co-owners a business for profit

* no formalities in formation of partnership (very easy to create)
* characteristics of a partnership/factors to consider in determining existence of partnership:
  + agreement of the parties (intention)
  + sharing of profits
  + sharing of losses
  + sharing on dissolution
  + sharing of management
  + holding out to third parties
* UPA §15(b): all partners are jointly and severely liable for all the debts of a partnership

**Existence of a Partnership:**

* **Partners vs. Employees:**
  + UPA § 7(4)(b): the receipt by a person of a **share of the profits** of a business is **prima facie evidence that he is a partner** in the business, but no such inference shall be drawn if such profits were received in **payment as wages** of an employee
  + *Fenwick v. Unemployment Compensation Commission:* cashier & receptionist at salon wanted raise & manager agreed to give her one based on profits of salon; drafted “partnership” agreement where she would get 20% of profits, but no control over management, didn’t have to contribute capital & wouldn’t be liable for any losses
    - receptionist was employee, **not a partner** in the business
      * there is no evidence that *intention of parties* was anything except to provide way for cashier to get raise contingent on business doing well
      * agreement was method of providing compensation (sharing in profits was *payment as wages*)
    - *policy:* want to given people in business the freedom to structure their business as they see fit, but also want to give protection to third parties against undue reliance on a certain business structure
* **Partners vs. Lenders:** 
  + *Martin v. Peyton:* firm PPF loaned other firm KNK good securities; in exchange KNK promised to return the securities, pledged speculative securities to PPF, gave PPF share in profits, gave PPF certain management control, gave PPF option to enter firm
    - PPF were **not partners** with KNK
      * all provisions in agreement that may point to partnership relationship were reasonable insurance to make sure that PPF would get paid back their loan
      * agreement very clearly stipulated that this is *not* a partnership agreement (no intention)
    - *policy:* court wants to respect agreement of sophisticated parties
* **Partners vs. Independent Contractors:**
  + *Southex Exhibitions, Inc. v. Rhode Island Builders Association, Inc.*: company entered into agreement with producer to produce home shows; signed “partnership” agreement stating profits would be shared, producer would indemnify company for show-related losses; when company hired new producer, old producer sued claiming company violated fiduciary duty as partner by hiring new producer
    - producer was **not partner** with company
      * the labels parties assign to their intended legal relationship, while probative of partnership formation, are not necessarily dispositive as a matter
      * of law, particularly in the existence of countervailing evidence
      * **totality of circumstances** determines if partnership exists
        + for partnership:

contract was called “partnership agreement”

profit sharing

* + - * + against partnership:

fixed-term contract

losses not shared (indemnification provision)

producer made most management decisions

didn’t represent themselves as partners to outside

* **Partnership by Estoppel:**
  + RUPA § 308(a): if a person, by words or conduct purports to be a partner, or consents to be represented by another as a partner, in a partnership or with one or more persons not partners, the person is liable to a person to whom the representation is made, if that person, relying on the representation, enters into a transaction with the actual or purported partnership
  + *Young v. Jones*: Young was defrauded of investment to bank when defendants transferred money to another company where it disappeared; letterhead on company audit listed PWC-Bahamas as accountant; Young sued PWC-US asserting that they operate as a partnership
    - PWC-US & PWC-Bahamas are **not partners**
      * plaintiffs provided evidence that PWC holds worldwide offices out as partnership (based on flyers, brochures, etc.)
        + no evidence that plaintiffs read flyer (no representation made to plaintiff)
        + no evidence that plaintiffs relied on flyer or fact that PWC-US & PWC-Bahamas were a partnership when deciding to do business w/ company

**The Fiduciary Obligation of Partners:**

* **Duty of Care:**
  + UPA §404(c): a partner’s **duty of care** to the partnership and other partners in the conducting and winding up of the partnership is limited to engaging in:
    - (1) grossly negligent conduct
    - (2) intentional misconduct
    - (3) knowing violation of the law
* **Duty of Loyalty:**
  + UPA § 404(b): a partner’s **duty of loyalty** to the partnership and other partners in a partnership is limited to:
    - (1) to account to the partnership for any property, profit or benefit services by the partners in the conduct of the partnership business;
    - (2) to refrain from dealing with the partnership as or on behalf of a party having an interest adverse to the partnership; and
    - (3) to refrain from competing with the partnership before the dissolution of the partnership
  + *Meinhard v. Salmon:* S leased hotel & made renovations; partnered with M to finance it; shared profits & losses but S was the manager; when lease was coming to an end S signed a new lease for bigger portion of land w/out telling M; M claims S violated his fiduciary duty
    - S **breached fiduciary duty by** **misappropriating a partnership opportunity** (had duty to tell M about opportunity for new lease)
      * the only reason S was the one told about this opportunity was bc he was the sole manager, if owner had known that S & M were partners he would’ve likely made offer to both of them (managing partner has advantage over financing partner)
    - partners owe to one another the **duty of finest loyalty while the enterprise continues**
    - note: compare judge’s colorful language e.g. “finest loyalty”, “highest honor”, etc. r.e. partnership relationship with UPA 404(b) language
* **Joint Venture:**
  + very similar to partnership but more limited in scope and duration; principles of partnership law (fiduciary duty) still apply
    - easier to find that joint venture exists, but duties imposed on the joint venture are more narrowly focused on what the joint venture does
      * *policy*: partnership definition was so engrained in case law, but court wanted another type of association where fiduciary duty applied but wasn’t quite a partnership
  + Elements of Joint Venture:
    - contribution to joint undertaking (but don’t need to be equal or of same nature)
    - a proprietary interest or right of mutual control over the engaged property
    - an agreement to share profits (and maybe losses)
    - an express or implied contract showing a joint venture was formed
  + *Sandvick v. LaCrosse*: 4 ppl (including S & L) purchased 3 oil & gas leases for 5 yr term w/ intent to sell them during that time; few months before leases were set to expire, L purchased top leases on the same ones that would kick in when these expire w/out telling S; S claimed L breached fiduciary duty by not offering S to purchase top lease with him
    - S **breached fiduciary duty**
      * Scope of venture was to purchase & attempt to sell leases
        + By buying top lease, S created conflict of interest because now he was better off *not* selling these leases before they expired
      * S **took advantage of** **joint venture opportunity**
* **Termination:**
  + *Meehan v. Shaughnessy:* M was partner in law firm; decided to start own firm w/ some other partners & associates; didn’t tell anyone at firm; took meetings w/ clients & solicited their business; when asked if was planning to leave by firm denied it until last moment
    - M **violated his fiduciary duty** to the firm
      * **fiduciaries may plan to compete with the entity to which they owe allegiance, provided that in the course of such arrangements they not otherwise act in violation of their fiduciary duties** 
        + *a departing partner can:*

make logistical arrangements (office space, financing, etc.)

* + - * + *a departing partner cannot:*

lie to any partner about anything affecting the partnership when asked

lied about leaving firm until last moment

misappropriate business opportunities

give themselves **unfair advantage** by delaying telling the partnership which clients they plan to solicit (not giving partnership fair chance at competition)

send letters to clients that don’t fully explain their right to either leave w/ new partnership or stay w/ old one

* **Expulsion:**
  + *Lawlis v. Knightlinger & Gray*: L was partner in law firm; became alcoholic; partnership gave him chances to recover & stay in partnership at first; later partners voted to expel him pursuant to rules of partnership agreement; L sued claiming breach of fiduciary duty & breach of partnership agreement
    - L’s expulsion was **not a breach of fiduciary duty *nor* the partnership agreement**
      * **when a partner is involuntarily expelled from a business, his expulsion must have been “bona fide” or in “good faith” for a dissolution to occur without violation of the partnership agreement**
    - partnership agreement trumps common law or statutory fiduciary duty definitions
      * firm’s partnership agreement said how expulsions are handled and was followed

**Partnership Property:**

* note shift from view of partnership as **aggregate of members** (UPA)to **own separate entity** (RUPA)
  + UPA § 24: the property rights of a partner are (1) his rights in specific partnership property, (2) his interest in the partnership, and (3) his right to participate in the management
  + UPA § 25(1): a partner is a co-owner with his partners of specific partnership property holding as a tenant in partnership
  + RUPA § 201(a): a partnership is an *entity* distinct from its partners
  + RUPA § 203: property acquired by a partnership is property of the partnership and not the partners individually
  + RUPA § 501: a partner is not a co-owner of partnership property and has no interest in partnership property which can be transferred, either voluntarily or involuntarily
  + RUPA § 401(g): a partner may use or possess partnership property only on behalf of the partnership
  + *Putnam v. Shaof*: P bought out her 50% stake of partnership in Gin Company because didn’t want to worry about debt and impending litigation anymore; turned out old bookkeeper was defrauding partnership; P wanted some of the damages bc she was partner while embezzlement occurred
    - P is **not entitled** to damages
      * partnership owns the property (including unrealized tort claims) and each partner has *interest* in it
        + P conveyed her interest in the partnership when she bought herself out

isn’t liable for losses/liabilities of partnership (even ones that occurred while she was partner), doesn’t get to share in gains of partnership (even ones that occurred while she was partner)

no longer has claim to any property of partnership (including unrealized tort claims)

* + - * any right to use partnership property dissolves when partnership terminates

**The Rights of Partners in Management:**

* partnership agreements detailing rights to management > default common law rules
* **Equality:** each partner can take actions on behalf of partnership
  + UPA § 18(e), RUPA § 401(i): all partners have equal rights in the management and conduct of the partnership business
    - default rule for general management decisions when no one is against a particular decision of a partner
      * (+): decisions made quicker; lower transaction costs
      * (-): risk that partner will do something others disagree with but are still liable for; chaotic
  + *National Biscuit Company v. Stroud*: S & F entered into grocery store partnership; nothing in partnership agreement restricted either partner’s authority to make general management decisions; S claimed he isn’t personally responsible for bread sold to partnership at request of F
    - S **is responsible** for F’s actions on behalf of partnership
      * each partner in general partnership has power to bind partnership in any manner legitimate to business; all partners have equal rights in management and conduct of the partnership business
        + buying bread for grocery store is general management decision
* **Majority:** majority of partners must agree before an action can be taken on behalf of partnership
  + UPA § 18(h), RUPA § 401(j): any difference arising as to a matter in the ordinary course of business of a partnership may be decided by a majority of the partners
    - default rule for general management decisions when there is a disagreement between partners
      * (+): can override holdouts; some protection against partner doing something you don’t agree with
      * (-): doesn’t help if even number of partners; “tyranny of majority” can lead to oppression of minority interests
  + *National Biscuit Company v. Stroud*: S & F entered into grocery store partnership; nothing in partnership agreement restricted either partner’s authority to make general management decisions; S claimed he isn’t personally responsible for bread sold to partnership at request of F
    - S **is responsible** for F’s actions on behalf of partnership
      * any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners, provided there is no other agreement by the partners that speaks to this issue
        + buying bread for grocery store is general management decision, but 1/2 of partnership is not a majority so S can’t restrict F’s actions
  + *Summers v. Dooly:* S & D formed trash collection partnership; S wanted to hire additional worker but D refused; S hired worker anyway and sued D claiming he was required to pay half the expenses of worker
    - D is **not responsible** for S’ actions of hiring additional worker
      * any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners, provided there is no other agreement by the partners that speaks to this issue
        + hiring additional worker is general management decision
        + majority of partners didn’t consent (1/2 is not majority)

D continually voiced disapproval

* + note: compare *National Biscuit Company* to *Summers*
    - in *National Biscuit Company* there was **no express disagreement** about buying bread, S just didn’t want to be responsible
    - in *Summers*, there was an **express disagreement** about hiring additional worker
* **Unanimity:** all partners must agree before an action can be taken on behalf of partnership
  + RUPA § 401(j): an act outside the ordinary course of the partnership may be undertaken only with the consent of all the partners
    - default rule when a management decision is outside the ordinary course of the partnership (no requirement of disagreement)
      * (+): everyone agrees; strongest protection against partner doing something you don’t agree with; no chaos
      * (-): possibility of deadlock; high transaction costs; holdouts
* **Partners’ Rights Against Partnership for Management Decisions:**
  + *Day v.* *Sidley & Austin*: D was partner at S&A law firm + chair of Washington office; partnership agreement allowed executive committee to manage affairs of partnership (Day not part of EC); EC was in secret talks of merging with other firm; when told plan to all partners including D approved; amended partnership agreement was signed by all partners; when Washington offices merged D became co-chair and firm moved locations (against D’s wishes); D left firm claiming changes were intolerable & sued firm for misrepresentation and breach of fiduciary duty
    - firm is **not liable** to D
      * D claims misrepresentation because partnership agreement promised no partner would be worse off as a result of merger
        + D wasn’t deprived of any legal right based on partnership agreement

partnership agreement made specific concessions to other partners but made no mention of co-chair position

D was sophisticated party, could’ve asked to include concession to him in agreement

* + - * D claims breach of fiduciary duty by EC by secretly beginning merger negotiations
        + fiduciary duty is mostly concerned w/ partners who make secret profits

concealment of this info doesn’t produce any profit for EC partners nor any losses for partnership as a whole

partnership agreement provided management authority to EC (too many partners to have majority vote on everything)

court wants to respect agreements between sophisticated parties

**Partnership Dissolution & Dissociation:**

* **Dissolution:** business terminates & there is a winding up
  + RUPA § 801: a partnership is **dissolved** and its business must be wound up, only upon the occurrence of any of the following events:
    - **notice**
      * RUPA § 801(1): in a **partnership at will**, the partnership’s having *notice* from a partner ... of that partner’s express will to withdraw as a partner
        + note: there doesn’t necessarily need to be reason for withdrawal, but if reason is in bad faith or against partner’s other fiduciary duties, court may find partner is acting contrary to partnership agreement even in partnership at will
    - **expiration of term/completion of undertaking**
      * RUPA § 801(2)(ii): in a **partnership for a definite term or particular undertaking**, the partnership dissolves *upon the expiration* of the term or completion of the undertaking
        + note: no notice requirement; can dissolve earlier if all partners agree
    - **illegality**
      * RUPA § 801(4): in a **partnership for a definite term or undertaking**, the partnership dissolves upon an event that makes it *unlawful* for all or substantially all of the business of the partnership to be continued, but a cure of illegality within 90 days after notice to the partnership of the event is effective retroactively to the date of the event
    - **judicial decree**
      * RUPA § 801(5): in a **partnership for a definite term or particular undertaking,** the partnership dissolves on application by a partner, by a *judicial determination* that
        + (i) the economic purpose of the partnership is likely to be unreasonably frustrated
        + (ii) another partner has engaged in conduct relating to the partnership business which makes it not reasonably practicable to carry on the business in partnership with that partner, or
        + (iii) it is not otherwise reasonably practicable to carry on the partnership business in conformity with the partnership agreement
      * *policy:* court will give remedy when it’s not economically efficient for partnership to continue, but requires a legitimate reason because don’t want partners frivolously dissolving partnerships after making promise to continue for certain term
      * *Owen v. Cohen:* O + C opened bowling alley as partners w/ no partnership agreement; O have partnership loan to get started w/ expectation that it would be paid back (i.e. partnership would at least last as long as it took to pay back loan); O + C disagreed on almost all business matters, C treated O badly & constantly tried to get more management control; O asked for judicial decree to dissolve
        + this case **warrants decree of judicial dissolution**

general rule is that trifling and mere differences and grievances which involve no permanent mischief will not authorize a court to decree a dissolution

but courts of equity may order the dissolution of a partnership where there are quarrels and disagreements of such a nature and to such extent that all confidence and cooperation between the parties has been destroyed or where one of the parties by his misbehavior materially hinders a proper conduct of the partnership business

not just large arguments may produce this type of trouble, continuous petty disagreements can also do a lot of damage

C’s vexatious treatment of O made it not reasonably practicable for business to carry on

* + - * *Collins v. Lewis:* C + L entered into partnership for cafeteria business; C would finance & L would manage; building of cafeteria took long time and more money than expected & C refused to give any more money; C claimed L mismanaged the construction & asked for judicial decree granting dissolution
        + this case **does not warrant judicial decree of dissolution**

L was competent manager and there was a reasonable expectation of profit for the business

* + - * + partner could always terminate their relationship with the partner themselves, but that leaves them subject to liability for damages that may flow from breach of contract
      * note: change from old to new UPA rule
        + **old rule:** UPA § 32(1)(e): a court may order dissolution if the business of the partnership can only be carried on at a loss
        + **new rule:** UPA § 801(5)(i): a court may order dissolution if the economic purpose of the partnership is likely to be unreasonably frustrated
        + *policy for change:* old rule was too restrictive; there are situations where while partnership can still operate at a profit but where dissolution is economically efficient nonetheless
* **Dissociation:** partner leaves partnership, but the business continues with the partners who remain (and remaining partners buyout dissociated partner’s interest in business)
  + RUPA § 601: a partner is **dissociated** by:
    - (1) the partnership’s having **notice** of the partner’s express will to withdraw;
    - (2) an event **agreed** to in the partnership agreement;
    - (3) the partner’s **expulsion pursuant to the partnership agreement**;
    - (4) the partner’s **expulsion by the unanimous vote** of the other partners [if certain conditions are met];
    - (5) the partner’s **expulsion by judicial determination** that
      * (i) the partner engaged in wrongful conduct that adversely and materially affected the partnership business
      * (iii) the partner engaged in conduct relating to the partnership which makes it not reasonably practicable to carry on the business in partnership with the partner
    - (6) the partner’s **insolvency**;
    - (7) the partner’s **death** [or **incapacity/incompetence**]
  + *Giles v. Giles Land Company:* Kelly Giles was partner in partnership with rest of his family; partnership wanted to become LLP (sensible business decision) but K refused; K had very distrustful relationship w/ rest of family – thought they were hiding something, refused to speak to them directly, threatened them, etc.; rest of family asked court to dissociate K from partnership bc he made it impossible for business to continue
    - this case **warrants a judicial decree of dissociation** 
      * K made it not reasonably practicable to carry on business in partnership with partner
        + bad family relationship, not speaking, etc. put business at a standstill & blocked sensible business change all other partners wanted

an irreparable deterioration of a relationship between partners is a valid basis to order a dissociation

* + - * K engaged in wrongful conduct that adversely and materially affected the partnership business
        + berated & threatened family members, refused to communicate regarding business, etc. causing partnership to be at standstill

**The Consequences of Dissolution:**

* **Winding Up Process:**
  + Steps:
    1. Consolidate assets
    2. Liquidate assets
       - assets can be sold to either third parties or partners (*Sheffel*)
       - assets can be sold privately or at public sale
    3. Pay off claimants (creditors) in order of priority
       - UPA § 40(b): subject to any contrary agreement, upon dissolution, the liabitlies of the partnership shall be paid in the following order:
         * i. those owing to creditors other than partners
         * ii. those owing to partners other than for capital or profits
         * iii. those owing to partners in respect of capital
         * iv. those owing to partnership in respect of profits
       - UPA § 40(d): the partners shall contribute the amount necessary to satisfy the above liabilities according to his share of the profits
    4. Distribute remainder to partners in proportion to their interest in partnership
  + *Prentiss v. Sheffel:* 3 partners bought & managed shopping center; formal partnership agreement was never finalized or agreed-upon; relationship of partners deteriorated & S was excluded from management affairs; court granted decree of dissolution; partnership property was to be sold & divided among partners; two other partners bid for the partnership property at auction w/ their partnership interest & won
    - there is no precedent that prohibits a partner from bidding at a judicial sale of partnership assets
      * there is no indication that S’ exclusion from management was done in bad faith in order to dissolve partnership and bid on the property
        + exclusion was a result of deteriorated relationship
      * there is no indication that S was injured by the other partners’ auction bids
        + they actually drove up the price (they were highest bidders) so it actually helped him because now he gets more money
* **Remedies for Breach of Partnership Agreement:**
  + dissolving partnership in violation of partnership agreement is a breach of contract
    - UPA § 38(2)(a)(II): when dissolution is caused in contravention of partnership agreement, each partner who *has not* caused the dissolution wrongfully shall have the right, as against each partner who *has* caused the dissolution wrongfully, to damages for breach of agreement
    - UPA § 38(2)(b): the partners who *have not* caused the dissolution wrongfully shall have the right, if they desire, to continue the business under the same name, provided they pay the partner who has caused the dissolution wrongfully the value of his interest in the partnership at dissolution, less any damages recoverable, and indemnify him against all present and future liabilities
      * UPA § 38(c)(II): if the business is continued ... a partner who *has* caused the dissolution wrongfully shall have the value of his interest in the partnership, less any damages caused to his co-partners by the dissolution, ascertained and paid to him in cash, but in ascertaining the value of the partner’s interest, the value of the good will of the business shall not be considered
        + *compare to*

RUPA § 701 **(new rule)**:

(a) if a partner is dissociated from a partnership without resulting in a dissolution, the partnership shall cause the dissociated partner’s interest in the partnership to be purchased for a buyout price determined by

(b) the amount of the partner’s share if, on the date of dissociation, the assets of the partnerships were sold at a price equal to the greater of the liquidation value or the value based on a sale of the entire business as a going concern without the dissociated partner and the partnership was wound up as of that date

note: no mention of good will exclusion

* + - *Pac-Saver Corporation v. Vasso Corporation:* PSC & V entered into partnership agreement; P was required to supply financing & PSC would allow partnership to use it’s patents; partnership agreement said partnership is to be permanent and dissolved only upon mutual approval and provided for stipulated damages if partnership is dissolved by one of the partners; business started doing poorly and parties began to disagree on management decisions; PSC asked for judicial decree to dissolve partnership; V counter-claimed that judicial decree would violate partnership agreement and that he should be allowed to continue business based on UPA and keep the trademarks & patents in order to be able to do so
      * PSC violated partnership agreement by asking for judicial decree
        + V chose to continue partnership as allowed by UPA

in order for partnership to be able to continue, V needs patents

* + - * note: this is an odd case because court went against express provisions of partnership agreement (which said that upon dissolution there would be stipulated damages but patents would be returned)
        + *Dissent*: duties and obligations of partnership are governed by partnership agreement to the extent that they’re covered thereby & agreement clearly calls for return of patent

**The Sharing of Losses:**

* RUPA § 401(b): each partner is chargeable with a share of the partnership losses in proportion to the partner’s share of the profits
* *Kovacik v. Reed:* K & R entered into partnership remodeling kitchens where K would provide the financing & R would supervise and estimate the jobs; profits would be split 50/50; there was no formal agreement or discussion of who would bare losses if they arose; business operated at a loss & K insisted that R has to pay half the losses
  + general rule is that in the absence of an agreement to the contrary, partners share losses in the same proportion as they share profits, regardless if they contributed unequal amounts of capital to the business
    - but when one partner contributes money capital against the other’s skill and labor, neither party is liable to the other for contribution for any loss sustained
      * *policy*: each partner has lost their own capital in the event of a loss (one his money, the other his labor); where this happens but parties agree to share profits equally, it seems that parties view each other’s contributions as equal in value
        + note: court is assuming here that R’s labor is worth the same amount as K’s capital contributions
  + note: RUPA expressly rejects *Kovacik* & says that partners who don’t contribute any capital are still liable for the partnership’s losses based on the % profits they are entitled to

**Buy-Out Agreements:**

* partnership agreements that outline what a partner is entitled to in exchange for his interest in the firm if he chooses to end his relationship with the partnership (spell out what happens if partner leaves)
  + **buyout agreements trump** default rules
    - usually based on formula & tailored to partnership’s unique needs and circumstances
      * most commonformula: partner gets his interest % of market value of partnership assets
* *G&S Investments v. Belman*: G&S entered into partnership w/ man to run apt complex; man became cocaine addict & was impossible to work with; G&S asked for judicial decree of dissolution; man died before court could respond; G&S invoked right to continue partnership & buyout man’s interest based on provision in partnership agreement which said the buyout would be based on the value of the partner’s capital account; man’s estate claimed buyout should be based on general formula of fair market value of assets
  + **partnership buyout agreements are valid and binding** & courts don’t have power to rewrite the agreement based on subjective notions of fairness just because the agreement didn’t turn out to be advantageous
    - modern business practice mandates that absent fraud or duress, parties should be bound by the contracts they enter into

**CORPORATIONS:**

**Defining Characteristics of a Corporation:**

* double taxation: the corporation itself is taxed on its earnings and shareholders are taxed when the corporation pays out dividends
* corporations are considered legal persons(have same rights as people)
  + corporation is own entity fully separate from its shareholders
  + Delaware General Corporations Law (DGCL § 121-122): corporations have the power to
    - have perpetual life
    - sue and be sued
    - hold and deal in real or personal property
    - appoint officers and agents
    - adopt, amend and repeal bylaws
    - wind up and dissolve
    - conduct business, carry on operations, have offices and exercise powers
    - make contracts
* shareholders don’t have an active role in the management of a corporation (unlike in partnerships)
* corporations confer limited liability onto shareholders (unless corporate veil is pierced (*see more below*))

**Corporation Formation & Governance:**

* to form corporation, must **file & register with state** (can’t form corporation accidentally, unlike partnership)
  + *policy*: protects creditors’ exposure to losses stemming from the limited liability of a corporation (unlike a partnership)
    - corporation is required to have something in their name that signifies they are a corporation (“inc.”, “corp.”, etc.) so creditors are aware
* public corporate governance: corporation’s activities, articles of incorporation and bylaws have to be consistent with US Constitution, State Constitution (where it’s incorporated), state corporation law statutes (e.g. DGCL)
* private corporate governance:
  + **articles of incorporation (charter):** establishes key powers of the participants of a corporate enterprise (“private Constitution”)
    - must file charter w/ secretary of state in order to become corporation
    - must be drafted to meet minimum statutory requirements (each state has own Corporate Law Code)
      * required provisions (in most states):
        + name

can’t be confusingly similar to another business incorporated or qualified to do business in that state

must include some word or abbreviation indicating business is incorporated

* + - * + maximum number of shares corporation is authorized to issue
        + name of corporation’s registered agent and address of its registered office

registered agent receives service of process when corporation is sued

registered office must be in state of incorporation

* + - * optional provisions:
        + statement of purpose: nature of corporation’s business and purpose for which it was formed
        + classes and series of shares (if corporation wishes to separate stock into multiple classes and series)
        + director & officers indemnification and liability limitation
    - articles of incorporation are usually drafted very loosely & generally because:
      * they are difficult to amend (need consent of *all* shareholders)
      * when there is a conflict between the articles of incorporation & the bylaws, articles of incorporation trump
        + drafting articles of incorporation generally helps to avoid conflicts
  + **bylaws:** “private statutes” of corporation
    - DGCL § 109(b): bylaws can contain any provision, not inconsistent with the law or charter, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors and officers
      * bylaws tend to be more detailed than articles of incorporation because:
        + don’t need to be filed w/ state government (not part of any public record)
      * bylaws are easier to pass/amend than charters
        + DGCL § 109(a): the power to adopt, amend or repeal bylaws shall be in the stockholders we entitle to vote … notwithstanding the foregoing, any corporation may, in it’s certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors. The fact that such power has been so conferred upon the directors shall not divest the stockholders … of the power, nor limit their power to adopt, amend or repeal bylaws

note: in practice, almost all corporations confer such power upon the directors in their articles of incorporation

* *Boilermakers Local 154 Retirement Fund v. Chevron Corporation:* Chevron board adopted bylaw provision that required all shareholder litigation be in Delaware (forum selection clause);stockholders claimed provision is statutorily & contractually invalid
  + bylaw provision is **statutorily valid**
    - DGCL allows bylaws to regulate rights of stockholders (DGCL § 109(b))
      * this provision regulates rights of stockholders because it affects where stockholders can exercise their right to sue the corporation
      * provision fits the “procedural, process-oriented nature” of Delaware corporation bylaws
  + bylaw provision is **contractually valid**
    - certificate of incorporation clearly states that directors are allowed to adopt bylaws & that shareholders are bound by them
      * articles of incorporation & bylaws constitute binding part of contract between corporation & its shareholders
    - shareholders still have power to check board’s decision by repealing or creating/amending bylaws themselves (DGCL § 109(a))

**Limited Liability & Piercing the Corporate Veil:**

* **Limited Liability:**
  + shareholder is not personally responsible for debts or torts of corporation
    - liability is limited because if value goes down, shareholder still loses their investment (but never anything more)
  + *policy:*
    - people would be deterred from investing in capital markets if they feared liability and we want to encourage equity investments
      * desire to keep capital in business enterprises to protect creditors against risk of insolvency
    - if liability was limited and severable, wealthy people especially would never invest because creditors would always go after them
    - if liability was limited and severable, transaction costs would be very high
      * creditors would have to sue each shareholder individually if corporation defaulted
    - could lead to corporate death spirals
      * if seemed like company wasn’t doing well 🡪 everyone would sell stocks to avoid liability 🡪 would create death spiral before market had a chance to reflect real value of corporation
  + who is hurt by limited liability?
    - contract creditors (not so much)
      * protected by notice regime (if agent makes contract for undisclosed principle, he is liable on the contract)
      * get to *choose* who they enter into contracts with & always know when they’re dealing with a corporation because corporations are required to ID themselves as such
        + can do due diligence before choosing to lend

if financials don’t look good, can:

choose not to lend

ask for higher down payment

ask for guarantee

put lien on their assets

* + - tort creditors (more so)
      * cant *choose* who you’re injured by
      * agent of corporation (employee) is *also* liable to you for tort (along with corporation)
        + gives tort creditors *some* cushion, but often agents are judgment-proof (can’t pay)
  + limited liability **creates conflicting public policy concerns** (encouraging investment vs. ensuring creditors are paid)
    - two ways law could with this:
      * **capital regulation**: law can require corporations to always have positive capital in case of liability (capital = assets – debt)
        + way to make sure that corporation is able to pay creditors and for liability of shareholders to never have to be called on

*problems with this approach*:

can never know how much capital is enough (liabilities are inherently uncertain)

costly to administer and regulate this requirement

* + - * **liability flip:** sort companies into two types – those who benefit from limited liability and those who don’t (based on overall net social benefit/cost of imposing LL) –and confer limited liability only on those that benefit from it
        + *problems with this approach:*

hard to sort between these two types of companies

transactions costs would be really high for creditors going after big companies with unlimited liability (would have to sue each individual shareholder)

would discourage investment in small businesses

* **Piercing the Corporate Veil:**
  + court will impose personal liability on shareholders of corporation in some **exceptional circumstances**
    - *policy:* provides creditors with adequate capitalization; protects against self-dealing (people hiding behind cloak of limited liability)
  + *Walkovsky v. Carlton:* W hit by cab owned by C’s corporation; C owned 10 other corporations w/ 2 cabs each, holding min amount of insurance required; ran all corporations as one even though were technically separate; W sued to hold C personally liable & other 10 corporations liable on veil piercing theory, claiming corporate label was just sham
    - courts will disregard corporate form (pierce veil) when necessary to avoid fraud or achieve equity
      * **whenever someone uses control of corporation to further his own - rather than the corporation’s – business, he will be liable for the corporation’s acts**
    - two veil-piercing theories:
      * (a) that multiple corporations are really one
        + if proven, plaintiff can recover from all

*policy:* corporations are only separated to limit liability

* + - * (b) that corporation is alter-ego of individual owner (owner was conducting business in his personal capacity)
        + if proven, plaintiff can recover from owner

*policy:* corporate status is only to limit liability

* + - W failed to provide enough evidence to show either theory
      * “corporate form may not be disregarded merely because the assets of the corporation, together with the mandatory insurance coverage, are insufficient to assure recovery sought”
        + note: demonstrates high burden on plaintiff
    - *Dissent:* corporation was intentionally undercapitalized
      * corporate law could not have been meant to shield those who organize corporations with specific intent of avoiding liability to the public
        + public policy dictates that participating shareholder in corporation vested with a public interest (e.g. taxicabs) may be held personally liable when the corporation is organized with capital insufficient to meet the liabilities certain to arise in the ordinary course of business
      * other possible ways for plaintiff to recover (ultimately rejected in this case):
        + **enterprise liability/reverse veil piercing:**all different companies are basically just one large company (common enterprise) and that their separate existences are immaterial

so can go after any of the companies for the fault of one of them or for the fault of the owner if there is unity of interest in ownership

* + *Sea-Land Services, Inc. v. Pepper Source:* SL shipped peppers on behalf of PS; PS didn’t pay bill & dissolved soon after; SL sued to pierce corporate veil and hold director & 5 other corporations liable for bill, claiming they were all alter-egos for one another and were created and manipulated by director for his own personal use
    - corporate veil may be pierced if:
      * (1) there is **unity of interest and ownership** that the separate personalities of the individual (or other corporation) and the corporation don’t exist; AND
        + factors considered:

failure to maintain adequate corporate records or comply with corporate formalities

e.g. board meetings, shareholder meetings, minutes, etc.

commingling of funds/assets

undercapitalization (insufficient funds to cover liabilities)

one corporation treats the assets of another as its own

* + - * (2) not piercing the veil would **sanction fraud & promote injustice**
        + some wrong beyond creditors inability to get paid must result from not piercing corporate veil (otherwise this prong would always be met and serve no purpose)

e.g. someone would be unjustly enriched, scheme to funnel assets into liability-free corporation would be successful, someone would be able to skirt liability, etc.

* + - in this case:
      * (1) is met: none of the corporations ever held board meetings; director ran all corporations from single office with same phone number, expense accounts, etc.; director borrowed $ from corporation; corporations borrowed $ from each other; director used corporate bank account for personal expenses
      * (2) requires more evidence & is remanded (SL was only able to show creditors not getting paid as “wrong”)
  + **Parent & Subsidiary Corporations:** when one corporation owns all the common stock of another
    - parent is generally not liable for debts of subsidiary unless participates heavily in activities of subsidiary
      * *policy:* allows corporations to venture into new business opportunities without risking current assets beyond the amount they’re willing to invest into subsidiary
    - *In re Silicone Gel Breast Implant Products Liability Litigation:* B was parent of MEC (breast implant supplier); class action plaintiffs seek to hold B liable for injuries caused by MEC’s breast implants
      * two theories of liability:
        + **veil-piercing:** when corporation is so controlled as to be alter-ego or mere instrumentality of its stockholder, corporate form may be disregarded in the interests of justice

**totality of circumstances** must be evaluated in determining whether subsidiary may be found to be the alter-ego or mere instrumentality of a parent corporation

factors: common directors/officers; common business departments; file consolidated financial statements & tax returns; parent finances subsidiary; subsidiary operates w/ inadequate capital; parent pays salaries/expenses of subsidiary; subsidiary doesn’t observe separate corporate formalities (own meetings, etc.); parent uses subsidiary’s property as own; daily operation of parent & subsidiary are not kept separate; all of subsidiary’s business comes from parent

showing of fraud is *not* necessary if subsidiary is found to be mere instrumentality of parent in tort suit (might be required in contract suit)

in this case, MEC was just B alter-ego

board of directors was same; B authorized MEC’s spending & budgets; B provided MEC w/ press releases, general counsel, etc.; B’s logo was on MEC merchandise

* + - * + **direct liability** (tort theory): one who undertakes to render services to third party is subject to liability for failing to exercise reasonable care if his negligence increased the risk of harm or the harm suffered because of a reliance by the third party

by putting name on MEC’s products, B held itself out as supporting product & caused reliance

* + - * note: strong public policy of holding large corporation liable to ensure compensation for class action due to product injuries heavily weighed towards piercing corporate veil in this case
        + this case is an outlier (courts usually don’t pierce corporate veil)

**The Role & Purposes of a Corporation:**

* **History:** history has shaped the view of the function of business corporations in our society
  + beginning of 19th century: government subsidized corporations because wanted to promote infrastructure (idea was that these businesses developed the US as an economic power)
    - conferred degree of monopoly power onto corporations, but limited what corporations could do
      * purpose & power clauses: stated purposes for which corporation is organized and the powers given to the corporation to fulfill its purpose
        + ultra-vires doctrine: anything corporation does outside its powers & purposes is unenforceable
  + today: US is developed enough that it no longer needs to subsidize corporate growth
    - anyone can form corporation (no more monopoly benefits)
    - assumed that corporation can be established “for any lawful purpose”
      * DGCL § 101(b): a corporation may be incorporated or organized for any lawful business or purpose
      * DGCL § 121-122 (*see text above*): corporations have same powers as persons
* **Business Judgment Rule:** decisions by corporate directors are generally respected as valid, carefully considered business judgments (not court’s place to evaluate soundness of decision)
  + *Dodge v. Ford Motor Co.:* Dodge brothers (shareholders in Ford Motor Co.) sued when Ford announced it would stop paying special dividends (even though company was doing really well and had paid these out before) in order to expand business to make more cars and sell them cheaper; Dodge brothers claimed proposed business expansion was against interests of corporation and should be enjoined & decision to stop paying special dividends was arbitrary
    - dividends:
      * directors of corporation and they alone have the power to declare dividends
        + **courts will not interfere in the management of directors unless it is clearly made to appear that they are guilty of fraud or misappropriation of corporate funds, or refuse to declare a dividend when (a) they can without detriment and (b) a refusal to do so amounts to such an abuse of discretion that it would constitute fraud and breach of good faith to stockholders**

to figure this out court can look at balance sheet to see how liquid (assets > debts) company is

* + - * in this case, Ford claimed that decision not to pay dividends was justified based on business plan to build new plant to make more cars and sell them cheaper
        + Dodge Bros. argued that this plan would actually amount to losses for corporation and that Ford’s intention was to give back to the community by creating more jobs & selling cars at lower price

since plan would make business less profitable, Ford is breaching duty of good faith the stockholders

there is a difference between (a) an incidental humanitarian expenditure of corporate funds for benefit of employees and (b) a general purpose and plan to benefit mankind at the expense of others (stockholders)

Ford’s decision r.e. not paying dividends seem to fall under (b), so he is required to pay them

note: real policy underlying decision was likely that Dodge Bros. were creating competitor w/ funding from these dividends and upholding refusal to pay them would’ve been anti-competitive (and Ford was actually refusing to pay them on purpose for this reason)

* + - injunction of expansion plan:
      * **the question of the validity of a company’s business decision turns on whether it appears that the company’s directors were acting in the best interest of the corporation** 
        + court is not a business expert and Dodge Bros. have no persuaded court that expansion plan is not a rationale business decision that has the long-term profits of the corporation in mind
  + *Shlensky v. Wrigley:* W (president of Wrigley Field & Cubs) refused to install lights in field for Cubs to play night games; shareholder sued claiming that decision was hurting profitability and W’s decision is only based on his personal beliefs that baseball is a daytime sport & playing night games would be bad for neighborhood and that this arbitrary decision constitutes mismanagement
    - **courts will generally not** **step in and interfere with honest business judgment unless there is a showing of fraud, illegality, or conflict of interest** 
      * it is not the court’s function to resolve for corporations questions of policy and business management, that is the job of the directors
        + in a purely business corporation, the authority of directors in conducting business is regarded as absolute
    - in this case, W’s motives aren’t necessarily arbitrary or unrelated to business of corporation
      * possible that there is genuine long term concern about what effects declining neighborhood would have on the value of the stadium’s real estate and game attendance
        + unless conduct at least borders on fraud, illegality, or conflict of interest, it’s not for court to decide on
      * no evidence cited that not playing night games hurts profitability (based on overall cost-benefit analysis)
* **Charitable Giving:** attitude has changed (now regarded as part of *business judgment* of corporation)
  + DGCL § 122(9): every corporation created under this chapter shall have the power to make donations for the public welfare or for charitable, scientific or educational purposes, and in time of war or other national emergency in aid thereof
  + *A.P. Smith Mfg. Co. v. Barlow:* stockholders objected to corporation’s donation to Princeton University, claiming that articles of incorporation didn’t expressly authorize such contribution and that under common-law principles, corporation doesn’t possess any powers to make such contribution
    - changing social conditions (most of wealth now belongs to corporations rather than individuals) has prompted change in public & judicial opinion on corporate charitable giving
      * charitable donations promote corporate objectives
        + in this case: testimony by president of corporation that public expects corporations to aid philanthropic causes; corporate giving improves good will; contributing to liberal arts education promotes flow of properly trained personnel

decision to donate was **valid business judgment**

* + - public policy dictates allowance of corporations to easily donate to community
  + **Public Benefit Corporation:** new possible corporate classification (recent development)
    - like corporation in almost every respect except purpose expressly includes serving the public (but still is for-profit)
      * idea is that the issues that come up in the above cases wouldn’t come up under this classification because public benefit becomes part of corporate purpose

**Management of Corporations:**

* **Corporate Governance:** three types of people play a role
  + shareholders (owners of corporation)
  + Board of Directors (those in charge of what corporation does)
  + employees (especially c-suite executives)
    - executives are technically supposed to be taking orders from the Board, but sometimes it ends up being the other way around
* **The Ur-Rule:** directors direct, shareholders sharehold
  + all corporate codes have some provision implementing this idea
    - **shareholder power** in theory is very large, but in reality is restricted because most of the powers are divested to Board (*see more below in RIGHTS OF SHAREHOLDERS*)
      * power of shareholders includes:
        + calling shareholder meetings (rarely done)
        + voting for election or removal of directors

can be done personally at shareholder meeting or by proxy

* + - * + voting on fundamental corporate changes (e.g. mergers, dissolution, etc.)

can be done personally at shareholder meeting or by proxy

* + - * + advisory (non-binding) voting on other matters presented at shareholder meeting
        + voting on shareholder proposals to send to Board of Directors (but Board rarely passes these)
    - **Board of Directors**
      * **Powers:**
        + DCGL § 141(a): the business and affairs of every corporation organized under this chapter shall be managed *by* or *under the direction of* a Board of Directors, except as may be otherwise provided in this chapter or in its certificate of incorporation

Board of Directors can choose to either (a) manage corporation themselves or (b) direct the management of the corporation by supervising executives

almost always, especially in large companies, Boards choose to delegate management tasks to executives

(+): allows Board to play central role in corporation instead of having to be involved in details

(-): asymmetrical information risk (Board might miss issues crucial to firm’s welfare or not get accurate feedback from executives in charge)

* + - * **Size:** studies suggest that board effectiveness decreases once size passes certain threshold, so determining optimal size involves tradeoffs
        + (+): each new member brings insight & perspective
        + (-): as size increases, individual responsibility decreases and Board becomes harder to organize
      * **Terms of Office:** Board members are typically appointed for a term defined in corporation’s charter
        + often elected annually, but are sometimes **staggered** (directors serve multi-year terms and only a minority are elected each year)

(+): greater independence if serving longer term; allows for continuity

(-): hard to accomplish hostile takeovers (if we view those as good); annually elected Board members are held more directly accountable for their actions

* + - * **Qualifications:** 
        + Independence: most corporate boards include a mix of inside (affiliated w/ company) and independent (not affiliated w/ company) directors

inside directors:

(+): intimately involved in & understand company’s business; have financial & reputational commitment to company

(-): might lack broader experience & perspective; biased in compensation decisions; limited in their actions for fear of retaliation from CEO (promotion, bonus, etc.)

independent directors:

(+): bring new perspective; less concerned about offending CEO; less severe compensation bias

(-): only work part-time; less invested in company; don’t have as intimate of knowledge base about company

note: companies listed on NASDAQ & NYSE are required to have majority *independent* directors

NYSE “independent” = no material relationship w/ company; not employee within last 3 yrs; no immediate family member is executive; not partner at company’s audit firm; no family members that work on company’s account in audit firm

* + - * + Skills: no general requirements (unless articles of incorporation say otherwise), except for certain committees

e.g. audit committee must have minimum financial competence

* + - * + Diversity: women & minorities are underrepresented on boards

diverse board members can:

provide valuable perspective

signal to employees that firm has inclusive culture

be favorable for PR

* + - * **Chairman:** leader of Board
        + gets only one vote (same as rest of Board), but gets to leads board meetings and is seen from outside as leader of the company
        + power is multiplied if Chairman also serves as CEO

some corporate governance advocates have called for split of these two offices

pro**-**split: Chairman’s job includes *overseeing* management (including CEO); respected institutions recommend split

anti-split: Board should have flexibility to decide who they think is best to serve as Chairman; CEO has in-depth knowledge of company; promotes alignment of strategic development & execution

sometimes when Chairman is also CEO, Boards appoint a **lead independent director** whose role is to act like leader among independent directors, be liaison and fill in for Chairman when necessary

* + - * **Committees:** Board is authorized to delegate specific functions to committees composed of smaller group of Board members
        + audit committee: supervises company’s finances & manages its relationship w/ outside auditor

required for all public companies

must be staffed with all independent Board members

at least one member must be financial expert & all must have minimum levels of financial competence

* + - * + risk committee: SEC requires companies to disclose extent of Board’s role in overseeing the organization’s risk exposure

increasingly common for large corporations

required for publicly traded bank holding companies w/ certain amount of assets

must include at least one risk management expert

* + - * + compliance committees: oversee compliance program, make sure compliant w/ relevant laws, review reports of lawsuits

common in companies in highly regulated industries

usually include at least one member from audit committee

* + - * + governance & nominating committees: nominate new directors

NYSE requires nominating committee to be comprised of all independent directors

* + - * + compensation committees: determine & review executive compensation

required by NYSE

must be comprised of independent directors

often rely heavily on compensation consultants to avoid conflicts of interest

**Shareholder Derivative Actions:** procedure for correcting breach of directors’ fiduciary duty

* **derivative vs. direct actions:**
  + ask: (a) who suffered the alleged harm (corporation or shareholders individually) & (b) who is receiving benefit of recovery or remedy (corporation or shareholders individually)
    - derivative action: if complaint is on behalf of the corporation and for the corporation’s benefit
      * NYGCL §629: a derivative suit is one brought in the name of the corporation to procure a judgment in it’s favor
    - direct action: if complaint is one of injury to shareholders, but not corporation generally
  + see *Grimes* (below) for example of difference
* **policy:** derivative action responds to the structural problem of corporate governance
  + shareholders are exposed to risk that directors may mismanage corporation at the expense of the shareholders, which why the directors owe a **fiduciary duty** to corporation
    - although duty owed to corporation by the directors is enforceable by the corporation, the directors of the corporation that would be enforcing that duty are the ones who would be the defendants in the lawsuit
      * derivative action allows shareholders to sue on behalf of the corporation when the directors of the corporation cannot be trusted to do so
* **collective action problem:** shareholder volunteers to represent the rest of the shareholders in a derivative suit (other shareholders have no say in who represents them)
  + problems with this procedure:
    - shareholder is usually just a figurehead in the lawsuit (suit is actually usually driven by entrepreneurial lawyer & shareholder just “holds they key to the courthouse” but has no control over the litigation)
    - shareholder may just be bringing suit to receive a personal settlement (“strike suits”)
* **derivative lawsuit controls** (to avoid misuse of derivative remedy)**:**
  + **security for costs/fee-shifting statutes:** 
    - statutes that require a derivative plaintiff to pay corporation’s legal fees if he loses case & statutes that require a derivative plaintiff to post a bond before being able to proceed with litigation in order to ensure that he has the funds to pay for corporation’s legal fees in case he loses
      * discourages smaller shareholders from instituting derivative actions
        + *policy:* deter strike suits, which are usually brought by small shareholders
    - two ways to avoid security for cost/fee shifting statutes:

1. frame lawsuit as direct, not derivative (*Eisenberg*)
   * + - * statutes don’t apply to direct shareholder suits
2. file lawsuit in state that doesn’t have security for cost/fee-shifting statute
   * + - * filing in federal court of same state based on diversity won’t work (*Cohen*)

raises *Erie* issue, and courts will generally view this type of statute as not merely procedural, but also substantive, and federal courts in diversity are required to apply statute substantive statutes

* + - *Cohen v. Beneficial Industrial Loan Corp:* shareholder filed derivative action alleging mismanagement; corporate defendant moved to require security from plaintiff pursuant to NJ statute; plaintiff claimed that statute doesn’t apply in federal court (where suit was filed) and that this type of statute is unconstitutional
      * statute is constitutional and applies in federal court (note: this court generally disfavored derivative actions)
        + constitutionality: states have power over these type of litigations if they see the potential abuses as problematic and sufficiently large enough to warrant remedial issues
        + applicability in federal court: federal courts can apply their own procedural rules, **but this law is not merely procedural but also substantive** because it creates a new liability where none existed previously (shareholder plaintiff becomes liable for defendant’s expenses if he loses), and state substantive laws apply in federal court
    - *Eisenberg v. Flying Tiger Line, Inc.*: shareholder sued to enjoin corporation from merging, claiming only reason for merger is to lessen voting rights of minority shareholders; corporate defendant moved to require shareholder to post bond pursuant to NY statute; shareholder claimed this is direct suit so statute doesn’t apply
      * security for cost/fee-shifting statutes only apply to shareholder derivative actions, not direct actions
      * **if the gravamen of the complaint is the injury to the corporation, the suit is derivative, but if the injury is one to the plaintiff as a stockholder and to him individually and not the corporation, the suit is direct** 
        + in this case, plaintiff’s suit is based on defendant’s impeding on his rights and privileges as a shareholder individually & remedy would not benefit corporation, but only the stockholder individually
  + **demand requirement:**
    - requirement that before a shareholder can bring a derivative lawsuit, he has to give directors a chance to remedy the claim themselves
      * *policy:* relieve court from deciding manners of internal governance by providing directors with opportunity to correct alleged abuses, discourage strike suits, provide boards with protection from litigation of matters within business judgment of board, but still allow shareholder to bring case where board wrongfully refuses to
    - procedure (*see flowchart*):
      * is case direct or derivative?
        + direct 🡪 no demand requirement 🡪 pursue case
        + derivative 🡪 demand requirement
      * plaintiff has choice to make or not make demand
        + demand (bad choice) 🡪 plaintiff writes letter to board, demanding they bring lawsuit to rectify harm done to corporation and board can either:

accept demand 🡪 board takes case and chooses what it wants to do with it

pursue case (unlikely because it’s basically like they’re suing themselves)

drop case 🡪 plaintiff can either:

do nothing 🡪 case over

challenge board’s decision as violation of their fiduciary duty (unlikely that plaintiff will win)

* reject demand 🡪 plaintiff can either:
  + do nothing 🡪 case over
  + challenge rejection by showing wrongful conduct on board’s part (unlikely that plaintiff will win) (*Grimes*)
* no demand (good choice) 🡪 court determines if demand is excused or not (*Grimes*)
  + - demand is excused 🡪 special litigation committee can still try to dismiss case
      * if dismissed 🡪 plaintiff can either:
        + do nothing 🡪 case over
        + appeal as wrongful dismissal (*Bennett, Maldonado*)

if win 🡪 can pursue case

if lose 🡪 case over

* + - demand is not excused 🡪 plaintiff has to file demand 🡪 must go through demand process (*see above*)
* *Grimes v. Donald* (Delaware): G (stockholder) filed suit against board of directors seeking declaration of invalidity of employment agreement between CEO & corporation; agreement allowed for CEO to claim constructive termination w/out cause when board unreasonably interfered with him carrying out his duties and entitled him to large severance package in that event; G claimed board breached fiduciary duty by abdicating their authority, failing to exercise due care & committing waste
  + - * + direct vs. derivative claims: abdication claim is **direct** (seeks invalidity of agreement, no money to corporation as result), waste & due care claims are **derivative** (damages will go back to corporation)

note: in Delaware, distinction turns on **(a) nature of wrong alleged, and (b) the relief, if any, that would result if plaintiff prevails**

Delaware law basically just allows plaintiffs to frame their case as direct by not asking for $$ damages

but lawyers (who run derivate suits) will generally not want to bring cases that don’t ask for $$ because they wont get their fee

* + - * + abdication claim (no demand requirement): employment agreement is valid because was a business decisionthat is to be respected (**business judgment rule**) (*see more below*)
        + waste & due care claims (demand requirement): a stockholder filing a derivative suit must (a) allege that board wrongfully refused his pre-suit demand or (b) allege with particularity why he is excused from demand requirement

**excuse**: must allege with *particularity* that *beyond a reasonable doubt* (1) majority of board has material financial or familial interest, (2) majority of board is incapable of acting independently for some other reason such as dominion or control, or (3) the underlying transaction is not product of valid business judgment

*allege with particularity* = plead facts, not conclusions (tough standard because no access to discovery yet)

* must use “tools at hand” (press accounts, SEC filings, right to inspect books, etc.)
* *beyond reasonable doubt* = flexible standard (to balance tougher pleading standard)
* **wrongful refusal:** if stockholder makes demand that is refused, he has a right to use “tools at hand” to show why it was wrongful

board rejecting demand is entitled to the presumption of the *business judgment rule* (hard presumption to overcome)

* *Marx v. Akers* (NY): plaintiff filed derivate suit alleging corporate waste via excessive compensation w/out first demanding that board initiate lawsuit; claimed had excuse
  + - * + M did not have excuse for not filing demand

Delaware approach: *Grimes* (see above)

Universal approach: requirement of demand in all cases, and allowance for wrongful rejection claim if demand is rejected acts as check

NY approach (similar to Delaware): complaint must *allege with particularity* that (1) majority of board is interested in the challenged transaction (interest can be self-interest or loss of independence bc director w/ no self-interest is “controlled” by self-interested director), (2) board did not fully inform themselves about the challenged transaction to the extent reasonably appropriate under the circumstances, or (3) challenged transaction was so egregious on its face that it could not have been the product of sound business judgment of the directors

in this case although majority of board is self-interested because compensation committee voted on compensation of outside directors and most of the board is outside directors, complaint failed to allege how increase in compensation resulted in any wrongdoing or waste

* *In Re China Agritech, Inc.:* shareholders filed derivative suit against board of directors alleging that they breached fiduciary duty by both (a) not properly evaluating interested transaction & (b) not having proper compliance and oversight procedures in place; shareholders pleaded that demand was futile to get around demand requirement of derivative suit
  + - * + two tests for determining whether allegations of a complaint sufficiently plead demand futility:

standard for claims regarding what the board *did* (didn’t properly evaluate self-dealing transaction, fired independent auditor, etc.):

***Aronson* standard: demand is excused when the particularized allegations create a reasonable doubt that (a) the directors are disinterested and independent and (b) the challenged transaction was a valid exercise of business judgment**

note: “challenged transaction” suggests there has to be some affirmative act by the board for demand to be excused

*issues with this standard:* doesn’t apply to situations where the board didn’t act but should have (breach by inaction); doesn’t say what to do in situation board that approved transaction in question was interested but the board has since turned over

in this case – **demand is excused** because there was reasonable doubt created that the directors were either interested or violated business judgment rule and so are **potentially personally liable**

thus, **directors can’t make disinterested judgment in responding to demand because of fear of personal liability**

standard for claims regarding what the board *didn’t do* (failed to institute oversight mechanisms):

***Rales* standard: demand is excused if the particularized factual allegations create a reasonable doubt that the board of directors can properly exercise its independent and disinterested business judgment in responding to the demand**

note: this standard tries to address the issues with the *Aronson* standard

*Rales* standard is more commonly used today, but sometimes *Aronson* standard is still used when the case doesn’t give rise to the problems with it

in this case – **likely that board fails *Caremark* standard and again be potentially personally liable for failure of oversight**

thus, **directors can’t make disinterested judgment in responding to demand for fear of personal liability**

* + - * **special litigation committees (SLCs):** 
        + most boards have SLCs which determine validity of shareholder derivative actions and whether they should move to dismiss them or go forward with them

if committee choses to dismiss case, plaintiff shareholder can appeal decision as wrongful, but since this is a duty of care issue and is bound by *business judgment rule* (court defers to board’s decision), it’s unlikely that plaintiff will win appeal

* + - * + *Auerbach v. Bennett* (NY): corporation launched investigation after rumors of bribes & kickbacks; investigation was affirmative; A filed shareholder derivative action against board & accounting firm; Board established SLC to determine what positions corporation should take with respect to suit; SLC concluded it was in corporation’s best interest not to pursue suit based on cost of litigation, unlikelihood of winning & bad PR effects

SLC’s decision is properly within business judgment rule and outside court’s review

**to get around court’s use of business judgment rule, plaintiff must show:**

**(1) committee members were not independent, or**

**(2) procedures committee used to evaluate merits of action were a sham**

neither allegation was shown in this case, so business judgment rule applies

* + - * + *Zapata Corp. v. Maldonado* (Delaware): M initiated shareholder derivative action against board of directors alleging breach of fiduciary duty (was excused from demand requirement); many of those directors were replaced and new independent SLC was formed to access validity of action; SLC determined it was best not to pursue action and filed motion to dismiss

**even past demand requirement, there is still a role for SLC** (*same as in NY*)**, but the committee’s actions will be subject to more stringent review** (*stricter than NY*)

**when an SLC files a motion to dismiss a derivative suit in this situation court should apply two-step test:**

**(1) court should inquire into the independence and good faith of the committee and the bases supporting its conclusions (*NY std.)***

**(2) if court is satisfied with (1), court should apply its own business judgment as to whether or not motion should be granted and see how it compares to SLC’s determination (*stricter std. than NY*)**

*policy:* court recognizes bias of SLC committees especially in case where demand was excused

* + - * + *In Re Oracle Corp. Derivative Litigation:* plaintiff filed shareholder derivative action against 3 directors on allegations of insider trading; company created SLC to investigate; appointed two Stanford professors to SLC; SLC conducted investigation and determined they should not pursue litigation

**the SLC was not properly independent in order to be able to make an unbiased decision about pursuing the litigation**

all three directors accused of insider trading had ties to Stanford (one was even former student of SLC committee member)

economic dependence is not the only benchmark of committee independence – factors like family, friendship, etc. should also be taken into account

independence of board members is a continuum and there is no bright line rule

matter of judgment for the courts

note: question of how far this goes (almost all directors are somewhat connected to each other – same social circle, professional circles, etc.)

**Fiduciary Duty:** shareholder derivative lawsuits occur when there are claims that corporate directors or officers or dominant shareholders have breached their fiduciary duties (duty of care, duty of loyalty, duty to act in good faith)

* **Duty of Care** (substantive standard: gross negligence; burden of proof: on plaintiff)
  + defined by **business judgment rule**: courts will defer to the business judgment of corporate directors unless there is a clear showing of fraud, oppression, arbitrary actions or breach of trust
    - *policy:* courts are not experts in complex field of business (don’t know as much as directors do); directors might fear potential liability from decision-making and be discouraged from serving on boards; shareholders don’t necessarily want directors to be so risk-averse (risk if often tied to profit); courts don’t want to have to rule on which decision is best (disputes often come about from subjective disagreement)
  + there are almost no cases where directors have been found liable for a breach of duty of care
    - even when directors *are* found to have breached duty of care (*Van Gorkom*), the law allows corporations to shield directors from personal liability in such instances
      * DGCL §102(b)(7): a corporation may include in its articles of incorporation a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty, *except* in cases of:
        + (a) a breach of duty of loyalty (only allowed for breach of duty of care),
        + (b) acts or omissions not in good faith, or those involving intentional misconduct or knowing violation of the law,
        + (c) any transaction from which the director derived a personal benefit,
        + (d) unlawful payments of a dividend
    - important for defendants to frame suit as breach of duty of care if want to avoid liability
      * note: in practice, line between duty of care & duty of loyalty is never clear cut
  + *Kamin v. American Express Company:* Amex stockholders filed derivative action against board members for declaring dividend in shares of a bad investment instead of selling the shares off at a loss (which stockholders claim would have saved company on taxes); claimed this decision was breach of duty of care on the part of the board
    - board’s decision to declare a dividend instead of selling was not a breach of duty of care
      * the question of whether or not a dividend should be declared is exclusively a matter of **business judgment** for the Board of Directors
        + mere errors of judgment on the part of the board are not sufficient grounds for judicial interference

**courts will not interfere unless it first be made to appear that the directors have acted or are about to act in bad faith or for a dishonest purpose (fraud, oppression, arbitrary actions, breach of trust)**

* + - * in this case, there is evidence that the board considered both courses of actions and decided this one is best (not up to court to judge this)
  + *Francis v. United Jersey Bank:* wife became largest shareholder & director of reinsurance company after husband died; sons (also directors & had remaining shares) misappropriated money from the company; wife wasn’t active in business, never read financial statements, didn’t pay attention to duties as director
    - wife is liable for the misappropriation of her sons based on breach of duty of care
      * **directors should acquire at least a rudimentary understanding of the business of a corporation** 
        + **directors are under continuing obligation to keep informed about the activities of a corporation**

may not shut their eyes to corporate misconduct

* + - * individual liability of corporate directors to third parties who assert that a director, because of nonfeasance, is liable for losses caused by acts of insiders depends on findings of
        + (a) duty to third parties: **directors have fiduciary duty to third parties when they hold funds of others in trust**
        + (b) breach of duty: directors are not required to audit corporate books but they **should maintain familiarity with the financial status of a corporation by regular review of financial statements**

review of financial statements **may give rise to duty to inquire further into matters revealed**

wife had obligation to read & understand the financial statements and make reasonable attempts at detection and prevention of illegal conduct

usually a **director can absolve themselves from liability by informing others of the inappropriate conduct, voting for a proper course of action, and if that action isn’t taken, resigning**

in this case, wife had **duty to take all reasonable action to stop the continued misappropriation** since company owed duty to trustees

* + - * + (c) proximate cause: breach was so obvious that wife would’ve noticed right away if she inspected books and if she said to stop they would’ve stopped since misconduct was so blatant
    - case shows there can be breach of duty of care when directors don’t do anything
  + *Smith v. Van Gorkom:* CEO sought leveraged buy-out at higher price than current share price, but reached deal at secret meeting w/ buyer; buyer gave board 3 days to approve or he would walk, board held 2-hour meeting and approved; no one on board read merger agreement or knew how it was negotiated
    - **business judgment rule is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company** 
      * the determination of whether business judgment is **informed** turns on whether directors have informed themselves prior to making a business decision, of **all material information reasonably available to them** 
        + no protection under business judgment rule for directors who made unintelligent or unadvised judgment
    - If merely negligent when approving deal, directors are not liable, but if **grossly negligent**, then directors are liable
      * board was grossly negligent when approving merger
        + board acted with **undue haste** (board meeting was called w/ no notice; decision had to be made in 3 days; meeting only lasted 2 hours)
        + board didn’t have **sufficient information**

need to show that (a) info was withheld or there were red flags that info was being withheld and (b) access to this info would’ve made decision better

board didn’t have access to definitive merger agreement

note: boards rarely read these anyway (?)

* + - * + board didn’t sufficiently inform itself of **price negotiations**
        + court said price didn’t reflect **intrinsic value** of company

note: how does court figure out intrinsic value?

three ways intrinsic value can differ from stock price:

market got it wrong (unlikely)

market is calculating value based on assumption that company won’t be sold

buyer was getting controlling interest & controlling interest is always worth more (will pay premium)

* + - * note: unclear why court decided this was *grossly* negligent
        + *possible policy:* soon after decision, Delaware imposed duty to auction the company (get highest price possible if it’s for sale) so this was direction court was moving in
    - case shows there can be breach of duty of care even if directors *do* do something
* **Duty of Loyalty** (substantive standard: ex ante fairness of transaction; burden of proof: on defendant)
  + duty of loyalty is enforced much more intensively than duty of care (**subject to strict scrutiny**)
    - *policy:* courts are more concerned when personal interests are involved because then there is stronger incentive to act against interests of shareholders than in just a breach of duty of care situation
    - important for plaintiffs to frame case as breach of duty of loyalty if want to win
      * note: in practice, line between duty of care & duty of loyalty is never clear cut
  + **Directors’ Duty of Loyalty**
    - **Interested Director Transactions:** transactions that director either has personal relationship with or is in a close personal relationship with someone who has an interest in the contract
      * just because transaction is interested doesn’t automatically mean it was a breach of duty of loyalty
        + interested director transactions can sometimes be good for corporation (lower transaction costs, interests aligned, less risk of contract breach)
      * test if interested director contract was breach of fiduciary duty is **overall fairness of transaction** 
        + *Bayer v. Beran:* company embarked on radio advertising program, hired president’s wife to sing on the program; shareholder suit claimed it was wasteful & breach of loyalty

president of company hiring his wife was not breach of duty of loyalty

**interested transactions are subject to stricter scrutiny by courts than pure business judgment decisions when they are challenged**

**the burden is on the defendant to show inherent good faith and fairness of the transaction when it’s challenged for being “interested”**

in this case, everything about embarking on the advertising program would’ve been a business judgment question had it not been for president hiring his wife

**transaction was fair to company:** there was nothing to show that wife was hired instead of someone more talented, that she was paid more than someone else would’ve been, that hiring someone else would’ve made the program better, etc.

* + - * **ratification of interested director transactions:**
        + **director ratification:** if *some* of the directors are interested

DGCL § 144(a)(1): an interested director transaction can be immunized from strict scrutiny and only be subject to the business judgment rule if the material facts of the director’s interest as to the contract or transaction are made known to the board and the majority of the board’s disinterested directors in good faith ratify the contract

*Benihana of Tokyo, Inc. v. Benihana, Inc.:* Benihana needed financing for construction project; hired financing firm that said issuing preferred stock was best option; one of the directors’ holding companies wanted to purchase the stock; negotiated terms & both parties said they were happy; board knew director was owner of holding company; board approved transaction;shareholders sued board for breaching duty of loyalty

board did not breach duty of loyalty because disinterested directors knew of director’s interest in contract and still ratified it

* + - * + **shareholder ratification:** if *all* the directors are interested

DGCL § 144(a)(2): an interested director transaction can be immunized from strict scrutiny and only be subject to business judgment rule if the material facts of the director’s interest as to the contract or transaction are made known to the shareholders entitled to vote thereon, and the contract or transaction is approved of in good faith by the vote of the shareholders

*Fliegler v. Lawrence:* defendant (president of Agua) purchased investment properties; offered to transfer properties to Agua but he and other directors decided it wasn’t good time; instead transferred properties to USAC (holding corp. owned by Agua directors & defendant) with option for Agua to acquire USAC; Agua exercised option and transferred shares of it’s stock to USAC as reimbursement; shareholder derivative suit claiming directors were self-dealing (owned USAC, so got Agua’s shares); directors claimed immunity bc shareholders approved transaction

in this case, shareholder ratification does not immunize directors because the majority of shareholders who approved were the interested directors themselves (since they owned most of Agua’s stock)

note: court is reading own requirement into DGCL that **majority of *disinterested* shareholders must ratify interested transaction** in order to immunize directors(DGCL language is ambiguous)

* *policy:* preserve purpose of statute & close potential loophole

transaction subject to entire fairness test but passed

* + - **Entrenchment:** directors are not permitted to act for the sole or primary purpose of making sure they stay on as directors
      * *Benihana of Tokyo, Inc. v. Benihana, Inc.:* at the same time as financing was needed, board also wanted to make sure they keep control of company because CEO transferred his shares to wife
        + financing decision was not entrenchment

primary purpose of stock issuance was to finance the construction and remodeling of the stores

* + - **Corporate Opportunities:** directors cannot misappropriate an opportunity belonging to corporation
      * Test:
        + (1) Was there a valuable opportunity?
        + (2) Did opportunity knock (was the opportunity presented to the corporation)?
        + (3) If opportunity knocked, would the corporation have invited it in?
      * *Broz v. Cellular Information Systems, Inc.:* B was president of cellular company and was on board of CIS (competing cellular company); B’s company was offered exclusive license, but not CIS; CIS just emerged from bankruptcy, B asked around and CIS officers said they aren’t interested based on current financial statute & business model
        + the doctrine of corporate opportunity requires that a corporate fiduciary agrees to place the interests of the corporation before his or her own in the appropriate circumstances

valuable opportunity? arguably no, since opportunity since the license was offered to other companies & was auctioned

did opportunity knock? no, license broker didn’t approach CIS

would CIS have welcomed opportunity? no, B asked other directors and they said CIS wasn’t interested anyway

* + - * + fact that CIS was later sold to company that *was* interested in license doesn’t matter (no duty to consider potential future owners’ interest)
      * *In Re eBay, Inc. Shareholders Litigation:* eBay hired Goldman Sachs to underwrite IPO; GS allocated shares of the stock at the IPO price to directors of the company as reward for their business & incentive to continue doing business w/ GS; shareholders filed suit that directors misappropriated an opportunity (getting stocks at IPO price) when that opportunity should’ve been given to the company itself
        + directors breached their duty of loyalty by misappropriating corporate opportunity

valuable opportunity? yes, IPO was very valuable;

did opportunity knock? no, GS allocated shares to directors instead of offering to eBay

would CIS have welcomed opportunity? yes, eBay would’ve invested in them since part of their business model is investing in securities (even if these were too risky, should’ve offered)

* + - * + this is also breach of duty under agency law (agent must account for profits obtained personally in connection w/ transactions related to principal)

Restatement § 387: an agent is subject to duty to act solely for the benefit of principal in all matters connected with his agency

Restatement § 388: an agent who makes a profit in connection with transaction conducted on behalf of principal owes the profit to principal

* + **Dominant Shareholders’ Duty of Loyalty**
    - dominant shareholders in corporation owe fiduciary duty to minority shareholders
      * note: the legal fiduciary duty clearly applies to *de jure* dominant shareholders (those who own > 50% of stock)
        + unclear what the legal fiduciary duty is for *de facto* dominant shareholders (those who own < 50% of stock but own most compared to rest of shareholders so still effectively dominate)

judges usually take this into account but actual law is unclear

* + - * *Sinclair Oil Corp. v. Levien:* SO owned 97% of subsidiary; minority shareholders of subsidiary sued SO for breach of duty of loyalty for: (a) causing subsidiary to pay out dividends to fund SO’s expansion & (b) breaching their contract with subsidiary
        + a parent owes a fiduciary duty to its subsidiary when there are parent-subsidiary dealings

when board engages in self-dealing, the test becomes intrinsic fairness instead of business judgment (note: **to see if self-dealing, test if action affects minority & majority shareholder interests equally**)

dividends were not self-dealing because the minority shareholders got the same proportional benefit as the majority shareholders

business judgment rule applies to dividends

breach of contract was self-dealing because parent company (and majority shareholders) received benefit of subsidiary’s products to the detriment of the minority shareholders (didn’t receive product & company didn’t get paid on time & didn’t get minimum order as promised)

SO failed to show how breach of contract was inherently fair to the minority shareholders of subsidiary

* + - * + note: issues like this is why most subsidiaries are wholly owner (no minority shareholders to owe duty to)
      * *Zahn v. TransAmerica Corporation:* TA was majority class B common stock shareholder of tobacco company (AF); AF stock was divided into preferred stock & common stock (Class A & Class B); Class A stock was callable at certain price but also had option to convert into non-callable Class B stock; TA controlled management of AF and called Class A stock when tobacco went up in price (unbeknownst to other shareholders) & then liquidated to make profit (Class B got a lot of $$); Class A minority shareholders filed derivative suit claiming TA breached fiduciary duty by calling stock w/out telling them reasoning
        + **dominant shareholders can control but when they do, they owe a fiduciary duty to minority shareholders**
        + **corporate directors cannot take any corporate action for the purpose of personal profit**

corporate directors in this case were basically instruments of TA and acted in order to benefit TA, not the corporation

if corporate directors that called the stock were disinterested there wouldn’t be an issue (would be business judgment rule)

in this case, violation was not that they called the stock, but that the **didn’t give full info to Class A stockholders** (bc then they would’ve converted to Class B, but TA wanted more % of profit so didn’t want them to convert)

* + - * + *note on stock structures:*

*stock* is an equity which gives shareholders certain rights & liabilities

right to vote

rights to dividends

rights to convert (can turn one class of stock into another if certain events occur)

rights on liquidation (get certain % of assets upon liquidation after creditors are paid off)

liability to call (company can make you sell stock back to them at certain set price)

*different classes of stock*:

*common stock* (most common): usually has 1 vote per share, usually no rights to dividends (up to company), usually not subject to call, usually no right of conversion, paid after creditors & preferred stock upon liquidation

*preferred stock*: usually fewer voting rights, rights to specific dividends, often subject to call, often has conversion rights, better rights on liquidation

*why would company want to issue preferred stock?*

if wants to keep control of company

if wants to reach broader area of capital market

* different investors have different preferences so want to offer a range of stock options
  + - * **ratification of interested shareholder transactions:**
        + Three Shareholder Ratification Scenarios:

interested dominant shareholder transaction 🡪 entire fairness test w/ burden on challenged party

interested dominant shareholder transaction, but approved by majority of disinterested shareholders 🡪 entire fairness test w/ burden on challenging party

interested non-dominant shareholder transaction, but approved by majority of disinterested directors 🡪 business judgment rule

*In re Wheelabrator Technologies, Inc. Shareholder Litigation:* Waste owned 22% of WTI and had 4 of 11 director spots on board; merger agreement between Waste & WTI was unanimously approved by disinterested directors & majority of disinterested shareholders; shareholder derivative action for breach of duty of loyalty

since Waste is not dominant shareholder and merger was approved by majority of disinterested shareholders, **standard of review is business judgment rule**

note: board approval is not enough (shareholder approval was required) because this is a merger and mergers require shareholder approval under Delaware law

* **Duty to Act in Good Faith** 
  + recall DGCL § 102(b)(7): corporation can include in its charter provision limiting personal liability of director … **provided that such a provision shall not eliminate or limit the liability of a director for acts or omissions not in good faith**
  + obligation of good faith is somewhere between duty of care & duty of loyalty
    - bad faith requires something more culpable than gross negligence but doesn’t necessarily require disloyalty
  + *In Re Walt Disney*: failure to act in good faith requires **intentional dereliction of duty** 
    - (a) where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation,
    - (b) where the fiduciary acts with intent to violate applicable law, or
    - (c) where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating conscious disregard for this duties
  + *Stone:* good faith is subsidiary element of duty of loyalty (not its own duty)
    - so duty of loyalty is not limited to cases involving a financial or some other cognizable interest, but also to cases where the fiduciary fails to act in good faith
      * e.g. cases of failure of oversight/compliance (what *Stone* is about)
      * “a director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest”
    - note: this reading seems odd because DGCL 102(b)(7) spoke separately of the duty of loyalty and duty of good faith
      * seems like court creatively interpreted the statute to avoid possible consequences of having duty of good faith be more akin to duty of care and subject to more lax standard

**Fiduciary Duty & Executive Compensation:**

* a lot of controversy lately over how much corporate executives should be paid
  + research doesn’t show strong correlation between company’s revenue and CEO compensation
  + when CEO changes within a company, stock price often reflects it
* Delaware courts have made an effort to enter field of executive compensation but haven’t necessarily been able to do much
* *In re The Walt Disney Co. Derivative Litigation*
  + *Facts:* Disney CEO vetted Ovitz to be President (w/out consulting board); negotiated huge compensation package w/ $130 M downside protection if fired w/ out cause (w/ out consulting board); work leaks about Ovitz joining & stock jumps; compensation committee approved compensation package after listening to short presentation; Ovtiz wasn’t good fit; was terminated even though termination w/out cause would trigger huge payout
  + *Issue:* Did board breach their fiduciary duties by approving compensation package? Did Ovitz breach his fiduciary duty by accepting compensation package?
  + *Ruling/Reasoning:*
    - *claims against Ovitz:*
      * Ovitz did not breach his fiduciary duty to Disney by accepting to compensation package because he didn’t become a fiduciary until the day he assumed office, at which point the package had already been accepted & negotiated
        + prior to assuming office, Ovitz was not a fiduciary to Disney (de facto nor de jure) and thus owed no duty to Disney
    - *claims against Disney directors:*
      * *did board breach duty of care & good faith by approving compensation package?*
        + no breach of duty of care because even though compensation committee definitely **didn’t adhere to best practices**, they **weren’t grossly negligent** as to amount to breach of duty of care

compensation committee met twice; had term sheet but no spreadsheet about potential costs of no-fault termination; only met for an hour; no minutes

court talks about what board *should’ve* done (kept minutes, had more info, etc.) even though doesn’t find what they did do as breach of duty of care bc board was still “adequately informed”

* + - * + **good faith requires something more than gross negligence** (*see above for full definition court gave)*, and since directors weren’t grossly negligent, they also didn’t breach good faith
      * *did board breach duty of care & good faith by approving hiring of Ovitz?*
        + no breach of duty of care in approving hire because board was adequately informed and made business judgment

Eisner chose Ovitz based on social relationship, but board knew about Eisner & management’s approval of Ovitz, his qualifications, stock’s positive reaction to news of his hiring

* + - * + no breach of good faith forsame reasons as above (no gross negligence = no good faith breach)
      * *did Eisner breach fiduciary duty by terminating Ovitz w/out cause?*
        + no breach by board because company’s bylaws allowed Eisner to terminate Ovitz w/out board approval anyway
        + no breach of duty of care by Eisner in firing w/out cause bc Eisner talked to lawyer, lawyer said there is no cause; Eisner acted on business judgment to fire anyway based on his other options
        + no breach of duty of care by board in relying on Eisner’s opinion that Ovitz couldn’t be fired for cause bc info was accurate, reliance was in good faith
      * *did severance package constitute waste?*
        + to recover on **corporate waste** claim, **must show that exchange was so one-sided that no business person of sound judgment could conclude that corporation received adequate consideration**

where business judgment presumptions are applicable, board’s decision will be upheld *unless* plaintiff can show corporate waste

in this case, **no corporate waste** because:

(a) payment of contractually obligated amount can’t be considered corporate waste unless the contract obligation itself is considered wasteful

(b) contract obligation is not wasteful because **had rational business purpose** of inducing Ovitz to leave his job as head of agency where he made a lot of money

* + notes on case:
    - the fact that court didn’t find breach of duty of care on part of board when considering compensation package undermines court’s prior decision in *Van Gorkom* (*see above*)
    - court spoke a lot about “best practices” and called Esiner “imperial CEO” who made “many mistakes” to
      * shame Eisner for his management style w/ out legally sanctioning him
      * to promulgate advice of how court wants companies to behave w/out actually subjecting them to legal sanctions (trying to impart convention on companies)
    - court’s decision in *Disney* will likely discourage entrepreneurial plaintiffs attorneys from bringing suits like this (since court didn’t hold *Disney* liable)
      * court knew that decision would lead to less cases so saw chance to promulgate best industry practices and took it

**Fiduciary Duty & Oversight of Compliance:**

* field of corporate compliance has grown tremendously in past 10 years
  + *reasons for growth*:
    - government has greatly increased requirements of level of expectation of companies
    - compliance violations are very costly to corporations:
      * government fines & sanctions (sometimes in the billions)
      * professional fees (might have to hire law firm to do investigation)
      * reputational harm (public cares more about compliance now)
      * debarment (might no longer be allowed to do business w/ government entities)
      * possible criminal liability (company on probation, executives in jail)
      * monitors (required to hire independent third party to monitor corporation)
* Delaware courts realize compliance is big issue and want to weight in (just like executive compensation)
  + held that **failure to oversee see compliance is a violation of fiduciary duty** partly to make sure Delaware courts’ preeminence in controlling corporate conduct isn’t displaced by government enforcement activity
* *Caremark* Duty: “generally, where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation … only a sustained systematic failure of the board to exercise oversight – such as an utter failure to attempt to ensure a reasonable information and reporting system exists – will establish the lack of good faith that is a necessary condition to liability”
  + standard of care is pretty lenient (“utter failure”), so it rarely actually creates liability
    - *policy:* reflects balance of tradeoff between wanting to create director liability and promulgating best practices standards, but not wanting to deter directors from serving on boards
    - instead of *Caremark* standard, other mechanisms tend to make sure there is proper compliance and oversight:
      * regulators and prosecutors
      * oversight of external auditors (required to make sure companies are compliant and report any issues they find)
      * direct regulation via statutes (e.g. Bank Secrecy Act, Volcker Rule)
  + oversight liability attaches if directors:
    - (1) “utterly fail” to implement any reporting or information system or controls; or
      * “three lines of defense” metaphor for a reporting/control system
        + first line: people (managers are obligated to make sure their part of the business doesn’t commit compliance violations)
        + second line: compliance & risk management departments
        + third line: internal audit
    - (2) having implemented such system of controls, consciously fail to monitor or oversee its operations
* *Stone v. Ritter:* AmSouth Bank was fined for failing to report suspicious activity regarding possible misconduct of their customers to the federal government; shareholder derivative suit was brought against board of directors for failure of oversight (breach of fiduciary duty)
  + plaintiff argues that demand requirement should be excused in this case because **the directors face personal liability** and thus cannot exercise independent and disinterested business judgment in responding to the demand
  + **oversight liability is a breach of good faith** 
    - *Caremark* duty is consistent with *Disney’s* definition of bad faith (“conscious disregard for responsibilities”, “failure to act in face of known duty to act”)
  + since breach of good faith is a breach of the duty of loyalty, failure of oversight is breach of duty of loyalty
    - directors do face personal liability, since directors can’t be immunized from breaches of loyalty or good faith under § 102(b)(7)
  + in this case, there is no director oversight liability because
    - (1) board of directors had compliance program in place
    - (2) board of directors put in numerous systems and procedures to attempt to ensure compliance
      * compliance officer made annual presentations to board
      * board established compliance committee to actively oversee compliance program
      * board enacted policies and procedures to ensure compliance with standards
* *In Re China Agritech, Inc.:* shareholders filed derivative suit against board of directors alleging that they breached fiduciary duty by both (a) not properly evaluating interested transaction & (b) not having proper compliance and oversight procedures in place; shareholders pleaded that demand was futile to get around demand requirement of derivative suit
  + two tests for determining whether allegations of a complaint sufficiently plead demand futility:
    - standard for claims regarding what the board *did* (didn’t properly evaluate self-dealing transaction, fired independent auditor, etc.):
      * ***Aronson* standard: demand is excused when the particularized allegations create a reasonable doubt that (a) the directors are disinterested and independent and (b) the challenged transaction was a valid exercise of business judgment**
        + “challenged transaction” suggests there has to be some affirmative act by the board for demand to be excused

*issues with this standard:* doesn’t apply to situations where the board didn’t act but should have (breach by inaction); doesn’t say what to do in situation board that approved transaction in question was interested but the board has since turned over

* + - * + in this case – **demand is excused** because there was reasonable doubt created that the directors were either interested or violated business judgment rule and so are **potentially personally liable** (duty of loyalty not included in DGCL § 120(b)(7) (excusing personal liability))

thus, **directors can’t make disinterested judgment in responding to demand because of fear of personal liability**

* + - standard for claims regarding what the board *didn’t do* (failed to institute oversight mechanisms):
      * ***Rales* standard: demand is excused if the particularized factual allegations create a reasonable doubt that the board of directors can properly exercise its independent and disinterested business judgment in responding to the demand** 
        + note: this standard tries to address the issues with the *Aronson* standard

*Rales* standard is more commonly used today, but sometimes *Aronson* standard is still used when the case doesn’t give rise to the problems with it

* + - * + in this case – **likely that board fails *Caremark* standard and again be potentially personally liable for failure of oversight** (duty of loyalty not included in DGCL § 120(b)(7) (excusing personal liability))

thus, **directors can’t make disinterested judgment in responding to demand for fear of personal liability**

note: this case shows that the *Caremark* standard, although lenient, is imposed in the most egregious cases of failure of oversight

**Rights of Shareholders:**

* **Shareholder Inspection Rights:** right to inspect corporate books and records
  + DGCL § 220(b): any stockholder … shall, upon written demand and *under oath stating the purpose thereof*, have the right during usual hours of business to inspect for any *proper purpose*, and to make copies and extracts from the *company’s ledger, a list of its stockholders, and its other books and records* 
    - access can be denied if requesting party refuses to furnish affidavit at corporation’s request that states that inspection is not desired for a purpose other than the business of the corporation and that the petitioner has not been involved in the sale of stock lists within the last five years
    - proper purpose = a purpose reasonably related to such person’s interests as a stockholder (*see cases below*)
    - statute reflects balancing of **policy tradeoffs** of allowing access to corporate records
      * (+): transparency; make sure corporation is acting in shareholders’ best interests; lets shareholders know what’s going on in their company
      * (-): burdensome on corporation; privacy/confidentiality issues
  + **access to shareholder list** 
    - if a shareholder wants to solicit proxies, management can choose to either (a) mail shareholder’s solicitation materials themselves & bill shareholders or (b) give shareholder a copy of the company’s shareholder list so he can solicit shareholders himself
      * management wants to keep shareholder list confidential, but shareholders want to list so they can identify which shareholders have the most shares (aka most votes) so they know who to focus their solicitations on
    - *Crane Co. v. Anaconda Co.:* C (shareholder of A) made tender offer to take over A; A’s management opposed offer & sent solicitations to shareholders encouraging them not to sell their shares to C; C requested shareholder list from A so they could solicit shareholders themselves and rebut A’s claims; A claimed C did not have a proper purpose in requesting list
      * a shareholder desiring to discuss relevant aspects of a tender offer should be granted access to the shareholders list unless it is sought for a purpose inimical to the corporation or its shareholders
        + burden of proof is on party opposing demand
      * **a purpose of informing shareholders of all information regarding tender offer is a proper purpose** because it has to do with shareholder interests
      * *policy rationale:* court favored hostile takeovers; wanted to give more decision-making power back to shareholders
    - *State ex rel. Pillsbury v. Honeywell:* plaintiff learned that H had government contract to produce weapons for Vietnam war; plaintiff was opposed to the war so bought shares of H for sole purpose of getting access to shareholder list to solicit proxies and gain ownership share to change H’s board of directors and end participation in the war;H refused to furnish shareholder list, claiming plaintiff didn’t have proper purpose
      * **a proper purpose is one that contemplates concern with investment return** 
        + only those with bona fide interest in corporation should be able to inspect corporate books since it’s costly and time consuming for corporation
      * in this case, plaintiff had no concern for long or short term profits of corporation, admitted his only concerns were the social and political aspects of corporation’s involvement in Vietnam war
        + note: plaintiff would’ve had inspection rights if he framed suit as claiming that involvement in war is bad for corporation’s reputation, sales, etc.
    - *Sadler v. NCR Corporation:* AT&T was beneficial owner of NCR and made tender offer as part of hostile takeover bid; shareholders were in favor of takeover, but NCR board rejected tender offer and redeemed “**poison pill**” (poison pill is way of blocking hostile takeovers by severely diluting shares of company is hostile acquirer takes over); AT&T wanted access to shareholder list to solicit proxies to vote for new board who would be in favor of takeover; AT&T had Sadlers (other shareholders) request list to get around NY statute about inspection rights; AT&T wanted access to **NOBO list** (list with identities of beneficial owners who consent to being contacted); NCR refused, claiming that NY statute regarding shareholder access to corporate books and records doesn’t apply to a list that is not already in corporation’s possession (NCR didn’t have NOBO list prepared) and doesn’t allow AT&T to use Sadlers to get list
      * NY Gen. Corp. Law § 1315: (a) any New York resident who for 6 months has been shareholder of corporation doing business in NY or who holds or acts for those who hold at least 5% of any class of outstanding shares to require corporation to produce a record of its shareholders; (b) corporation can require requesting shareholder to furnish affidavit stating that inspection is not desired for a purpose other than the business of the corporation and that the requesting shareholder has not engaged in the sale of stockholder lists in the past five years
        + the Sadlers (NY residents) are eligible to make shareholder list request on behalf of AT&T

law allows “agent” (AT&T) to act for the qualifying NY resident in inspecting books & records

technical aspects of agency law don’t apply to this statute

statute should be liberally construed in favor of shareholder

* + - * + statute requires corporation to create NOBO list if it doesn’t already have one (actual text of statute is ambiguous; court construed statute broadly)

statute should be liberally construed to facilitate communication among shareholders on issues regarding corporate affairs

creating NOBO list is a simple, mechanical task and not a huge burden on corporation

* + - * notes on case:
        + Delaware courts construe statute narrowly and don’t require corporations to create list if it’s not already in its possession

shows *different policy preferences between NY & Delaware courts*

NY: center of finance, caters to banks, more favorable to takeovers

Delaware: center of corporate charters, caters to corporate boards & managers, against hostile takeovers

* + - * + after *Sadler*, NY Gen. Corp. Law was amended not to require corporation to obtain info not already in its possession

shows that NY legislature was not in agreement w/ NY court’s policy preferences

* + **access to books and records** 
    - *Amalgamated Bank v. Yahoo! Inc.:* Mayer was Yahoo’s new CEO (and everyone was excited about it bc Yahoo was having a lot of instability and turnover at the time and Mayer represented a fresh start); wanted to hire DeCastro from Google to be COO; didn’t tell board his identity but told them hiring him would require competitive compensation; Mayer presented board with term sheet of DeCastro’s potential compensation; compensation packaged included salary and equity options that would vest at various times and had scenarios for how options would vest if DeCastro was terminated for cause or without cause and depending on when he was terminated; terms were complex and board was not given table explaining consequences of different payout structures; board met for 30 min and approved term sheet, and allowed Mayer to make nonmaterial changes to offer letter; Mayer went back to board with proposed changes; misrepresented that original offer letter had 12-month option tail if DeCastro was terminated without cause when it really had a 6-month tail and based on that assumption board approved another change that made DeCastro get more equity quicker if he was terminated without cause; DeCastro did not perform as well as excepted, Mayer fired DeCastro after 14 months; board approved DeCastro’s termination without cause (neither considered possibility of terminating for cause); Amalgamated (shareholder) served demand on Yahoo to examine books and records for purpose of investigating potential mismanagement in connection with the hiring & firing of DeCastro
      * **to obtain books and records under DGCL §220(b) (*see above*), plaintiff must establish by a preponderance of the evidence that: (a) the plaintiff is a stockholder, (b) the plaintiff complied with the statutory requirements specifying the form and manner for making a demand, and (c) the plaintiff possesses a proper purpose for conducting the inspection** 
        + **if party seeking books and records is not record holder of stock, must attach prima facie evidence that party is either beneficial owner of stock or is duly empowered agent acting on behalf of record holder or beneficial owner**

Amalgamated is acting as trustee of funds that own Yahoo stock so meets requirement

* + - * + **proper purpose is a purpose reasonably related to such person’s interests as a stockholder**

**a stockholder’s desire to investigate wrongdoing or mismanagement is a proper purpose**

**stockholder is required to show by a preponderance of evidence that there is a credible basis from which the court can infer that there is possible mismanagement that warrants further investigation**

in this case, there is sufficient evidence to establish credible basis of possible breaches of fiduciary duty & waste by board and Mayer

**desire to investigate questions of director disinterestedness and independence is a proper purpose**

* + - * **if inspection right is established, court should tailor inspection to only requiring disclosure of information that is “essential” for the plaintiff to achieve his purpose, but should not order disclosure beyond what is “sufficient”**
        + **in tailoring an inspection order, the court should consider:**

**the importance of the information to the achievement of the plaintiff’s purpose**

**the burden on the company to collect and furnish these materials**

**whether plaintiff can obtain the information in question from other sources**

* + - * + the tailoring order a court usually gives is based on (a) custodian (who has the documents) and (b) general subject matter of documents

i.e. “all documents in Mayer’s possession relating to hiring & termination of DeCastro”

* + - * notes:
        + advantages of issuing equity & options as part of executive compensation package: equity is tied to performance so incentivizes executive to act in ways that will raise stock price; corporation doesn’t have to pay cash up from; options are a retention strategy because they vest over time
        + case was brought by entrepreneurial plaintiff’s firm likely as part of plan to eventually file shareholders derivative suit
        + case has potential to be next mega-case (like *Disney*)

similar to *Disney* in that Mayer comes off as imperial CEO who doesn’t have an effective check from the board

shows continued concern with executive compensation

court knows that another *Disney* case likely wont happen due to *Disney’s* anti-plaintiff outcome

tailoring inspection rights allows way for court to bring back shaming sanction (“directors who fail to ask questions take the risk that they may have to provide explanations later”)

another way for court to promulgate best practices without imposing liability

* **Shareholder Voting** 
  + DGCL § 151(a): every corporation may issue one or more classes of stock which may have voting powers as shall be stated and expressed in the certificate of incorporation or any amendment thereto, or in the resolution providing for the issue of such stock adopted by the board of directors
    - who gets to vote:
      * *shares held in a trust*: trustee is the one who has the right to vote
      * *pledged security*: you are still the one who has the right to vote unless you indicate otherwise in the agreement
        + pledging security = e.g. giving your stock as collateral to bank for a loan
      * *if you hold shares in common* (own shares w/ someone else): majority vote unless there is an agreement about whose opinion controls
    - what matters are subject to vote:
      * *matters that law requires shareholders to be given a vote on:*
        + election and removal
        + fundamental changes (e.g. mergers, charter amendments)
        + shareholder proposals to send to board
        + *“say on pay”* (for public companies by Dodd Frank Act): shareholder vote on executive pay

in US, vote is currently advisory (not binding on board)

public companies have to have say on pay votes for senior executive compensation at least every 3 years

unclear how much say on pay requirement has accomplished

shareholders generally approve pay packages

times when shareholders will vote against package:

if stock doing poorly

if compensation is grossly different to peers

if proxy advisory firm recommends no vote

executive compensation has been largely flat since requirement

hard to say if this is due to requirement or overall economic conditions

shaming sanction is lost bc directors can just point to shareholder approval of large compensation package when questioned

* + - * *matters that management has voluntarily submitted to shareholders for a vote:*
        + ratification of auditor selection
        + proxy access
    - when votes occur:
      * shareholder meetings
        + most companies have annual shareholder meetings
        + shareholders can call for special meeting if enough votes (uncommon)
    - how votes are cast:
      * votes can be cast by shareholder at shareholder meeting
      * most votes are cast by **proxy**
        + shareholder fills out proxy form and sends it in so doesn’t have to attend meeting
    - important players in shareholder voting:
      * **institutional investors**: funds that collect money and invest it on behalf of a group of people (asset management funds, investment companies, etc.)
        + shareholding in big public companies is dominated by institutional investors
        + corporation cares most about institutional investors votes

these are the votes that really count bc they have so many shares

* + - * **activist investors**: investment funds that try to change or influence decision-making and management
        + have a lot of influence because (a) own a lot of stock themselves and (b) can persuade more passive investors
        + *influence strategic management by*:

threatening proxy fight (*see more below*), sending letters to shareholders disapproving of management, proxy fight, hostile takeover (tender offer)

* + - * + *leading reasons for shareholder activism:*

underperformance, balance sheet problems, clarity on objectives, corporate control, governance

* + - * + there is evidence that activist investors add value (stock rises 2-3% within month that activist investor announces campaign)
        + activists today are taken very seriously by corporate managers and their advisors
      * **proxy advisory firms**: influence institutional investors on how to vote
        + SEC has said that if institutional investors vote by recommendation of proxy advisory firms, they will not be held as voting by conflict of interest
      * note: when you combine the influence of proxy advisors on institutional investors and the growing prominence and influence of activist investor funds, market today reflects biggest potential challenge to incumbent management
  + **Proxy Fights:** many issues arise from proxy contests
    - **access to shareholders:** how to get access to shareholders to solicit
      * incumbents already have access
      * insurgent has to get access via request for access to books & records (*see above*)
    - **payment of expenses:** who pays expenses of proxy solicitation
      * expenses of corporate incumbents are almost always paid by corporation
        + *Levin v. MGM, Inc.:* conflict of corporate control between L & present MGM management (defendants); each group intends to nominate slate of directors at annual meeting; L claims that corporation shouldn’t pay present management’s proxy solicitation expenses

**the court should only interfere if illegal or unfair means of communication are being employed by present management in soliciting proxies**

modes of communication are not illegal or unfair

proxy statement said that MGM would bear all costs in connection with management solicitation of proxies

amount doesn’t seem excessive

* + - * + *Rosenfeld v. Fairchild Engine & Airplane Corp.:* plaintiffs brought shareholder derivative suit seeking to compel return of $ paid out of corporate treasury to reimburse both sides of proxy contest;part was spent by old board in defense of position, part was paid to old board by new board to compensate for remaining expenses of unsuccessful proxy fight, part was reimbursed to prevailing insurgents (reimbursement was ratified)

**as long as contest is over *policy* (not personality), corporation can pay the reasonable expenses of incumbents in a proxy contest**

when directors act in good faith, they have a right to incur reasonable and proper expenses for solicitation of proxies and in defense of their corporate policies

note: incumbents get reimbursed win or lose (successful insurgents still chose to reimburse losing incumbents in this case)

*Dissent*: hard to sever questions of policy from persona (usually the two go hand in hand)

* + - * much of litigation centers around who pays insurgent costs
        + *Rosenfeld v. Fairchild Engine & Airplane Corp.* (*see above*)

**stockholders have the right to reimburse successful contestants for the reasonable and bonafide expenses incurred by them in any such policy contest**

note: insurgents only get reimbursed if they win & shareholders ratify

*policy:* courts don’t want to encourage reimbursement of insurgents even if they lose proxy fights because there would be a lot of burdensome and not credible proxy contests

* + - **federal regulation of proxy contests:** proxy solicitations must follow SEC Rules
      * SEC Rule §14(a)(9): proxy solicitation can’t make false or misleading statements or omissions
        + SEC requires those who solicit proxies to furnish each shareholder with a proxy statement including all relevant info
      * *J.I. Case Co. v. Borak:* shareholder brought derivative suit against JI Case alleging that merger was effectuated through circulation of false and misleading proxy statements; alleged violation of §14(a)(9); statute had no private right of action (unclear if only SEC can institute proceedings for violation or if private person can too)
        + **private right of action is implicit** based on purposes of SEC statute

private right of action exists forboth **derivative and direct suits**

* + - * + **courts may use any available remedy**
        + note: court adopted very pro-plaintiff attitude

*policy:* protecting proxy process would control some of the management issues corporate law is concerned with; want shareholders to have more rights so they’re more protected

* + - * *Mills v. Electric Auto-Lite Co.:* plaintiffs filed shareholder derivative suit alleging merger was approved based on misleading information; materials said that directors of EAL approved merger, but didn’t mention that directors of EAL were controlled by company EAL was merging with
        + failure to inform shareholders of directors’ relationship to merger was **material omission**

**material = information *might* have been considered important by reasonable shareholder in deciding how to vote**

note: test is not very demanding

* + - * + have to establish **causal connection** between defendant’s misstatements and harm to plaintiff

lower court test: if terms were fair

idea is that if terms are fair, shareholders would’ve voted for them anyway

SCOTUS said §14(a)(9) is not about fairness, but about disclosure and ensuring stockholders get full and fair information

SCOTUS test: **where there has been a finding of materiality, shareholder has made a sufficient showing of causal relationship between the violation and the injury**

* + - * + possible forms of **relief** for §14(a)(9) violations

**courts are to be alert to provide such remedies as necessary to make effective Congressional purpose**

specific performance (injunction, unwinding)

(+): good policy, undoes the damage; (-): almost impossible for a merger

damages

(+): easily administered; (-): hard to calculate; circular (company pays damages to shareholders, but shareholders own the company)

prophylactic relief: governance changes, corrective disclosure, etc.

(+): good to prevent future problems; (-): unclear if changes are effective, doesn’t remedy current injury

attorney’s fees

cases are almost always brought by entrepreneurial plaintiffs’ attorneys

if damages are uncommon, cases wont be brought bc attorneys won’t get paid contingency fee

* court gets around this by **awarding attorney’s fees as long as case generated some sort of benefit to shareholders (not necessarily $)**
* *Seinfeld v. Bartz:* plaintiff brought derivate suit against Cisco for §14(a)(9) violation; alleged that proxy solicitation for amendment of option grant program for directors was materially misleading because didn’t include Black-Scholes calculation of the prospective value of increased options; claimed information was materially misleading as to how much compensation directors get
  + Black-Scholes valuations are **not material** 
    - *policy:* court didn’t want judges to be making technical/expert decision of whether this info should be required, thought it was up to the SEC
      * note: SEC eventually required valuation disclosures
* **Shareholder Proposals** 
  + - * SEC Rule §14(a)(8): if any security holder of an issuer notifies the issuer of his intention to present a proposal for action at a forthcoming meeting of the issuer’s security holders, the issuer shall set forth the proposal in its proxy statement and identify it in its form of proxy and provide means by which security holders presenting a proposal may present in the proxy statement a statement in support of the proposal
        + proxy access proposals are more commonly being proposed and they usually pass because institutional investors (who have the most votes) usually like them
        + shareholder has prima facie right to get their proposal on the proxy statement as long as:

has held at least $2,000 in market value of stock or 1% of company for at least a year and continues to hold it during proposal

submits only one proposal at a time

supporting statement cannot exceed 500 words

* + - * + since prima facie standard is so low, the more important question is what the corporation’s **affirmative defenses** are

SEC Rule §14(a)(8)(i)(1): the issuer need not submit a proposal if the matter being proposed is **not a proper subject for action by shareholders** under the laws of the jx of the company’s organization

*CA, Inc. v. AFSCME Employees Pension Plan:* plaintiff shareholder wanted corporation to include in its proxy statement a bylaw that would require corporation to reimburse stockholders for reasonable expenses of nominating one of more candidates to corporation’s board in proxy contest as long as at least one of their nominees is elected

DGCL §109(a) empowers both the board of directors and shareholders to amend, adopt and repeal corporations’ bylaws but DGCL §141(a) requires that business of a corporation be managed by board of directors, unless articles of incorporation say otherwise (they don’t in this case)

only **procedural bylaws** are within proper subject matter of shareholder action, not substantive bylaws

* this bylaw involves process for electing directors and protects shareholder rights in fair election process, so is proper subject for proposal

bylaw violates Delaware common law because **bylaws can’t require board to act in such ways that would limit the exercise of their fiduciary duty**

this bylaw would require directors to reimburse even when their fiduciary duties would otherwise compel them not to

* make sure bylaw has **fiduciary out** (exception which says that directors don’t have to follow bylaw if doing so would violate fiduciary duty)

SEC Rule §14(a)(8)(i)(5): the issuer may refuse to include a proposal if it relates to operations which account for less than 5% of the issuer’s total assets at the end of its most recent fiscal year, and for less than 5% of its net earnings and gross sales for its most recent fiscal year, and is **not otherwise** **significantly related to the issuer’s business**

*Lovenhein v. Iriquois Brands, Ltd.:* plaintiff shareholder wanted corporation to include in its proxy materials a proposal that the corporation form a committee to investigate suppliers’ foie gras making process to make sure it’s humane; corporation claims §14(a)(8)(i)(5) exception applies because foie gras is small % of business; plaintiff shareholder claims “significantly related” doesn’t just apply to economic significance but also social and ethical significance

legislative history shows that exception was not meant to hinge solely on economic relativity of proposal

policy issues such as economic or social significance are included

SEC Rule §14(a)(8)(i)(8): issuer may exclude a shareholder proposal if the proposal relates to an **election** for membership on the company’s board of directors or analogous governing body

*AFMCME v. AIG, Inc.:* plaintiff shareholder wanted corporation to include in its proxy statement a proposal to change corporate bylaws to require corporation under certain circumstances to publish the names of shareholder-nominated candidates for director positions, along with any candidates nominated by corporation’s board; corporation claims §14(a)(8)(i)(8) applies to general election rules as well as specific elections

when text is ambiguous, courts look for guidance in agency interpretation of regulation

court rejected SEC’s most recent interpretation of exception that it includes general election proposals and interpreted it based on SEC’s original interpretation to only include specific election proposals

* said SEC has duty to explain departure from prior norms and failed to give explanation for changed interpretation

*policy:* court liked idea that shareholders should be able to nominate board of directors

note: post-*AFMCME*, SEC updated §14(a)(8)(i)(8) to not preclude shareholder bylaw amendments

updated SEC Rule §14(a)(8)(i)(8): an issuer may exclude a shareholder proposal from its proxy statement if it

would disqualify a nominee who is standing for election;

would remove a director from office before his term expires;

questions the competence, business judgment or character of one or more nominees or directors;

seeks to include a specific individual in the company’s proxy materials for election to the board of directors; or

otherwise could affect the outcome of the upcoming election of directors

SEC Rule §14(a)(8)(i)(9): shareholder proposal can be excluded if it directly conflicts with one of the corporation’s own proposals to be submitted to shareholders at the same meeting

note: if corporation gets shareholder proposal it doesn’t want to include, can just put up own sufficiently overlapping proposal to trigger this exception

SEC Rule §14(a)(8)(i)(10): shareholder proposal can be excluded if the corporation has already substantially implemented the proposal

**Closely Held Corporations:**

* small companies organized in corporate form for limited liability advantage over partnerships
  + close corporations came before LLCs, LPs, etc. which are now better options (*see below*)
* **Shareholder Control via Shareholder Agreements**
  + concerns regarding deadlock & oppression in close corporations are dealt with via shareholder agreements
    - **shareholder agreement:** agreement between shareholders that they will vote as dictated under the terms of the agreement
      * issues come up regarding legality, deadlock, and proper remedies
      * shareholder agreements are very common in close corporations
        + upheld as long as drafted carefully with specified remedies and don’t prejudice minority shareholders
  + **Joint Voting Agreements** (agreements that shareholders will vote jointly to have more power)
    - exception to *voting rule* (voting should be tied to stock ownership to ensure incentives are aligned with stock doing well)
      * other exceptions:
        + *revocable proxies*: authorize proxy to vote your stock a certain way, but can always take back voting right
        + *irrevocable proxies*: shareholder can give their voting right in an irrevocable proxy as long as it’s coupled with an interest

e.g. can pledge irrevocable proxy voting right as collateral

interests are still aligned (lender wants stock to go up bc that’s his payment)

* + - * + *voting trust:* shareholder can create trust and endow voting rights in a trustee
    - *Ringling Bros. Shows v. Ringling:* corporation was owned by three shareholders; two had equal shares, one had more; *cumulative voting* structure allowed shareholders to aggregate the number of shares owned by the number of board positions open and if they want use all their votes for a particular director (*protects against oppression* by giving representation guarantee to minority shareholders – they can pick at least one director by aggregating their votes and using them all for one person); the two minority shareholders entered into *agreement to vote jointly* for directors, with an arbitration provision if they couldn’t agree; one refused to vote the way arbitrator rule; other sued for breach of contract
      * **shareholder joint voting agreements are valid** 
        + shareholders may lawfully contract with each other to vote in the future such ways as they, or a majority of their group, determine
        + arbitration is a reasonable provision for situations where the group fails to reach a consensus

solves the deadlock problem of shareholder voting agreements

* + - * **remedy** would be not to count the shareholder’s votes that were cast in breach of contract
        + note: *damages* are the ordinary remedy for breach of contract, but very hard to calculate damages for breach of shareholder agreements & court didn’t want to order *specific performance* to require shareholder to vote a certain way (against voting rule)
  + **Agreements that Restrict Management Rights** (agreements regarding directorship, employment, compensation, etc.)
    - controversial because seem to violate *ur rule* (directors are supposed to be the ones making management decisions)
      * considered valid, at least for closely held corporations as long as agreement doesn’t prejudice minority shareholders
    - old rule:
      * *McQuade v. Stoneham:* shareholder agreement between 3 shareholders in closely held corporation that they would use their best efforts to ensure that all 3 continue as directors and officers (President, VP, Treasurer) with fixed salaries; S refrained from voting for M to continue as director & officer during shareholders meeting; M claimed S breached shareholder agreement
        + **shareholder agreement limiting rights of directors is not valid**

shareholders may not, by agreement, control the directors in the exercise of judgment vested in them by virtue of their office to elect officers and fix their salaries

contract is illegal and void so far as it precludes directors – at the risk of incurring legal liability – from changing officers, salaries, etc. without consent of the contracting parties

shareholders may unite to *elect* directors, but **cannot place limits on directors’ rights to manage the business**

* + - new rule:
      * NY Bus Corp Law §620(b): a provision in the certificate of incorporation otherwise prohibited by law because it restricts the board in its management of the business of the corporation or improperly transfers to shareholders all or any part of such management otherwise within the authority of the board shall nevertheless be valid
        + (1) if all the incorporators or holders of record of all outstanding shares have authorized such provisions, and
        + (2) if subsequent to the adoption of such provisions shares are transferred only to those who have knowledge or notice of and consent to such provision
      * *Clark v. Dodge:* D (75%) & C (25%) were sole shareholders & directors of corporation; entered into agreement that S would vote so that C continues as director & manager and gets ¼ net income as salary as long as he is “efficient, faithful and competent”; C claims D breached by failing to vote to keep him on as director & limiting his salary
        + shareholder agreement is valid even though it limits rights of directors to manage

no other shareholders are affected (C & D are sole shareholders)

where the directors are the sole shareholder (common for closely held corporations), there seems to be no objection to enforcing an agreement among them to vote for certain people as officers

no minority or third party interests are harmed

all the shareholders agreed to the shareholder agreement

there was no attempt to “sterilize” board

level of interference in directors’ role was less than in *McQuade*

* + - * *Galler v. Galler:* IB & BG were equal shareholders in corporation (very similar to partnership); entered into shareholder agreement where if one of them died, wife would have right to nominate director in his place and wife would be paid part of salary
        + a close corporation is one in which the stock is held in a few hands or in a few families and wherein it is not at all, or only rarely, dealt in by buying or selling

**shareholder agreements are often practically necessary for the protection of those financially interested in a close corporation**

shareholder in large corporation can sell their shares on the public market if they are unhappy with management, but a shareholder in a closely held corporation can’t do that because there is no ready market for his shares

shareholder in close corporation is more vulnerable to oppressive majority

large, public companies more closely watched

there are generally no majority shareholders in large, public companies

shareholders in close corporation are often directors and managers thereof as well

* + - * + note: this is *modern view of shareholder agreements*

courts understand that these type of shareholder agreements make sense for small companies

* + most states have **statutory provisions for closely held corporations**
    - DGCL §324(1): close corporation status may be elected by a corporation with not more than 30 shareholders
      * policy concerns of closely held corporation are different than large corporations & statutes address those needs
    - *Ramos v. Estrada:* two groups merged into Television, Inc. with each group getting half the shares; one group had joint voting agreement to vote all their shares in a manner determined by majority of the group and deflecting shareholder would have to sell their shares; deflecting member claimed agreement is invalid
      * CA had statute that held that close corporations can have agreements dictating shareholder voting
        + Television, Inc. was not registered close corporation, but was a *de facto* close corporation, so statute still applied and agreement was valid
* **Abuse of Control**
  + abuse of control in close corporations often results from failure to adopt proper shareholder agreements
  + **freeze out:** situation that occurs when there is a disagreement within small company consisting of a limited group of individuals that are all shareholders, directors and employees and the majority tries to force the dissenting member out of company
    - four elements of freeze out:
      * black sheep is deprived of position as director
      * black sheep is deprived of position as employee
      * black sheep is deprived of their salary and benefits
      * majority attempts to force or forces the black sheep to resell the stock, often at an inadequate price
    - **fiduciary duty & freeze out** 
      * question arises as to whether freeze outs are considered a breach of fiduciary duty
        + freeze outs don’t easily fall within duty of loyalty or duty of care

duty of care isn’t implicated because it’s not a situation of inaction or neglect

duty of loyalty isn’t implicated because it’s not a case of self-dealing

* + - * + conflict between allowing company to manage as it wishes vs. protecting vulnerable minority shareholders in close corporations
      * *Wilkes v. Springside Nursing Home, Inc.* (MA)*:* four shareholders formed close corporation to run nursing home; relationship deteriorated btwn W & rest of shareholders; at next board meeting, rest of shareholders voted to remove W as director and fire him from being officer
        + **shareholders in close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe each other (utmost good faith and loyalty)**

unique aspect of close corporation is opportunity afforded to majority shareholders to “freeze out” minority (breach)

**pleading freeze out claim:**

**(1) plaintiff pleads freeze out**

deprived of directorship, employment, salary & forced to sell shares

**(2) defense can assert affirmative defense that action served legitimate business purpose**

corporation should keep a record of misconduct

**(3) plaintiff can try to show that same purpose could’ve been effected in a different way less harmful to plaintiff**

corporation should try to show that they tried to work it out with plaintiff, but plaintiff wasn’t cooperating

note: no employment agreement in this case

* + - * *Ingle v. Glamore Motor Sales, Inc.* (NY): four shareholders (and directors/officers) in close corporation entered into shareholder agreement which stated that in the event that any shareholder shall cease to be an employee of the corporation for any reason, other shareholders have right to buy back the shares owned by that shareholder; shareholders fired I & removed him from directorship, bought back shares; I claimed freeze out was breach of fiduciary duty
        + **a minority shareholder in a close corporation, by that status alone, who contractually agrees to the repurchase of his shares upon termination of his employment for any reason, acquires no right from the corporation or majority shareholders against at-will discharge**

in the absence of any employment agreement, corporation has a right to discharge employee **at-will**

* + - * + nothing to show bad faith to I as *shareholder*

shares were purchased back at fair price

* + - * + note: NY much stricter towards minority shareholders
      * **remedies:**
        + *Brodie v. Jordan:* three sole shareholders of corporation; W slowly became less involved, disagreed with others, stopped receiving compensation; W died & wife inherited his shares; nominated herself as director, but other two voted against her; she asked for valuation of company so she could ascertain value of her shares but they refused

**defendant shareholders violated their fiduciary duty** by denying plaintiff access to corporate info and excluding her from decision-making

**shareholder in close corporation owe one another essentially the same fiduciary duty in the operation of the enterprise as partners owe one another**

**majority shareholders violate this duty when they freeze out minority**

freeze out = majority frustrates minority’s reasonable expectations of benefit from their ownership of shares

**proper remedy for freeze out is *corrective justice***

**restore minority shareholder as nearly as possible to position she would have been in had there been no wrongdoing**

since freeze out denies reasonably expected benefit, **remedy should restore to shareholder the benefits she reasonably expected** but didn’t receive as a result of breach

* in this case, buy-out isn’t appropriate remedy because plaintiff didn’t have expectation of being bought out
  + maybe court can order prospective relief to ensure plaintiff has access to corporate info
* **fiduciary duty of minority shareholders with veto power:**
  + *Smith v. Atlantic Properties, Inc.:* four shareholders each held 25% of close corporation; shareholder agreement required 80% consensus for decision (gave each shareholder veto power); W kept refusing to issue dividends against wishes of rest of shareholders and despite warnings & penalties from IRS
    - **W breached fiduciary duty** because refusing to issue dividends despite warning is not acting with “utmost good faith and loyalty”
      * **shareholders in close corporation owe one another the same fiduciary duties as partners owe each other** (utmost good faith and loyalty)
        + **situation may come up where majority needs protection from minority** (e.g. when minority has veto power)

minority owes fiduciary duty to majority as well

**MERGERS, ACQUISITIONS & TAKEOVERS:**

**Mergers & Acquisitions:**

* M&A transactions involve fundamental changes within corporation, so shareholders are put at risk
  + law tries to protect minority shareholders from being taken advantage of (not as concerned about majority bc they have the voting power)
* **Types of Mergers:**
  + **Statutory Mergers**
    - DGCL §251(a): any two or more corporations existing under the laws of this State may merge into a single corporation, which may be any one of the constituent corporations or may consolidate into a new corporation formed by the consolidation***, pursuant to an agreement of merger or consolidation, complying and approved in accordance with this section*** 
      * DGCL §251(b): the ***board of directors of each corporation*** which desires to merge or consolidate ***shall adopt a resolution approving of the merger*** or consolidation and declaring its advisability
      * DGCL §251(c): the resolution in (b) shall be ***submitted to the stockholders of each corporation at an annual or special meeting***, where a vote shall be taken for its adoption or rejection. ***If a majority of the outstanding stock of each corporation entitled to vote thereon shall be voted for the adoption, the resolution shall be filed and become effective*** 
        + note: this is pretty stringent since it requires majority of *all outstanding* stock to approve the merger, not just majority of shareholders that are voting
    - DGCL §262: ***any stockholder*** who holds shares of stock on the date of when the directors adopted a merger resolution and who continuously holds such shares through the effective date of the merger and ***who has not voted in favor of the merger***, ***shall be entitled to an appraisal by the Court of Chancery of the fair value of the stockholder’s shares of stock***
      * note: both target & acquirer dissenting shareholders get appraisal rights
  + **Sale of Substantially All the Assets** 
    - sale of substantially all the assets is technically not a merger, but because the resulting business operation looks like a merger of firms, shareholders are at risk basically the same way they are from a merger
    - law imposes limits on sale of substantially all the assets
      * normal pattern is for larger company to buy smaller company, so most of the protections are around the company whose assets are being sold (since that’s usually the smaller company)
        + but some transactions are structured so that the smaller company buys the assets of the larger company, and then the smaller company shareholders don’t get the protections they were designed to have …
    - *Farris v. Glen Alden Corporation*(PA)(old rule): GA (smaller company) wanted to merger with L (larger company); GA would buy all of L’s assets, in exchange would issue GA’s stock to L; L would distribute GA stock to shareholders; L would dissolve & GA would carry on operations of both companies; majority of each company’s shareholders approved transactions; dissenting GA shareholder wanted appraisal rights, but PA law expressly said that dissenting shareholders of corporation *acquiring* assets of another get no appraisal rights (bc PA laws were structured expecting bigger company to buy smaller company, not the other way around)
      * this transaction is a **de-facto merger**
        + transaction fundamentally changes the character of the corporation and the plaintiff’s interests as a shareholder refusing him the rights and remedies of a dissenting shareholder would in reality force him to give up his stock in one corporation and against his will accept shares of another = merger which requires appraisal rights
      * “court will not allow transacting parties to structure their transactions in an unnatural way in order to avoid the protections usually given to minority shareholders in merger statutes when the result of the transaction is basically the same as a merger”
      * note: PA later changed their laws to repeal this decision
        + PA Corporation Code: the doctrine of de-facto mergers is abolished

have to look state-by-state to see what the law is

* + - *Hariton v. Arco Electronics, Inc.* (Delaware) (most states follow this): A & L entered into reorganization agreement; A would sells its assets to L, L would issue A its stock in return; A would distribute L’s shares among its shareholders; majority of each corporation’s shareholders approved agreement; dissenting shareholder claimed this was de-facto merger & wanted appraisal right
      * there is overlapping scope between the merger statute and the sale-of-substantially-all-the-assets statute
        + **framers of a reorganization plan may resort to either type of corporate mechanics to achieve a desired end**

even though this transaction looks just like a merger, it’s technically a sale of assets and should be treated as such

* + **Short Form (Freeze-Out) Mergers**
    - courts don’t view these statutory requirements alone as enough to protect minority shareholders in an interested transaction 
      * if majority shareholder is trying to takeover the company they have a majority stake in, the transaction will be reviewed by the courts at a higher level of scrutiny
        + note: if merger is based on short form merger statute, then there is no fiduciary duty issue but the dissenting shareholders get appraisal rights
    - *Weinberger* *v. UOP, Inc.* (Delaware): S had majority stake in UOP & control of board; S wants to acquire rest of UOP (get rid of minority shareholders); had to make sure acquisition was fair since S owes fiduciary duty to both S shareholders *and* UOP minority shareholders; S was willing to pay up to $24/share; UOP directors that S controlled used UOP data for the sole benefit of S to determine that $20-21/share would be fair, but never shared report w/ UOP; S hired bank to conduct fairness evaluation but rushed bank; UOP board & majority of UOP minority shareholders approved $21/share offer; dissenting minority shareholder claimed merger was not fair
      * fiduciary duty principles apply to the regulation of interested acquisitions
        + **burden-shifting framework:**

was the deal *validly* (with all info) approved by majority of target’s *disinterested* shareholders?

yes 🡪 did *plaintiff* demonstrate lack of **entire fairness** of transaction?

no 🡪 defendant (acquiring company) wins

yes 🡪 plaintiff (target company shareholder) wins

no 🡪 did *defendant* (acquiring company) demonstrate that the transaction was **entirely fair**?

no 🡪 plaintiff (target company shareholder wins)

yes 🡪 defendant (acquiring company) wins

* + - * + **entire fairness:**

(a) fair dealing

includes duty of candor

issues w/ rushed fairness evaluation, conflict of interest of directors, etc.

note: interested directors should not be involved at all (create totally independent committee) to ensure no conflict of interest

(b) fair price

discounted cash flow method should be used

* + - * in this case, failure to disclose results of UOP study & the fact that S was willing to pay as much as $24/share was made the vote uninformed & invalid
        + since deal was not validly approved, no need to do entire fairness
    - *Kahn v. M&F Worldwide Corp.* (Delaware): M&F had majority stake in MFW; wanted to acquire rest of MFW (get rid of minority shareholders); hired firm to advise the what fair price should be; offered $24/share, but required acceptance on the condition that (a) a special committee is formed to negotiate w/ M&F and (b) the terms approved by special committee are approved my majority of minority shareholders
      * **business judgment rule** is the appropriate standard of review that should govern mergers between controlling stockholder and its corporate subsidiary where the merger is conditioned on both the approval of an independent, adequately empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority shareholders
        + **in controller buyouts, the business judgment standard of review will be applied if and only if**

**(1) the controller conditions the procession of the transaction on the approval of both a special committee and a majority of the minority shareholders**

**(2) the special committee is independent**

to show that a director is not independent, a plaintiff must demonstrate that the director is beholden to the controlling party or so under the controller’s influence that the director’s discretion would be sterilized. Bare allegations that directors are friendly with, travel in the same circles as, or have past business relationships with the proponent of a transaction or the person they are investigating are not enough to rebut the presumption of independence

**(3) the special committee is empowered freely to select its own advisors and to say no definitively**

special committee must function in a manner which indicates that the controlling stockholder did not dictate the terms of the transaction and that the committee exercised real bargaining power at arms length

the existence of some financial ties between the interested party and the director, without more, is not disqualifying

the inquiry must be whether applying a subjective standard, those ties were material, in the sense that the alleged ties could have affected the impartiality of the individual director

**(4) the special committee meets its duty of care in negotiating a fair price**

**(5) the vote of the minority is informed**

**(6) there is no coercion of the minority**

* + - * **framework:**
        + is the acquirer a controlling shareholder?

no 🡪 no duty to target shareholders

yes 🡪 is the deal approved by the target’s *independent* directors?

yes 🡪 is the deal approved by the target’s *disinterested* shareholders?

yes 🡪 business judgment rule

no 🡪 did *plaintiff* demonstrate lack of entire fairness of transaction?

yes 🡪 plaintiff wins

no 🡪 defendant wins

no 🡪 is the deal approved by the target’s *disinterested* shareholders?

yes 🡪 did the *plaintiff* demonstrate a lack of entire fairness of transaction?

yes 🡪 plaintiff wins

no 🡪 defendant wins

no 🡪 did *defendant* demonstrate that the transaction was entirely fair?

yes 🡪 defendant wins

no 🡪 plaintiff wins

* + - *Coggins v. New England Patriots Football Club, Inc.* (MA): S owned majority stake in football league; wanted to own entire thing; got loan from bank to finance ownership & loan required that S use his best efforts to reorganize corporation so income would be devoted to payments of S’s personal loan; majority of minority shareholders approved acquisition; dissenting shareholder claimed merger should be rescinded because unfair
      * the dangers of self-dealing and abuse of fiduciary duty are greatest in freeze-out situations and it is in these cases that a judge should examine with close scrutiny the motives and behavior of the controlling stockholder
        + test should be (a) **proper business purpose** + (b) entire fairness

duty of corporate director must be to further the legitimate goals of the corporation

the court must first be satisfied that a freeze out was for the advancement of a legitimate corporate purpose and then it can proceed to determining whether the transaction was fair by examining the totality of the circumstance

note: most states don’t use business purpose test (unique to MA)

* + - * + in this case, merger did not have a legitimate business purpose

purpose of merger was for S’s own purpose of gaining control of entire corporation and paying back his creditors

* + - * usually the remedy for an improper merger is *rescission*, but sometimes it’s too complicated to undo merger
        + if recession is too complicated, proper remedy is to **award damages based on value of shares of corporation** right now (as if the merger had never happened)

**Takeovers:**

* **tender offers:** way for potential acquirer to gain control of corporation
  + offeror offers to buy target company’s shareholders’ securities at a premium over market price
    - can impose conditions on tender offer (e.g. only if over 50% of shareholders tender)
    - can make two-tier tender offer (front-end & back-end) to induce shareholders to tender (*see below*)
  + economic effect of tender offers:
    - when tender offer is made at a premium, stock price goes up
      * if market is confident that tender offer will be successful 🡪 stock will go up to bid price
      * if market thinks there will be competition for bid price 🡪 stock will go even above bid price
      * if market thinks tender offer will not be successful 🡪 stock will fall down, but just to where it was before (no real loss)
    - offeror’s stock usually goes down when they make a tender offer, but less than the amount that the offeree’s stock increases (overall net gain in value)
  + **corporate defensive measures against unwanted tender offers (hostile takeovers)**
    - **standard of scrutiny:**
      * **modified business judgment rule** (*Unocal*): before business judgment rule can be applied to a defensive measure, corporate directors must show (a) reasonable grounds for believing that danger to corporate policy & effectiveness existed & (b) defensive measure must be reasonable in relation to the threat posed
        + *policy:* there is fear that board may be resisting takeover for fear of losing their positions as directors, not bc takeover is bad for corporation
    - **types of defensive measures:**
      * **“greenmail”:** corporation re-purchases securities from potential acquirer at premium price to avoid takeover
        + *Cheff v. Mathes:* M bought up shares of HF Co., wanted to acquire it and change business practices; HF Co. board was opposed to it; as defensive measure HF Co. repurchased big block of M’s stock for premium; shareholder filed suit claimed re-purchase of shares for elevated price was improper waste of money bc it’s sole purpose was entrenchment (board of directors didn’t want takeover bc they didn’t want to get fired)

DGCL §160: a corporation is granted power to sell & re-purchase shares of its own stock

test for whether re-purchase is proper is business judgment rule, as long as directors show that there was a **proper business purpose** for this tactic *other than entrenchment*

fending off threat of potential corporate takeover that threatens to reorganize the company = proper business purpose

in this case, the defendants showed they had reasonable grounds for believing that acquisition by M would alter corporate policies and effectiveness of the business

* + - * **discriminatory self-tenders** (now banned)**:** corporation announces competing tender offer but excludes potential acquirer from being allowed to take advantage of it (prevents greenmail)
        + *Unocal Corporation v.**Mesa Petroleum Co.:* M made two-tier tender offer to U shareholders (coerces shareholders into accepting tender so wouldn’t be forced to accept worse back-end offer); U made self-tender for higher price to all shareholders except M (to prevent M from capitalizing on it); M sued claiming that only purpose of self-tender was to entrench existing management & that it was discriminatory to M as a shareholder of U

modified business judgment rule applies to corporate defensive measures against takeovers

“because of an *omnipresent specter that a board may be acting primarily in its own interests*, rather than those of the corporation of shareholders, there is an **enhanced duty that calls for judicial examination at the threshold *before* the business judgment rule may be conferred**”

(a) directors must show that they had reasonable grounds for believing that a danger to corporate policy & effectiveness existed

(b) defensive measure must be reasonable in relation to the threat posed

in this case, corporation had reasonable grounds for believing danger to corporate policy & effectiveness (didn’t want to be acquired) + defensive measure was reasonable response to threat posed (believed M’s tender offer was “grossly inadequate)

* + - * + note: after *Unocal*, SEC banned discriminatory self-tenders

SEC Rule §13e-4(f)(8): issuers that tender their own shares have to hold the tender offer open to all shareholders

* + - * **poison pills:** “right” attached to stock structured as a dividend issued to shareholders; if third party announces intent to acquire certain % of stock, right separates from stock (pill is triggered); if third party actually acquires certain % of stock, then to holders of the right (*except the third party bidder, even if he has “right”*) can purchase issuer’s stock at a big discount; result is that shares get massively diluted
        + effect: poison pill discourages bidder from trying to acquire company bc if he does, stock will be diluted and lose value

note: poison pills can be rescinded by board (e.g. if friendly acquisition)

way to defeat poison pill:

put a lot of pressure on the market or directors to rescind poison pill

if tender offer is high enough, market will pressure board to rescind poison pill bc shareholders will get so much money

* + - * + pros: gives company more bargaining power in negotiating acquisitions; gives company ability to fend off hostile takeover bids
        + cons: destroys market for corporate competitors for takeover bids; just a way to ensure incumbent management stays in company
  + **duty to auction**
    - *Revlon, Inc. v. McAndrews & Forbes Holdings, Inc.:* PP makes tender offer to takeover Revlon; Revlon resists (claims offer is grossly inadequate); institutes defensive measures such as poison pill & self-tender; PP persists w/ higher tender offer; Revlon seeks out another acquirer they prefer more (F); F makes tender offer; PP offers even more; Revlon agrees to lockup, no-shop & rescission of poison pill clauses w/ F; PP offers more & sues
      * Revlon directors breached their fiduciary duties by effectively ending an auction for acquisition of company
        + first defensive measures (poison pill & self-tender) were ok bc Revlon found PP’s original tender offer grossly inadequate & a threat (wanted to stay whole, PP wanted to liquidate) (*Unocal* standard)

but **once it becomes inevitable that corporation is for sale, the duty of the board is the get the best price for the corporation** (duty to auction)

once Revlon sought out White Knight and entered into takeover negotiations, it became clear that company was for sale

lockups, no-shop clauses, cancellation fees, etc. are all okay if the *induce* auctioning, not if they shut off an action

in this case, PP was offering higher price than F, Revlon had a duty to entertain it once it was clear that company was being sold

* + - *Paramount Communications v. Time Inc.:* Time wanted to acquire Warner; two companies were about to make deal; Paramount comes in at last minute w/ very high tender offer to acquire Time; Time wants deal w/ Warner, continuously rejects Paramount offers as inadequate; Paramount sues claiming violation of *Revlon* duty to auction
      * ***Revlon* duty to auction only applies when it is inevitable that company is going to be sold.** 
        + **otherwise, *Unocal* duty (business judgment about adopting defensive measures as long as reasonable & not for purpose of entrenchment)** (*see above*)
      * in this case, court says that it wasn’t inevitable that Time would be sold (planned to keep employees & directors, stay in business, etc.), unlike Revlon where understanding was that it was going to be sold off for parts
        + Time merger was not a sale but a strategic move

*Unocal* duty applied and Time passed modified business judgment rule - (a) reasonable threat from Paramount bc Time didn’t think that Paramount takeover was good for long-term interests of corporation but Warner merger was & (b) rejecting tender offer was reasonable response to threat

**ALTERNATIVE BUSINESS FORMS:**

Evolution of new business forms arose due to some of the limitations of traditional business forms (double taxation for corporations, unlimited liability for partnerships)

**Limited Partnerships (LPs):**

**Structure:**

* **include two types of partners:**
  + general partner: like traditional partner (unlimited liability)
  + limited partner: like shareholder (limited liability, no management)
* **offer benefits of limited liability & tax advantages:**
  + generally created for **tax purposes** 
    - if structure business as corporation, taxed twice (once on profits made by corporation, once on dividends paid to shareholders)
    - if structure business as partnership, taxed only once (profits “flow through” to the partners, so they are only taxed once on their persona income taxes)
  + limited partnerships are also a **financing vehicle**
    - encourages investors to invest in partnerships (can contribute funds while being protected from personal liability)
      * opens up public market to the financing of limited partnerships

**Formation:**

* ULPA §201(a): in order to form a limited partnership, a certificate of limited partnership must be executed and filed in the office of the Secretary of State
  + usually also must have something in name that signals limited partnership
    - *policy:* requirepublic notice of limited partnership form to protect creditors (since creates limited liability) (same concern as requiring formal formation process for corporation)

**Liability of General & Limited Partners:**

* RULPA §404(a): except as provided in this Act or in the partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners
  + general partner in LP is like partner in regular partnership (including unlimited liability)
* RULPA §303:
  + (a): a limited partner is not liable for the obligations of a limited partnership unless he *participates in the control of the business*. However, if the limited partner participates in the control of the business, he is liable *only to persons who transact business with the limited partnership, reasonably believing, based upon the limited partner’s conduct, that the limited partner is a general partner*
  + (b): a limited partner *does not* participate in the control of the business within the meaning of (a) solely by doing one or more of the following … *consulting with and advising a general partner* with respect to the business of the limited partnership
* *Holzman v. De Escamilla:* HF was limited partnership farm; E (farmer) was general partner, R & A were limited partners; farm went bankrupt & trustee claimed that R & A should be considered general partners and be personally liable for the debts of the partnership
  + R & A were general partners
    - **a limited partner shall not become liable as a general partner, unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business** 
      * R & A had sufficient control of the farm
        + conferred w/ E and made decisions about what crops to plant
        + checks from partnership could only be drawn upon signature of 2/3 partners

R & A had absolute power to withdraw money and power to restrict E from withdrawing money

* *but see* ULPA §303 (newest rule): an obligation of a limited partnership, whether arising in contract, tort or otherwise, is not the obligation of a limited partner. A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being limited partners, even if the limited partner participates in the management and control of the limited partnership
  + note: this effectively overrules the old RULPA §303 and allows limited partners to avoid personal liability even if in control of the business
    - *commentary:* control rule has become an anachronism with all the new business forms out there (LLPs, LLCs, etc.)

**Limited Partnership Agreements:**

* **Fiduciary Duties**
  + *In Re El Paso Pipeline Partners, LP Derivative Litigation:* El Paso MLP was master limited partnership (just hold assets for investment, but are taxed on a “pass through” basis); El Paso MLP was sponsored by corporate parent (EPP), which sold assets to El Paso MLP which El Paso MLP then traded; EPP owned 100% of general partner of El Paso MLP, who owned 2% of El Paso MLP (so EPP had 2% stake in El Paso MLP); EPP offered to sell El Paso MLP their interest in natural gap companies; plaintiffs thought that since the market for natural gas was bad, EPP wanted to offload the risky assets to El Paso MLP for inflated price; since transaction was conflict of interest, had to be approved by majority of Conflicts Committee acting in good faith; CC met to review proposal & unanimously approved, but at the time didn’t know that EPP was refusing to buy more of those assets at even lower price than they were offering to sell their existing ones to El Paso MLP; plaintiffs claimed info was material and led to inference of bad faith
    - the **limited partnership agreement eliminated all common law duties that EPP would’ve otherwise owed to El Paso MLP**
      * as long as majority of Conflicts Committee approves transaction in good faith, it’s valid and will not be deemed breach of any fiduciary duty
        + good faith = subjective belief that decision is in the best interest of partnership

objective facts are only logically and legally relevant to the extent that they permit an inference that the defendants lacked the necessary subjective good faith belief

in this case, failure to take into account info about EPP refusing to buy more assets doesn’t lead to inference of bad faith because committee didn’t know that information

**subjective good faith cannot be challenged based on information that the committee didn’t have**

* + - **under implied covenant of good faith & fair dealing under common law, only general partner that withheld info is liable** 
      * a limited partnership doesn’t expressly eliminate a good faith obligation of general partner to offer information
        + if the agreement addressed the issue, then no common law obligation would be imposed, but since the agreement is silent on this issue, then there is room for common law determination
      * if agreement said general partner doesn’t owe any fiduciary duty to limited partnership, there would be no liability imposed

**Limited Partnerships as Tax Shelters:**

* in order to protect general partner from being personally liable for the debts and torts of a limited partnership, a form of limited partnerships was created where the **general partner in a limited partnership is a corporation** 
  + this makes sure that no individual is personally liable to creditors of limited partnership
* *Frigidaire Sales Corporation v. Union Properties, Inc.:* plaintiff entered into contract with Commercial (limited partnership) whose general partner was Union (a corporation); defendants were officers, directors and shareholders of Union and limited partners of Commercial (controlled Union and through their control of Union, controlled management of Commercial); Commercial breached contract and plaintiff sought to hold defendants personally liable as general partners of Commercial
  + defendants are not general partners of Commercial
    - limited partnerships are a statutory form of business organizations and **the law allows parties to form limited partnerships with a corporation as the sole general partner**
      * **when the shareholders of a corporation, who are also the corporation’s officers and directors, *conscientiously keep the affairs of the corporation separate from their personal affairs*, the corporation’s separate entity should be respected**
        + plaintiff knew he was dealing with Union, never mistakenly assumed that defendants were general partners since they were careful to separate their actions, and was never led to believe that defendants were acting in any capacity other than agents for Union

**rights of creditor to limited partnership with corporate general partner can only be vindicated by “piercing the veil”**

* + - Union is the only entity with general liability, not the individual defendants
  + note: this **structure allowed the defendants to control Commercial without being subject to personal liability, while still getting the tax benefits of a partnership** 
    - money from limited partnership will “flow through” to limited partners and just be taxed once
      * money will go to defendants through partnership, not corporation to avoid double taxation
        + Union just wont declare any dividends

**Limited Liability Companies (LLCs):**

**Structure:**

* investors are called “members”
  + all members are shielded from personal liability, including managers (unlike limited partnership)
* almost unparalleled managerial and operational flexibility
  + LLC can be managed by it’s members or by managers, who may or may not be members
* advantageous tax treatment
  + profits “flow through” to members and are only taxed once on members’ personal tax returns
  + members can offset company’s losses on personal tax returns (unlike corporation stockholders)
* membership interest in an LLC is usually not considered a security and thus not subject to securities laws

**Formation:**

* have to file a document with the state that has the name of the LLC, name & address of agent for service of process, address of LLC (easy)
  + have to file annual report to maintain LLC status (with just basic information)
* **De-Facto LLC/LLC by Estoppel**
  + *Duray Development, LLC v. Perrin:* DD entered into excavating contract w/ Perrin, then updated contract to be between DD & Outlaw (Perrin’s LLC); DD understood he was no longer in contract w/ Perrin, but with Outlaw; Outlaw breached; DD sued Outlaw, but discovered Outlaw hadn’t filed all the forms and wasn’t valid LLC at the time of their contract; DD sued Perrin
    - **doctrines of de-facto corporation & corporation by estoppel both apply to LLCs because of the similarities between corporations & LLCs**
      * **de-facto LLC:** defectively formed LLC may obtain legal status of LLC if the members (a) proceeded in good faith, (b) under valid statute, (c) for authorized purpose, (d) have executed and acknowledged articles of association for that purpose
        + Outlaw meets these requirements (nothing to show Perrin acted in bad faith or to defraud)
      * **LLC by estoppel:** equitable doctrine that doesn’t concern legal status but states that where a body assumes to be an LLC and acts under that name, third party dealing with it under such name is estopped to deny it’s LLC existence
        + Outlaw meets these requirements (DD thought he was dealing with Outlaw, Perrin made all communications in Outlaw’s name, etc.)
    - note: court is trying to address problem where business forms have to register with government, which creates a delay, but they still have to do business during that time while waiting for government approval

**Management of LLCs:**

* no strict rules regarding management of LLC
  + can have board of directors managing LLC, but not required
  + most often, members or a professional manager manage LLCs
* RULLCA §407(b): in a **member-managed** LLC
  + (1) the management and conduct of the company are vested in the members
  + (2) each member has equal rights in the management and conduct of the company’s activities
  + (3) a difference arising among members as to a matter in the ordinary course of business may be decided by a majority of the members
  + (4) an act outside the ordinary course may be undertaken only with the consent of all members
* RULLCA §407(c): in a **manager-managed** LLC
  + (1) except as otherwise expressly provided in this Act, any matter relating to the activities of the company is decided exclusively by the managers
  + (2) each manager has equal rights in the management and conduct of the activities of the company
  + (3) a difference arising among managers as to a matter in the ordinary course of the activities of the company may be decided by a majority of the managers
  + (4) the consent of all members is required to undertake any other act outside the ordinary course of the company’s activities

**LLC Operating Agreements:**

* LLC Operating Agreements > ULLCA/RULLCA default provisions
  + strong policy favoring *freedom to contract* = courts give great deference to operating agreements
* *Elf Atochem North America, Inc. v. Jaffari:* Elf, J & J’s company entered into LLC; LLC operating agreement had arbitration clause and CA forum-selection clause; E sued J both individually & derivatively on behalf of LLC in Delaware
  + arbitration & forum-selection clauses are valid and must be adhered to
    - although Delaware LLC Act says Delaware courts have jx over disputes regarding Delaware LLCs, **LLC** **operating agreement > default statutory provisions**
      * policy of Delaware LLC Act is to give maximum effect to principle of freedom to contract
        + approach is to permit members to have broad discretion in drafting operating agreements
  + Delaware also allows for derivative suits in Delaware court (why J tried derivative action too), but since the operating agreement doesn’t distinguish between direct and derivative actions, both will be assumed
* **Fiduciary Duties**
  + LLC operating agreements can contract around, but can’t fully eliminate fiduciary duties
    - RULLCA §110(c): an operating agreement may not *eliminate* the duty of loyalty, duty of care, or any other fiduciary duty
    - RULLCA §110(d): if not manifestly unreasonable, the operating agreement may
      * (1) restrict or eliminate the duty to refrain from competing with the business in the conduct of the company’s business
      * (2) identify specific types or categories of activities that do not violate the duty of loyalty
      * (3) alter the duty of care, except to authorize intentional misconduct or knowing violations of law
      * (4) alter any other fiduciary duty, including eliminating particular aspects of that duty
      * (5) prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing
        + to be subject to the arbitration and forum selection clauses
  + *Fisk Ventures, LLC v. Segal:* Genitrix, LLC does medical research; Segal owns 55% of Class A, Fisk owns majority of Class B, other investors owe Class C; operating agreement says Segal appoints 2/5 board members, but agreement requires 75% board approval (A & B have to work together); Class A & Class B disagreed over financing strategy, business went under; Segal sued claiming Class B members violated implied covenant of good faith and fair dealing by not agreeing to Segal’s financing plan
    - Class B members did not breach implied covenant of good faith and fair dealing
      * operating agreement endowed Class A & Class B members with protections and doesn’t require Class B to acquiesce to Class A’s demands
        + **court cannot use implied covenant of good faith where contract expressly covers the issue**

in this case, LLC operating agreement expressly required approval from both Class A & Class B members

just because Class B members didn’t agree with Segal’s idea doesn’t mean it was bad faith (business judgment)

* + - *policy:* want to allow companies to structure management and policies as they want
  + *McConnell v. Hunt Sports Enterprises:* H & M are members in LLC; want to lease sports arena to franchise a team; disagree as to whether lease offer for particular arena is satisfactory (H doesn’t want to lease, M wants to lease); M & other members form separate company and lease the arena; H sues claiming that M breached his fiduciary duty to the LLC by competing with it
    - M did not breach his fiduciary duty by competing with LLC
      * **LLC operating agreement had a specific provision that said members may compete with the LLC**
        + normally in an LLC, fiduciary duty of loyalty wouldn’t allow members to compete with LLC, but **operating agreement trumps default**
      * in general, members of LLC owe each other duty of utmost trust and loyalty
        + but that duty must be considered in the context of the terms of the operating agreement
    - note: if this was a corporation, M’s actions would have been breach of duty of loyalty
      * LLC gives greater flexibility (can contract around)
      * shows that courts give great deference to terms of LLC operating agreements

**Piercing the LLC Veil:**

* the piercing the veil doctrine applies to LLCs
  + *NetJets Aviation, Inc. v. LHC Communications, LLC:* NJ entered into contract with LHC to lease plane for five years; LHC terminated agreement; NJ requested balance LHC owed; LHC dissolved w/out paying balance; NJ tried to get court to pierce corporate veil and collect from LHC’s sole owner, Z
    - the LLC veil should be pierced in this case
      * **to prevail under veil piercing theory, plaintiff must show: (1) there was comingling of assets between entity and owner; (2) overall element of injustice and unfairness**
        + courts look at factors such as: whether business was adequately capitalized, whether company was solvent, whether company was in general a façade

note: in *corporate* veil piercing courts look to see whether corporate formalities were followed, but they don’t place as much emphasis on that for LLC veil piercing since LLCs are required to follow any particular formalities

might be harder to pierce veil for LLC since courts look at one less factor

* + - * in this case, Z comingled money from LHC, his other companies and personal account; used jet for personal travel; had one office for all his companies; LHC was not adequately capitalized

**Raising Additional Capital as an LLC:**

* *Racing Investment Fund 2000, LLC v. Clay Ward Agency, Inc.:* RIF was LLC that owed outstanding insurance premiums to Clay Ward; Clay Ward tried to get court to force members of RIF to pay remaining costs by invoking capital call provision of operating agreement which stated that manager of LLC can call for additional capital contributions from members on a pro rata basis
  + hallmark of an LLC is the limited liability enjoyed by its members
    - **members of LLC will not be personally liable for the debts and obligations incurred by the LLC unless their operating agreement states otherwise** 
      * **any assumption of personal liability in an LLC must be stated clearly and unequivocally in the language of the LLC operating agreement and leave no room for doubt of the parties’ intent** 
        + capital call provision is not enough to constitute an agreement that allows for personal liability of members of an LLC

capital call provision is designed to ensure members will contribute capital as needed, not create assumption that members will be liable for the debts incurred by the corporation

* + note: shows courts take limited liability in LLCs very seriously

**Dissolution:**

* an LLC is dissolved upon the happening of the first of the following:
  + the occurrence of events specified in the operating agreement
  + the written consent of all members
  + entry of a decree of judicial dissolution
* LLC can also be considered de-facto dissolved
* *New Horizons Supply Cooperative v. Haack:*  H signed contract between her LLC & NH; didn’t make payments as required; LLC dissolved and H never made required payments to NH; NH tried to hold H personally liable for remaining debts
  + H can be held personally liable for remaining debts of LLC upon dissolution
    - **a dissolved LLC may dispose of known claims against it by filing articles of dissolution and then providing written notice to its creditors containing info regarding filing claims** 
      * H didn’t take these steps to shield members from liability
    - creditors enjoy first priority of distribution of company’s assets upon dissolution
      * **a claim owed to a creditor may be enforced against a member of dissolved LLC to the extent of the assets that that member from the LLC got upon dissolution** 
        + burden seems to be on member to show they didn’t get any assets upon dissolution

is there any benefit to forming corporation instead of an LLC?

* LLC interests aren’t traded on major exchanges
* Corporations seem more reputable, serious, etc.
* Corporations can just choose not to pay dividends and not be subject to double taxation

**Limited Liability Partnership (LLP):**

Business form generally used by **professionals** (doctors, lawyers, etc.)

* RUPA §306(c): an obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the partnership. A partner is not personally liable directly or indirectly, by way of contribution or otherwise, for such an obligation solely by reason of being or so acting as a partner
* pros:
  + partnerships generally have greater barrier to entry than corporations
    - don’t want members coming in and competing with existing members for management, etc.
  + there may be conflicts between professionals’ fiduciary duty to clients vs. shareholders (if organized in corporate form)
  + easier to form
* cons:
  + harder to raise capital
  + LLPs don’t immunize professionals from liability for their own malpractice (only from partners’ malpractice)

**Business Trusts:**

Business form used to facilitate passive management of asset/investment pools

* trust: body of assets managed by trustee for the benefit of a beneficiary
* generally used for passive investment pools (real estate funds, mutual funds, investment funds, etc.)

**Benefit Corporation:**

Business form organized to allow a corporation to act for the benefit of public good as well as profit

* authorized to act in the interest of serving some public welfare objective
  + not just profit-maximizing firm
    - so if corporation doesn’t make profit or makes less of a profit because they chose to do actions that benefit the public, directors wont be held liable for violating fiduciary duties
      * not considered breach of fiduciary duty if corporation acts for benefit of public welfare at the expense of the company
* note: *see more on public benefit corporations in the context of corporate charitable giving (above)*

**FEDERAL SECURITIES LAW:**

Securities law is primarily about **disclosure & fairness**

Securities law is primarily based in **federal law** and promulgated by the SEC

* Securities Act of 1933 (regulates primary market - IPOs)
* Securities & Exchange Act of 1934 (regulates secondary market – trading after securities were issued)

Securities law tries to balance two competing policies of **protecting investors vs. facilitating capital markets**

* factors that play a role in regulations:
  + size of the investment offering
    - small offer = less investors can get hurt, issuer is likely small firm (less effect on capital market)
  + sophistication of investors
    - SEC is less worried about them getting tricked, so has laxer regulations for them
  + disclosure
    - disclosure = more protection up to a certain point (then becomes too overwhelming & $$)
      * the more disclosure there already is, the more lenient SEC will be
  + amount of time passed between when security was initially sold & when it’s being re-sold
    - right after initial sale = greater risk
      * securities laws regarding re-sale are more permissive as more time passes
  + overlapping regulations
    - if another regulatory body has rules performing similar functions, SEC may defer to the other regulatory body

**Security:**

* if an instrument is considered a security, it is *subject to federal securities regulations*
  + Securities Act of 1933 §2(1): unless the context otherwise requires, “security” means “any note, stock, treasury stock, security future, bond, debenture, investment contract... or, in general, any interest or instrument commonly known as a ‘security’”
  + *Robinson v. Glynn:* R agreed to invest in G’s LLC if his product passed a field test; G lied & told R it did; R invested & became member of LLC; R found out G lied and sued G for federal securities fraud; G claimed R’s interest in LLC was not a security; R claimed it was a stock or an investment contract
    - R’s interest in the LLC was not a security (not stock & not investment contract)
      * **investment contract:** 
        + **a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits “solely” from the efforts of others**

courts now use *“substantially”* instead of *“solely”* (too unrealistic)

what matters is **whether the investor, as a result of the investment agreement itself or the factual circumstances that surround it, is left unable to exercise meaningful control over his investment**

in this case, R was not a passive investor (was board member, treasurer, exercised management rights)

*policy:* securities laws are not as worried about sophisticated investors who can protect themselves

* + - * **stock:** 
        + **instrument must be called a stock and bear a stock’s usual characteristics**

characteristics: right to receive dividends, negotiability (freely transferrable), ability to be pledged, conferring of voting rights in proportion to number of shares owned, capacity to appreciate in value

in this case, membership interest wasn’t called a stock, didn’t have most of the characteristics (didn’t share in profits via dividends, couldn’t transfer interest, couldn’t pledge control rights)

* + - courts decline to give bright line rule whether LLC membership interest is a security
      * to be determined on case-by-case basis

**Registration:**

* Securities Act of 1933 prohibits interstate sale of securities unless issuer has “registered” them with SEC
  + Securities Act of 1933 §5(a): it shall be unlawful for any person, directly or indirectly, to sell a new issue of a security through the use or medium of any prospectus or otherwise, unless a registration statement is in effect
    - must file **registration statement** & **prospectus** (elaborate document w/ extensive info about issuer’s finances and business) with SEC and send prospectus to purchaser before sale
      * penalties for selling a security without complying with registration requirement:
        + Securities Act of 1933 §12(a)(1): any person who … offers of sells a security in violation of §5 [registration requirement], shall be liable to the person purchasing the security from him, who may … recover the consideration paid for such security with interest thereon, less the amount of income received thereon, upon the tender of such security, or for damages if he no longer owns the security

person who bought unlawfully unregistered security basically gets a *right of recession plus interest*

issuer is held *strictly liable* under §12(a)(1)

* + - issuers look for ways to *evade registration requirement* because filing registration statement (a) is timely and expensive & (b) subjects issuer to other securities laws
* **Exceptions to Registration Requirement**
  + **Exempt Security:** instrument is exempt from registration requirement by statue (uncommon)
    - most exempt securities (a) are very safe & low risk and/or (b) have market of sophisticated investors
      * ex: US Treasury securities, municipal bonds, commercial paper, bank deposits, federal agency issues, in-state issues (securities offered only to people of certain state by issuer is resident/incorporated in that state)
    - exempt securities are still subject to federal securities laws, just not registration requirement
  + **Transactional Exemption:** 
    - **transactional exemptions for initial offers by the issuer**
      * **private placements**
        + Securities Act of 1933 §4(a)(2): §5 [registration requirement] doesn’t apply to transactions by an issuer not involving any public offering

characteristics: limited maximum offering amount (*Doran*); buyers should be sophisticated (*Doran*); disclosures should contain all the info a registration statement would provide (*Doran*); no public solicitation allowed; limits on resale; no SEC reporting requirement

* + - * + *Doran v. Petroleum Management Corp.:* PMC organized LP; contacted 4 ppl w/ offers to participate; D agreed to be “special participant” & contributed $; partnership went under and D was ordered to pay part of judgment; D sued seeking recession of contract claiming partnership interest sold to him violated §5(a) because it wasn’t registered; PMC claimed interest was private placement & exempt from registration requirement

defendants bear the burden of showing via affirmative defense that a security interest was a private offering and thus exempt from registration

purpose of Securities Act was to protect investors by promoting the full disclosure of information thought necessary to informed investment decisions

exemption’s applicability should turn on whether particular classes of persons affected need the protection of the Securities Act

**factors courts look at to determine whether offer qualifies as private offering:**

**number of *offerees* and their relationship to each other and the issuer** (\*\*\*)

**number of units offered**

**size of the offering**

**manner of the offering**

there must be a sufficient basis of accurate information upon which the investor may exercise his skills

**defendants must demonstrate that all the information that a registration statement would have offered an investor in a public offering is available to the offerees**

note: pretty vague standard makes this risky since you’re never sure if court will consider your security a private placement

* + - * + types of private placements:

**regulation A**

**tier 1:** $20M maximum offering within 12-month period; no buyer limits; disclosures must include offering statement and circular; public solicitation permitted; no limits on resale; minimal SEC reporting requirement

**tier 2:** $50M maximum offering within 12-month period ; offering must be ≤ 10% of the greater of the buyer’s annual income or net worth; disclosures must include offering statement and circular; no limits on resale; must file annual and semi-annual reports w/ SEC

**regulation D**

**rule 504** (1% of Reg. D offerings)**:** $5M maximum offering within 12-month period; no buyer limits; must contain disclosures as required by state law; no public solicitation allowed; limits on resale; must file Form D w/ SEC within 15 days after first sale

**rule 505** (2% of Reg. D offerings)**:** $5M maximum offering within 12-month period; buyers can only be accredited investors + 35 others; extensive disclosures required for non-accredited investors, including audited financials; no public solicitation allowed; limits on resale; must file Form D w/ SEC within 15 days after first sale

**rule 506** (\*\*\*)(97% of Reg. D offerings)

**506(b):** no maximum offering (unlimited); buyers can only be accredited investors + 35 other *sophisticated* investors; extensive disclosures required to non-accredited investors, including audited financials; no public solicitation allowed; limits on resale; must file Form D w/ SEC within 15 days after first sale

**506(c):** no maximum offering (unlimited); buyers can only be accredited investors; no specific disclosure requirement; public solicitation permitted; limits on resale; must file Form D w/ SEC within 15 days after first sale

**crowdfunding** (new) (meant as investment vehicle for startups)

JOBS Act §4(a)(6): $1M maximum offering within 12-month period; limited to purchases of ≤ $100K based on income or net worth; disclosures must include offering statement on Form C; issuer may not advertise terms, securities may be sold through registered funding portals and broker-dealers; no limits on resale; must file annual report on Form C w/ SEC

**regulation S** (international/off-shore offerings)**:** no maximum offering (unlimited); buyer and sale must be outside the U.S.; no required disclosures (foreign law applies); no restrictions on solicitation (foreign law applies); limits on resale (within the U.S.); no SEC reporting requirement

* + - **transactional exemptions involving re-sale**
      * Securities Act of 1933 §4(a)(1): registration requirement is exempted for transactions by any person other than an issuer, underwriter or dealer
        + **rule 144:** if you are an insider and got securities from a company or you bought securities via a transactional exemption, you can re-sell the securities as long as you hold them for the required holding period (then they become unrestricted and can be sold in public market w/out having to be registered)

characteristics: no maximum offering (unlimited); no buyer limits; current information about the issuer, including financial statements must be disclosed to the public; public solicitation permitted; reporting companies must hold the security for 1 year before resale, non-reporting companies must hold security for 6 months before resale; no SEC reporting requirement

* + - * + **rule 144A:** exemption deals with qualified institutional buyers (very sophisticated investors)

if buyer is deemed by SEC to be qualified institution buyer (QIB), then seller can sell restricted securities he bought via a transactional exemption to the QIB without any restrictions

there is basically an unrestricted market for QIBs (sophisticated investors so SEC isn’t worried about them)

note: if QIB wants to re-sell to non-QIB, must do rule 144 or some other exemption to get around registration requirement

* **Analysis Overview:**

1. is the instrument a security?
2. is it an exempt security?
3. is there a transactional exemption?

**Liability for Misstatements in Registration Statement:**

* part of the reason issuers try to avoid being subject to a registration requirement is that it opens them up to potential liability for what they say in the registration statement
* Securities Act of 1933 §11(a): in case any part of the registration statement, when such part became effective, contained an **untrue statement of a material fact** or **omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading**, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may sue -
  + (1) every person *who signed the registration statement*
  + (2) every person who was a *director* of … or *partner* in the issuer at the time of the filing of the part of the registration statement with respect to which liability is asserted …
  + (4) every *accountant, engineer, or appraiser*, or any person whose *profession* gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him
  + (5) every *underwriter* with respect to such security
* Securities Act of 1933 §11(b)(3): it is an *affirmative defense* that the **defendant took due care to verify that the statements in the registration statement were accurate** 
  + two types of due diligence defenses:
    - **affirmative due diligence:** defendant has to make a reasonable investigation (standard of care is that which prudent man would take in the management of his own property)
      * applies to all defendants for non-expertised statements
      * applies to experts on expertised statements
    - **lack of reasonable grounds:**defendant had no reason to believe that the statements in the registration statement were untrue (don’t have to make investigation as long as there are no red flags)
      * applies to non-experts on expertised statements
        + note: attorneys are *not* considered “experts” because they wrote or blessed everything in the registration statement which would mean that everything is expertised and that everyone but the attorneys are held to a lack of reasonable grounds defense (which courts don’t want)
  + note: the issuer (company) is always liable under §11(a) and has no affirmative defense
* *Escort v. BarChris Construction Corp.:* BarChris sought financing; court found that in registration statement for some of the securities issued BarChris overstated their assets, profits and earnings and understated their liabilities
  + BarChris violated §11(a)
    - misstatements or omissions are **material** when it regards **those matters of which an average prudent investor should be informed before purchasing the security registered**
      * material information includes facts which have an important bearing upon the nature or condition of the issuing corporation’s business
        + most misstatements about assets/liabilities made were material

**Securities & Exchange Act of 1934 §10b-5:**

* 10(b) & 10b-5 carryan **implied private right of action**
* **Statutory Language:**
  + Securities & Exchange Act of 1934 §10(b): it shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of any facility of any national securities exchange … to use or employ, *in connection with the purchase or sale of any security* … any *manipulative or deceptive device* in contravention of such *rules and regulations as the SEC may prescribe* as necessary or appropriate in the public interest or for the protection of investors
    - Securities & Exchange of 1934 §10b-5: it shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, in connection with the purchase or sale of any security:
      * (a) to employ any device, scheme or artifice to defraud
      * (b) to make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statement made, in light of the circumstances under which they were made, not misleading, or
      * (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deception upon any person
* **10b-5 Fraud Claims**
  + limit on 10b-5 fraud claims:
    - 10b-5 only applies to fraudulent conduct (material misstatement or omissions), not other fiduciary duty breaches
      * *Santa Fe Industries, Inc. v. Green:* SF had 95% of K stock; exercised right under Delaware short form merger statute to force minority shareholders to sell rest of stock to them; Delaware statute allowed minority shareholders to object if they thought price was unfair; shareholders instead sued under 10b-5, claiming that purpose of merger was to freeze out minority shareholders at an inadequate price (breach of fiduciary duty that majority shareholders owe to minority)
        + **10b-5 does not pertain to breaches of fiduciary duty**

there was no deception, manipulation or misrepresentation by the majority shareholders to the minority shareholders (gave all info as required)

“manipulative” under 10b-5 = intending to mislead investors in connection with purchase/sale of securities

policy of act is to encourage full disclosure (imposing fiduciary duty cause of action doesn’t accomplish this)

fiduciary duty is generally in the realm of state law, not federal law

* + elements of 10b-5 fraud claim:
    - **false statement** (*Basic*)
      * ok to say “no comment”, silence is not considered misleading (*Basic*)
        + but these days, people will just assume that “no comment” = yes if you otherwise would say no

better to adopt a pre-announced policy of always saying “no comment” to any press questions

* + - **material fact** (*Basic*)
      * *Basic Inc. v. Levinson:* B was in merger negotiations; made three public statements that denying it; later issued statement that merger was approved; stock price went up; shareholders who sold stock during time that false statements were issued & before announcement sued under 10b-5; claimed they relied on an artificially-low market price made by B’s false statements
        + a misstatement/omission is **material** if:

there is a substantial likelihood that the information would have been viewed by a reasonable investor as having significantly altered the total mix of information available

depends on how much significance would reasonable investor place on the omitted or misrepresented information

for **speculative events** (e.g. merger negotiations):materiality will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of company activity

information is material when:

[(probability x magnitude) / (size of company)] > W (threshold of materiality (constant))

*rule of thumb:* look to see whether there was an “indicia of interest in the transaction at the highest corporate levels”

note: depends on the model that companies use to get deals done, but for things like mergers, high corporate officers tend to get involved early on (even if low probability)

* + - **in connection with purchase or sale of security** 
      * *SEC v. Texas Gulf Sulphur Co.:* TGS was conducting preliminary mining operations & found very promising tract of land; had to keep info secret not to alert competitors; while info was being kept secret, many directors bought shares & call options of stock; rumor circulated that TGS found major minerals; TGS issued press release saying findings so far were not conclusive; later issued release about significant findings (*see more on case in insider trading*)
        + press release was “in connection” with security

**in connection = anything that would cause reasonable investors to rely thereon and in connection therewith cause them to purchase or sell a corporation’s securities**

misstatements don’t have to be directly related to purchase or sale to fall within 10b-5

* + - * + but press release was not deceptively misleading
    - **reliance** (*Basic*, *Halliburton, West*)
      * problems with 10b-5 claims based on common law fraud reliance requirements:
        + (a) substantive problem: hard to establish reliance by the plaintiff

usually plaintiff doesn’t trade securities based on statement made directly to him by the defendant …

* + - * + (b) procedural problem: 10b-5 claims are usually class actions because it’s not worth it for each individual investor to use, but class actions require all members to have common issue of law and fact

all class actions members would have to prove that they each relied on the exact same statement made by the defendant …

* + - * **fraud on the market theory:** solution to common law 10b-5 reliance problems
        + *Basic Inc. v. Levinson:* B was in merger negotiations; made three public statements that denying it; later issued statement that merger was approved; stock price went up; shareholders who sold stock during time that false statements were issued & before announcement sued under 10b-5; claimed they relied on an artificially-low market price made by B’s false statements

**the fraud on the market theorycreates a rebuttable presumption of an investor’s reliance on any public, material misrepresentation**

idea is that in an open and developed securities market, the price of the company’s stock is determined by the available information regarding the company and its business

class action can now get certified because all plaintiffs relied on same misrepresentation (the stock price)

**presumption can be rebutted** by any showing that severs the link between the alleged misrepresentation and either the price received/paid by the plaintiff *or* his decision to trade

rebut proof of elements that gave rise to the presumption

show that misrepresentation didn’t change price

show that plaintiff traded or would’ve traded despite knowing the truth

* + - * + *Halliburton, Co. v. Erica P. John Fund, Inc.:* EJP claims H made a number of public misrepresentations regarding its potential liability in pending lawsuit & it’s expected revenues in an attempt to inflate stock price; after H made corrective disclosures, the stock price dropped & investors lost money

to establish a presumption based on the fraud of the market theory, plaintiff must show:

(a) that the alleged misrepresentations were publicly known

(b) that the misrepresentations were material

note: Miller thinks materiality has nothing to do with reliance (which is what the fraud on the market theory is about) and that this shouldn’t be a factor

(c) that the security traded in an efficient market

note: usually hire an expert or someone to provide testimony on this & show that there is movement in market based on information

(d) that the plaintiff traded in the security between the time the representations were made and the truth was revealed

ways to rebut presumption defendant can show:

**trading impact:** that the particular investor in question didn’t rely on the market value of the security when trading

but just because some investors don’t rely on market value of stock doesn’t render entire presumption invalid, since most investors do

**price impact:** that the misstatement did not affect the stock price

note: defendant can establish this at the class action certification stage and if the rebuttal is accepted, class action can’t go on because there is no longer a common misrepresentation that was relied upon

now less class actions might be certified

* + - * + *West v. Prudential Securities, Inc.:* broker falsely told 11 customers for months that merger was going to happen; customers traded on basis of tip; other shareholders who traded stock during period that broker was lying tried to sue based on fraud on the market theory, claiming that trading activity itself affects the market price (broker lied 🡪 customers traded 🡪 trading increase demand for stock 🡪 stock price goes up)

**to get fraud on the market recovery, false information must be publicly disclosed** (no tips)

the fraud on the market theory relies on the market’s ability to react to *public information*because professional traders are always alert to any new public info, rapidly adjust to that info, and market follows

if traders see movement based on information they don’t have, they will know it’s inside info, will quickly sell their securities, and price will adjust back down

* + - **scienter** (intent or knowledge of wrongdoing)
    - **damages**
    - **standing**
      * protections of 10b-5 only extend to purchasers/sellers of an issuer’s securities
        + no protection if you claim you chose not to buy/sell shares based on misleading information bc that’s too difficult to verify (easy to lie)
      * *Duetschman v. Beneficial Corp:* B made false/misleading disclosures about their recent losses suggesting problems were behind them; plaintiff bought call option based on defendant’s misstatements (right to buy stock at certain price by certain date, betting that price will go up and you’ll make a profit bc you contracted to buy the security at a lower price than its worth now) and after truth came out, the call option became worthless bc price dropped
        + **an option is a qualifying security under the Securities Act, so is covered by 10b-5 as long as it was bought/sold while misstatements were being made**

the fact that the plaintiff didn’t trade in the underlying stock during the time the misstatements were being made is immaterial

plaintiff bought an option based on defendant’s misstatements and an option is a security

**10b-5 covers *all* qualifying securities** (even exotic ones)

* **10b-5 Insider Trading Claims**
  + traditional rule for face-to-face transactions is *caveat emptor* (buyer/seller beware)
    - don’t have to disclose something you know but other person in transaction doesn’t know unless you’re asked about it (can’t lie)
      * but in securities markets the rule is **disclose or abstain** from transacting if you know material information that the other person doesn’t know
        + unlike in face-to-face transactions, there is no opportunity for buyer to ask for warranties or representations from seller
  + situations where there is a *need and opportunity for secrecy*and where the *secret would create big changes in value* for the company tend to especially give rise to insider trading
    - e.g. mining companies, pharmaceutical companies (drug trials), etc.
  + rationale for insider trading ban:
    - average investors will be dissuaded from entering market
      * increased bid-ask spread will slow trading activity
    - executives may be more incentivized to mismanage company and personally benefit via insider trading that way (easier to mismanage than to make stock price go up)
  + **common law history of insider trading**
    - *Goodwin v. Agassiz:* A was director and bought shares of her mining company on the basis of a theory a geologist told her; G sold the shares A bought; neither party knew who the other was; G claims A should have told him to info on which she was buying the stock bc otherwise he wouldn’t have sold
      * fiduciary duty of directors is usually related to the *company*, not the shareholders
        + court extends fiduciary duty to disclosing inside information but in this case there is no insider trading liability bc director wouldn’t have been able to disclose (impersonal securities exchange = no opportunity to disclose)

note: this takes away any power insider trading liability has because most securities are trading on impersonal exchanges …

* + **10b-5 insider trading liability** 
    - **breach of fiduciary duty requirement for 10b-5 liability** 
      * courts have held that for there to be liability under 10b-5 for insider trading, there must be a breach of fiduciary duty
        + *justification:* trading on inside information alone is not manipulative or deceptive as required by 10(b), so requires breach of duty in order for insider trading to fit that requirement
      * **(a) classic theory of insider trading:**
        + if a corporate insider (or anyone who is or temporarily becomes a fiduciary of a corporation) is in possession of material, nonpublic information, his fiduciary duty gets extended from just a duty to the corporation to a duty to the shareholders of the corporation to either disclose that information or abstain from trading

*SEC v. Texas Gulf Sulphur Co.:* TGS was conducting preliminary mining operations & found very promising tract of land; had to keep info secret not to alert competitors; while info was being kept secret, many directors bought shares & call options of stock; rumor circulated that TGS found major minerals; TGS issued press release saying findings so far were not conclusive; later issued release about significant findings

**anyone in possession of material inside information must either disclose it to the investing public or if he or she is disabled from disclosing the information or chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed**

materiality = same test as fraud 10b-5 claim

**material inside information is that which is reasonably certain to have a substantial effect on the market price of the security if the information is disclosed**

* test is whether a reasonable man would attach importance to the information in determining his choice of action in the transaction in question
  + (probability x magnitude) / (size)
* sufficient disclosure must be in medium large enough to reach general public
* can’t trade right after disclosure if there was not enough time for the public to digest the information & for market to reflect info (need “reasonable waiting period”)
* note: these days courts think market adjusts so rapidly that can trade within minutes after disclosure
* no obligation for insider to confer upon outside investors his superior financial or other expert analysis by disclosing his educated guesses or predictions
* **(b) misappropriation theory of insider trading:**
  + SEC Rule 10b5-1(a): the manipulative and deceptive devices prohibited by 10b-5 include, inter alia, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, **in breach of a duty of trust or confidence** that is owed directly, indirectly, or derivatively to the issuer of that security or the shareholders of that issuer, or to any person who is the source of material nonpublic information
    - SEC Rule 10b5-2: a person has a duty of trust or confidence, inter alia
      * when someone agrees to maintain information in confidence
      * when the recipient of the information knows or should know that the speaker expected the recipient to maintain confidentiality
      * when someone receives information from a spouse, parent, child or sibling
    - *United States v. O’Hagan:*O’Hagan was partner at firm retained by company trying to acquire Pillsbury; bought Pillsbury stock before merger was announced bc knew it was going to happen and that stock would go up
      * misappropriation theory of insider trading states that **a person commits fraud “in connection with a securities translation” and therefore violates §10b-5 when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information**
        + this conduct is “manipulative or deceptive” as required by §10(b) because of the trader’s deception of those who entrusted him with confidential information

in this case, O’Hagan violated his fiduciary duty to the client that gave him the confidential info (didn’t owe any duty to Pillsbury or its shareholders)

* + - * misappropriation theory is designed to protect the integrity of securities markets against abuses by outsiders to a corporation who have access to confidential information that will affect the corporation’s security price when revealed, but who owe no fiduciary duty or other duty to that corporation’s shareholders
        + this theory also satisfies 10(b)’s purpose ensuring honest securities markets and promoting investor confidence
    - SEC Rule 10b-5.1: a purchase or sale of a security of an issuer is **“on the basis”** of material, nonpublic information about that security or issuer if the person making the purchase or sale was **aware** of the material nonpublic information when the person made the purchase or sale
      * the fact that you were going to buy or sell the security regardless of the inside information is not a defense
        + but an affirmative defense *is* available if you can show that before you got access to inside information, you already had a pre-formed trading plan that you couldn’t affect or change at that point
* **(c) liability of tippees:**
  + to sustain an insider trading conviction against a tippee, the government must prove each of the following elements beyond a reasonable doubt:
    - (1) the corporate insider was entrusted with a fiduciary duty
    - (2) the corporate insider breached his fiduciary duty by
      * (a) disclosing confidential information to a tippee
      * (b) in exchange for personal benefit
    - (3) the tippee knew of the insider’s breach; and
    - (4) the tippee still used that information to trade in a security or tip another individual for personal benefit
  + **knowledge of breach** 
    - *Dirks v. SEC:* D was investment analyst; was told by ex-officer of EF that there was fraud in company; D investigated & was told by EF employees that there was; D didn’t have shares of EF but told his clients who did have shares and they sold their shares; fraud was found out & stock crashed
      * Dirks is not liable for insider trading because didn’t have duty not to disclose
        + **there is no general duty to disclose before trading on material, non-public information**

**a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on or disclose material, non-public information only when the insider has breached their fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach**

* + - *United States v. Newman:* analysts at hedge funds received inside info from employees, shared info with each other and passed it onto their bosses who traded based on that info; bosses were each three or four steps removed from source of information & didn’t know who insider sources were
      * a tippee has a duty refrain from trading/disclosing when the tippee got information from a tipper who breached his fiduciary duty by disclosing that information
        + a tippee may only be found liable when the insider (tipper) has breached his fiduciary duty and the tippee knows or should know that there has been a breach

because a breach requires personal benefit, **a tippee must know that the insider received a personal benefit for disclosing the information before they can be held liable**

note: court here says tippee must know insider received a personal benefit, unlike *Dirks* which says knows or should know

* + - * in this case, not enough evidence to show that hedge fund managers knew insiders got received personal benefit
        + managers were too far removed in tipping chain and didn’t even know who the insiders were
        + not enough information to support an inference that the managers knew the info came from *some* breach of duty because information gets leaked or speculated about often in finance world so there isn’t the presumption that whenever this info is made available it’s necessarily from a breach
  + **personal benefit requirement**
    - *Dirks v. SEC* (SCOTUS)*:* D was investment analyst; was told by ex-officer of EF that there was fraud in company; D investigated & was told by EF employees that there was; D didn’t have shares of EF but told his clients who did have shares and they sold their shares; fraud was found out & stock crashed
      * a tippee must refrain from disclosing or trading on inside information when tippee got that information from a tipper who breached his fiduciary duty by disclosing that information and the tippee knows or should know that there was a breach
        + **the test for determining whether a corporate insider has breached his fiduciary duty is whether the insider will personally benefit, directly or indirectly, from his disclosure.**

**absent some personal gain, there has been no breach of duty to the shareholders**

* + - * + in this case, the insiders who tipped Dirks (ex-officers & employees) didn’t do it for personal gain, but did it to expose fraud

no breach by insiders (tippers) = no breach by Dirks (tippee)

* + - * *policy:* court didn’t want to say ex-officer breached his duty to shareholders by telling D about the fraud because wanted to protect whistleblowers & didn’t want to hold D liable to protect investment analyst industry
        + SEC solutions to these policy concerns:

SEC Whistleblower Program: compensates & protects identity of whistleblowers

Regulation FD: if corporate insiders tell analysts material info, must simultaneously make that info publicly available

* + - *United States v. Newman* (2nd circuit)*:* analysts at hedge funds received inside info from employees, shared info with each other and passed it onto their bosses who traded based on that info; bosses were each three or four steps removed from source of information & didn’t know who insider sources were
      * **personal benefit is broadly defined to include not only pecuniary gain but also any reputational benefit that will translate into future earnings and *the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend*** 
        + **this standard, although permissive, doesn’t suggest that the Government may prove the receipt of a personal benefit by the mere fact of a friendship, particularly of casual or social nature**

**an inference of personal benefit from a personal relationship between the tipper and tippee is impermissible in the absence of proof of a *meaningfully close personal relationship* that generates an exchange that is objective, consequential and represents at least a potential gain of a pecuniary or similarly valuable nature**

* + - * in this case, there is not enough evidence to show that the tippers received a personal benefit by disclosing the inside information
        + one tipper attended business school with tippee and tippee gave him career advice

there was evidence that tippee would’ve and did give career advice without any tips

* + - * + one tipper went to church and occasionally socialized with tippee
    - *United States v. Salman* (3rd circuit)*:* Maher worked as investment banker, gave tips to brother Michael, Michael gave tips to brother in law Salaman; Salaman knew information was coming from Maher and that Maher wasn’t supposed to be disclosing it; Salaman claimed he couldn’t be liable for insider trading under *Newman* bc there was insufficient evidence to show that Maher received personal benefit from disclosures or that Salaman knew about it
      * personal benefit:
        + personal benefit includes a pecuniary gain or a reputational benefit that will translate into future earnings, but also **exists when an insider** **makes a gift of confidential information to a trading relative or friend**

in this case, Maher testified that he gave brother Michael inside information because he loved him and wanted to help him

this is enough to show personal benefit bc *Dirks* (SCOTUS) expressly held that element of personal gain is met when the insider makes a gift of confidential information to a trading relative or friend

* + - * knowledge:
        + unlike managers in *Newman*, Salaman was close enough to family to infer that Maher was giving Michael inside information as a gift (and therefore in breach of his duty)

**Short-Swing Profits (§16(b)):**

* Securities Exchange Act of 1934 §16(b): officers, directors and beneficial owners have to pay to the issuer any profits they make if they buy and sell the issuer’s equity securities registered with the SEC within a six-month period
  + §16(b)is meant to get at same problem as 10b-5 insider trading regulation
    - “for the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director or officer by reason of his relationship to the issuer…”
  + **securities included under §16(b):** *equity* securities *registered with the SEC*
    - pure debt securities (bonds, debentures) are not included, but convertible securities are included
  + **who is included under §16(b):** directors, officers, beneficial owners
    - *directors*: board of directors
    - *officers*: president, principal financial officer, principal accounting officer or comptroller, any VP in charge of a principal business unit, any other officer who performs similar policy-making functions for the issuer
    - *beneficial owners*: shareholder who owns 10% + of issuer’s stock
      * must already be 10% owner at time of purchase (*Foremost*)
  + §16(b) is a **bright-line rule** (unlike 10b-5), so it’s both over-inclusive and under-inclusive
    - *under-inclusive*: might people who made profits on inside information that are not insiders or didn’t buy & sell within six months
    - *over-inclusive*: might get insiders who made a profit without relying on any inside info
  + §16(b) violators are held **strictly liable** (“irrespective of any intention”)
  + §16(b) can be enforced derivatively by shareholders or by issuer
  + **“unconventional” transactions exceptions** to §16(b)
    - the Supreme Court hasn’t fully adhered to bright line of §16(b) and has been willing to make exceptions for unconventional transactions
      * *Kern County Land Co. v. Occidental Petroleum:* O was over 10% owner of K; purchased more shares; K was merging & as a result of merger, O was forced to sell their shares against their will; O made a profit on the sale (which happened within 6 months) since merger made stock price go up
        + this is an “unconventional” transaction and **§16(b) doesn’t impose liability on people who were forced to sell their shares and received a profit but had nothing to do with the decision to sell**

three factors to determine if transaction is unconventional:

(a) whether transaction was volitional (voluntary)

(b) whether beneficial owner had any influence over the transaction

(c) whether the beneficial owner had access to confidential information

* + **calculating damages** under §16(b)
    - when calculating damages, court matches stock sales & purchases in whichever way would maximize the amount the company can recover
      * match lowest price buy with highest priced sale
        + no accounting methods, don’t let shareholders identify which shares were bought/sold when
    - *ex:* April 1 – insider buys 1,000 shares @ $100; May 1 – insider sells 1,000 shares @ $500; June 1 – insider buys 1,000 shares @ $250
      * court would just look at (highest price sold) – (lowest price bought)
        + damages = $400,000
        + actual profit = $150,000
* *Reliance Electric Co. v. Emerson:* E bought 13.2% of D’s stock as part of planned tender offer; acquisition plans fell through and D ended up being acquired by E’s competitor; E wanted to get rid of stock; decided to first sell just enough stock to bring their holdings below 10% and then sell the rest separately so that wouldn’t be subject to §16(b) for the second sale; D tried to recover profits from both sales under §16(b)
  + the language of 16(b) clearly contemplates that a **statutory insider might sell enough shares to bring his holdings below 10% and later - but still within six months - sell additional shares free from liability**
    - it is irrelevant that the sale of the shares was all part of a single plan
* *Foremost-McKesson, Inc. v. Provident Securities Company:* F purchased stock in P; P decided to liquidate within 6-months; agreement was that P would sell all its shares
  + in order to be liable under §16(b), **a beneficial shareholder must have already owned 10% of the issuer’s stock at the time of purchase and sale**
    - purchase of stock that makes someone a 10% owner isn’t included in §16(b) liability
  + note: this would mean that in *Reliance*, E wouldn’t have had to surrender any of its profits, since its initial purchase made it a 13.6% owner, it wasn’t already a beneficial owner before the purchase