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# Introduction: The Corporate Structure

## Introduction

**Notes on the Balance Sheet**

* ***Authorized Stock* –** This is the amount of authorized shares from the Certificate of Incorporation. This becomes relevant when you wish to raise additional equity or more importantly, when they wish to acquire another company and want to pay in shares of stock.
  + **Issued Stock versus Issued and Outstanding:** The distinction between issue and issued/outstanding is that stock considered outstanding has *not been* repurchased/cancelled by the firm.
  + **Treasury Stock** is stock that has been repurchased by the firm. It is aggregated on the balance sheet based on the price at which the firm purchased the stock back from the equity holder.
* ***Additional Paid In Capital*** on the balance sheet tells you how to calculate what the firm sold its stock for. You aggregate this number with the par value on the balance sheet and that is the total value the firm sold its shares for.
* ***Retained Earnings*** is the sum of the net income minus dividends throughout the lifetime of the corporation.

**Things to calculate:**

* Restricted Payments
* Review Capital structure and leverage (pg34)
* Creditor Priority / Distribution of Assets
* Being able to read a balance sheet (PG 26)
* Time Value of Money
  + Risk-adjusted rate (which includes the risk premium for more riskier investments)
  + Risk-free rate (treasury securities)
  + Think of the market price of stock as the value of the firm discounted for the time value of money (PG

### Creditor Priority

* The general rule for debt is that all debt has equal priority. **However, debt of creditors has seniority over the equity interests of the firm.**
* In the case of a liquidation or dissolution of assets where the company is bankrupt, the remaining asset values are distributed on a pro rata basis amongst the creditors assuming that the general rule applies (all debt has equal priority).
* **There are exceptions to the general equal priority rules:**
  + (1) Preferences under Bankruptcy Law – e.g. taxes must be paid over other types of debt in bankruptcy
  + (2) Secured Debt – Secured debt is “secured” by some form of collateral. The debt has a “lien” on the asset.
    - Note: The deficiency claim (the amount not covered by the collateral if its market value is less than the debt value) is treated according to the default pro-rata basis of unsecured debt.
  + (3) Subordinated Debt – This implies that someone is subordinated to some form of senior debt. So if the pro rata share is not enough to cover the senior debt, then the subordinated creditor would have to pay the senior debtor until either (a) the subordinated creditor is out of money or (b) the senior creditor is fully paid.

**Forms of Debt**

* (1) **Trade / Operational Debt –** This is mainly debt to suppliers and is mostly held in accounts payable.
* (2) **Financial Debt** – This is debt to run the company and invest – it consists mostly of bank loans and corporate bonds.
* Debt has several components, but the main ones can be described below as follows:
  + Maturity – the time at which the debt will mature and need to be paid
  + Interest – The rate at which interest is accrued and whether that rate is fixed or variable
  + Covenants – The debt may be specified with additional terms or limitations (e.g. what it can be used for)
  + Conversion and Redemption – The debt may have terms for conversion into stock or for redemption.
  + Priority – The debt may vary in order of how it is paid upon liquidation *see below*.

**Equity Securities**

* ***Equity Securities* –** Common stock and preferred stock are examples of equity securities. These types or securities are those that carry an ownership interest in the business. Ownership interests typically entail two particular aspects:
  + **Claim on the firm’s residual earnings** (the earnings that remained after workers, suppliers, creditors, and taxing authorizes are paid in full)
  + **Right to participate in the control of the business** (through voting, shareholder meetings, etc.)
* ***Relationship between Seniority and Control* –** In general, the most senior debt holders have a right to receive a given amount of money. Other investors, such as the shareholders, are not entitled to receive anything. So some investors are pretty well covered while others are not.
  + Order of Seniority (1) Debt-Holders / Creditors (2) Preferred Stockholders (3) Common Stock holders
  + Notice that the order of seniority is the *inverse* of the level of control given to the investors. This makes sense because those who have the least to lose (senior holders) will demand the least control over the business’ actions because they have the least incentive to monitor the corporation closely.
* ***Five Aspects of Stock:*** 
  + **(1) Seniority –** Seniority is relevant for the order of both (a) periodic payments (e.g. such as dividends) or (b) the liquidation value (e.g. bond holders get paid before stockholders)
  + **(2) Voting Rights –** Not all shareholders are always given the right to vote. Voting rights can be made contingent upon whatever rights the corporation assigns (e.g. some assign voting power to how long you have held the stock *Google*)
  + **(3) Par Value –** This is dollar figure attached to the stock with virtually no significance, since almost all stock is worth more than par value.
  + **(4) Conversion –** Some securities have the ability to convert into other types of securities (e.g. a preferred stockholder may convert her shares into common stock if the preferred stock has conversion rights)
  + **(5) Redemption –** Securities can often be redeemed for cash. This may done on behalf of both the stockholder or sometimes, by the company. The terms would specify both (a) the conditions for company redemption and (b) the rate at which the redemption would be processed.

**Preferred Stock**

* **Preferred Stock –** This is a stock with a claim on the company’s residual earnings or assets and it comes ahead of the common stock in terms of seniority. The precise rights of preferred stockholders vary from issue to issue.
* Generally speaking, preferred stockholders are entitled to receive fixed dividends prior to the payment of dividends on the firm’s common stock.
* The specific terms of preferred stock can be outlined in the charter, but more frequently are specified in a separate **Certificate of Designation** that is a separate document. Preferred stock that is issued without the terms in the charter is called “blank check preferred stock” because its terms can be specified at any time by the Certificate of Designation.
* Preferred stock is important in the context of a **Stock Split.** The stock split will affect the preferred stockholder’s conversion rights because the post-conversion proportion of preferred to common stock needs to remain the same in the event of a stock split. The protection afforded to preferred stockholders in the case of a stock split is called an **Anti-Dilution Provision.** 
  + ***The holder will convert preferred stock if the value of her common stock (after conversion) will exceed her liquidation preference for her preferred stock.***
* *Note:* The same anti-dilution provision would apply if the firm paid dividends (in the form of stocks – e.g. paid a dividend of one share of stock for each outstanding share owned). The firm is permitted to do this under § 173. The provision would also protect Tamara if the firm issued warrants for common stock.

**Warrants and Options**

* **Warrants –** These are options to **buy *new*** shares at a specified price. (note warrants are a special kind of option for new shares)
* **Options (regular options) –** This is the ability to buy pre-existing shares at a specified price.

### NOTES ON CERTIFICATES OF INCORPORATION

**Requirements –** What is required to be specified in the certificate of incorporation appears under section § 102(a) of the DGCL. The relevant sections are (a)(1) through (a)(6) and they are broken down in the following table.

**Optional Inclusions –** The Corporation may choose to include optional provisions in the certificate of incorporation as it sees fees. These optional inclusions are outlined in section § 102(b) of the DGCL.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Topic** | **Mandatory** | **Optional** | **Default Rule** | **Where to Opt Out** |
| Name | X |  | § 102(a)(1) |  |
| Address; Registered Agent | X |  | § 102(a)(2) |  |
| Nature of Business | X |  | § 102(a)(3) |  |
| Classes of stock; authorized shares; etc. | X |  | § 102(a)(4) |  |
| Address of Incorporator | X \*see last column |  | § 102(a)(5) | \*not necessary if charter is amended because of 245(c) |
| Names and Addresses of Initial Directors | X \* see last column |  | § 102(a)(6) | \*not necessary after first shareholder meeting |
| Who can amend the bylaws? |  | X | § 109(a) Default rule is that Shareholders may amend bylaws by majority vote. | Charter can specify otherwise, as in the fifth article of sample charter.  **XYZ** – Board or Shareholders may act alone |
| Classes/ Term of Directors |  | X | § 141(d) 1 class with 1 year terms for directors | Charter or the Bylaws may amend this. \*see note on staggered boards below.  **XYZ** – staggered with 1/3 up for election each year for three year total term |
| Can directors be removed without cause? |  | X | § 141(k); § 141(k)(1)  Removal without cause means just because, while with cause means because they are obviously doing something wrong. Whether you can remove a director without cause depends on if you have a staggered board or not, as per below:  Annual Board: yes, remove with or without cause;  Staggered Board: no, cannot remove without cause; unless specified in the Charter (but not the bylaws) [DGCL 141(k)(1)] | § 141(k)(1):  If the charter specifies, you can remove a staggered board without cause.  You cannot get away from default rule for non-staggered board. It is always with or without cause.  \*default rule is a majority vote for removal.  **XYZ – follows default,** only with cause. |
| Who may call special meetings? |  | X | § 211(d);  Default is that only the Board may call special meetings | Charter, Bylaws may specify that anyone may call a special meeting.  **XYZ –** charter specifies only board; cannot be changed then by bylaws. |
| Can Shareholders Act by Written Consent? |  | X | § 228(a)  Yes | Can be restricted by the charter.  **XYZ –** no -- can’t action through written consent |
| % of SH Approval Required to Amend Charter |  | X | § 242(b)(1)  Majority of those entitled to vote | The charter can specify a greater number of votes required more than a majority.  **XYZ –** 70% of outstanding stock entitled to vote |
| Director Liability |  | X | *Will Address Later* | *Will Address Later* |

**Staggered Board –** One may wish to adopt this structure because you can’t change the control of the entire board of directors very quickly. This staggers the election of the board members over a period of years, similar to the US Senate. Annual meetings are still required but the term is more than one year as stipulated in charter, initial bylaws, or bylaws later adopted by stockholder vote. *See § 141(d)*. The board may be staggered into 1, 2, or 3 classes as per section § 141(d).

**General Notes on Board Power Allocation –** The charter sample in the packet seems to allocation power closer to the board of directors (by making shareholder amendments harder, etc.). This power structure protects the minority shareholders more from new majority/activist shareholders but comes with the cost of risking the directors not doing as well of a job. As the charter shifts more power to the board, you see these tradeoffs more generally.

**Provisions in Charter vs. Bylaws –**

* Anything in the bylaws can be placed in to the charter, but not necessary vice versa.
* Technical provisions that don’t affect the allocation of power between the board and shareholders are normally found in the bylaws, and the shareholders can change the bylaws through votes.
* Notice the default rules for charter and bylaw amendment; both require stockholder approval. The bylaws however can be modified by the board alone if the charter specifies. This is important because it may determine whether certain provisions are placed in the charter or in the bylaws.
  + A corporation who doesn’t want something to be changed may place it in the charter to require shareholder majority approval, whereas things that matter less may be placed in the bylaws, where the directors may be to amend it by themselves (if the charter specifies)

## HB Korenvaes Investments v Marriott Corporation—1993—Chancery Court

**Marriott International—Marriott Host—Special Dividend—Preferred stockholders**

* The court has occasionally enjoined corporate action designed principally to coerce stockholders in the exercise of a choice committed to them by the applicable certificate of incorporation, bylaws, or statute
* While suspension of dividends may exert a powerful influence upon the decision to convert or not, but I cannot see a violation of any implied right duty of good faith—what is at issue here is not a fiduciary duty but interpretation of rights and duties as set forth in the certificate of designation, which are to be strictly construed
* Under the certificate of designation, Marriott has a right to suspend dividend payments, and in the event that happens, the preferred shareholders have a series of robust protections that are substantial—secondly, it cannot be contended that discontinuation of the dividend is not itself a prudent, business-driven decision
* In providing a mechanism to maintain pre-distribution value, the issuer impliedly undertook to refrain from declaring a dividend so large that what is left in the corporation is worth less than the pre-distribution value of the preferred stock

# Limited Liability and the Rights of Creditors

## Pleading

* **Limited Liability**
  + The corporation is an artificial legal entity. It has limited liability only in the sense that *the creditors cannot go after the equity holders of the firm.* The c2wreditors can go after the assets of the firm though, so the firm is not limited in that sense.
  + ***Agency Cost of Debt***
    - Creditors lend money to the firm, and yet they have no say in how the firm is run. The firm is run by the board, who in turn is accountable to the shareholders. Thus, there is a misalignment of interests here to run the firm in a certain way favorable to the creditors. The undesirable consequences from this misalignment are called the *agency cost of debt.*
* **Legal protections for Creditors**
  + ***Fraudulent Conveyance Law*** (a broad statutory framework for voiding any transfer made for the purpose of delaying, hindering, or defrauding creditors)
    - See *Gleneagles*
  + ***Equitable Subordination*** (where an insiders’ debts are subordinated to outsiders debts in bankruptcy)
    - See *Costello*
  + ***Piercing the Corporate Veil*** (where the court will set aside the entity status of corporations and permit creditors to hold shareholders liable directly)
* **Contractual Creditor Protection** 
  + Creditors regularly demand greater protection than the ones offered by these general doctrines. Most bank credit agreements and many indentures (agreements by which bonds are issued) contain elaborate provisions, called covenants, detailing those protections
  + One important one is the use of “Restricted Payment” covenants

## United States v Gleneagles Investment Co—1983—M.D. Pa.

### In order to buy out management of a firm, an investment company obtains a loan to do a LBO that requires liens (two rounds) to be placed on the property of a number of subsidiaries, resulting in the LBO financiers being considered secured creditors above all then-existing creditors—creditors challenged the security interest in the property of the various companies because a bulk of the consideration exchanged did not go to these companies but Gleneagles in order to pay the selling shareholders for their stock

* Under the Uniform Fraudulent Conveyances act §354, every conveyance made/obligation incurred y a person who is or will be thereby rendered insolvent is fraudulent as to creditors—under §355, any conveyance made without fair consideration, when the person making it is engaged in a transaction for which the property remaining in his hands after the conveyance is unreasonably small capital is fraudulent, as to creditors
* I.E., these provisions require a creditor to show (1) insolvency or (2) lack of fair consideration and under-capitalization—fair consideration must be a good-faith fair equivalent of the property given/debt incurred
* ITT, the bank, was fully aware hat no individual member of the Raymond Group would receive fair consideration within the meaning of the act—the funds were lent immediately to Great American, merely passing hands and ultimately to the selling shareholders and cannot be deemed consideration received by the company
* The court believes the drafters intended consideration to mean only consideration with a monetary value—the value of new management is not worth it

## Costello v Fazio—1958—9th Cir

**Three-way partnership between Fazio, Ambrose, and Leonard—the three decided to incorporate the partnership, in order to even out potential liability. In order to equal out the investment, Fazio and Ambrose withdrew most of their capital contributions by the issuance of partnership promissory notes, no interest being specified—allowing the two to move from equity contributors to creditors in effect. In bankruptcy, the trustee sought to have their claims subordinated to the claims of general unsecured creditors—the trustee now appeals the decision of the referee that the promissory notes were made in good faith and took no unfair advantage of the corporation**

* On appeal the trustee argued that claims of the controlling shareholders must be subordinated when a corporation in bankruptcy has not been adequately or honestly capitalized, or has been managed to the prejudice of creditors, or where to do otherwise would be unfair to creditors
* The official test to be applied, is whether the transaction can be justified within the bounds of reason and fairness—more recently, invoked “in order to prevent the consummation of a course of conduct which would be fraudulent or otherwise inequitable”
* Here, the inequitable conduct comes not in acting to the detriment of creditors then known, but to the determine of future creditors whoever they might be—more than undercapitalization was shown here, persons owing a fiduciary duty withdrew capital already committed, stripping 88% of its stated capital for personal gain, under circumstances which allege actual knowledge that the corporation & creditors would be endangered

## Zaist v Olson—1967—Connecticut

**East Haven Homes–Martin Olson–Olson, Inc and many other corporations established by fungible with the actual owner, Martin Olson. Olson owned all stock himself or held custody through a trust established for his children**

* Courts will disregard the fiction of a separate legal entity when a corporation is a mere instrumentality or agent of another corporation/individual owning all or most of its stock—dominating stock ownership is not enough,
* Stockholder immunity will be protected when the corporation functions as an entity in the normal manner contemplated and permitted by law–however, when the corporation is so manipulated by an individual or another corporation so as to become a mere puppet or took, justice may require liability upon the principal
* The instrumentality rule requires (1) control (complete domination of not only finances but policy and practice with respect to the transaction so attacked so that there is no separate mind, will, or existence of its own) (2) that such control must have been used to commit fraud or wrong, to perpetrate violation of a statutory or other positive legal duty, or a dishonest or unjust act in contravention of π’s legal rights and (3) the above control and breach must proximately cause the injury or unjust loss complained of

The referee could reasonably find that Olson transacted business as an individual and through corporate entities under his control and that all of the services rendered accrued to the benefit of Olson—

## Walkovszky v Carlton—1966—NY Court of Appeals

**Cab Company Structure challenged by tort victim—Δ owned 10 corporations, all had only two cabs and carried the statutory minimum per car—essentially leaving tort victims without much to recover in the event of an injury—π tried to pierce the veil arguing the corporations are “operated as a single entity unit and enterprise with regard to financing, supplies, repairs, employees, and garaging” in an attempt to “defraud members of the general public”**

* Whenever anyone uses control of the corporation to further his own rather than the corporation’s business, he will be liable for the corporation’s acts under respondeat superior—this liability extends not only to commercial dealings but negligent acts as well
* You could assert (1) a corporation is a fragment of a larger corporate combine which actually conducts the business or (2) the corporation is a “dummy” for its individual stockholder who is carrying on business in their personal capacities for purely personal rather than corporate ends—both justify piercing the veil, but in different ways—(1) the larger corporate entity could be held financially responsible and (2) the stockholder
* Had the fleet been owned by a single corporation, it would be apparent π could not establish personal liability, the result is no different because ownership is deliberately split among many corporations
* The record is barren of any sufficiently particularized facts showing Δ was doing business in their individual capacities, shuttling personal funds in and out of the corporations without regard to formality and to suit their immediate convenience—there is no cause of action against Carlton in his individual capacity

# Management’s Powers and Duties

## Management’s Powers and Duties

### Agency Cost of Equity

* + The agency costs of equity are where the managers may act in their own personal interests instead of in the interests of the shareholders. Conflicts of interest between what is best for the shareholders and what is best for management may arise in several areas, including:
  + • Effort, risk-taking, compensation, job retention, asset diversion, etc.

### The Business Judgment Rule, Fiduciary Duties, and Shareholder Suits

* + As a general matter, courts define and enforce fiduciary duties in ways that do not trench too deeply on the discretion of the BOD. The BJR operates three ways, and if rebutted, triggers entire fairness:
  + (1) **Evidentiary Presumption –** The BJR is an evidentiary presumption; that is:
    - The presumption is that the directors acted without self-dealing (independent), or personal interest (disinterested), and exercised reasonable diligence (informed), and with good faith (good faith?). Any party challenging the board of director’s decision bears the burden of rebutting the presumption.
    - The BJR can be rebutted at 12(b)(6) stage (notwithstanding being applied after a cleansing act), thus necessitating discovery, and then used as a legal conclusion if the facts that were taken to be true end up not materializing. If true, then EF (Think *Orman v Cullen*)
  + (2) **Substantive Rule -** The BJR is a substantive rule whereby if its conditions are met, the courts will not pay attention to breach of fiduciary duty claims.
    - If the directors are entitled to protection of the rule (because they were independent, disinterested, informed, and acted with good faith), then the courts shall not second guess their decisions. The breach of fiduciary claims will be defeated.
    - *Note:* The decision of the board does not have to be an intelligent one.
    - *Note:* This does not defeat other claims other than fiduciary duty claims (e.g. violation of the charter)
  + (3) **Legal Conclusion –** Even if the BJR has been rebutted according to the burden of interpretation (1), the court will still find that the plaintiff loses without substantively reviewing the fairness of the board decision. This is consideration under entire fairness when there has been one or more cleansing acts.
* **Entire Fairness**
  + The concept of fairness has two basic concepts: fair dealing and fair price. All issues must be examined in a whole since the question is one of entire fairness. (*Weinberger v UOP, Inc*)
    - Fair dealing address questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained
      * Of this, disclosure has a unique position in substantive law. Existing policy and law have evolved into a virtual per se rule of damages for breach of the fiduciary duty of disclosure
    - Fair price related to the economical and financial considerations of the proposed transaction, including all relevant factors such as assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock
* **The Duty of Care**
  + Directors are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances (*Allis–Chalmers*)
  + The duty to exercise an informed business judgment is in the nature of a duty of care—gross negligence is the proper standard for determining whether a business judgment reached by a BOD was an informed one. (*Van Gorkom*)
  + As of the early 1990s, most states had adopted statutory provisions limiting the liability of BOD or breach of Duty of care, modeled after DGCL §102(b)(7). In Delaware, well over 90% of public corporations had passed charter provisions eliminating liability to the full extent permitted by statute
    - A DGCL §102(b)(7) provision does not eliminate or limited liability (i) for any breach of the duty of loyalty (ii) for acts or omissions not in good faith or which involve intentional misconduct or knowing violation of the law (iii) under §174 or (iv) any transaction which the BOD derived an improper personal benefit
  + *First stop at gross negligence, but note that most governing documents outlaw director liability for violation of the duty of care under DGCL §102(b)(7)—then move on to the Walt Disney special out for knowing/deliberate indifference to act in an informed manner as bad faith and bypassing the exemption*
* **The Duty of Loyalty (Fraud, Bad-Faith, Self-Dealing [Van Gorkom]—AKA disinterested & independent)** 
  + Corporate officer, directors, and controlling shareholders must not exercise their discretion over corporate policy to benefit themselves at the expense of shareholders/co-investors—
    - There have been some cases which appear to recognize the proposition that corporations have responsibilities beyond shareholders and embrace creditors, employees, communities and “other constituencies”
    - Although it has long been clear a corporation may properly expend funds for these groups, in Delaware, such expenditures must advance the long-term interest of the corporation and its shareholders
    - Note that recent case law in some jurisdictions holds that directors of an insolvent corporation owe a fiduciary duty to creditors
  + A disabling “***interest***” (FN50 of Orman)
    - When (1) A director personally receives a benefit/suffers detriment (3) as a result of or from the challenged transaction (3) generally not share with/suffered by the other shareholders and (4) that benefit/detriment is of such subjective material significance that it is reasonable to question whether the director objectively considered the advisability of the transaction (Material Conflict of Interest)
    - When a director stands on both sides of the challenged transaction, allegations of materiality are not required (Self-Dealing)
  + ***Independence*** (FN50 of Orman)
    - Independence involves in inquiry into whether the director’s decision resulted from being controlled by another.
    - A director can be controlled if he is in fact dominated y another party, whether through close personal or familial relationship or through force of will
    - One can also be beholden to an entity when the allegedly controlling entity has unilateral power to decide whether the challenged director continues to receive a benefit of such subjective material importance that the threatens loss of such benefit may create reason to question the ability to objectively consider the proposed transaction
* **The Self-Dealing Paradigm**
  + Statutory provisions on self-dealing transactions almost all contain language to the effect that a self-dealing transaction will not be voidable “solely” because it involves a conflict of interest—if its (1) adequately disclosed and approved by a majority vote of disinterested directors or (2) shareholders, or (3) if it is fair (DGCL § 144)
  + If a *director* stands on both sides of a *routine business transaction*, full disclosure and a cleansing act under §144(a)(1) or (2) permit invocation of the BJR (Marciano [extension of credit])— Note neither party was a “controlling shareholder” because neither owned a majority, they owned the same amount
    - Failure to disclose could trigger EF under *Orman* for less than a majority, notwithstanding cleansing acts which may be used
  + *A controlling shareholder standing on both sides of a transaction in a squeeze-out transaction*, as in a parent-subsidiary merger context, bears the burden of proving its entire fairness—approval by an independent committee or an informed MoM shifts the burden of proof to the challenging party (Kahn v Lynch)
    - Notwithstanding, the BJR may be applied if and only if: (1) Approval is conditioned ex ante on approval of both a special committee and a MoM (2) the committee is truly independent (3) the committee is empowered to freely select its own advisors and say “no” definitively (4) the committee meets its duty of care in negotiating a fair price and (5) the vote of the minority is informed and (6) there is no coercion of the minority (*MFW*)
* Cleansing Acts
* **Corporate “Waste” Doctrine**
  + Waste of Corporate Assets is traditionally regarded as a cause of action separate from breach of fiduciary duties—thus outside the protection of the BJR
  + The standard is extremely high and claims rarely succeed; a BOD must authorize an exchange that is so one-sided that no business person of ordinary, sound judgment would conclude the corporation has received adequate consideration—Shareholders may not ratify waste except by unanimous vote
* **Shareholder Suits**
  + Shareholder suits fall into two classes depending on the nature of the underlying claim
    - ***Direct suits*** - Are suits brought against officers and directors in their own name, where shareholders are either injured directly (entitled to sue directly and any damages would be paid to the shareholder directly) or
      * In the merger context, breaches often give rise to direct suits where shareholders are directly harmed in the sense of receiving too little money/consideration in the merger
    - ***Derivative suits*** - Actions against officers/directors brought on behalf of the corporation, where shareholders are injured indirectly (as owners of the company where damages goes to the corporation & standing must be reconciled with the BOD authority to manage the corporation)
      * Many alleged breaches of fiduciary duty that occur during the normal operation of the corporation are conceptualized as injuries to the corporation
      * There are three primary elements of a derivative suit: (1) a complex set of standing requirments (2) regimes for the plantiffs’ bar for successful suits and (3) a set of procedural screens or filters that can block otherwise viable derivative suits (demand)
  + ***The Demand Requirement*** 
    - To institute a derivative suit, a shareholder must show that demand on the board was futile/excused or that demand was wrongfully denied.
    - To be **excused**, under the facts there must be reasonable doubt that (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment
      * If demand is excused, the board retains the option of setting up a special litigation committee to investigate the suit. If the committee recommends dismissal, it is evaluated under Zapata
    - To be wrongfully denied, a plaintiff must establish the BOD failed (1) to reasonably investigate whether bringing a suit is in the corporations best interest or (2) did not act in good faith
      * Beyond being hard to make, by making such demand, one is deemed to concede that a BOD is independent—so in reality, this is never done

## Graham v Allis-Chambers Manufacturing Co—1963—Delaware Superior Court

**π sought to use 1937 consent decrees to argue the BOD was liable for antitrust violations as a matter of law for their failure to take action designed to learn of and prevent anti-trust activity on part of employees.**

* πs have wholly failed to establish actual notice or facts which should have put them on guard to take steps to prevent the future possibility of antitrust activity—directors are not liable per se by reason of their gross inattention to the common law duty of actively supervising and managing corporate affairs
* Directors are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances—directors are entitled to rely on the honesty and integrity of their subordinated until something occurs to put them on suspicion that something is wrong—if such goes unheeded, then liability may follow
* If one has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected to perform his duty as a director, or has ignored (willfully or through inattention to obvious signs of employee wrongdoing) the law will case the burden of liability upon him personally

*(Dicta in Caremark (1996 Chancery case) indicates that directors (even in the absence of red flags) have a fiduciary duty to set up an information and reporting system that monitors compliance; however, directors can only be held liable for violating their duty to monitor if they acted in bad faith (“a sustained or systematic failure of the board to exercise oversight—Stone v Gritter (Delaware 2006) endorsed both parts of Caremark)*

## Smith v Van Gorkom—1985—Delaware

**Van Gorkom was CEO and Chairman of TransUnion. In pursuit of a long-term strategy to use ITC tax credits beyond its program of buying smaller companies to increase operating income. Van Gorkom decided to seek a leveraged buy-out by management with the funding of Jay Pritzker at $55 (mkt $38), a price decided by a feasibility study, not inherent valuation of the firm. Van Gorkom did not disclosure the mythology by which he arrived at $55, or the fact that he first proposed the figure with Pritzker. The BOD approved the buyout after a two hour meeting based solely upon Van Gorkom’s oral presentation, legal advice, supporting representations, and personal knowledge without ever reading the merger agreement prior to execution. BOD sought to rely on stockholder ratification through majority vote (Found grossly negligent in approving the merger)**

* The duty to exercise an informed business judgment is in the nature of a duty of care—gross negligence is the proper standard for determining whether a business judgment reached by a BOD was an informed one.
* Under DGCL§141(e), directors are fully protected in relying in good faith on reports made by officers—but there is no evidence any “report” was made to the BOD. At minimum, a “report” must be pertinent to the subject matter and otherwise entitled to good faith (not blind) reliance—the BOD was bound to make reasonable inquiry into the proposal; if they had done so, the inadequacies would have been apparent.
* A substantial premium may provide one reason to recommend a merger, but in the absence of other sound valuation information, a premium alone is not adequate basis upon which to assert fairness of price—adequacy is indeterminate unless assessed in terms of other competent valuation information that reflects inherent value
* Where a majority of fully informed stockholders ratify action of even interested directors, an attack must normally fail—Whether stockholders are informed turns on the fairness and completeness of the proxy materials—BOD must disclose all facts a reasonable stockholder would consider important
* Here, the BOD did not know (and thus did not disclose) material facts, therefore ratification is not valid

## In re: Walt Disney Company Derivative Litigation—2003—Chancery Court

**Plaintiffs sued the BOD alleging breach of fiduciary duties for blindly approving an employment agreement with Michael Ovitz, 25-year friend of CEO Michael Eisner. Eisner hired Ovitz a President of Disney against the protest of three old-BOD members—after which the compensation committee delegated authority to approve the final contract to Eisner. The final version differed significantly from the version approved by the CC, but no one sought to see the final contract. After things did not work out, Eisner agreed to grant Ovitz a “non-fault termination,” although the bylaws required BOD approval for such termination and the BOD never noticed such**

* Notwithstanding the information vacuum, the BOD and CC appointed Eisner to handle his friend’s contract and never sought to, nor were provided, the final contract. No expert was retained to advise during the process
* The facts here do more than protract a negligent or grossly negligent BOD; instead, they suggest the BO consciously and intentionally disregarded their responsibilities, adopting a “we don’t care about the risk” attitude with a material corporate decision.

***(Walt Disney (cont.))***

* Knowing violation or deliberate indifference by a BOD to their duty to act faithfully and with appropriate care is conduct that may not be honestly and in the good-faith best interest of the corporation—delegation of such broad responsibilities to Eisner case doubt on good faith judgment to allow two friends to control the payment of the shareholders money to Ovitz

## Marciano v Nakash—1987—Delaware [Self Dealing w/ no controlling shareholder]

**The Marciano and Nakash brothers launched a joint venture to marker copies of Guess Jean creations in a broader retail market under “Gasoline”—the Nakashes paid $4.7M for 50% of the equity in Guess, from an operational standpoint, the Nakashes ran Gasoline and the Marcianos ran Guess. Because of a family dispute, the Gasoline board deadlocked and a custodian was appointed, but unable to solve the problem and recommended liquidation. This action arises from loan claims asserted by the Nakases what would have the effect of exhausting Gasoline’s assets. The Marciano’s were arguing that DGCL §144 was exclusive and if a self-dealing transaction did not meet that standard, than it was de facto voidable (seems to be before §144 was amendmented with 144(3))**

* DGCL§144 merely removes an ‘interest director’ cloud when its terms are met—it is not otherwise dispositive if its terms are not met—Where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass careful scrutiny by the courts
* Directors who advance funds to a corporation to help keep it functioning do not forfeit their claims as creditors merely because of the relationship—furthermore, in arranging for the loan, the interested directors were not depriving the corporation of a business opportunity but were instead providing a benefit for the corporation which was unavailable elsewhere
* It is not disputed that the direct financing by the Nakshes was essentially duplicative of the terms imposed in an arms-length transaction with the Israel Discount Bank
* (FN3) Although none of the cleansing acts in §144(a) were available because of the deadlock, a non-disclosing director seeking to remove his interested nature must prove the entire fairness of the transaction—on the other hand, approval by fully-informed disinterested directors or disinterested stockholders permits invocation of the BJR and limits review to waste with the burden upon the attacking party

## Kahn v Lynch Communication—1994—Delaware [self-dealing squeeze out w/ controlling SH]

**Controlling shareholder of Lynch (Alcatel) hijacked Lynch’s determination that it would acquire a company in the fiber optics field—Lynch’s management identified Telco, but Alcatel instead opposed and proposed a combination with another of its indirect subsidiaries, Celware. Lynch CEO/Chairman expressed an opinion that Celware would not be of interest if not owned by Alcatel—Alcatel gets mad and makes an offer to buyout the rest of the company and essentially forces the issue**

* If a shareholder owns a majority interest in or exercises control over the business affairs of a corporation, he owes a fiduciary duty of loyalty—a shareholder with less than 50%, a π must allege domination by a minority shareholder through actual control of the corporation—here, the independent directors deferred to Alcatel because its position as a major shareholder and not because they decided in their own judgment it was correct
* A controlling shareholder standing on both sides of a transaction, as in a parent-subsidiary merger context, bears the burden of proving its entire fairness—approval by an independent committee or an informed MoM shifts the burden of proof to the challenging party—*holds that entire fairness is the only standard, but that is probably no longer good law under MFW*
* Showing that action was taken as through each contenting party had in fact exerted its bargaining power against the other at arm’s length is strong evidence the transaction meets the fairness test—(1) the majority shareholder must not dictate the terms of the merger and (2) the special committee must have real bargaining power that it can exercise on an arm’s length basis
* Consideration must be given to evidence of whether the special committee was truly independent, fully informed, and had the freedom to negotiate at arms length—the use of an independent committee may have significant advantages, but is does not de facto establish procedural fairness —the burden will not be shifted by the use of a committee which concluded its processes with a quick surrender to dictated terms

## Kahn v M & F Worldwide(MFW)—2014—Delaware [self-dealing squeeze out w/ controlling SH]

**The Delaware Supreme Court, in interpreting Kahn v Lynch, gives the process by which the BJR may still be invoked to review of a transaction where a controlling shareholder stands on both sides.**

* (1) Approval is conditioned ex ante on approval of both a special committee and a MoM (2) the committee is truly independent (3) the committee is empowered to freely select its own advisors and say “no” definitively (4) the committee meets its duty of care in negotiating a fair price and (5) the vote of the minority is informed and (6) there is no coercion of the minority

## Kahn v Tremont—1997—Delaware [self dealing w/ controlling SH (no squeeze)]

**Valhi was a trust owned by the family of Simmons. Valhi controlled Tremont through 44% ownership and was a owner of a majority of NL industries. Kahn was a shareholder in Tremont who challenged the purchase by Tremont of 15% of NL’s outstanding stock, allowing Valhi to take minority status and deconsolidate NL from its financial statement among other tax benefits. Δ argue the Tremont transaction was appropriate because the 44% stake would lessen the blow of a 20% illiquidity discount and could lower such a discount because Tremont could have access to inside NL information about the true value of the firm due to it being “in the family.” Tremont employed a special committee, but the functioning of that committee was challenged.**

* To obtain burden shifting, a special committee must function in a manner indicating the controlling shareholder did not dictate the terms and that the committee exercised real bargaining power “at arms length”
* The special committee established to negotiate the purchase of the block of NL stock did not function independently—all three had previous affiliations with Simmons and companies he controlled and received significant financial compensation or influential positions on the boards of these controlled companies
* The choice of advisors is also raises questions, the financial advisor had derived significant fees from Simmons controlled companies—in addition, the legal advisor had previously been retained y Valhi in connection with a convertible debt offering and NL with respect to a proposed merger with Valhi
* It is the attention and sense of individual responsibility to the performance of one’s duties which generally touches on independence (care, attention, and sense of responsibility)—the failure of all three directors to attend informational meetings with the advisors shows the default on the obligation to remain fully informed
* Still, on the disclosure concerns, Valhi had no duty to disclose information (such as the Salomon brother advice on the illiquidity discount) that may be adverse to his interest because the normal standards of arms-length bargaining do not mandate a disclosure of weaknesses
* Because the independent committee did not function properly, Δ bears the burden of proving entire fairness

## In re Orchard—2014—Chancery Court

**The Chancery Court considered a controlling shareholders duty to disclose its true intentions for the company**

* The court suggested that a controlling shareholder breached its disclosure obligations by misleading a committee about its willingness to agree to sell the company to a third party. Based on these assurances, the committee routed third party inquiries to the controlling shareholder—who negotiated for a “go shop” provision which only had value if the controlling shareholder was truly willing to sell to a third party
* The unwillingness to accept a third party offer could present a material conflict of interest and lead to there not being true “arms-length” bargaining

## Orman v Cullman—2002—Chancery Court [Material conflict—BOD majority not Indep/Disint]

**The Cullman’s took General Cigar public in 1997, with Class A and B common stock. Class B had to votes per stock, vs class A that had one. Although there was 10x the voting power, the Certificate of Incorporation required equal consideration in the event of a sale/merger. The Cullman’s owned 162 Class A shares and 9.9M class be shares (37% outstanding stock but 67% voting power). The Cullman’s were approached by Swedish Match about purchasing the interest owned by the public shareholders, striking a deal to see 1/3 its equity and retain their board positions for atleast three years before handing negotiations to a Special Committee. The substantive changes were increased consideration of $.25—despite voting control; approval of the merger required a MoM. Voting separately as a class, vote in favor of the transaction. (11 man board, 4 Cullman’s on the BOD) [Controlling SH w/o voting majority]**

* [Disclosure] When a number of interested directors less than a majority fail to disclose their interest in a transaction to a board—such that a reasonable BOD member would regard the existence of such conflict of “significant” in evaluation of the proposed transaction—the BJR may be rebutted leading to EF review.
* In order to state a claim for breach of a duty to disclose, one must plead facts identifying: (1) material (2) reasonably available (3) information that was (4) omitted from the proxy materials—to be material, there must be substantial likelihood disclosure would be viewed by the reasonable investor as having significantly altered the “total mix” of information available to the shareholders
* The BOD disclosed the facts leading to Solmon’s conflict of interest without including the explicit statement that Solomon was in fact subject to such a conflict—the BOD is not required to draw legal conclusions—although material facts must be disclosed, negative inferences or characterizations of misconduct need not be articulated
* As for the carrying value and not fair value of the headquarters: when an asset is fundamental to operations, as opposed to a surplus asset that could readily be sold for market value, the FMV of such an asset need not be included in a proxy material—Buildings determined to be an “integral part” of a business are equated with other operating assets—but the court cant say that the headquarters is “integral” in the operating asset sense yet
* Inadequate pleadings in support of separate interest/independent allegations cannot be combined to create an inference of improper conduct—and naked assertions of a previous business relationship is not enough to overcome the presumption of independence—a director is also not de facto interested solely because he will be a director in the surviving corporation
  + Still, atleast two additional directors’ independence could reasonable be questioned [(1) $75K consulting agreement and (2) $3.3M transaction fee] therefore the BJR cannot be relied upon to dismiss the case, although discovery must be had to determine whether the facts as they truly existed (and not taken as true) are sufficient to rebut the BJR and trigger entire fairness

## In re PNB Holding Co. Shareholders Lit.—2006—Chancery Court [Material Conflict-Entire BOD]

**A number of stockholders were cashed out in a merger that had the effect of allowing PNB to reclassify itself as a subchapter S corporation—reducing the number of stockholders to less than 75. All of the BOD was to retain their position in the surviving corporation. Plaintiffs challenged the transaction as not subject to the BJR because a majority of the board was interested (Also tried under a unified controlling shareholder theory among the BOD that was quickly dismissed by the court)**

* This plaintiff’s argument argues the directors’ personal self-interest—in the conflict faced between themselves as major stockholders who would remain and the more numerous stockholders to be cashed out— left them disabled from disinterestedly setting the transaction price. On this record, the conflict invokes EF review
* That the BOD took steps to include family members in the class of remaining stockholders that would otherwise not have been in—by transferring personal shares of stock that did not trade regularly—is indicative of the material nature ascribed to continued ownership in PNB. Given that, it s impossible to infer that the economics of the merger were immaterial to them
* In all, the BOD majority was not positioned to make a judgment that is presumptively entitled to the BJR
* In the context of Lynch where shareholder ratification and invocation of the BJR is not possible (which is questionable under MFW), the law presumes votes are not acts of free will and requires EF review regardless of MoM vote, therefore the doctrine of acquiescence cannot logically apply
* Here, where the merger could possibly be ratified, the traditional concept of acquiesce remains viable and requires a showing that plaintiff, by word or deed, as acknowledged the legitimacy of the defendant’s conduct—met when an uncoerced shareholder, acting on an informed basis, cast an affirmative vote in favor

## In re Hammons Hotels SH Litigation—2009—Chancery Court [Material conflict w/ controlling SH]

**Hammons owned mostly Class B shares, Class A shares were traded publically. Hammons negotiated w/ a third party for class B shares while an independent committee negotiated separately for the Class A public shares on behald of minority shareholders. An independent committee approved the transaction, but the MoM approval was not 50% of shares outstanding, but shares entitled to vote. The Chancery Court decided to apply EF upfront because of the Controlling SH’s ability to veto any transaction not favorable to him [controlling SH w/ voting majority]**

* Similar situation to Orman where there is a controlling shareholder on one side who receives benefit different than the other shareholders Hammons seems to start with the presumption that when a controlling shareholder receives a materially different benefit, the “entire fairness” standard is the initial burden, but the BJR can be reinstated—Note there are some differences with Orman though! [Voting Majority / negotiation process]
  + (1) Approval by a well-functioning Special committee or independent, disinterested direcros AND
  + (2) Non-waivable approval by a majority of outstanding shares held by unaffliated shareholders (MoM)
  + All conditions need to be required ex ante (e.g., simply counting the votes/verifying that condition was not waived by Special Committee ex-post is not enough)
* Rationale?
  + Why both? It more closely replicated “arm-length” bargaining when no controlling shareholder is present
  + Why require the MoM be non-waivable? It provides a more effective complement and check on the special committee
  + Why use outstanding (as opposed to actually cast) as denominator? So as to more closely replicate an “arms length” merger or because of the idea of “passive dissent
* Note that the BOD in Orman happened to have these protections when it started with the BJR—After Hammons, those protections are a requirement to have the BJR presumption

## Lewis v Vogelstein—1997—Chancery Court

**Challenge to stock option plan which granted a large one-time option and other options to be given annually; challenged as wasteful since a informed and disinterested MoM had ratified the plan by shareholder vote**

* Waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range that any reasonable person would be willing to trade—generally reserved for transfer of assets that serves no corporate purpose or which zero consideration is received—the risky nature of a transaction is immaterial
* Delaware law seems to hold that shareholder ratification of corporate plans authorizing stock options by an informed and noncoerced majority validate such plan unless the plan is wasteful—however, the “waste” standard in this context was not waste at all but a form or “reasonableness” or proportionality review
* In 1960, the Supreme Court relaxed this formulation—holding in Beard v Elster that to validate a stock option grant required finding “a reasonable BOD could conclude from the circumstances that the corporation may reasonably expect to receive a proportionate benefit. A good faith determination by a disinterested BOD or committee when ratified by a disinterested shareholder vote is entitled to the BJR, triggering classical waste
* Given the size of the one time option, the court cannot conclude that under no set of facts could the granting of the options be an exchange that no reasonable person acting in good faith could agree to—therefore the 12(b)(6) must fail

## Zapata Corp v Maldonado—1981—Delaware

**Maldonado instituted a derivative suit in 1975 (demand excused) alleging breach of fiduciary duty—by 1979, 4/10 directors were no longer on the board and the remaining directors appointed two new outside directors to the board. The BOD then created an Independent committee of the two new diretors to investigate the actions to determine whether or not the corporation should continue with all or any of the litigation: the determination was final, not subject to review by the BOD, and binding in all respect upon the corporation. The court considered when an authorized BOD committee should be permitted to end a derivative suit properly initiated by a stockholder.**

* Derivative suits enforce corporate rights solely for the purpose of preventing injustice where it is apparent that material corporate rights would not otherwise be protected—even if demand is excusable, circumstances may arise when continuation of the litigation is not in the corporations best interest
* An independent committee comprised of disinterested BOD members conducted a proper review of the matters before it, considered a variety of factors, and in good faith reached a business judgment that the action was not in the best interest of the corporation, the action must be dismissed.
* The issue solely becomes independence, good faith, and reasonable investigation. The ultimate conclusion of the committee under that view is not subject to judicial review—we do not want situations where motions are filed after years of vigorous litigation for reasons unconnected with the merits of the lawsuit
* The final substantive judgment whether a particular suit may be maintained requires a balance of many factors ethical, commercial, promotional, public relations, employee relations, fiscal as well as legal
* The basis of the motion is the best interest of the corporation and must include a through written record and findings/recommendations—akin to proceedings on summary judgment where parties meet the normal burden of no genuine issue as to any material fact and that the moving party is entitled to dismiss as a matter of law
  + First, the court should inquire into the independence and good fait of the committee and the basis supporting its conclusion—the corporation with the burden of proving all of these
  + If satisfied, the second step is for courts to apply their independent business judgment as to whether the motion should be granted—intended to thwart circumstances where corporate actions meet the criteria of step one but the result does not satisfy its spirit or where actions would be prematurely terminated where deserving of further consideration in the corporation’s interest

## Ryan v Gifford—2007—Chancery Court

**Concerns backdating of stock option grants, resulting in grants “in the money” instead of at market value as required per the approved stock option plan**

* When challenging specific board action—the analysis must differ where the challenged decision is not a decision of the BOD in place at the tie the complaint is filed.
* Where there is no conscious decision by the corporate board of directors to act or refrain from acting, the absence of board action makes it impossible to perform the essential inquiry contemplated by the Aronson test—given the action was taken by a committee and the BOD is protected from good faith reliance upon the committee to exercise authority under DGCL§141(c), this would not be a BOD decision, triggering *Rales*
* ***(Rales test)*** where the challenged transaction was not a decision of the BOD upon which plaintiff must seek demand, π must create reasonable doubt that the BOD could have properly exercised its independent and disinterested business judgment in responding to a demand
* Directors have a disabling interest for pre-suit demand purposes when “the potential for liability is not a mere threat bit instead may rise to a substantial likelihood
* Here, Maxim’s BOD consisted of six members at all relevant times, the Compensation committee consisted solely of three members—where atleast one half or more the BOD at in place at the time of filing approve the underlying challenged transactions, approval may be imputed to the entire BOD and avoiding §141(c)

# The Voting System

## Preclusion:

**Public Corporations and the Voting System**

* The corporate governance structure is built around the institution of shareholder voting; it is central to every aspect of management of the public corporation
* From a time when shareholder participation in governance was extremely low, §14(a) of the Act was designed to introduce more “democracy” into such corporations and under this provision the SEC has promulgated n increasingly elaborate set of proxy rules to encourage informed shareholder electorates
* Notwithstanding skeptism, a new shareholder’s right movement, led by large pension funds, has emerged since the end of the Great Takeover Wave of the 1980s—backed in part by the power these investors exercise though the voting system. Equally critical, the SEC amended its rules in 1992 to further decrease cost to large investors
* In the last few years, the voting standard applicable to a vast majority of corps has moved from the “plurality” standard in non-contested elections to a “majority” requirement—meaning anyone receiving more “against” or “withhold” votes than “for” votes is not elected or is supposed to offer resignation

**SEC Proxy Rules—**

* ***Rule 14(a)(1) Definitions***
  + Solicitation means:
    - (i) any request for proxy
    - (ii) any request to execute or revoke a proxy (asking SH to vote a certain way)
    - (iii) Communication “reasonably calculated to result in the procurement, withholding, or revocation of a proxy”
  + Solicitation excludes:
    - (i) furnishing a proxy to someone who request it
    - (iv) Communication by a shareholder stating how the holder intends to vote and reasons, if made in public forums, without convincing people what to do and without campaigning
* ***Rule 14(a)(2) Exemptions from disclosure*** 
  + *14a-2(a) exemptions*
    - Generally seems to exempt those who hold securities for others (brokers, etc) to give information or to solicit instructions with respect to the shares owned or held by such person
  + *14a-2(b) exemptions* (must still comply with *24a-6(g)* [minor filing requirements, but no proxy statement] and *14a-9* [no false or misleading statements])
    - (1) exemption for shareholders communicating w/other shareholders when there is no intent to seek a proxy
    - (2) One may solicit fewer than 10 people
    - (3) One may give proxy voting advice to one they have a business relation with
* ***Rule 14(a)(3) Information to be furnished to security holders***
  + No one may be solicited for a proxy unless they’ve been furnished w/a proxy statement containing info in Schedule 14A (101)
* ***Rule 14(a)(4) Contents of proxy statement*** 
  + (b)(2) Must instruct shareholders they can cross out particular director on solicitor’s slate
* ***Rule 14(a)(6) Filing requirements***
  + (a)-(b)—draft proxy statements must be filed with the SEC 10 days before they are sent out; final proxy statements must be filed with SEC when sent to shareholders
  + (g) If ownership stake is at least $5 million, must file Notice of Exempt Solicitation
* ***Rule 14(a)(7) List or mail rule***
  + A company must provide either a shareholder’s list or undertake to mail the dissident’s proxy statement and solicitation materials to record holders (at shareholder’s expense); company’s choice
  + DGCL§220—a person can get a list of beneficial owners—a better route, so go with this
* ***Rule 14(a)(9) Antifraud Rule***
  + Proxy statement cannot contain any statement that is false or misleading w/ respect to a material fact. Can’t write half-truths (omit material facts that are relevant).
  + We didn’t really go over this, so look for arguments under Rule 10b-5
* ***Rule 14(a)(12) Solicitation before furnishing a proxy statement***
  + (a) Notwithstanding 14a-3(a), a solicitation may be made before furnishing security holders with a proxy statement meeting the requirements of § 240.14a-3(a) if:
    - (2) A definitive proxy statement is sent or given to security holders solicited in reliance on this section before or at the same time as the forms of proxy is furnished or requested
  + (b) must still be filed with SEC

**Shareholder Proposals and Rule 14a-8**

* 14a-8 entitles shareholders to force the company to include certain proposals into its proxy materials
  + Proponent must own $2000 or 1% worth of stock for at least one year [14a-8(b)(1)]
  + The proposal may not exceed 500 words (tight limit and corp can use as much space as it wants to argue against the proposal) [14a-8(d)]
* This right is subject to a number of limitations (company’s burden to prove [14a-8(i)]
  + (1) improper under state law (not proper action for SH to take);
  + (2) violation of a state, federal, or foreign law;
  + (3) violation of the commission’s proxy rules;
  + (4) relates to personal grievance or addressing a special interest and not shared by SH writ-large
  + (5) irrelevance – if relates to small amount of assets, earnings (less than 5% of total)
  + (6) company’s inability or lack of power to implement the proposal (against articles of incorporation)
  + (7) relates to company’s ordinary business operations and management function;
  + (8) relates to election for membership on the company’s BOD;
  + (9) direct conflict with one of the company’s own proposals;
  + (10) company has already substantially implemented the proposal;
  + (11) proposal substantially duplicates another proposal submitted in this proxy;
  + (12) proposal duplicates a prior submission
  + (13) proposes a specific dividend
* The significance of Rule 14a-8 is related to the scope of shareholder voting rights. Board elections themselves are outside the reach of 14a-8, but the bylaws, which govern elections, can be voted on via a 14a-8 proposal
* Companies receiving a requires they would prefer not to include frequently request the SEC to approve omission of the proposal (Rule14a-8(j)) in a “No Action Letter”—which essentially states that the SEC Division of Corporate Finance will not recommend disciplinary action if the proposal is omitted
  + The proponent has the opportunity to respond to the request for a no-action letter as well

**State Law Regulation of the Voting System**

* Notwithstanding the importance of the SEC’s proxy rules, state corporate law erects the basic structure of the voting system and decided many of the most important issues affecting shareholder franchise

## CA, Inc v. AFSCME Employees Pension Plan—2008—Delaware

**AFSCME submitted a proposed stockholder bylaw for inclusion in proxy materials that “the BOD shall…reimburse a stockholder for reasonable expenses incurred in connection with [a proxy war] so long as [certain circumstances are met including one or more candidate must actually win].” The company challenged the proposal as (1) not a proper subject for action by shareholders (per se) and (2) alternatively under 14a-8(i)(2) for otherwise violating the DGCL**

* The proper function of bylaws is not to mandate how the board should decide substantive business decisions but rather to define the process and procedures by which those decisions are made
* Because the bylaw is crouched as a command, it lends itself to criticism—still, wording is relevant but not dispositive of whether or not it is process related—meaning, a bylaw that requires the expenditure of corporate funds does not de facto become deprived of its process-related character for that reason alone
* The bylaw could be phrased more benignly to provide “a stockholder shall be entitled to reimbursement…for reasonable expenses…”—emphasis on the entitlement rather than the BOD obligation to act—it would also need to contain a provision reserving full authority to discharge according to their fiduciary duties
* The context of this bylaw is the process for electing directors, shareholders are entitles to facilitate the exercise of that right through a bylaw amendment encouraging candidates other than BOD sponsored nominees.
* As for violation of other provisions of the DGCL under 14a-8(i)(2)—were this issue presented during the course of litigation involving specific facts, it would start with the presumption that the bylaw is valid and the court would exercise caution before invalidating corporate acts upon hypothetical injuries
* But when presented on certification by the SEC, we determine validity in the abstract, thus any possible circumstances under which a BOD may be required to act must necessarily be considered—atleast one such hypothetical would require the BOD to breach their fiduciary duties, and therefore cannot stand

## Response of the Division of Corporate Finance to Waste No Action Letter

**Carpenters Pension Fund proposed a 14a-8 to Waste Management which read “the bylaws of Waste…be amended to provide that the BOD shall consist of a majority of independent directors. For these purposes, the definition…shall mean a director who…[list qualifications].” Waste requested a no-action letter to exclude the amendment, arguing pursuant to SEC law which states “a proposal mandating BOD action intrudes upon discretionary authority of the BOD and is therefore excludable under 14a-8(i)(1)**

* **[CPF Argument]** The proposal is not the specific language of the amendment, rather it describes in clear terms the effect to be made by the bylaw changes should the proposal receive the requisite support, it would be incumbent upon the board to implement the changes consistent with the DGCL and the Company Charter—the independence requirement should be viewed simply as eligibility requirements for a certain number of seats
* Although there is some basis for excluding the proposal under Rule 14a-8(i)(1) to the extent it mandates the BOD to undertake an act, but this may be cured if the proposal is revised to a request or recommendation
* The proposal may not be excluded under 14a-8(i)(2) or (i)(6)—the proposal does not include the specific language that may be presented ultimately for adoption, accordingly, the BOD may draft the provision in a matter to implement the purpose consistent with the DGCL and the Articles of Incorporation—defeating the 14a-8(i)(2) and (i)(6) challenges

## Schnell v Chris-Craft Industries, Inc—1971—Delaware

**Management attempted to move the annual stockholder meeting up one month—pursuant to a recently enacted DGCL section, in hopes of cutting down the amount of time otherwise available to plaintiffs to wage a proxy war**

* Management has disingenuously resisted the production of a list of stockholders and has otherwise turned a deaf ear to πs demands about a change in management—because of these tactics and he moving of the meeting, πs are given little chance to wage a successful proxy fight due to the exigencies of time

***(Schnell (cont.))***

* Management attempted to use the corporate machinery and the GCL for the purpose of perpetuating itself in office, and to that end, for the purpose of obstructing the legitimate efforts of unhappy stockholders in the exercise of their rights to undertake a proxy contest against management‑contrary to equity
* Inequitable action does not become permissible simply because it’s legally possible, moving of the date reversed

## Blasius Industries, Inc v. Atlas Corp—1988—Chancery Court

**Blasius, acquired its 9% stake in Atlas to encourage management of Atlas to consider a restructuring or other transaction to enhance shareholder value, in its 13D filing, Blasius also disclosed it was exploring the feasibility of obtaining control of Atlas. Atlas rejected several restricting proposals, and when Blasius proposed extending a 7 member board to 15 and electing 8 new directors, the BOD extended the board to 9 and elected its own representatives.**

* On balance, I cannot conclude the BOD was acting self-interest in any important respect, rather the BOD saw the “threat” of the Blasius recapitalization proposal as posing vital policy differences between itself and Blasisus—it acted in a good-faith effort to protect its incumbency, not selfishly, but in order to thwart implementation of the recapitalization it reasonably feared would cause great injury to the company
* Sound principles tell us that Unocal and the BJR are not meant to apply to action taken for the primary purpose of interfering with the effectiveness of stockholder votes—closer scrutiny must be accorded to such transactions
* The shareholder franchise is the ideological underpinning upon which the legitimacy of BOD power rest; matters involving the integrity of the voting process involve consideration not present in any other context—the BOD bears the heavy burden of demonstrating a compelling justification for such action
* This need not be true to other forms of corporate action with an entrenchment effect, such as stock buybacks and other defensive tactics, but a decision to prevent shareholders from implementing a new board does not involve management of the corporation, but allocation of power with respect to governance of the company

## Speiser v Baker—1987—Chancery Court

**Complex circular voting whereby Speiser and Baker (directors in Health Med) control the voting power of Chem (where they are managers) through Health Med ownership of equity in Chem. The two had a split, and Baker sued to enjoin an annual meeting where he would have been kicked out of Health Med, arguing the structure violated DGCL §160(c) prohibiting the voting of stock that belongs to the issuer and prohibits of the issuer’s stock when owned by another corporation, if the issuer directly or indirectly holds a majority of the shares entitled to elect the BOD of the second corporation.**

* The statutory language of §160(c) read literally does not proscribe the voting of Health Med’s stock in Chem—Chem does not own a majority of shares “entitled to vote,” just majority voting power through preferred shares
* Still, the inquiry is not over—even when read as Speiser contends, the provision does not confer a right to vote shares otherwise, only a restriction—other words may be read to extend §160(c) to this action, specifically, the words “belonging to the corporation,” which is not technically precise and requires interpretation
* 160(c) does not create a conclusive statutory presumption that in no event would stock owned by another corporation that did not satisfy the new test (majority of shares entitled to vote) be considered stock “belonging to the corporation”—stock held by a corporate “subsidiary” may in limited circumstances “belong to” the issuer, thus prohibited from voting, even if the issuer does not hold a majority of shares entitled to vote
* The principle and sole effect of this arrangement is to muffle the voice of the public shareholders of Chem in the governance of the corporation as contemplated by the certificate of incorporation; the arrangement entrust Chem management with the power and means of keeping themselves in power perpetually

# The Acquisition Market

## The Acquisition Market

* **Generally**
  + A variety of transactions can restructure, extend, or transfer corporate control. These diverse transactions re known as “change of control” transactions
  + Management retains considerable power to dispose of corporate assets and block outsiders from purchasing control, even when management holds little or no equity in the firm (to the extent there is no large shareholder or organized shareholder opposition)
    - Still, without 100% owndership, the controlling shareholder cannot pledge or sell the corporation’s assets to finance private (as opposed to corporate) investment opportunities; thus, in most acquisitions, buyers don’t merely seek control but 100% ownership or target firms
* **Corporate Combinations** 
  + Corporate combinations can principally take three forms: Mergers (and consolidations), asset acquisitions, and stock acquisitions
  + ***Mergers***
    - One corporation is merged “with and into” a second; the second is known as the surviving corporation—as opposed to consolidation where two corporations are combined and neither survives—the designation of which corporation survives does not depend on the treatment of shareholders; thus, it is possible to have a cash merger where the shareholders of the surviving corp are cashed out and the shareholders of the other receive stock of the surviving corp
      * The assets and liabilities of both corporations become assets and liabilities of the surviving corporation as a matter of law
    - In cash mergers, shareholders of one of the constituent corporations receive cash, while shareholders of the other receive (or retain) stock of the surviving corporation—In stock mergers, shareholders of both corporations receive (or retain) stock of the surviving corporation
    - ***Approvals needed***
      * A regular merger (§251(c)) requires approval by the BOD and shareholders of both constituent corporations
      * A short-form merger (§253) are allowed when one constituent corporation (the parent) owns atleast 90% of the stock of the other. Generally, only the board of the parent needs to approve a short-form merger
        + The rationale is that presumably, the merger has no major economic effect on the parent’s shareholders and given the stock ownership, requiring approval by the subsidiary would be a meaningless formality
      * §251(h) eliminates the need of a shareholder vote of the acquired corporation following a tender offer by the acquirer—subject to several requirements including that the acquirer owns a majority of the stock (or the amount required to approve such merger) after the tender and was not a 15% stockholder when the merger agreement was signed
      * §251(f) dispenses with the requirement of shareholder approval of the acquiring corporation if (1) the shareholders of that corporation retain their shares, (2) the corporation’s charter is not changed, and (3) the number of any newly issued shared to shareholders of the acquired corporation does not exceed 20% of the acquirers outstanding shares prior to the merger
    - In practice, approval by the shareholders of one corporation is often avoided by structuring a merger as a “triangular merger” where one corporation forms a subsidiary and that subsidiary merges with the second corporation in a §251(c) merger—unless the parent must issue new shares in excess of 20% or if the merger requires amendment to the certificate of incorporation
      * This also has the benefit of shielding the parent’s other assets from the Target’s (unknown) liabilities; since Target’s operations will be ran though a separate subsidiary
  + Asset Sales
    - One company acquires the assets of another company (and often assumes its liabilities) by contract. The acquiring company can pay in cash or in its own shares—if the selling company liquidates after the asset sale, the end result is economically very similar to a merger (§271)
      * Subject to the rules on issuance of more than 20% of outstanding stock/COI amendment
      * Although there are some advantages, one major disadvantage: since assets are transferred by contract, and not automatically, an asset sale requires more extensive documentation and title work than a merger
  + Stock Acquisitions
    - One corporation buys the stock of another and thereby obtains indirect ownership of the other’s assets (subject to its liabilities). Stock acquisitions only require shareholders willing to sell stock; formally, no other approval is required subject to the usual caveats
    - What Is generally done is to buy up a large majority of shares in a tender, and after completion, cash-out the remaining shareholders in a triangular merger
* **Appraisal Rights (§261)**
  + Check §262 for rights
  + The appraisal right is a put option -- the opportunity to sell shares back to the firm at a “fair” price that is supposed to reflect their value prior to the transaction triggering the right
  + Generally, it has become clear in Delaware that a dissenting shareholder’s claim is a pro rata claim on the third-party sale value of the company (i.e., what the firm might have fetched from the highest bidder on the market), but this is not universal, you will still find cases that apply a “minority discount” to the appraisal claims of small shareholders
* **Freeze-out Transactions**
  + Freezout transactions are those in which a controlling shareholder employs a merger or other fundamental transaction to buy out minority shareholders and differs from arms-length negotiations in two respects: (1) a controlling shareholder has the statutory power to impost a merger regardless of how minority shareholders value the deal and (2) a controlling shareholder can force a merger without fearing a competing bid as no one can compel him to vote his shares against himself
* **Sales of Control**
  + A control block in a public corporation is costly to aggregate and valuable to have—this leads to the ability of the seller of a control bloc to obtain a control premium not available to the other shareholders.
  + Arguably, directors of publically owned companies have a duty to receive a control premium when selling to/merging into a controlling shareholder
* **Tender Offers and the Williams Act**
  + A tender offer is an offer of cash or securities to the shareholders of a public corporation in exchange for their shares at a premium over market price—the premium is generally analogized to the control premium paid to a controlling shareholder
  + Before the Williams Act in 1967, tender offers were essentially unregulated. Although the act does not define tender offer, the regulatory structure established by the Act and developed by the SEC divides into four principal elements
    - §13(d) erects an “early warning system” designed to alert target management and the market of any concentration in shareholding that might foretell a future change in control by any method
    - §14(d)(1) and an associated set of rules require extensive disclosure about the identity, financing, and future plans of a tender offeror
      * 13(d) imposes parallel disclosures on large shareholders who cross the 5% threshold, although disclosure under 13(d) is usually far less complete
    - §14(e) provides an anti-fraud provision to prohibit misrepresentations, non-disclosures, and “any fraudulent, deceptive, or manipulative practices in connection w/ a tender
    - §14(d)(4)–(7) and Rules 14d regulate the substantive terms of tender offers, including how long they must be left open, when shareholders and withdraw previously tendered shares, the equal treatment of shareholders who do tender, and the effect of altering terms while a tender is “open”. (Add these things to notes)
* The Takeover Debate
* **Defensive Tactics**
  + *Unocal* and its protegeny establish the principal framework for allocating power between managers and shareholders when a company becomes the subject of a hostile tender offer
  + Given the strong anti-takeover effect of poison pills, it is not surprising that opponents of takeovers have crafted provisions to strengthen pills and proponents of takeovers have tried to weaken it.
    - One such provision is a “dead-head” provision, which prohibits directors elected in a proxy war from redeeming a rights pill to allow for a takeover; unless the BOD is made of a majority of Continuing Directors or the new directors were recommended by the BOD—While they have been upheld in some jurisdictions, they have been rejected in Delaware in *Quickturn*.
  + Attempts to weaken pills have principally involved shareholder pressure on boards, most commonly taking the form of precatory shareholder resolutions (or threats of such) under Rule 14a-8 asking a BOD to redeem or modify a pill
    - A fair number have won a majority of votes and several companies have let their pills expire–this does not per se prevent a company from reenacting a pill when faced with a hostile bid.
    - More recently, shareholders have proposed binding by-law amendments requiring the redemption of existing pills and mandating shareholder approval for any new pill. The validity of these provisions, however, is unsettled because technically any restriction must fall in the COI
    - The rise of posion pills has made most anti-takeover statues irrelevant because they attack completion of the tender at step-one, preventing the need for step-two protection
  + **Lock Up Option –** Allows a bidder to receive shares of the corporation at the current market price so that if he is outbid by another potential buyer, the initial bidder can sell those locked up shares to the new buyer and pocket the difference between the current market price and the highest bid.
    - This forecloses additional bidders in the sense that they would now have to be able to generate more profit from the deal in order for it to be attractive to cover the cost of the lock up options – but incentivizes bidders to enter into negotiations for the purchase of a firm.
* Duties Revisited

## Ace Limited v Capital Re Corp—1999—Chancery Court

**Merger agreement contained both “no talk” and “no shop” provisions—one relevant provision prohibited Capital RE from participating in discussions or negotiations with, or even providing information to, a third party unless outside counsel gives a written opinion such negotiations are “required” to comply with fiduciary duties ----- After the merger was announced, ACE’s stock fell substantially resulting in a major drop in the value of the consideration. The day before the vote, Capita RE received a new offer that the market considered significantly more valuable—Counsel gave an opinion that entering negotiations was “consistent with” fiduciary duties; ACE filed suit requesting a TRO**

* The relevant section is better interpreted as leaving the ultimate “good-faith” judgment about whether fiduciary duties required them to enter into discussions, although the board must “base” its judgment on the “written advice” of outside counsel
* A ban on considering such proposal, even with an exception where legal counsel opines in writing such negotiation is “necessary,” comes close to self-disablement by the board. Delaware case law takes a rather dim view of restrictions that tend to produce such a result—it is critical the board retain sufficient flexibility to ensure stockholders are not unfairly coerced into accepting a less than optimal exchange
* The provision involves an abdication by the board of its duty to determine what its own fiduciary obligations require at precisely that time in the life of the company where the board’s own judgment is most important -- no talk provisions are troublesome precisely because they keep a BOD from making its own informed decision
* “No talk” provisions are particularly suspect when failure to consider other offers virtually guarantees the consummation of the original transaction, however more valuable an alternative may be and less valuable the original transaction may have become
* One would think there are limited circumstances where a board could prudently place itself in the position of not being able to entertain and consider a superior proposal to a transaction dependent on a stockholder vote, but this case does not seem to be of that nature (think of situations where the final say still rest with stockholders since there is no controlling stockholder thus no affirmative duty to the minority)

## Omnicare v NCS Healthcare—2003—Delaware

**The NCS board agreed to terms of a merger with Genesis that required NCS to submit the agreement for a vote even if management withdrew its recommendation. When combined with the personal agreement of two stockholders owning a majority of the voting power agreed unconditionally to vote for Genesis and the lack of a fiduciary-out clause; consummation of the merger was guaranteed. Omnicare made a competing offer worth over double the consideration, and then sued to invalidate the provision requiring the board to submit the Genesis proposal**

* Where a cohesive group of stockholders with majority voting power is irrevocably committed to a transaction, effective representation of the financial interest of the minority shareholders imposes upon the BOD an affirmative duty to protect those minority interest; the board cannot abdicate this responsibility
* Taking collective action that is otherwise legally possible does not de facto comport with the fiduciary duties of a BOD in all circumstances. §251 provisions are presumptively valid in the abstract, but they may not define or limit the directors’ fiduciary duties or prevent directors from carrying out such duties under Delaware law
* By acceding to Genesis’ ultimatum for complete protection the NCS BOD disabled itself from exercising its own fiduciary obligations at a time when the BOD’s judgment is most important. The BOD has no authority to execute a merger agreement that subsequently prevented it from discharging its ongoing fiduciary duties
* The NCS BOD was required to contract for an effective “fiduciary out clause” to exercise its continuing fiduciary responsibilities to the minority stockholders

## Weinberger v UOP—1983—Delaware

**In 1975, Signal Corp acquired 50.5% ownership of UOP through a management supported tender offer (@ $21), after which they nominated and elected 6/13 directors. When the President/CEO of UOP retired soon after, Signal caused him to be replaced by a Signal insider (bringing the BOD to 7/13). In 1978, after finding no other suitable investments, Signal prepared a feasibility study to consider freezing out the minority—completed by two Signal officers who were also on the UOP Board—which determined any price up to $24 per share would be a good investment. Signal decided to offer $20-$21 per share for the remaining 49.5%, without using an Independent committee, having its directors on the UOP board abstain from the process (only the vote), or making minority shareholders aware of the feasibility study (although the merger agreement had a nonwaivable majority-of-the-minority provision)**

* A primary issue mandating reversal is the preparation of the feasibility study by two UOP directors for the sole and exclusive use and benefit of Signal. Signal designated directors on UOP’s Board still owed UOP and its minority shareholders an uncompromising duty of loyalty -- Signal’s UOP directors participated in the decision making process, atleast to some extent, without full disclosure of the conflicts they faced
* Public Policy has been established that demands of directors the observance of their duty not only to affirmatively protect the interest of the corporation, but also to refrain from doing anything that would injure the corporation or deprive it of profit/advantage which his skill and ability may properly bring to it
* Where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts -- there is no dilution of this duty where one holds dual or multiple directorships, as in the parent-subsidiary context
* Individuals that act in a dual capacity owe the same duty of good management to both corporations, and in the absence of an independent negotiating structure or total abstention from any participation in the matter, this duty is to be exercised in light of what is best for both companies
* The concept of Entire Fairness has two basic aspects: Fair dealing and Fair Price.
  + Fair Dealing embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the needed approvals were obtained.
  + Fair price relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock
* Part of fair dealing is the obvious duty of candor (full-disclosure); one possessing superior knowledge may not mislead any stockholder by use of corporation information to which the latter is not privy -- the matter of disclosure to the UOP directors was wholly flawed by the conflicts of interest raised by the feasibility study
* (FN7) Although perfection is not possible, the result here could have been entirely different if UOP had appointed an independent negotiating committee of outside directors to deal with Signal at Arms’ length. Particularly in a parent-subsidiary context, such a showing of arms’ length bargaining is strong evidence that the transaction meets the test of fairness [Cleansing Acts shift the burden under Kahn (double check)]
* As for calculation of the appraisal (which the Chancery Court would only apply the Delaware Block Method of evaluation), to the extend the DBM excludes other generally accepted techniques (Discounted Cash-Flow) used in the financial community and the courts, it is not clearly outmoded
* Only the speculative elements of value that may arise from the “accomplishment or expectation” of the merger are excluded from consideration

## Glassman v Unocal Exploration Corp.—2001—Delaware

**Class of hemophiliacs exposed to HIV against manufactures of contaminated blood solids (Certification reversed)**

* Appraisal is the exclusive remedy in short-form mergers under §253 of the DGCL, absent fraud or illegality
* Although entire fairness is not necessary, the duty of full disclosure remains with regard to all material factual information concerning whether to accept the merger consideration or seek appraisal

## In re Siliconix Inc—2001—Chancery Court

**Vishay, owner of 80.4% of Siliconix stock, began to consider acquiring the remaining Siliconix stock that it did not own. Vishay publically announced a proposed all-cash tender offer, at a 10% market premium, also disclosing it would consider a short-form merger if it obtained over 90% for the same price—Vishay also requested the opportunity “to discuss its tender” with a special committee of independent non-management Siliconix directors unaffiliated with Vishay. Although both members of the committee had done extensive work with Vishay, they expressed a view that the price was not a fair price for Siliconix; Vishay management was unwilling to increase the price. A few months later, Vishay announced it would proceed with a stock tender offer without obtaining the Special Committee’s approval (consideration =1.5 shares of Vishay). The tender had a non-waivable majority-of-the-minority provision for acceptance of shares; Special Committee decided to remain neutral and not express an opinion on the fairness of the stock offer. [Freezout Transaction as opposed to a Tender/Merger]**

* A controlling shareholder extending an offer for minority-held shares is under no obligation to offer any particular price for the minority-held stock, absent some evidence that material information about the offer has been withheld or misrepresented or that the offer is coercive in some significant way
* This court will intervene to protect the right of minority shareholders to make a voluntary choice, the issue of voluntariness of the tender depends on the absence of improper coercion and the absence of disclosure violations
* In short, as long as the tender is pursued properly, the free choice of the minority shareholders to reject the tender provides sufficient protection -- unless coercion or disclosure violations can be shown, no defendant has the duty to demonstrate entire fairness in these circumstances
* The difference in judicial approach in this context vs entire fairness in self-dealing merger context can be traced to two simiple concepts: (1) Accepting or rejecting a tender is an individual decision and not a corporate decision and (2) the acquired company in the merger context enters into a merger agreement, but the target company in the tender context does not confront a comparable corporate decision—shareholders are the target

## Zetlin v Hanson Holdings Inc—1979—NY Court of Appeals

**Π, 2% shareholder of Gabel Industries, Inc, sued Δs, who together own 44.4% of the company (and concededly, control the corporation) arguing minority stockholders are entitled to an opportunity to share equally in any premium—Δs sold their interest for a premium of $15 when Gabel stock was selling on the open market for $7.38**

* Absent looting of corporate assets, conversion of a corporate opportunity, fraud, or other acts of bad faith—a controlling shareholder is free to sell that controlling interest at a premium price
* Certainty minority shareholders are entitled to protection against such abuse, but they are not entitled to inhibit the legitimate interest of the other stockholders
* Minority right to control premiums would profoundly affect the manner that controlling interest is now transferred, would be contrary to existing law, and so radical a change it would best be effected by legislature

## Brecher v Gregg—1975—Find Out

**Gregg, President of LIN Broadcasting, sold his 4% stock interest to the Saturday evening post, promising to resign and cause the election of the Post’s president and two others to the Lin board and the selection of the Post’s president to succeed him in office. The price paid to Greg was $1.26M above market value. The agreement was carried out, but several weeks later the LIN board terminated the new president’s tenure and all of the Post directors resigned. Post sued for a refund of the premium paid for the stock, which was dismissed on the grounds of he illegality of the payment. A shareholder of LIN then sued to recover the premium paid by the Post**

* The court held that Gregg was liable to the corporation for the premium.
* The agreement, insofar as it provides for a premium in exchange for a promise of control with only 4% of shares actually being transferred, is contrary to public policy and illegal
* The only remedy available is an equitable one and is only available to the extent of the actual profits realized by Δ—In sum, an officer’s transfer of less than a majority stake at a premium over market value accompanied by his promise to effect the transfer of offices is a transaction which braches the fiduciary duty owed to the corp

## McMullin v Beran—2000—Delaware

**ARCO, 80.1% owner of Chemical, received an unsolicited call from Lyondell expressing interest in acquiring Chemical. ARCO then contacted a number of firms and entities to gauge their interest in a bidding process. After rejecting numerous Lyondell offers, starting at $51 per/share and ending with $57.25 per share. When the Chemical board met to consider the proposal, they received an opinion that the price was fair to all shareholders, and the BOD unanimously approved the transaction. Lyondell commenced its tender, receiving 99% of shares and freezing out the rest in a §253 merger. Shareholder sues alleging the BOD violated its Duty of care to make an informed decision (no real diligence) and by not disclosing the basis of such decision so shareholders may make their own informed decision**

* When the entire sale to a third-party is proposed, negotiated, and times by a majority shareholder, the board cannot realistically seek any alternative because the majority shareholder has a right to vote its shares in favor; nevertheless, the directors are obliged to make an informed and deliberate judgment in good faith about whether the sale to a third party will result in a maximization of value for the minority shareholders
* When the board is deciding whether to approve a proposed “all shares” tender offer to be followed by a cash-out merger, the decision constitutes a final-stage transaction for all shareholders—The BOD has a duty to make a decision w/ due care so the minority may make an informed decision whether to tender or seek appraisal
* Effective representation of the financial interest of the minority require the BOD to (1) conduct a critical assessment of the third party transaction and (2) make an independent determination whether the transaction maximized value for all shareholders—the complaint alleges ARCO gained a financial advantage against the minority by insisting on an all cash transaction and sacrificing some of the value thereby
* There is no compromising the duty of loyalty for the ARCO designated officers and directors. The Chemical BOD could properly rely on the majority shareholder to conduct preliminary negotiations, but the BOD had an ultimate duty to make an informed and independent decision on whether to recommend approval
* An informed decision must be made upon the basis of all the information then reasonably available and relevant to their decision

## Unocal Corp v Mesa Petroleum—1985—Delaware

**Mesa, owner of 13% of Unocal’s outstanding shares, commenced a two-tier front-loaded cash tender offer (two-tier coercive) for 37% of Unocal’s outstanding shares. The board was presented with various defensive tactics, opting for a self-tender by Unocal for its own stock at a price it considered fair. The cost of such proposal was more than $6.1B, but a presentation was made by Goldman of Unocal’s ability to handle such debt, with the addition of certain covenants on the debt securities. The deal contained a “mesa purchase condition” which requires Mesa to obtain a certain number of shares for the self-tender to take effect, although the company waived this as to 50M shares due to shareholder pressure. Law at the time allowed Mesa to be excluded if it was for a “legitimate business purpose,” but this is no longer the case.**

* The BJR, including the standards by which BOD conduct is judged, is applicable in the context of a takeover—a court will not substitute its judgment for that of the BOD if the latter’s decision can be attributed to any rational business purpose (informed basis, in good faith, and w/ honest belief the action was in the corps’ best interest)
* When a BOD addresses a pending takeover bid, it has an obligation to determine whether the offer is in the best interest of the corporation & its shareholders—because of the omnipresent specter that a board may be acting primarily in self-interest, there is an enhanced duty which calls for judicial examination before the BJR is invoked
* Against this inherent conflict, the BOD must show (1) they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed; they satisfy this burden by showing “good faith and reasonable investigation” and (2) the defensive tactic was reasonable in relation to the threat posed ***[Unocal Standard]***
* Such proof is materially enhanced by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standard
* The element of balance entails an analysis by the BOD of the nature of the takeover bid and its effect on the corporate enterprise. Such concerns include: inadequacy of the consideration, the nature and timing of the offer, questions of legality, the risk of non-consummation, and the quality of securities offered in exchange
* A corporation does not have unbridles discretion to defeat any perceived threat by any “Draconian” means available, directors may not have acted solely or primarily out of a desire to keep themselves in office -- add the further caveat that inequitable action may not be taken under the guise of law
* Specifically, the BOD concluded that the value of Unocal was substantially above the $54 price per share; furthermore, the subordinated securities to be given in the back-end “freeze-out” merger were “junk bonds” worth far less than $54—Thus, we are satisfied that the poison pill is reasonably related to the threat posed

## Moran v Household—1985—Delaware

**In this case, the target Household Int’l adopted a “flip-over” poison pill as a preventative mechanism prior to receiving a hostile takeover attempt**

* Court concludes that the pill, when adopted, was a reasonable response to the potential threat of coercive acquisition techniques
* Yet, when faced with an actual tender offer, the BOD cannot arbitrarily reject the offer, rather the BOD’s decision to reject the offer and not redeem the pill will be analyzed under the same fiduciary standards any BOD would be held to in deciding to adopt a defensive mechanism
* In other words, the ultimate validity of the pill is determine when the board is faced with an actual offer and has to decide whether to redeem it or not; at this point, the decision not to redeem will be analyzed under the relevant legal standard

## Quickturn Design Systems Inc v Shapiro—1998—Delaware

**Challenge to a “dead-head” provision preventing a new & opposing board from redeeming a pill—provision prohibited a newly elected BO from redeeming the pill for six months if the purpose or effect of such redemption would be to facilitate a transaction with an “Interested Person”**

* One basic tenet of Delaware corporate law is that the BOD has the ultimate responsibility for managing the business affairs. §141(a) of the DGCL requires that any limitation on this power be placed in the certificate of incorporation.
* The “Delayed Redemption Provision” would prevent a newly elected BOD from completely discharging its fundamental duties for six months. While it limits BOD authority in only one respect, it nonetheless restricts the BOD in an area of fundamental importance—negotiation of a possible sale
* To the extent a contract, or a provision thereof, purports to require a BOD to act or refrain from actin in a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable—this provision tends to substantially limit the freedom of newly elected directors’ decisions on matters of management policy

## In Re: Interco—1988—Chancery Court

**Interco was the target of a takeover bid by the Rales brothers. Interco adopted a rights plan, followed by a restricting plan whereby the company would pay substantial dividends of cash, debt securities, and convertible preferred stock to shareholders. According to Interco’s Banker, the value was $76 ($68-70 from Rales banker); the Rales offer was $74 all cash/all shares. The Rales brothers sued arguing Interco could not leave the pill in place while it proceeded to implement the restructuring; Interco argued the price was inadequate, so they needed to make an alternative offer**

* The board has made a good faith determination that there is a threat to shareholders’ economic interest posed by an inadequate offer, that alone will justify leaving the pill in place—even in the setting of a noncoercive offer—for a period until the BOD can take such steps as it deems (in good faith) appropriate to protect and advance shareholder interest in light of the significant development an offer doubtless is
* That action may entail negotiation with the offeror, institution of a Revlon-style auction, a recapitalization or restructuring designed as an alternative, or other action—in this instance, there is no threat of coercion
* Yet, once that period is closed, and it is apparent the BOD does not intend to institute an auction, negotiation for an increase, and that it has taken such time as required in good faith to arrange a value-maximizing alternative, then generally, the legitimate role of the pill in the context of a non-coercive offer will be satisfied
* Past this point, the only function left for the pill is to preclude the shareholders from exercising a judgment about their own interest, which may differ from the directors who have some interest in the question—Perhaps there is a case where a permanent foreclosure from accepting a noncoercive offer may be justified, but not this

## Paramount Communications Inc v Time—1989—Delaware

**Time’s board decided to expand into the entertainment industry on a global scale. After considering a wide range of companies, the BOD for various reasons concluded that Warner was the best candidate (Think Time Culture). At a March meeting, Times BOD adopted several defensive tactics including a No Shop clause, and an automatic share exchange agreement along with a special committee of outside directors to oversee the merger. Paramount then made an unsolicited tender all cash/all shares for $175 in June—Time rejected this believing this bid posed a threat to Time’s control of its own destiny—Time and Warner restructuring the deal as an outright cash and securities acquisition of Warner for fear Time stockholders would not comprehend the long term benefits and kept defensitve tatics in place.**

* Analyzing the decision to reject the amended $200 offer must be analyzed under the Unocal standard—Because Unocal involved two-tier coercive offer, the Chancery Court has suggested that all cash/all shares offers within a range of values cannot constitute a legally cognizable “threat” to shareholder interest sufficient to withstand Unocal step one analysis. This represents a fundamental misconception of the Unocal standard
* Unocal is useful because of its flexibility in the face of a variety of scenarios—the open-ended analysis is not intended to lead to a simple mathematical exercise. Precepts underlying the BJR counsel against a court engaging in the process of evaluating the relative merits of long v short term investment goals
* The court cannot conclude that Time’s June decision was lacking in good faith or dominated by motives of either entrenchment or self-interest
* Proportionality. Clear identification of the threat posed requires an evaluation of the importance of the corporate objective threatened, alternative methods of protecting that objective, impacts of the defensive action, and other relevant factors
* The fiduciary duty of management includes the selection of a time frame for achievement of corporate goals—a duty which cannot be delegated to shareholders—Directors are not obliged to abandon a deliberately conceived corporate plan for short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy
* (FN19) As decided in *Shamrock Holdings v. Polaroid Corp.*, the Chancery Court upheld BOD adoption of a employee right’s plan prior to any contest for control that was reasonably determined to increase productivity and enhance profits because the plan did not appear to primarily be a device to affect/secure corporate control

## Revlon, Inc v MacAndrews & Forbes, Inc—1986—Delaware

**Pantry Pride threatened a hostile takeover of Revlon. Determining the tender ($45) to be grossly inadequate, the BOD adopted a share repurchase and Notes Purchase Rights Plan (right to exchange one common stock for one Principle note at 12% with one year maturity, effective upon one acquiring beneficial ownership of 20% or more of Revlon’s shares unless all cash/all shares at $65 or more, redeemable before triggering event). PP responded by instituting a tender at $47.50, triggering additional defensive tactics, including a repurchase program with restrictive covenants—eventually authorizing management to negotiate with other parties interested in acquiring Revlon, leading to a leveraged buyout deal with Frostmann worth $56 cash per share (PP’s highest was $56.25) where the board treated Frostmann favorable, including many tactics virtually locking up the deal. PP challenged them all**

* When it became apparent that break-up of the company was inevitable—shown by authorization to negotiate a buyout with third parties—the duty of the BOD changed from the preservation of the corporate entity to the maximization of value for stockholder benefit. This significantly alters the BOD’s responsibilities under Unocal.
* The original threat of the break-up of Revlon had become a foregone conclusion. The question of defensive tactics became moot, the BOD’s role changed from defenders to auctioneers charged with getting the best price
* Selective dealing to fend off a hostile bidder was no longer a proper objective. The BOD cannot make the requisite showing of good faith by choosing to sure up the Notes’ market and ignoring the duty of loyalty/maximization—the rights of Noteholders are fixed by contract, they require no more protection

***Revlon* (cont.)**

* A corporation may have and consider various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders—such concern for stockholder interest is inappropriate when an auction among active bidders is in progress and the object is to maximize value
* While lock-ups and similar tactics which draw bidders into the battle benefits shareholders, similar measures which end an active auction and foreclose further bidding operate to the shareholders detriment
* The BOD seems to have failed to ensure that negotiations for alternative bids were conducted by those whose only loyalty was to the shareholders. The principle benefit went to the directors, who avoided liability to a class of creditors to whom the BOD owed no further duty under the circumstances
* Favoritism might be justifiable when the latter’s offer adversely affects shareholder interest, but when bidders make relatively similar offers or dissolution of the company becomes inevitable, the directors cannot fulfill their enhanced Revlon/Unocal duties by doing so—Market forces must operate freely to maximize value

## Mills Acquisition Co v Macmillan, Inc—1988—Delaware

**Macmillan Management proposed a leveraged restructuring that would have given management control over the company. After announcement, the company received two unsolicited competing bids. The Chancery court found the BOD breached its fiduciary duties in their conduct of the auction between management and Maxwell**

* The sole responsibility of the BOD in such a sale (CoC) is shareholder benefit. The BOD may now allow any influence inconsistent with the best interest of the shareholders to alter strict fulfillment of these duties—it is the BOD’s duty to get the highest value reasonably attainable
* The requirement of fairness does not preclude differing treatment of bidders when necessary to enhance shareholder interest—variables may occur which necessitate such treatment, however the BOD’s essential purpose must remain enhancement of the bidding process for the benefit of the stockholders
* The board may invoke a panoply of devices, but when that happens, there must be a rational basis for the action such that the interest of the stockholder are manifestly the board’s paramount objective
* When Revlon duties devolve upon BODs, the two-part test of necessity is slightly different. (1) π must show that the BOD treated one or more of the respective bidders on unequal terms; in the face of disparate treatment, the trial court must examine (2) whether the BOD properly perceived that shareholder interest were enhanced(Good faith and reasonable investigation)—(3) in any event, the action must be reasonable in relation to the advantage sought to be achieved (threat avoided)

## Paramount Communications, Inc v Time (Pt. II)—1989—Delaware

**See facts above. Contention on whether Paramount’s offer initiated Revlon duties**

* The Chancery Court’s ruling that Revlon duties were not triggered is premised on a finding that control of the corporation was held in a fluid aggregation of unaffiliated shareholders representing a voting majority both before and after the merger
* We premise our affirmation on the absence of any substantial evidence to conclude that Time’s BOD made the dissolution or breakup of the corporate entity as inevitable, as was the case in Revlon
* Generally speaking and without excluding other possibilities, two circumstances may implicate Revlon duties: (1) When a corporation initiates an active bidding process seeking to sell itself or seek reorganization involving a clear break-up of the company or (2) where in response to a bidder’s offer, a target abandons its long-term strategy and seeks an alternative transaction also involving the breakup of the company
* If a BOD’s reaction to a hostile tender is found to constitute only a defensive response and not an abandonment of continued existence/long-term plan, *Revlon* duties are not triggered and *Unocal* duties attach

## Paramount Communications Inc. v QVC Network Inc—1994—Delaware

**Paramount—Viacom—QVC. Past CEO of Paramount goes to QVC, has bad blood with new CEO, who is friends with Redstone of Viacom and attempts a Viacom merger with numerous defensive tactics designed to stop the QVC bid.**

* With the QVC hostile bid offering greater value to the Paramount stockholders, the BOD had considerable leverage with Viacom. Although the Amended Merger Agreement offered more consideration to the Paramount stockholders, the defensive measures designed to make competing bids more difficult were not removed
* Because of the intended sale of control, the transaction has economic consequences of considerable significance to the Paramount stockholders. Once control has shifted, stockholders will have no leverage in the future to demand another control premium. As such, stockholders are entitled to, and should receive, a control premium and/or protective devices of significant value for becoming a minority stockholder
* In particular, this Court has stressed the importance of being adequately informed in negotiating a sale of control. In this context, the role of outside, independent directors becomes particularly important because of the magnitude of a sale of control transaction and the possibility that management wont be impartial
* The paramount board (unintentionally) initiated an active bidding process by agreeing to sell control of the corporation to Viacom in circumstances where another potential acquirer was equally interested in bidding —the duty becomes to search for the best value reasonable available to stockholders
* In determining best value, a BOD is not required to totally ignore its view of the future value of a strategic alliance. While assessment of factors its complex, the goal is maximization—A court must decide whether the BOD made a decision within a range of reasonableness, not a perfect decision based on subsequent events
* The values of the revised QVC offer exceed the Viacom offer by over $1B at then-current values. This significant disparity of value cannot be justified on the basis of the BOD’s vision of future strategy, primarily because CoC would supplant the authority of the current BOD to implement their vision in any meaningful way—moreover, the uninformed process (BOD buried head in sand) has deprived their strategic vision of much credibility
* (FN20) Where a BOD has no reasonable basis upon which to judge the adequacy of a contemplated transaction, a no-shop restriction gives rise to the inference that the BOD seeks to forestall competing bids.

# Insider Trading and Rule 10b-5

## Insider Trading

## Rule 10b-5

* + In addition to the relationship between shareholders and managers, shareholders relate to each other as traders in the stock of the corporation
  + Securities transactions are regulated by a complex body of state and federal securities law—these regulations represent a distinct body of law apart from traditional corporate law; yet there is considerable overlap in practice
  + Rule 10b-5 is the catch-all fraud provision and governs disclosure in all purchases and sales of securtities, from face-to-face transactions in closely-held corporations to open-market purchases of shares in public corporations. It is also the backbone of federal proscription against insider trading
  + Two issues of considerable practice and theoretical importance under Rule 10b-5 are (1) the latitude of companies to deny rumors about important new developments which the company is not expressly required to disclose under the reporting provisions of the Act and (2) the evidence necessary to establish reliance (Both addressed in *Basic*)

## Rule 10b-5 and Securities Fraud (Elements)

* + Implied Right of Action (*Borak*)
    - The statutory object of “protection of investors” animated Congress’ intent to provide judicial relief where “necessary,” creating an implied private right of action
  + Standing to Sue (*Blue Chip Stamps*)
    - Only actual buyers and sellers are entitled to seek relief under the implied private right of action for violating §10(b) of the Act
    - The court held against extending a class to whose who rely on deceptive sales practices by taking no action (either to sell what they own or buy what they do not) -- π’s must identify with specificity the number of shares bought/sold
    - The root of these concerns was a π’s capacity to manufacture claims of hypothetical action, unconstrained by independent evidence (Policy)
    - BCS does not apply to manager statements of reasons or beliefs (as petitioners in *VA Bankshares, Inc.* argured); such statements are factual in two senses (See VA Bankshares)
  + Scienter
    - π must to show that Δ acted with the intent to deceive, or knew that a statement made was false --- or --- according to some courts, that Δ showed reckless disregard for the truth. In any case, mere negligence is not enough
  + Pleading Standard
    - See §21D(b)(1)-(2)
  + Materiality
    - To fulfill materiality, there must be a substantial likelihood that disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available
    - In the context of preliminary merger negotiations (or other times when material facts relate to a particular event), use the “Probability/Magnitude” approach
  + Reliance
    - Court ok’s the “Fraud-on-the-Market” rebuttable presumption. See *Basic*
* **Rule 10b-5 and Insider Trading**
  + Modern insider trading law began in the 1960s when federal courts first imposed a duty on company insiders to disclose material corporate information or refrain from trading on it. Although 10b-5 does not expressly bar insider trading, its sweeping language proved sufficiently flexible to reach insider trading
  + Efforts to define the duties of “outsiders” who trade on material non-public information—such as tippees, investment bankers, lawyers, financial printers, and journalist—have yielded atleast three theories as the basis for fraudulent conduct
  + The insider duty is said to arise from (1) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose and (2) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure (*Cady, Roberts*)
  + ***The Equal Access Theory***—provides that all traders owe a duty to the market to disclose or refrain from trading on non-public corporate information
    - Policy considerations aside, the basis for this duty is said to be the “inherent unfairnes” of exploiting an unerodable informational advantage: that is, confidential information from which others are legally excluded
    - The 2nd Cir followed this path starting with *Texas Gulf Sulphur* until SCOTUS ended its use in *Chiarella* -- the theory comes back as apart of Rule 14e-3
  + ***The Fiduciary Duty Theory***—provides that insider trading violates 10b-5 when there is a preexisting “relationship of trust and confidence” to support a duty to disclose between the insider and uninformed traders on the market
    - The effect is to relate the ban on insider trading within the common law paradigm of fraud in which a disclosure duty arises from a fiduciary relationship or equivalent tie
    - Seen through *Cady, Roberts*, the threshold relationship is not a source of information but the reverse—a preexisting tie that gives rise to a duty apart from the source of insiders’ information
  + ***The Misappropriation Theory***—holds that deceitful misappropriation of market-sensitive information is itself a fuard that may violate 10b-5 when occurring “in connection with” a securities transaction
    - developed lower courts responded to *Chiarella* and *Dirks* by developing the misappropriation theory to reach outsiders who trade illicitly on confidential information
    - Seen through Cady, Roberts, the relationship that triggers 10b-5 and the result unfairness both refer to deceitful betrayal of the insider’s source of information
* ***Rule 14e-3 and Tender Offers*** —imposes a duty to disclose or abstain from trading on any person who obtains inside information about a tender offer that originated with either the offeror or the target, provided he knows or has reason to know such information is nonpublic—reintroducing the equal access norm in the limited but important context of corporate takeovers (in response to *Chiarella/Dirks*)
  + ***Limits “Warehousing***”
  + ***Note “such securities” refers to the securities of the target, not necessarily securities of the offeror***
* ***Insider Trading and Securities Fraud Enforcement Act of 1988***—part of Congress’ response to Chiarella/Dirks and introduces harsh new enforcement provisions ranging from tougher criminal penalties, a “bounty system” for detecting insider trading and novel civil penalties for “controlling persons” who knowingly or recklessly fail to establish or enforce procedures for discouraging insider trading

## Basic Inc. v Levinson—1988—SCOTUS—Blackmum

**Basic begin discussions with Combustion, Inc concerning a possible merger in 09/1976—during 1977 and 1978, Basic made three public statements denying that it was engaged in merger negotiations. On Dec 18, 1978, Basic asked NYSE to suspend trading and announced the next day that it had been “approached” by another company endorsed the tender offer for all shares ----- π’s, class of Basic shareholders who sold after the first public statement and before suspension of trading, brought suit alleging injury by selling Basic shares at artificially depressed prices in a market effected by petitioners misleading statement arguing for application of the “fraud-on-the-market” theory**

* The court rejects Basic’s “agreement-in-principle” bright-line test for determining materiality of merger discussions for three reasons
  + Fear that investors may be overwhelmed by too much information assumes investors are nitwits, unable to appreciate the risky nature of merger discussions, eve when told. A fundamental purpose of the Acts was “to substitute a philosophy of full disclosure,” not paternalistic withholding of accurate information
  + Arguments that disclosure would be “premature” in a sense are more properly considered under a “duty to disclose” and not to the definition of materiality
  + As for bright line rules, any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding must necessarily be over-or-under inclusive
* Materiality will depend on a balancing of both the indicated probability the event will occur and the anticipated magnitude of the event in light of the totality of the company’s activity **(The probability/magnitude approach)**
  + In order to assess probability, one needs to consider indicia of interest in the transaction at the highest corporate levels. Factors include (without cataloging all possible factors): board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries
  + To assess magnitude, one needs to consider facts such as the size of the two corporate entities and the potential premiums over market value
* Since a merger where a firm is bought-out is the most important event that can occur in a small corporation’s life (its death), inside information with regard to the merger can become material at an earlier stage than would be the case with lesser transactions; although the mortality rate in such formative stages in doubtless high
* The modern securities markets differ from face-to-face transactions contemplated by early fraud cases; our understanding of 10b-5’s reliance requirement must encompass these differences -- arising out of fairness, public policy, judicial economy, presumptions are useful devices for allocating burdens of proof among parties
* Where materiality misleading statements have disseminated into an impersonal, well-developed market for securities, reliance on the integrity of the market price may be presumed for purpose of a 10b-5 action **(Fraud-on-the-market Theory)**
* Any showing that severs the link between the alleged misrepresentation and either the price paid or the decision to but/sell will be sufficient to rebut the presumption of reliance:
  + Δ may show that “market makers” were privy to the truth, thus the market price would not have been affected by their misrepresentations
  + If despite allegedly fraudulent statements, news of the merger credibly enters the market and dissipated the effects of the misstatements, those who traded would have no direct or indirect link with the fraud
  + Δ’s could also rebut as to π’s who would have traded without relying on the integrity of the market, possibly because of unrelated concerns, antitrust problems, political pressures, or other things
* (FN17) Silence, absent a duty to disclose, is not misleading under 10b-5. “No comment” statements are generally the functional equivalent of silence (absent a duty to disclose)

## SEC v Texas Gulf Sulphur Co.—1967—2nd Cir

**SEC brought a civil action against several of TGS’s officers and employees who either traded or tipped on the basis of advance knowledge of a major mineral discovery**

* Anyone in possession of material inside information must either disclose it to the investing public or, if he is disabled from disclosing for some reason, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed
* Whether facts are material with regard to a particular event depends on the probability/magnitude test (same as *Basic*, but before Basic was handed down)
* Although in view of unrelated events, one may find only nominal support for an inference of materiality, , the timing of purchases by those who knew the information—in some cases by some who had never owned stock—virtually compels the inference that the insiders where influenced by the drilling results

## Chiarella v United States—1980—SCOTUS—Powell

**Δ financial printer, who worked for an acquiring corporation, deduced the name of targeted corporations—without disclosing his knowledge, Δ purchased stock and sold shared immediately after the attempts were made public, realizing gains of slightly more than $30K over 14 months. The district jury instruction permitted conviction if the jury found “Δ willfully failed to inform sellers that he knew of a forthcoming takeover bid that would make their shares more valuable”**

* One who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to disclose—the duty to disclose arises when one party has information “that the other party is entitled to know because of a fiduciary duty or similar relation of trust and confidence between them”
* This guarantees that corporate insiders, who have an obligation to place the shareholder’s welfare before their own, will not benefit personally through fraudulent use of material non-public information
* The SEC/COA failed to identify a relationship between petitioner and the sellers that could give rise to a duty. Its decision rest solely upon a belief that the Acts have “created a system providing equal access to information.” This reasoning suffers from two defects: (1) Not every instance of financial unfairness constitutes fraud under §10(b) and (2) there is not duty to disclose in this case
* Δ had no prior dealings with the sellers of the target securities, he was no a fiduciary, and he was no a person in whom the sellers had placed their trust and confidence—He was in fact a complete stranger who dealt with the sellers only through impersonal market transaction -- therefore no duty could arise
* A duty to disclose does not arise from the mere possession of nonpublic market information -- there can be no fraud absent a duty to speak, which Δ did not have -- (FN14) A duty arises from the relationship between parties, not merely from one’s ability to acquire information based on market position

\*\*\*This conduct is likely reachable under the misappropriation theory. The charge was not submitted to the jury so the court declined to decide whether the theory had merit; although the dissent was ready to accept it\*\*\*

## Dirks v SEC—1983—SCOTUS—Powell

**Δ Dirks, officer of a NY broker-dealer firm, received information that Equity Funding of America had vastly overstated its assets as the result of fraudulent corporate practices and that various regulatory agencies were notified but failed to act. Upon his own investigation, Δ was able to corroborate the charges. Neither Δ nor his firm owned or traded any Equity Funding stock, but Dirks openly discussed the information with clients and investors, some of which sold their holdings (including five advisors who liquated more than $16M). Dirks spoke with the LA bureau chief of the WSJ, who declined to public the story for fear of libel. ----- ALJ found Dirks has aided and abetted 10b-5 violations holding “where tippees, regardless of motivation or occupation, come into material information they know to be confidential, they must either publically disclose or refrain from trading”**

* Not all breaches of fiduciary duty come within the ambit of 10b-5; there must be manipulation of deception—usually this fraud derives from using corporate information not intended for the personal benefit of anyone; thus, an insider is liable under 10b-5 only where he fails to disclose and realizes “secret profits”

**Dirks (cont.)**

* The SEC’s position is that a tippee “inherits” the *Cady, Roberts* obligation to shareholders when he receives information from an insider; this seems rooted in the idea that the antifraud provisions require equal information among all traders and this view has been rejected
* Not only are insiders forbidden from personally using undisclosed information for personal benefit, they also may not give such information for the same improper purpose of exploiting information for their personal gain -- transactions of those who knowingly participate with the fiduciary in such a breach are as forbidden
* The tippee’s obligation arises from his role as a participate after-the-fact of the insider’s breach of a fiduciary duty; therefore a tippee must assume *Cady, Roberts* duties not because they receive information, but because it was made available to them improperly
* All disclosures of confidential information are not inconsistent with duties owed to shareholders; whether disclosure is a breach depends on large part on the purpose of the disclosure. The test is whether the insider will personally benefit, directly or indirectly, from their disclosure. Absent some personal gain, there has been no breach of fiduciary duties and therefore no derivative tippee breach.
* *Thus, a tippee assumes a fiduciary duty only when (1) the insider has breached their fiduciary duty and (2) the tippee knows or should know that there has been a breach—it is necessary to find that the tippee knew the information was given to him in breach of a duty not to disclose the information*
* It is important to focus on policing insiders and their conduct rather than policing information per se and its possession-- this requires courts to focus initially on the objective criteria of whether there has been a breach; such as pecuniary gain or a reputational benefit that will translate into future earnings
* (FN10) *Cady,Roberts* duties differ from the common-law duty not to mismanage corporate assets, of which confidential information is one, but the Constitution requires more precise standards in the criminal context

*Note: The SEC seems to have no problem in finding a “benefit” in most cases. Some of these have been on the basis of a “close personal relationship” with the woman tippee and (*US v Reed*) on the basis of a father-son relationship where confidential business relationship where information was regularly disclosed (as limited by* Chestman*)*

## United States v Carpenter—1986—2nd Cir

**Concerned a scheme by WSJ journalist to buy/sell stocks that were scheduled to be the topic of the influential “Heard on the Street” column**

* It is clear that Δ breached a duty of confidentiality to his employer by misappropriating confidential pre-publication information that he learned in the course of his employment ***(Fraud-on-the-source Theory)***
* Application herein promotes the purposes and policies underlying §10(b) and rule 10b-5—repeated use of the word “any” evidences Congress’ intention to draft the Rule broadly
* Merely using information not available to others does not give rise to a violation of 10b-5; the critical issue is found in the distinction between “information” and “conduct”—whatever may be the legal significance of merely using one’s position to obtain information, here we address an employee’s use of that information in breach of a duty of confidentiality to an employer
* One may gin a competitive advantage by conduct which constitutes skill, foresight, industry, etc—but one may not gain such advantage by conduct which constitutes secreting, stealing, or otherwise misappropriating material nonpublic information in breach of an employer-imposed fiduciary duty of confidentiality
* (FN5) An agent is subject to a duty to the principle not to use/communicate information (confidentially given or acquired during the course of his agency) in competition with or to the injury of the principle, or on his own account, although such information does not relate to the transaction in which he is then employed (unless the information is a matter of general knowledge) [Restatement of Agency]

## United States v Chestman—1991—2nd Cir—en banc

**Closely-held Waldbaum Supermarket Chain agrees to tender a controlling bloc of shares. Ira (family patriarch/CEO & Chairman) tells > Shirley (sister of Ira/holder of shares to be tendered) tells > Susan (daughter of Susan) tells > Keith (husband of Susan) tells > Chestman (Keith’s stockbroker) buys shares—Keith agrees to cooperate with the SEC and Chestman is convicted of aiding and abetting Keith’s purchase and as a tippee with regard to the others under 10b-5**

* Dirks established (in dictum) an additional means by which outsiders become fiduciaries beyond tipper/tippee liability which clothes an outsider with ***temporary insider status*** based on access to confidential information solely for corporate purposes in the context of “a special relationship” in the conduct of the business of the enterprise—such as underwriters, accountants, lawyers, or consultants working for the company
* Because the Fraud-on-the-Source theory has the potential to broadly expand 10b-5 liability beyond the confined sphere of fiduciary/shareholder relations, a “similar relationship of trust and confidence” must be the functional equivalent of a fiduciary relationship
* We must note two actors that do not themselves create the necessary relationship as a matter of law: (1) a duty cannot be imposed unilaterally by entrusting a person with confidential information and (2) marriage does not, without more, create a fiduciary relationship.
  + “Mere kinship does not itself establish a confidential relation, rather the existence must be determined independently of a preexisting family relationship—therefore Reed must be limited to its essential holding: repeated disclosure of business secrets may substitute for a factual findings of dependence and influence and thereby sustain a finding of such a relationship
* A fiduciary relationship involves discretionary authority and dependency: One depends on another to serve his interest. In this process, one may entrust the fiduciary with custody over property; because the fiduciary obtains access to serve the relationship, he is duty-bound to not misappropriate the property personal gain
* The principle characteristics of a fiduciary are dependency (or reliance) and influence—put differently, “At the heart of the fiduciary relationship lies reliance and de facto control and dominance”
* ***Absent a pre-existing fiduciary relation or an express agreement of confidentiality, the coda “don’t tell” does not impose such a relationship of “trust and confidence”*** —There is no evidence that Keith’s relationship to the family or Susan was characterized by influence or reliance.
* Susan’s disclosure was unprompted, Keith did not induce her to convey the info through misrepresentation of otherwise. Likewise, the disclosure to Keith served no purpose, business or otherwise
* We recognize that equity has occasionally established a less rigorous threshold for a fiduciary-like relationship in order to right civil-wrongs; useful as such a definition may be in civil context, it has no place in criminal law

*Note: Δ’s convictions under Rule 14e-3 were affirmed*

## United States v O’Hagan—1997—SCOTUS—Ginsburg

**O’Hagan was a partner in a law firm representing a company as local counsel regarding a potential tender offer for common stock of Pillsbury Corp. Although O’Hagan did no work on the deal, O’Hagan purchased stock and call options resulting in profit of more than $4.3M post announcement of the offer**

* [SCOTUS recognizes and accepts the misappropriation theory] accepting liability premised on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information
* Because the deception essential to this theory involves the source of information, if the fiduciary discloses his intention to trade on the nonpublic information, there is no “deceptive device” (§10(b)) and thus no 10b-5 violation although one may be liable under state law for a breach of a duty of loyalty
* ***SCOTUS also holds SEC did not overstep its authority in Rule 14e-3; they do not hold the authority in §14(e) is broader than §10(b); but I think it is broader because it is explicit and does not contain “as necessary” but instead “means reasonably designed to prevent”***