Fall 2012

Jennifer Arlen – Corporations – Attack Outline

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **CSH & Board Actions/Duties During Transactions** | | | | |
| Action | **Selling Control of Firm** | **Merger** | | **Self-Dealing** |
| **CSH** | CSH has *Perlman* duties (if looter), else entitles to control premium (*Zetlin*)  **Page 48** | Friendly Self-Merger | Tender Offer – Short-form Merger (Hostile) | CSH gets something on *pro rata* basis that minority does not get  **Page 32** |
| If CSH completing merger with sub 🡪 *Weinberger/Kahn*  **Page 50** | If CSH is doing tender offer 🡪 *Pure* duties  **Page 54** |
| **No CSH** | Board selling control/break-up of firm, no CSH 🡪 *Revlon*  **Page 58** | No SH Threat | SH Threat | Director is dominated by interested outsider, owes FD to outsider in X  **Page 28** |
| No SH threat, board actions recommending/rejecting merger is under BJR  **Page 20** | Board response to hostile offer/threat to firm 🡪 *Unocal*  **Page 57** |

**For State/Federal SH Voting, Inspection rights, and Reimbursement Checklist – Page 43**

NOTE: If there is CSH-X, but non-dominated board 🡪 Analyze CSH actions, then analyze board for violations of FD 🡪 BJR?

When directors are seeking SH votes like proxies 🡪 duty to disclose material non-public information

No duty during ordinary business

Analysis

Board made decision, Π claims breach of duty of care

Board not adequately informed

Π must rebut BJR

Assume no 102(b)(7)

If Π succeeds, and it is an affirmative decision of the board

Fairness

If not fair you might get damages or injunction

BE CAREFUL – Must start with direct/derivative, demand required? Etc.

Courts can award rescissory damages sometimes 🡪 puts the firm back where it would have been had the deal never happened 🡪 can be higher damages because – what if doing this deal right after doing this crappy one, you had an offer of some other deal

HOW CERTAIN DOES THIS LOST OPPORTUNITY HAVE TO BE?

How does this fit in with Unocal/Revlon?

Unocal

Need threat

Board must act with BJs to ascertain threat

Smith v. van gorkom tells us what is reasonable investigation

For Revlon you’ve got the *Del Monte* kind of problems

Spot the issue – acquiring bid offers to bring on some people into the new firm

Might not name the particular people

Tries to prevent conflict

Point is that all the Disney, Smith, etc. still is in effect when you’re doing Revlon

1. **AGENCY**
   1. **Agents and Principals**
      1. RSA §1 – Agency is the relationship resulting from the *manifestation of consent* by P to A that the agent shall act on P’s behalf and be *subject to P’s right of control* and A manifests assent
      2. **Forms of Agency**
         1. Actual Authority – (RTA §2.01) – Agent *reasonably* believes, in accordance with *P’s manifestations* to A, that P wishes A to act
            1. Express – P&A agree explicitly that A has power to act for P and is subject to P’s right of control – NOTE: Turns on A’s assent, not T (*Cargill*)
            2. **ANALYSIS**: Does P have *incentive* to control A?

Express K? Actions of P/A indicating P/A relationship? Incentives?

Does P get all of the financial gain from A’s operation? (*Cargill*)

* + - 1. Implied Authority – A person in A’s position would reasonably infer that P was delegating authority to A to act (*Mill St. Church*) (circumstantial actual authority)
         1. Includes powers practically necessary to carry out duties
         2. Factors (*Mill St. Church*)

Past practice

Standard in industry

Genuine belief of A that A had authority based on P’s manifestation

* + - 1. Apparent Authority – (RTA §2.03) – T *reasonably* believes A has authority to act on P’s behalf and that belief *is traceable to P’s manifestations* (*370 Leasing*)
         1. Reasonable belief by T and within the scope of apparent authority (*Lind*)
         2. If A’s authority is atypical of A’s position, P must inform (*Lind*)
         3. Some jurisdiction require detrimental reliance (CA/DE)
    1. **Ratification**
       1. Elements (RTA §4.01)
          1. A purports to act for P
          2. A did not have authority to act for P
          3. P, knowing material facts either

Expressly affirms A’s conduct

Engages in conduct only justifiable if P’s intention was to affirm

* + - 1. Requirements
         1. P must exist at the time of the K-formation (RTA §4.04)
         2. T did not already withdraw claim before ratification 🡪 both parties bound
         3. Some jurisdictions require reliance (CA/DE)
      2. A no longer liable to P
    1. **Estoppel (Apparent Authority)**
       1. RTA §2.05 – P liable to T for acts of A if
          1. T has changed her position and
          2. P intentionally or carelessly caused such belief or
          3. Knowing T has such belief, does not take steps to notify T
    2. **Liability Between A/P and T**
       1. Disclosed Principal – RTA §6.01 – A makes K for disclosed P
          1. P liable for all K executed by A for P *within the scope of authority*
          2. A not liable to P for K unless A and T agree otherwise
       2. Undisclosed Principal – RTA §6.03 – A makes K for undisclosed P
          1. P liable unless otherwise in K
          2. A is liable on the K
       3. Partially Disclosed Principal – RTA §6.02 – A makes a K for unidentified P
          1. P liable to on the K
          2. A is liable on the K unless A/T agree otherwise

A’s duty to ID P to avoid K-liability (*Atlantic Salmon*)

Actual knowledge, not enough that T *could* ID P (*Atlantic Salmon*)

* + - 1. Liability
         1. P liable to T

Actual/apparent/ratified

* + - * 1. A liable to T

No authority/undisclosed/unidentified

* + - * 1. P indemnifies A

Actual/ratified

* + - * 1. A indemnifies P

No authority/apparent

* + 1. **Buyer/Supplier vs. P/A Relationships**
       1. RSA § 14K – One who contracts to buy from T and convey to another is an A only if it is agreed that he is to act *primarily for the benefit of the other and not himself*
          1. Factors that someone is a Supplier rather than an Agent

Fixed price for the property irrespective of the price paid by S

S acts in his own name and receives the title before transferring

S has an independent business buying and selling similar property

* + 1. **Debtor/Creditor**
       1. RSA § 14O – Lender exercising veto power over sales is not a P, but a creditor who assumes control of his debtor’s business is liable for debts in connection with the business
    2. **Cases**
       1. *Gay Jenson Farms Co. v. Cargill* (Implied actual authority)
          1. Buyer/supplier relationship
          2. All of Warren’s business was financed by Cargill – power to discontinue anytime
          3. Warren sold almost all of its grain to Cargill – Right of refusal on any grain
          4. Cargill had direct monitoring of Warren’s activities
          5. Cargill made management suggestions to Warren
          6. Holding: Cargill is liable on all grain Ks (not liable on K they have no interest in) – Cargill is liable to all farmers because it is the agent’s assent, not 3rd party that creates agency relationship
       2. *Atlantic Salmon v. Curran* (Liability of A for partially disclosed P)
          1. Δ bought salmon from Π as A for BIS, certificate filed that BIS is A for MD
          2. Δ defaults
          3. Holding: Δ is liable – Either BIS is disclosed and liable (Δ is sole proprietor), or BIS is A for undisclosed MD and Δ is liable with co-owner of MD
          4. Rule – it is the obligation of A to disclose P if he wants to not be liable
       3. *Mill St. Church v. Hogan* (Implied actual authority)
          1. Church hires H to paint, H indicated 2-man job, church suggests P indicating he is hard to contact
          2. H hires S who he has hired before, S is injured on day-1
          3. Holding: H had authority to hire S based on past practice and failure of church to manifest a change in practice for this job
       4. *Lind v. Schenley Industries* (Apparent authority)
          1. L promoted, told by VP that K is his boss and K will set salary
          2. K promises 1% commission on sales of those below him
          3. Testimony that only Pres. can set salary, not VP or K
          4. Holding: VP had apparent authority because VP usually would have ability to set salaries 🡪 VP delegated to K 🡪 P is liable
       5. *370 Leading Corp. v. Ampex Corp.* (Apparent authority)
          1. Ampex salesman approaches 370 about 370 buying equipment
          2. Meeting: 370 must pass credit check, only manager can finalize sale
          3. 370 K with EDS to transfer equipment, 370 signs sale-K (2 signature lines, Ampex never signs)
          4. Salesman sends letter confirming delivery dates
          5. Holding: Δ allowed all communication to flow through salesman, salesman had apparent authority to finish deal which was communicated via delivery date
  1. **Tort Liability**
     1. **Analysis**
        1. Is this a master-servant relationship? 🡪 Does P have the right to control the *physical conduct* of A’s job and A has agreed? (RSA §220(1)) (Otherwise IC)

|  |  |  |
| --- | --- | --- |
|  | *Humble Oil* | *Sunoco* |
| Express indicia of control (K) | Reports required | No reports required |
| Indirect indicia (capacity to control) | At will arrangement | Termination required notice |
| Incentives to control (residual risk) | Rent tied to sales, retained title of goods | Rent tied but capped, A had title to goods |

* + - * 1. **ASK**: Who bears residual risk of business failure or poor management?
        2. **ASK**: Who has the expertise?
        3. Does P have control over offending instrumentality? (*Murphy*)
        4. Factors (RSA §220(2))

Extent of P’s control over work details

Is A engaged in a distinct occupation or business?

Trade practice of supervision in the locality

Skill required of A

Whether P or A supplies the instrumentalities, tools, and place of work

Term of the relationship

Method of payment: by time or by job – flat rate or portion of profit

Whether the work is part of P’s normal business

Beliefs of the parties

Whether P is in business for herself

Amount of business risk borne by each party

* + - 1. Is this a tort that master is liable for? 🡪 Master is liable for all torts done *in the scope of employment* even if master is not negligent (*VanDemark v. McDonald’s*)
         1. RSA § 228 – Conduct of servant is within scope if (a) it is of the kind he is employed to perform, (b) it occurs within authorized time and space limits, (c) it is actuated by purpose to serve the master, and (d) if force is intentionally used, it is not unexpectable by the master
         2. RSA § 219 – M is liable *outside scope* if: M intended conduct, was negligent, violated non-delegable duty, or S purported to act for M and there was reliance upon apparent authority
    1. **Policy**
       1. Insolvency problem – Corporation should invest in deterring/preventing wrongs
       2. Puts liability on the person with greatest ability to avoid harm *ex ante*
       3. Balance liability or P will simply hire thinly capitalized ICs 🡪 no liability
       4. Franchisor/Franchisee
          1. Franchisor wants sufficient control to guarantee brand protection
          2. Immunity from tort doesn’t encourage cost cutting – in flat fee scenario, franchisor incentive is to maximize quality
       5. Optimize: Direct control of As, Financial incentives of all parties, Screening of As
    2. **Cases**
       1. *Murphy v. Holiday Inns Inc.*
          1. Franchise includes controls on architecture, ability to sell stock in business, training of employees, reports…
          2. Π slips and falls on premises
          3. Analysis

Contract – Focus is on standardizing product/brand protection

No day-to-day control

Incentives – Flat fee, franchisee bears all residual risk

Instrumentality – Δ had no control over offending instrumentality

* + - 1. *Humble Oil & Refining v. Martin* (M/S-yes)
         1. Customer drops car, doesn’t set brake, hits Π across the street
         2. Control:

Rent proportional to sales, Humble pays 75% of utilities

Right of entry, required reports…

Humble retains title to products til sold 🡪 residual risk

* + - * 1. It does not matter if P/A *call* it a franchise, what matters is control
        2. Possible defense: Outside the scope of the relationship 🡪 Control pumps and store, but not service (*See VanDemark v. McDonald’s*)
      1. *Hoover v. Sun Oil Co. (Sunoco)* (M/S-no)
         1. Station was leased, employee drops cigarette, fire injures Π
         2. Control:

Rent tied to sales subject to min/max

Right of entry

Hoover had title of goods, could sell competing products, bears expenses

Some adjustment of prices reflecting market risk, but A bears residual risk

* + - * 1. Holding: IC not M/S so no V/L
  1. **Fiduciary Duties**
     1. **Contractual Duties (RTA § 8.07)**
        1. A has duty to act in accordance with express/implied K-terms
     2. **Duty of Care (RTA § 8.08)**
        1. A has duty to P to act with care, competence and diligence normally exercised by As in similar circumstances
           1. Special skills or knowledge of A are taken into account
           2. Take-home – No shirking, if hired to monitor/investigate, that is what you do
           3. Can K out of duty of care generally (not duty of loyalty)
     3. **Duty of Loyalty (RSA § 387)**
        1. *Unless otherwise agreed*, A has a duty to P to act only for the benefit of P in all matters connected with the agency
        2. Specific Duties of Loyalty (RSA/RTA)
           1. Account for profit arising out of employment (§388/§8.02)
           2. Not to act as adverse party (be on both sides of transaction) (§§389-92/§8.03)
           3. Not to compete in subject matter of agency (§393/§8.04)

Agent may take action, not otherwise wrongful, to prepare for competition following termination of relationship (8.04)

* + - * 1. Not to act with conflicting interests (broader than adverse party) (§394)
        2. Not to use/disclose confidential info (§395-6/§8.05(2))
        3. Not to use P’s property for personal benefit (§8.05(1))
        4. Duty not to deal with P’s property to appear as A’s and to account to P for any money received on P’s account (§404/§8.12)
        5. Duty to provide P with facts that A knows when A knows P would want to know them and can be provided without violating a superior duty owed by A to someone else (§8.11)
        6. Not to usurp a business opportunity belonging to P
      1. Consent/Waiver (RTA § 8.06)
         1. No liability to P as long as P consents AND

A acts in good faith

A discloses all material facts that would affect P’s judgment

Consent concerns *a specific act/DoL* or transactions that could be expected to occur in ordinary course of agency

* + 1. **Policy**
       1. Primary agency cost is *moral hazard*
          1. P must rely on A, A has incentive to shirk because A has all the information
          2. Hold up – Over time, A’s skills are specific to P’s business, P can hold-up A
          3. Private solutions are expensive, information costs are high – hard to K
       2. Fiduciary duties = legal default rules – assumption is complete K is hard to write
    2. **Cases**
       1. *Reading v. Regem* (Duty not to use P’s property/Duty to account for profit)
          1. A is sergeant, got $ from T for riding in trucks to avoid civilian checkpoints
          2. Holding: A must account to P for profits arising from agency and has duty not to use P’s property for A/T’s purpose without P’s consent
          3. Remedy: $ is disgorged to P because job was cause of A obtaining $
       2. *Rash v. J.V. Intermediate Ltd.* (Duty not to be adverse, duty not to compete)
          1. Rash runs Tulsa, gets permission for side business
          2. Runs scaffolding business that competes with JVIL scaffolding business
          3. Analysis

Duty not to act as adverse – Even if he gives JVIL a better price

Defense: He got a release – BUT release must be specific, got permission for a business not a specific K

Duty not to compete in subject matter of P’s business

Even without self-dealing, JVIL and Rash owned scaffolding business

KEY: JVIL-Tulsa is a division, not a subsidiary

* + - 1. *Meinhard v. Salmon* (Duty to not usurp an opportunity belonging to P)
         1. G leases to S who takes on M in joint venture, S ran 100% of business
         2. Son of G enters lease with S to start at expiration of current lease
         3. M sues
         4. Analysis

Define scope and length of joint venture

Ask: Did S take something that was rightfully property of the JV?

Did opportunity come to S in agency capacity or independently?

Did opportunity fall within M’s area of business

Did S disclose opportunity to M & get rejected?

* + - * 1. Holding: S usurped the ability to bid for the new venture 🡪 M can buy in

1. **CORPORATE FORMATION**
   1. **Corporate Form**
      1. Shareholders 🡪 Directors 🡪 Officers 🡪 Employees
         1. SH own the corporation and vote on important corporate issues
            1. Sale of substantially all corporate assets (DGCL § 271)
            2. Merger (§ 251)
            3. Amendment to the cert (§ 242)
         2. Directors meet periodically, make policy decisions, and elect officers
         3. Officers run day-to-day operations of the firm – Inside directors are also officers
2. **VALUATION**
   1. **Time Value of Money**
      1. Future Value of Money – 
         1. Borrow $10m and repay $11.3m in 1y 🡪 11.3 = 10(1+r)1 🡪 11.3=1+r, r=0.13
      2. Present Value of Money – 
      3. Expected Return –  🡪 PV of ER: 
   2. **Risk Preference**
      1. **Risk** – Amount that actual return can deviate from expected return
         1. Risk Neutral – Concerned only with expected return, and not the variance
            1. Indifferent to a “fair bet” 🡪 corporate ideal
         2. Risk Averse – Equivalent losses count more than gains
            1. Would not take a “fair bet” – Issue of declining marginal utility of wealth
         3. Risk Premium – Amount investor requires above ER in exchange for risk
            1. Difference between risk adjusted and risk free rate
      2. **Variance**: If 50% chance of $60k and 50% chance of $150k
         1. ER = 0.5(60k)+0.5(150k) = $105k 🡪 variance is $45k – 150 or 60 minus 105
      3. **Analysis**
         1. Consider investment in year 0 that may earn uncertain return in year t
            1. Calculate ER in year t
            2. Discount to PV using the interest rate that reflects rate investor requires

Note diversification – If diversified there is no risk premium

Note risk neutral investor

* + - * 1. Subtract investment cost
      1. Compare to certainty equivalent for each year 🡪 ER
         1. Comparison will indicate whether or not to invest
    1. **Diversification**
       1. Makes people more risk neutral – if risks offset, variance is smaller
       2. It isn’t possible to diversify against losses that affect all stocks 🡪 downturn
    2. **Efficient Market Hypothesis** – Stock prices = unbiased estimate of future price based on public info – no trader with public info should be able to beat the market
    3. **Example**
       1. Bank has 2 hotels who each want $5mil; each competing for K to build hotel
          1. Issue: If hotel 1 or 2 gets K, it repays $10.7mil; if it doesn’t, repays $0 at 1y
          2. Risk free rate = 6%, risk premium = 2% 🡪 risky rate = 8%
       2. Analysis – Loan to 1 hotel
          1. Nominal rate = (10.7 – 5)/5 = 14%
          2. ER = 0.5(10.7mil)+0.5(0) = $5.35mil 🡪 Expected rate = (5.35-5)/5 = 7%
          3. PV = 5.35mil/(1+0.8) = $4.95mil
          4. NPV = $4.95mil - $5mil (loan) = -$50k
          5. No deal!
       3. Analysis – Loan to both hotels – Diversified risk
          1. ER = 0.5(10.7mil) + 0.5(10.7mil) = $10.7mil
          2. PV = 10.7mil/(1+0.6) (note risk free) = $10.94mil
          3. $10.94mil - $10mil = $940k
          4. Deal!

1. **CORPORATE SECURITIES AND CAPITALIZATION**
   1. Debt (trade debt, bank debt, bonds, zero coupon [loan paid in full @ termination]) paid before Equity (Common/preferred stock)
      1. Equity – Common gets control rights, preferred gets claim on residual earnings
      2. Debt – Secured recourse (collect if security < loan), secured non-recourse (only get up to security value), unsecured
   2. Advantages of Debt – No fid. Duties, tax break, no share in control, leverage
   3. Disadvantage of debt – Fixed claim on failure, or lower return
   4. Analysis – Leverage problem
      1. $100k investment which will earn 10% 🡪 $10k
         1. You have $50k, get $50k from partner, or bank @ 6% (0.6\*$50k = $3k)
         2. Partner: Split profit 🡪 $5k (10%), Bank: Get $10k, pay off $3k, $7k profit (14%)
      2. Alice needs $100k; 50% get $16k, 50% get $8k
         1. ER = 0.5(16k)+0.5(8k) = $12k (12% of $100k if all equity)
         2. Leverage that shit! (50% equity, 50% debt @ 10%)
            1. ER = 0.5(16k – 5k) + 0.5 (8k – 5k) = $7k 🡪 14% of $50k
         3. So ERLeverage = 14%; EREquity = 12%
         4. BUT VarianceLeverage = 22% (11k/50k) or 6% (3k/50k)
         5. SO! Higher ER but higher Variance
            1. When return on debt > interest payment, equity keeps upside
            2. When return on debt < interest payment, equity bears downside risk
2. **LIMITED LIABILITY**
   1. **Analysis**
      1. Alice has $10k: $4k equity, $6k debt at 5%; choosing between P1 and P2 (both 1y)
         1. 2 Possible Projects
            1. **P1**: 50% $12k, 50% $9k, ER = $9k; **P2**: 50% $18k, 50% $0, ER = $9k
         2. **NPV if Partnership** – Take each state of the world, subtract debt, calc. ER, get PV for each, get NPV (what is here skips the PV step 🡪 ER/(1+r)t)
            1. **P1**: 0.5(12-6.3) + 0.5(9-6.3) = $4.2 - $4 (equity) = $200
            2. **P2**: 0.5(18-6.3) + 0.5(0-6.3) = $2.7 - $4 (equity) = -$1.3
         3. **NPV if Corporation** – Take each state of the world, subtract debt, if negative goes to zero, calc. ER, get PV for each, get NPV (what is here skips the PV step 🡪 ER/(1+r)t)
            1. **P1**: 0.5(12-6.3) + 0.5(9-6.3) = $4.2k - $4k (equity) = $200
            2. **P2**: 0.5(18-6.3) + 0.5(0) = $5.85 - $4 (equity) = $1.85k
      2. NOTE: Downside risk of liquidity failure is on everyone, but upside only to equity
         1. In LL, calculation can’t go negative, equity only loses investment, but debt loses investment plus whatever interest they were supposed to make. On upside, equity gets return, while debt makes its interest.
   2. This is the origin of the **Agency Costs of Debt**
      1. Incentive to take negative net present value projects
      2. Costs of K and laws designed to limit agency costs
      3. Costs to debt of monitoring equity resulting in higher interest rates
      4. *Hansmann-Kraakman Theory of Tort Liability*: Pro rata unlimited SH liability for torts is a counter argument 🡪 agency costs of LL in tort are extremely high, and tort creditors have no ability to monitor or diversify risk
   3. **Benefits of Limited Liability**
      1. Centralized, delegated management 🡪 SHs don’t have to monitor
      2. Promotes transferability of shares, allows SHs to diversify investments
   4. **Creditor Protection**
      1. Contracts – Debt covenants, secured debt
      2. Laws – Keep the firm from acting contrary to creditors
         1. Min. capitalization, distribution constraints, capital maintenance requirements
         2. Fiduciary Duties – Director liability 🡪 duty is to equity unless firm is insolvent
      3. Laws – Maintaining the pool of assets
         1. **Fraudulent Conveyance** – UFTA § 4 – Transfer made (1) with intent to defraud, (2) without receiving reasonably equivalent value in exchange and debtor (i) was engaged in a transaction for which remaining assets were unreasonably small or (ii) intended to incur debt beyond his ability to pay
         2. **Equitable Subordination** – Unravels a SH loan to corporation to get priority over other equity
         3. **Piercing the Corporate Veil**
3. **PIERCING THE CORPORATE VEIL**
   1. **Step 0**: Prerequisites
      1. Must be a creditor *of the corporation*; NOT of a director/officer
      2. Must have a judgment against corporation and have tried to collect judgment
   2. **Step 1**: Presumption of Limited Liability
      1. **Limited Liability** – SH is not liable for debts of corp. *even if foreseeable* that corp. can’t pay *and* SH is – Sole SH/Director/Officer of firm or SH is parent corp.
      2. **Publicly Held Firms** – No court has pierced publicly held firm with dispersed SHs
   3. **Step 2**: Theories of piercing the veil
      1. **Agency/Respondeat Superior** – Corporation as agent to SH as principal
         1. Generally
            1. Control – Need M/S type control for tort, P/A control for K-default
            2. On behalf of principal – SH gains, not through dividends (*Walkovsky*)

*Zaist* – No 🡪 Free work for other subsidiary

*Walkovsky* – Yes 🡪 Rational to undercapitalize a cab company

Promote Δ’s interest over the firm 🡪 misappropriation, shady dealing, business decision not in the best interest of the corp. (*Zaist*)

“Hypothetical CEO” – A hypothetical CEO, acting in firm’s best interest would NEVER make the same decision (*Zaist* – WRT EH K’s)

* + - 1. Instrumentality Rule (*Walkovsky*/*Zaist*) – **Test**
         1. Control of corp. by Δ so complete that corp. has no separate mind
         2. Control is used to commit a fraud, wrong, or other violation of Π’s rights

Firm is used to directly benefit Δ personally, not just maximize firm value

* + - * 1. Control and breach were proximate cause of Π’s injury
    1. **Alter Ego** – SHs and corporation don’t have separate legal existence (*Sea Land*)
       1. Unity of interest and ownership, AND (*Sea Land*)
          1. Lack of corporate formalities

Operation of the firm may be fine, but co-mingling of accounts, etc.

Most common for getting across multiple firms in an enterprise

* + - * 1. Comingling of funds and assets
        2. Severe under-capitalization
        3. Treating corporate assets as one’s own
      1. Refusing to pierce would either (*Sea Land II*)
         1. Sanction a fraud or
         2. Promote injustice

Look for active or intentional misconduct by Δ (*Sea Land*)

“Unjust enrichment” theory (*Sea Land II*)

* 1. **Other Types of Piercing** – Pierce in direction of unjust enrichment
     1. **Enterprise Liability** – Horizontal – Pierce to other corps. of sole SH when firms are not separable, or one firm acts for sole benefit of the other 🡪 No access to SH
     2. **Reverse Piercing** – Pierce through SH to SH other corps. 🡪 now creditor of that corp. rather than equity holder
  2. **Cases**
     1. *Walkovsky v. Carlton*
        1. C owns 10 cab co’s, each with 2 cabs, no $, minimum insurance
        2. NOTE: Companies comingled financing, supplies, repairs, employees, etc.
        3. Rule – Piercing goes in direction of abuse, piercing here would get other companies, not the sole SH (Under Alter Ego)
        4. Holding: No piercing
           1. Think hypothetical CEO – Undercapitalizing by paying out dividends, maximizes the value of the firm
           2. There is unity of interest between Δ and the firm here
        5. Dissent: Would hold that corps. that are intentionally thinly capitalized in order to avoid tort liability should be pierced 🡪 BUT The companies complied with law, had minimum insurance required by Congress
     2. *Zaist v. Olson* (Instrumentality, P/A theory)
        1. O owns EH and NLSC, EH K w/ NLSC to build shopping center, NLSC gets loan
        2. EH sub-K to Π to do leveling work on the land
        3. Key facts
           1. O owns the land
           2. NLSC will own and run the shopping center
           3. EH is underbidding on a K which *will* go over budget
           4. Land was shuffled between corps. to secure the loan
        4. Holding: Facts indicate Π was unaware and indifferent to the ID of the property owner. EH had no actual interest in the transactions and EH can’t pay because O shuffled funds out of the company 🡪 Pierce the veil
     3. *Sea Land v. Pepper Source* – Alter Ego
        1. PS is one of several firms of M, PS defaults on K to Π
        2. Key facts: M is sole SH, PS never held SH meetings, no articles of incorporation, no by-laws, M regularly borrows from companies to pay personal expenses
        3. Remand (*Sea Land II*)
           1. Tax fraud by treating personal expenses as business expenses

NOTE! This results in *more* capital for the firm *not less*!!

* + - * 1. Misrepresentation when assured Π that PS would pay knowing PS wouldn’t have the money
      1. Reverse pierce to Tie-Net – Co-owned corp. of M and someone else
         1. Need to reverse pierce because if TN is undercapitalized, owning M’s stock does nothing 🡪 Makes Π a creditor of TN rather than equity owner
         2. Counter-argument – As co-owned corp., M would be moving $ *away* from TN, not towards it

1. **CENTRALIZED MANAGEMENT – DGCL**

|  |  |  |
| --- | --- | --- |
|  | General Partnership | Corporation |
| Limited Liability | No (Partnership agreement can have indemnity provisions) | Yes (Creditors may require personal guarantee) |
| Free Transferability | No (Default) | Yes (Default) |
| Continuity | At Will (Default) | Indefinite (Default) |
| Fiduciary Duties | Care/Loyalty | Care/Loyalty |
| Management | Decentralized (Default) | Centralized (Default) |
| Flexibility | Excellent | Awkward |
| Formation | Informal | Formalities Required |
| Tax Treatment | Pass-through | Double on earnings; Corporate on losses |

* 1. **Corporate Formation**
     1. **Internal Affairs Rule** – Internal corp. issues governed by law in state of Inc.
     2. **Step 0**: Promoter – Business concept formed, K-signed have personal liability, no LL
     3. **Step 1**: Certificate of incorporation (DGCL §§ 101-103)
        1. §101 – Incorporators; how corp. formed; purposes – formed for any legal purpose
        2. §102 – Contents of cert.: (a) shall have (1) name, (2) address, (3) purpose (“for any lawful purpose” ok), (4) number/classes of shares, (5) duration (perpetual), (6) names/addresses of incorporators
        3. §103 – Filing w/ SEC to make corp. come alive
     4. **Step 2**: Draft By-laws (§109 see below)
     5. **Step 3**: Organizational meeting of incorporators
        1. §108 – Adopt by-laws, elect directors, open bank account, issue stock, etc.
  2. **Management Power vs. Shareholder Power (The Patterson Problem**)

|  |  |
| --- | --- |
| **Management Power** | |
| Directors | Shareholders |
| **§141(a)** – Business affairs *shall* be managed by the board unless otherwise in cert.  **§141(b)**   * One or more people provided in by-law or cert. * Majority constitutes quorum * Can provide that board approval requires > majority   *Directors are agents of firm not SHs* | *Manson v. Curtis* – SHs can’t act in relation to ordinary business of the corp., nor can they control the directors in the exercise of the judgment vested in them by virtue of their office   * Voided agreement of 2 SHs that Π would be general manager and any president elected is only a figure head for 1y |

* + 1. **Take homes**
       1. SHs CANNOT adopt a by-law granting someone unilateral right to make all firm management decisions regardless of position
       2. SHs CANNOT agree on matters outside their authority
          1. CANNOT elect officers unless provided in by-laws

|  |  |
| --- | --- |
| **Delegation** | |
| Directors | SHs |
| **§141(c)** – Board can delegate to a committee (not for things requiring SH vote)   * Members must be on the board (See SLCs below) – CANNOT delegate merger/cert. amendment   **§141(e)** – Safe harbor for reliance on advice of 3rd party experts/reports of officers IF   1. Board relies in good faith 2. Reasonable belief in the professional/expert competence of the person giving the report 3. And expert is chosen with reasonable care by or on behalf of the corp. | NO! |

* + 1. **Take homes** – Committee of disinterested board can make decisions others can’t

|  |  |
| --- | --- |
| **By-Laws** | |
| By-Laws CAN Contain | By-Laws CANNOT Contain |
| **§109(a)** – May be adopted, amended or repealed by initial directors in cert. Or by board before stock is sold. **After stock is sold, power is in SHs**. Cert. can confer power to the directors, **even if conferred,** **SHs can still also adopt, amend, repeal by-laws**  **§109(b)** – By-laws may contain anything not inconsistent with law or the cert.  NOTE: Cert. can contain anything that can go in by-laws | Classified board, board power to amend by-laws, elimination of SH power to act by written consent (§228), classes of stock, § 102(b)(7) provision  **§102(b)(7)** – Provision eliminating or limiting personal *liability* of a director to corp./SHs for breach of fid. duty. CANNOT eliminate (i) breach of loyalty, (ii) acts in bad faith, (iii) under § 174, (iv) transactions director gains personally |

* + 1. **Take home** – Supermajority requirement in by-law to change by-law must also require supermajority to change *this* (the enabling) by-law 🡪 otherwise §228
       1. Board cannot change supermajority BL created by SHs

|  |  |
| --- | --- |
| **Amendment to the Certificate** | |
| Directors | Shareholders |
| **§242** – Power to propose amendment | **§242(b)** – Power to approve amendment adopted by the board at special/annual meeting by majority of outstanding shares |

* + 1. **Take home** – SH only have power to veto not to propose

|  |  |
| --- | --- |
| **Mergers & Sale of Substantially All Firm Assets** | |
| Directors | Shareholders |
| **§251** – Power to propose merger   * Can contain provision to back out even after SH approval   **§271** – Board resolution for sale of assets | **§251(c)** – SHs approve the merger with majority of outstanding shares  **§271** – SH approve board resolution for sale of assets |

* + 1. **Take home** – Controlling SH CANNOT vote to have firm purchase a company
    2. **Meetings/Consent**
       1. **§211** – Date of annual meeting in cert. and must be held. (a) Special meeting held @ time/place in cert., BL or at time determined by board. (d) Special meeting can be called by board or other authorized in BL/Cert. (Refusal of SH request must articular pro-firm reason)
       2. Must have a quorum for valid annual meeting (present or by proxy)
          1. **§216** – Quorum is majority of outstanding shares (unless otherwise in BL/Cert. but > 1/3). 🡪 BL by SH specifying votes needed for directors can’t be amended/repealed by board
       3. Amend by-laws/cert. requires annual meeting or §228 (or vested in board in cert.)
          1. **§228** – Consent of SH in lieu of meeting. (a) Any action that can be taken @ SH meeting can be done in signed writing if you have sufficient votes as if all outstanding shares showed to meeting (Can be eliminated in cert.)
       4. *Airgas Inc. v. Air Products and Chemicals Inc.*
          1. AP takeover of AG (staggered board, see below), AP elects 3 members then accelerates next annual meeting (4mo later) to get another 3

AG cert. requires vote of 67%+ SH to alter staggered board provision or to adopt inconsistent BL

Cert. holds board member term ends @ 3rd annual meeting after election

* + - * 1. Holding: extrinsic evidence clarifies cert. ambiguity 🡪 BL is invalid
        2. **Rule**: BL inconsistent with cert., cert. wins. Ambiguity clarified with extrinsic evidence 🡪 Course of dealing in the firm and in industry

|  |  |
| --- | --- |
| **Elections/Voting/Classified Board** | |
| Directors | Shareholders |
| **§141(d)** – Classifying board: Board divided into groups that are elected at different times   * Up to 3 classes, can be different sizes * Serve # of years as there are # of classes * By cert., initial BL, or BL adopted by vote of SHs   + BL must be SH adopted after init.! * If in BL, anyone w/ 51% of vote can amend to declassify at meeting or §228 unless special preventative provisions are there (*See Airgas*) * See below effect on removal | **§212(a)** – 1 share = 1 vote unless otherwise in cert.  **(b)** SH vote @ meeting or elect a proxy in signed writing  **(e)** Irrevocable proxy permitted  **§218(c)** – Agreement between SHs that voting rights are exercised in certain way (proxy, etc.)  **§214** – Cumulative voting, in cert., Shares get # Shares x # directors votes allocated however.   * See below effect on removal * Can be undercut by classifying – 3 directors in 3 classes means all shares vote on 1 director each year   **§216** – Board elected by plurality unless cert./BL requires supermajority   * Voting on other than board is majority at meeting – note many SH don’t show * NOTE: Creating supermajority provision needs to indicate requires supermajority to change enabling provision (BL cannot be altered by board) |

* + 1. **Directors, Position/Removal/Vacancy**
       1. **§142** – (a) Officers’ duties are in BL or board resolution consistent w/ BL, (b) # and term in BL unless in cert., *shall* hold office until succeeded, resigned, or removed, (e) death, resignation or removal is filled as provided in BL or by the board
          1. Removal *without cause* requires **proper purpose** related to SH interest
       2. **§211(b)** – Unless directors are elected by written consent in lieu of annual meeting, annual meeting is held for SH to elect directors.
          1. SH can act by written consent – provided that if consent is *less than unanimous*, such action may be in lieu of meeting *only if* all of the directorships to which directors *could* be elected at an annual meeting are vacant and are filled by such action

Avoid this outcome by simply removing the directors first, then electing new ones

|  |  |
| --- | --- |
| **Director Removal/Vacancy** | |
| Directors | Shareholders |
| **§223** – Vacancies filled by majority of board   * SH retain inherent power in Del. * “Whoever gets there first” | **§141(k)** – Any director or whole board can be removed w/out cause by SH majority  (1) unless cert. provides otherwise, or board is classified – Directors can only be removed by shares that can elect them   * If classified, need cause * (2) If cumulative, w/out cause can’t be removed if votes against removal > votes needed to elect the director * Cause = breach fid. duty * If cause – notice/opportunity for director |

* + - 1. *Crown EMAK Partners v. Donald A. Kurz*
         1. SH holds AA stock w/ right to elect 2/7 board members
         2. Pass amended BL to shrink board to 3 w/ 2/3 voted by AA stock
         3. Rule – SH cannot shrink board to smaller than # of sitting members

Board sits until successor is elected, resign, or remove (§142(b))

Can only remove directors that your stock can vote for (§141(k))

Quorum is based on directorships (now 3) with majority (3) much less than # of sitting directors (7)

Cannot elect successor outside of annual meeting unless (i) unanimous or (ii) all directorships that *could* be elected are already vacant and would be filled by such action (§211(b))

* + - * 1. NOTE: SH could have achieved by adopting shrinking BL @ next meeting
        2. NOTE: Directors can be *removed* with less than unanimous – focus is on when SH is trying to elect new directors w/out first removing
      1. SH could amend BL to increase size of board – pack board w/ §228
         1. Avoid by classifying or setting # of directors in cert.

|  |  |  |  |
| --- | --- | --- | --- |
|  | Classified Board | Classified Stock | Cumulative Voting |
| Defining Feature | Director term lasts multiple years, offset so a fraction are up for election each year | Directors are divided into 2+ classifications, each elected by a different class of stock | Directors don’t run for specific seat – SH gets votes that are distributed any way they want.  Votes = # shares \* # directors |
| Statutory Authority | § 141(d) – In cert, initial bylaw, or bylaw adopted by SH vote | § 141(d) – In cert, can also provide for certain directors to have increased voting power | § 214 – Can opt in to CV if in cert |

1. **THE BUSINESS JUDGMENT RULE**
   1. **Generally**
      1. **Elements** – Review at pleading stage (*Aronson v. Lewis*)
         1. Π challenging an action by the board faces a presumption that the board was
            1. Prong #1: Disinterested (Duty of Loyalty)
            2. Prong #2: Acted with due care in making an informed decision (Duty of Care)

Gross negligence standard in reviewing the *process* of the decision

* + - * 1. Prong #3: Acted in a rational, good faith belief that the action is in the best interests of the corporation (Bad Faith/Waste)

Bad Faith – Subjective bad faith, intentional dereliction of duty (*Disney*)

* + 1. **Misc**
       1. Π must plead particularized facts to rebut the presumption
       2. Prong #1/#2 preclude examining decisions substantively without a defect in process of coming to decision, Prong #3 examines substance
       3. Statute
          1. §141(a) – Powers of the board to manage corporation

Always return here, SH can’t challenge every decision of the board

* + - * 1. §141(c) – Power to delegate to committees/experts
        2. §141(e) – Safe harbor relying on opinions/info from committees/experts
  1. **Challenges to Substantive Decisions**
     1. **Generally** – Without a defect in process courts won’t examine substantive decisions
     2. *Kamin v. American Express* (Difficulty of demonstrating waste/challenging decision)
        1. Minority SHs sue board for distributing shares of DLJ as dividend rather than selling and declaring loss on taxes – Bought at $30mil, now worth $4mil

Take Home:

If you can articulate rational basis – no substantive decision challenge

* + - 1. **Rational Basis Test** – So long as the board can articulate a pro-firm rational basis for the decision, the BJR will save it no matter how stupid it turns out to be so long as the BJR stands unrebutted – error in judgment is not sufficient
      2. DoC – Minutes of the meeting indicate that the board considered both outcomes
      3. DoL – 4/20 directors would get a benefit in compensation, but it was approved by a majority of the board and 16/20 were disinterested
      4. Waste – Selling shares would force them to book the loss 🡪 lower stock price
    1. **Policy**
       1. Example – If a manager is liable every time a transaction goes bad
          1. Project: 80% $100mil gain, 20% $10mil loss
          2. SH EV: 0.8(100)+0.2(-10) = $78mil
          3. Manager EV if makes 1% of gain: 0.8(1)+0.2(-10) = -$1.2mil
       2. Want to encourage directors to take risks (§141(a))
       3. Judicial inaccuracy vs. Agency Costs
       4. Other means of control: Incentive pay, elections, market for corporate control
  1. **Ultra Vires & Waste (Prong #3) – Overcoming Substantive Deference**
     1. **Waste** – Decision that destroys corporate assets
        1. When manager fails to articulate a **rational basis** behind a decision
     2. **§124 – *Ultra Vires*** – Decision outside the powers of the director (typically waste)
        1. Cannot be asserted as a defense to K
        2. Actions contrary to the purpose of the corporation (§§ 101(b), 102(a)(3))
        3. Waste
        4. Board knowingly have the corporation commit a crime
     3. **Effect of §124** – Cannot get $ from third party, but can recover from board. Can set aside/enjoin K if not performed & all parties are joined to suit
     4. **§122(9) – Corporate donations** – Donations for public welfare, charitable, scientific or educational purposes, time of war or national emergency are OK
        1. Contribution must be within board’s fid. duties and best if board articulates benefit to firm (long run/reputation) (*Smith Mfg.* – modest donation to Princeton)
     5. **ALI §2.01 – 3 Exceptions to Firm Maximizing Profit**
        1. Comply with law, charitable contributions, devote reasonable resources to public welfare, humanitarian, educational, and philanthropic purposes
     6. **Compare *Ford* with *Wrigley***

|  |  |
| --- | --- |
| *Dodge v. Ford Motor Co.* | *Shlensky v. Wrigley* |
| * Ford as controlling SH decides Ford Motor Co. won’t pay special dividend anymore * Articulate investing in business (smelting plant) and altruistic intention for welfare of his work force   Holding: Court leaves smelting plant, but orders payment of the special dividends   * Dodge (minority SH) offered to sell shares and Ford refused after dividend announcement   + Can’t easily liquidate   + Controlling SH owes FD to minority when acting like a board member * Welfare of employees is not a rational basis   + Instead, say “happy employees will stay w/ Ford and work harder” 🡪 more profit | * Π sues Δ to compel building stadium lights at Wrigley Field and to have night baseball games * Δ owns 80%, Π argues night games = more profit * Δ argues lights will have deleterious effect on surrounding neighborhood/negatively affect patrons 🡪 bad for profits * Board considered issue and rejected it 🡪 no DoC problem   Holding: Δ articulated pro-firm rational basis for not installing the lights  *See also Smith Mfg.* – Donation to Princeton  Holding: Modest donation to preeminent institution, within statutory limit 🡪 generate good will, provide more trained personnel |

* 1. **Duty of Care (Prong #2)**
     1. **Analysis**
        1. **Duty of Care** – Board must inform itself of all **material** information **reasonably available** to them prior to decision (*Van Gorkom* – Gross Negligence)
           1. Fully informed, Active board participation (can’t just rely on CEO, ask Qs, etc.), Advice of outside experts (Law firm, investment bank), READ DOCUMENTS ahead of meetings
        2. If Π shows breach, Δ has affirmative defense showing **entire fairness** (*Cinerama*)
           1. **§144(a)(3) – Entire Fairness**

|  |  |
| --- | --- |
| Fair Dealing | Fair Price |
| **Aggressive bargaining and by whom**  **Fiduciary’s knowledge of the business**  **Outside valuation/advice**  Timing of transaction  How transaction is initiated  How transaction is structured  How transaction is negotiated  How it is disclosed to directors  How the approval of directors was obtained  How the approval of the stockholders was obtained | **Magnitude of premium over market price**  **Surmountability of lock-ups**  Economic and financial considerations  Including assets  Market value  Earnings  Future prospects  Any other elements that might affect the intrinsic or inherent value of a company’s stock |

* + - 1. **Ratification**
         1. §144(a)(1) – Disinterested board members can cleanse vote of interested
         2. §144(a)(2) – Vote of SHs can cleanse interested board action
         3. Elements – Must be aware of all material facts and SH vote must have not been otherwise required (*Gantler* – need 2 votes, one to cleanse, one to approve of action)
         4. Effect – Reinstates BJR, but waste claim remains
      2. **§141(e)** – Safe harbor for good faith reliance on committee/experts (ask Q’s)
         1. Elements – Board relies in good faith, reasonable belief in the competence of the expert, who has been selected with reasonable care by/on behalf of corp.
         2. Challenge – Director doesn’t rely/relies in bad faith, advice is outside expertise of expert, expert not selected with care, material/obvious fact board should know aside from expert report (failure = GN), decision was waste
      3. **§102(b)(7)** – Certificate provision limiting damages for breach of fid. duty.
         1. Only applies to damages, *not* injunctive relief (*London*)
         2. Only protects directors, not officers/controlling SH, persons helping director
      4. Scrutiny – Important decisions like mergers (§251(b)) are examined at higher level of scrutiny than day-to-day decision making
      5. **Damages** – Even failure of Fair Dealing, must consider damages especially if there is Fair Price
         1. Damages are difference between fair and market price – No rescissory 🡪 maybe a breach but no damages
    1. **Cases**

|  |  |  |  |
| --- | --- | --- | --- |
|  | *Van Gorkom* | *Cinerama* | *Disney* |
| Importance of decision | Sale of corp./last act of bd | Sale of corp. | Hiring/Exec. Pay |
| Conflict? | VG interest, short time | CEO interested | None |
| Experts | None | Outside fairness opinion | Outside experts |
| Info | No info on valuation to outsider | Adequate info, no deliberation | Could calculate info |
| Meetings b4 set path | 1 | 1 | Multiple |
| Standard | Gross Negligence | Gross Negligence | Negligence (not best practice) |
| Liability | Yes – Remand for fairness | Rebut BJR but Fair | No – BJR, 141(e) args. |

* + - 1. *Smith v. Van Gorkom* – Merger with active, interested inside director/CEO
         1. TU has cash, no income, can’t exploit tax credits 🡪 need merger with cash-generating firm to exploit tax credits
         2. Board considers LBO, Romans runs #’s 🡪 VG says he’d take $55/share
         3. VG approaches Pritzker, offers to sell $55/share, known firm is undervalued

P requires **lock-up** to be stocking horse

Sell P 1mil *new* shares at market ($38)

SO P has to pay $55/share for all shares, bidder has to pay $55/share for all shares + P’s new shares 🡪 Lock-Up

* + - * 1. Special meeting – VG calls, board doesn’t read proposal, doesn’t know VG offered price, board satiated by market test but reacted negatively overall
        2. Board meeting – 2hrs, based on VG presentation and other representations (Romans, Brennan [legal], etc.), board/VG doesn’t read deal, approved

NOTE! Fundamental decision that put corp. down specific path

* + - * 1. Meeting – Amendments to merger/agreement
        2. Market test – Can’t solicit bids, can’t give bidders proprietary information
        3. SH approve board proxy statement/merger
        4. Holding: Board not informed of VG’s role, value of corp., GN in process

Board discharged duty @ meeting that set them on a path

Relied on interested CEO, no expert, no participation

Subsequent actions didn’t cure

No out from the merger, bogus market test, lock-up

SH vote did not cleanse – SHs not fully informed

* + - 1. *Cinerama, Inc. v. Technicolor, Inc.* – Breach of DoC, transaction fair
         1. CEO deal with Perelman, presents to board which approves quickly
         2. No adequate deliberation, no market check
         3. BUT – CEO bargained hard, price went $15🡪$23/Share, hired experts, etc.
         4. Breach of DoC, BUT Entire Fairness burden met by Δ

CEO consistently sought highest price (despite conflict of interest)

CEO was well informed about the business

CEO and board were advised by good banks

* + - 1. *Gantler* – SH vote approve cert. amend. where board interested/deceive SHs
  1. **Good Faith (Prong #3) – Spot: §102(b)(7), Executive Pay**
     1. **Generally** – Failure to act in good faith requires conduct that is more culpable than conduct in violation of duty of care (*Disney*)
        1. Requires subjective bad faith or intentional dereliction of duty (*Disney*)
        2. If board can reasonably derive material information from provided material, there is no failure to inform of material facts (*Disney*) – i.e. can you calculate it?
        3. Stock Options: Right, but not obligations to buy shares at “exercise” price
           1. Dilutes SH value, purchase is in future at current market price
           2. Agency cost – CEO wants compensation for “risk,” company sees as low cost 🡪 no cash outlay, tax benefit on exercise, etc.
     2. **Analysis – DoC/Bad Faith**
        1. Determine importance of decision – Hiring/firing, merger, etc.
        2. Determine conflicts of interest on the board
        3. Consider board delegation to committees (§141(c))
        4. Consider board use of experts (§141(e)) 🡪 Consider rebutting safe harbor
        5. Determine material facts and which material facts board knew
           1. Determine what *could* have been determined from what the board had
        6. Assess the # and quality of the board meetings
        7. Determine breach of DoC
           1. For Bad Faith – Need subjective bad faith (desire to harm), intent to violate a positive law, or intentional dereliction of duty (deliberate neglect in face of duty to act) (*Disney*)
     3. **Policy and Other Considerations**
        1. Bebchuk/Fried/Walker – Executive compensation is a symptom of agency costs 🡪 high CEO power, decline in public outrage
        2. Dodd-Frank – Report to SHs on executive pay, symbolic, non-binding vote
        3. Driving force: Short CEO tenure, small CEO job market
        4. Sarbanes-Oxley: Criminal liability for securities fraud, false certifications, mail/wire fraud, retaliation against whistleblowers, public accounting/oversight board, auditors, ban personal loans to officers/directors, etc.
     4. **Cases**
        1. *In re Walt Disney Co.*
           1. §102(b)(7) – Directors not liable for breach of DoC

Applies to action for damages, not injunctive relief

Protects directors, not officers

Does not protect violation of DoL, Bad Faith, or intentional misconduct

* + - * 1. Eisner courts Ovitz (owned 55% of CAA 🡪 $20-25mil/y) prelim. deal
        2. Original Board – Hired O, $1mil/y, big pay-off for no-fault termination

Process: CEO negotiates subject to Compensation Comm. (outside board members) approval, director of CC meets w/ exec. pay expert, CC approves (1hr), board approves

NOTE: No doc. contains value of NFT, but can be calculated

* + - * 1. New Board – Allows E no-fault termination of O - $39mil+$101mil options

E consulted w/ counsel, tried to find alternate employment, etc.

* + - * 1. Analysis

Old board vested decision in Compensation Committee (§141(c)) (**DoC**)

BUT – CC met for 1hr, didn’t have value of NFT agreement

REBUTS §141(e) – Missing material/reasonably available fact

Counter – Did committee know the value of the NFT?

Knew based on E’s K, Knew early calc., knew O wanted $150-200mil in downside to compensate for CAA $$

Conclusion – Board could have calculated given information provided

Understood basics, knew what he was leaving, relied on CC

Not best practice, but not violation of DoC

Old board bad faith? 🡪 Requires subjective bad faith/intentional dereliction of duty

New Board firing decision – Waste/substantive due care violations?

E has implicit authority, considered other options with attorney (§142)

No waste (considered alt., rational basis), no substantive (same)

* + - 1. *Seinfeld v. Slager* – No waste where cop. Has received *any* substantial consideration and board made good faith judgment transaction was worthwhile
  1. **Failure to Supervise – Director Inaction**
     1. **Analysis – *Caremark* Liability**
        1. Step 0: *Francis* – **Minimum duties**
           1. Directors must discharge duties with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions
           2. Director must get a rudimentary understanding of the business, keep informed about corporate activities, attend board meetings, review financial statements, raise objections to illegal actions, and take appropriate remedial measures
           3. BJR does not apply to complete inaction (*Francis*)
        2. Δ has a **duty to implement an information reporting system** (BJR, *Caremark*)
        3. Π must plead particularized facts showing (good Π does §220 books/records req)
           1. Directors **knew/should have known** that violations of the law were occurring
           2. AND that Δ **took *no steps in good faith effort*** to prevent or remedy AND

Subjective bad faith, intentional illegal act, intentional dereliction of duty

* + - * 1. That such failure **proximately resulted in the losses**

Generally – If directors had done what they were supposed to do, they would have notice the wrongdoing, and if they had noticed, they would have been able to stop it

Board is supposed to stop crimes 🡪 proximate (*Pyott*)

Risk of a crime ≠ commission of crime

*Citigroup* – Can operate at the limit of the law in good faith

*Francis* (NJ) – Can infer causation on failure to act in face of a duty to act

* + - * 1. Only a **sustained/systematic failure of Δ to exercise oversight** will establish lack of good faith necessary for liability (*Caremark*)

Pleading large losses is not sufficient (*Citigroup*)

* + - 1. Inside directors have different duties than outside directors
      2. Lack of oversight ≠ Intent to commit a crime
      3. On notice of a problem, directors often have duty to inquire further (*Francis*)
    1. **Policy**
       1. Sentencing Guidelines – Increased corporate penalties dramatically
          1. Reduced if (1) effective compliance program, (2) high level personnel not involved in crime, (3) firm reported the wrong, (4) firm cooperates with investigation
          2. Implies the board must have reporting system to be reasonably informed

Level of detail is BJR (Need to monitor, not necessarily that well)

Monitoring is done in good faith

* + - 1. Sarbanes-Oxley §404(a) – Duty of top officers to attest to good reporting system and requires an audit committee, no duty to have compliance program
    1. **Cases**
       1. *Alice Chalmers* – No duty to operate system of corporate espionage to ferret out wrongdoing without cause for suspicion (historical)
       2. *Francis v. United Jersey Bank* (NJ)
          1. Reinsurance broker, wife owns 48%, on board with sons
          2. Sons give self “loans” bankrupting company while wife failed to figure it out
          3. BJR does not apply to inaction. Need to find Δ had duty to clients, Δ breached, and breach was proximate of the losses

Duty to creditors: Firm is insolvent, merger, bank-like business

* + - * 1. Rule - Director must discharge their duties *in good faith* and with the degree of diligence, care, and skill which RPP would exercise in like circumstances

Director must: Have rudimentary understanding of business, keep informed of corp. activities, monitor corp. activities, review financial statements, **make inquiries into suspicious matters**, prevent illegal conduct

* + - * 1. §141(e) safe harbor rebutted because Δ failed to *read* the report 🡪 did not rely on the report
        2. Proximate cause – Must vote against dealings, resign, threaten suit, etc.

Court will infer causation from failure to act on notice of duty to act

* + - 1. *Caremark*
         1. CVS giving illegal kickbacks to docs for referrals, gov sues 🡪 $$$, SH sue
         2. Rule – Directors have duty to create compliance program and to monitor it in good faith 🡪 Note, not what RPP does, need subjective bad faith (see above)

Liability if Δ: Fails to implement the reporting system or Consciously failed to monitor or oversee its operation

* + - 1. *Stone v. Ritter*
         1. SH derivative suit against board to recover fines/penalties stemming from employee violations of the Bank Secrecy Act/Anti-Money Laundering
         2. Issue is whether demand is excused which turns on whether directors are subject to damages (i.e. no BJR or §102(b)(7))
         3. Holding: Duty to implement reporting system, good faith effort to monitor
         4. No liability since KPMG consulted and banks had reporting system, oversight committees, directors get annual presentations, etc.
      2. *Citigroup*
         1. Π claimed failure to monitor exposure to subprime mortgages
         2. Δ had committee/monitoring, failure to catch a problem like this is not the same as consciously disregarding it 🡪 12(b)(6) dismissed
      3. *AIG* – Successful *Caremark* claim – execs failed to exercise oversight over pervasive fraudulent criminal conduct and pleading supported inference that execs knew and approved of much of the wrongdoing
  1. **Duty of Loyalty**
     1. **Generally**
        1. Fiduciary intentionally acts with purpose other than advancing firm’s best interest
        2. Fiduciary acts with intent to violate the law
        3. Fiduciary fails to act in face of duty to act 🡪 conscious dereliction of duty
        4. Remedies – Can corp. avoid transaction? Can director(s) be held liable?
        5. No controlling SH – use of outside expert can usually avoid fairness (*Benihana*)
        6. Controlling SH – Going to fairness w/ burden shifting
     2. **Self-Dealing – No Controlling Shareholder – Spot the issue**
        1. Member of board gets gain greater than if she was a SH
        2. Member of the board is dominated by outsider
        3. Member of board owes fiduciary duty to serve someone who gets a gain the SHs of the firm are not getting
     3. **Self-Dealing – Cleansing**
        1. Burden on Π to demonstrate conflict of interest (*Aronson*)
        2. **Self-dealing K rebuts BJR unless approved by**
           1. §144(a)(1) – fully informed, disinterested directors (think §141(c))

Must be @ meeting, nothing informal (*See London* – Disinterestedness)

* + - * 1. §144(a)(2) – fully informed, *disinterested* SHs (*Wheelabrator*/*Fliegler*)

*Gantler* – If *required* (merger, cert.), need cleansing and approving votes

MUST determine if there is controlling SH (*See Wheelabrator* below)

* + - * 1. §144(a)(3) – Demonstrate that the transaction was fair (*Lewis v. SL&E*)
      1. Must disclose **interest** and any **material info about the transaction** (*Benihana*)
         1. Must know @ meeting that puts the company on the definite path
         2. Board must know facts about the process (who approached whom?)
         3. Includes what the board could reasonably figure out from provided facts
      2. If (1)/(2) then need to show waste, or lack of good faith (DoL cleansed)

For materiality, see pg. 46

* + - * 1. Waste requires unanimous SH approval
        2. Note: DoC is separate inquiry
    1. **Cases**
       1. *Bayer v. Beran* (NY)
          1. “Celanese” hour – Singer-wife of director/president hired
          2. Directors found out conflict after deal approved 🡪 no bad faith

Most directors employees of president 🡪 dominated (could not be disinterested unless they were unaware), NOTE no formal meeting of bd

* + - * 1. Holding: BJR rebutted from self-dealing, but quality/compensation of/for singing was not challenged, further argument board ratified when they voted to renew the show
      1. *Fliegler* – Interprets §144(a)(2) to require fully informed ***disinterested*** SHs
      2. *Benihana of Tokyo, Inc. v. Benihana, Inc.*
         1. Benihana trust owned 100% of BOT, owned 50.9% common/2% class A of B
         2. Hired outside advisor (J) who does negotiations
         3. Abdo on B board contacts J about deal w/ BFC (Abdo owns 30%) – sell convertible preferred stock to BFC and 1 seat – would dilute BOT to 36.5%
         4. Board informed about BFC/Abdo interest, but not that Abdo negotiated for BFC. Board gets presentation from Abdo
         5. B gets 3 other offers 🡪 rejected by independent committee
         6. Board approves BFC deal
         7. Holding

For (a)(1) cleanse, board must know material facts about interest and process 🡪 Abdo negotiated

Sufficient to know at time they approve the deal (material Δ position)

Knowledge can be conveyed outside meeting, gleaned from circumstances

Shares issued for entrenchment must be met with legitimate business reason 🡪 they were trying to renovate and couldn’t take on more debt

* + - 1. *In re Wheelabrator Technologies*
         1. W has 22% of WT and elects 4/11 directors
         2. Negotiates merger to buy 33% more of WT
         3. Disclosure – Board used outside experts, considered 3hrs (not from 1st principles, experts, familiar, etc.), W/WT have long, close relationship (familiarity), proxy adequate

Vote of committee of disinterested directors, then whole board

Proxy put to SHs, then SH cleansing vote (§144(a)(2))

* + - * 1. Possible DoC claim – Ratified by vote of fully informed SHs (*Van Gorkom*)
        2. **NOTE on SH Ratification/Cleansing – Depends on if there is CSH**

Interested transaction between corp. and director

§144(a)(2) allows BJR to be cleansed, otherwise fairness

Interested transaction between corp. and controlling SH

Approval of “majority of minority” does not cleanse 🡪 shifts fairness burden to Π instead of Δ

Determine if controlling SH

% of shares? – Majority = *de jure* (presumptive) control

What % of board is beholden to SH? – 4/11 insufficient

Other evidence of control

* + 1. **Policy – Self-dealing Transactions**
       1. NOTE: Don’t necessarily want airtight self-dealing rule
          1. Some self-dealing directors have special expertise/connections and are brought on SO THAT THEY WILL SELF-DEAL
    2. **Corporate Opportunity**
       1. **Generally**
          1. Director/Officer can’t pursue corporate opportunity unless

Disclose to the board – opportunity and conflict of interest

Get firm’s permission (Vote of board of SHs)

Different from §144 (no cleansing), must formally reject opportunity

* + - * 1. Remedy – Injunction, punitive damages, constructive trust (disgorgement)
        2. **§122(17)** – Firm can renounce, in cert. or by action of board, any interest of the corp. in specified business opportunities or classes/categories thereof presented to the corp. or officers
      1. **Analysis**
         1. Is this a corporate opportunity? (@ time of decision to pursue, *Broz*)

Test is broad, based on theory that directors should promote firm

Not just refrain from harming (**Interest**/**Expectancy**/**Necessity**)

*Guth v. Loft* – **Line of Business Test**

Activity to which the firm has fundamental knowledge, practical experience, and ability to pursue

Is adaptable to its business

And is consonant with its reasonable needs and aspirations for expansion

**Additional Factors**

How the matter came to the attention of the exec/director

Corporate capacity or independently? VERY careful for CEO

How far removed from “core economic activities” of the business?

Whether corporate info was used in recognizing/exploiting opportunity

* + - * 1. **§ 122(17) provision**? 🡪 If yes, no breach – Can’t be a blanket provision
        2. **Did the director disclose?** – Both **material facts** and **interest in transaction**
        3. **Did board reject?**

If board rejects 🡪 approved by fully informed, disinterested SHs (§ 144 by analogy)

If board rejects and SHs approve also consider DoL non-compete/account for profits arising out of agency (*eBay*)

* + - * 1. If not (b)/(c)/(d), can Δ show a **complete lack of financial capacity**? (*Broz*)

VERY strong evidence (bankruptcy is NOT enough)

Contractual impediment? (Loan covenants from *Broz*)

Liability even if offeror didn’t want Δ’s firm (*Energy Resources*)

* + - * 1. LIABILITY if (a) and not ((c) AND (d)) unless (e)

Injunction + punitive damages, no fairness

**Step 0**: Did you hurt the firm? 🡪 usurp something the firm has an interest in, expectancy in, or necessity in?

**Step 1**: Did you take something that *should have* been the firms? 🡪 Was it in the firm’s line of business?

**Step 2**: If 0 or 1, is there § 122(17)

**Step 3**: Did director disclose and did board reject?

**Step 4**: If 0 or 1, and not 2 or 3 🡪 Was there complete lack of financial capacity?

**Liability**

**Step 1**: If 0 or 1 and not 2, 3, or 4 – Liability.

**Step 2**: If 0 or 1 and 2, 3, or 4 🡪 consider common law liability to account for profit/non-compete

* + - 1. **Cases**
         1. *Broz v. Cellular Information Systems, Inc.*

Broz president and sole SH of RFB & member of CIS board

Broz wants to buy license that CIS may have wanted

Broz discussed w/ CEO & 2 CIS board who claimed no interest

RFB outbids PC (who is trying/does take over CIS after this)

PC sues claiming Broz took corporate opportunity

Don’s Framework from Broz

Financial ability? (same as above)

Line of business: Consistent w/ plan of expansion?

How did it come to agent’s attention

In corp. position, thumb on LOB of firm

Conflict of Interest w/ Principal? Use corporate info?

Conflict between fid. duties to firm and self-interest?

How far removed from core economic activities?

Application

Opportunity originally presented to Broz NOT CIS

Opportunity not consistent with plans of CIS 🡪 not CO

CEO/Board informally turned down

CIS already divesting licenses, & this license outside their service

CIS financially incapable – CIS loan limited ability to get new debt

Evidence indicates not a corporate opportunity of CIS (not that informal board moves rejected an opportunity)

Broz does not owe fid. duty to PC 🡪 analyzed @ time CO is taken

* + - * 1. *In re eBay, Inc.*

Allegation that GS allocated IPO shares to Δs to get business from eBay 🡪 claim that IPO was CO of eBay

Application

eBay invests over $550mil currently in stock

Investing is integral to their cash management strategy

Investment came to Δ because of position at eBay (to spur them to give more business to GS)

eBay has financial capacity to invest in the IPOs

Holding: IPOs are a corporate opportunity of eBay that wasn’t rejected and eBay was financially capable of exploiting

Alternatively common law DoL requires Δ to account for profits

* + - * 1. *Beam v. Martha Stewart*

MS sells shares in Omnimedia to investors

Π claims corporate opportunity that Omni could sell stock to raise capital

Holding: Firm can sell shares to anyone, Δ didn’t get better than market

* + 1. **Self-Dealing Transaction WITH Controlling Shareholder**
       1. **Analysis**
          1. NOTE: Normally SH does not owe fiduciary duties to other SHs – Controlling SH creates fiduciary duties to minority
          2. **Is there a controlling shareholder**? (*Wheelabrator*) (*de jure*/*de facto* control)

% of shares? – Majority = *de jure* (presumptive) control

What % of board is beholden to SH? – 4/11 insufficient (*de facto*)

Other evidence of control (*de facto*)

Evidence board has capitulated in past?

Board treats itself as if dominated?

* + - * 1. **Is CSH acting as a SH?** 🡪 Simply voting no, no FD to other SHs (pg.48)

CSH selling control at premium does not have to share with minority (*Zetlin*, *BUT see Perelman* – Notice of CSH changing a favorable business plan 🡪 “the Feldman plan”)

* + - * 1. **Is this self-dealing?**

Controlling SH is on both sides of transaction and minority SH is not

Transaction gave preference/priority to dominant SH over minority SHs

Test focus on what goes out of firm, not what each SH gets

*Sinclair* – tax opportunity to Sinclair that minority wouldn’t get

Multiple classes of shares? (*Zahn*)

Does not really cross classes of stock

If calling stock – SH must decide whether to agree

*Zahn* – Duty to inform why directors are calling the stock

Board must act disinterested – Must provide info to all

Residual duty goes to common stock on liquidation

* + - * 1. If yes to (d)(i)/(ii) 🡪 Fairness burden-shifting

If committee approves – Did they exercise arm’s length bargaining power?

CSH doesn’t dictate terms

Committee was granted actual bargaining power which it exercised

If either committee approves or majority of minority 🡪 Burden on Π

Else burden on Δ

* + - * 1. If no to (d)(i)/(ii), it is a normal board decision and BJR attaches
        2. NOTE: Huge incentive to settle when fairness attaches because litigation is expensive, damages can be huge, §102(b)(7) doesn’t cover, and insurance won’t cover either
      1. **Cases**
         1. *Sinclair Oil Corp. v. Levein*

Sinclair owns 97% of Sinven & controls board

Challenging board decision to pay out massive dividends (exceed earnings, but comply w/ §170)

Π claims Sinven should have developed oil fields in other countries which Sinclair developed with other subsidiaries

Π claims Δ let Sinven slept on K-enforcement remedies with other sub

Analysis

Dividend decision is under BJR because there is no self-dealing

No corporate opportunity because no offer came to Sinven personally

K-enforcement has self-dealing (K w/ Sinclair wholly owned sub)

Δ must show fairness

* + - * 1. *Zahn v. Transamerica Corp.*

Axton-Fisher Tobacco

B shares: Common stock, voting, 1x payout on liquidation

A shares: larger dividend, voting rights (procedural default), 2x payout on liquidation, buyback provision, convertible to B

Preferred shares/debt

Z holds A, TA bought 66% A, 80% B

TA liquidates AFT – executes buyback of A then liquidates 🡪 A’s lose out on 2x payday, TA maximizes B payout

Analysis

TA is controlling SH 🡪 fiduciary duty to minority

Self-dealing? 🡪 No

Question of whether to buy-back will inevitably favor one stock over the other

Test – What would disinterested board do?

Would favor common stock 🡪 B

Fiduciary duty to class A? 🡪 Must provide info so they will convert to class B

1. **SHAREHOLDER SUITS – DIRECT VS. DERIVATIVE**
   1. **Direct/Derivative Suits, Demand, SLCs – Checklist**
      1. **Direct or Derivative?** (*Tooley*, pg. 35)
         1. Who suffered the alleged harm?
            1. If corporation 🡪 Derivative
            2. If SH 🡪 Direct 🡪 NO DEMAND REQUIRED

Must be an individual harm – Voting, participation, governance rights

* + - 1. Who receives the benefit?
         1. If corporation 🡪 Derivative
         2. If SH 🡪 Direct
      2. Direct: Board breaches FD in merger, board abdicates management
    1. **If derivative** (pg. 36)
       1. **Standing** – Π must be SH at time of wrong, and be SH for duration of suit
       2. **Bond** – Not in DE, Use bond rule of the state
          1. NJ (SH<5%, SH<$50k) 🡪 bond for reasonable attorney’s fees of Δ for failure to make a good complaint
       3. **Test if Demand is Required**
          1. Π uses § 220 to get books/records, look @ SEC filings/media reports (pg. 42)
          2. *Rales* – Majority of the board is interested in (receives material benefit) or is dominated by someone interested in:

The underlying transaction – beyond normal board decision, must be a direct and substantial financial interest

The litigation – Board is being sued or dominated by someone being sued

Uncleansed SDX, CSH SDX

No BJR

Waste/*Caremark*

* + - * 1. *Aronson* – Π sues under claim where BJR can attach and majority of current board is named in the suit; Π alleges facts that create a doubt that

Majority of the board is disinterested and independent

Direct and substantial financial interest in transaction

Challenged transaction was the product of valid BJ

* + - 1. **If Demand is Excused** (pg. 38)
         1. Board creates SLC (*Zapata*) (*Auerbach* NY – SLC gets BJR unless SH rebuts)

Did SLC act independently, in good faith, and with reasonable investigation (Burden on SLC)? If no 🡪 case proceeds, if yes 🡪 step 2

Is there any substantial reason that an SLC member is incapable of making a decision with only the corporation in mind? (*Oracle*)

Can be impaired by lesser affiliations so long as they present a material question of fact of whether SLC can make unbiased decision

Independence impaired if SLC feels he owes something to Δ (*London*)

Does dismissal pass independent judicial inquiry into business judgment?

Can’t prejudge case, must conduct genuine investigation (*London*)

Ex. Damages = $10k, Suit = $100k 🡪 SLC motion to dismiss granted

* + - 1. **If Demand is Required** (pg. 37)
         1. Board makes SLC to consider demand 🡪 BJR
         2. Wrongful refusal

Π brings wrongful refusal of demand 🡪 Board gets presumption of BJR

Π concedes majority of board is disinterested/indepedent (*Spiegel*) (BJR Prong 1)

Challenge that board breached DoC, bad faith or committed waste

Failed to investigate whether bringing suit is in board’s interest

* 1. **Direct Suits**
     1. **Generally**
        1. SH suing corp. as represented by fiduciaries (board/officers) for breach of K
        2. Remedy goes to SH
        3. There is no demand or bond requirement
     2. **Test** (*Tooley*)
        1. **Who suffered the alleged harm?** 🡪 Corporation or SH individually?
           1. SH must allege individual harm 🡪 voting, participation, governance rights
        2. **Who would receive the benefit of any remedy?** 🡪 Corp. or SH individually?
           1. Must ask for individual remedy – not something going to corporation
           2. If harm is to SH, but remedy is ambiguous 🡪 direct (*Grimes*)
        3. Two cases almost always end up direct
           1. In merger context, violation of fiduciary duties often results in direct suit
           2. Board owes SH contractual obligation to manage the firm 🡪 can’t abdicate
     3. *Eisenberg v. FTL, Inc.*
        1. SH owns part of FT, FT creates FTC which creates FTL
        2. FT and FTL merge resulting in SHs only owning shares in the holding company
        3. Effect is that they can’t vote on operating company affairs (FTC)
           1. Dilution of SH power
        4. Holding: Since reorganization deprived the SHs of any voice in affairs of the operating company, harm runs to Π as would remedy 🡪 Direct action, and Π doesn’t need to post bond/demand
  2. **Derivative Suits**
     1. **Generally**
        1. Remedy goes to firm
        2. Special procedural impediments (Standing, Bond, Demand, SLC)
        3. Firm pays attorney fees on success and usually if is settles
           1. Not worthwhile for single SH to shoulder burden so award fees 🡪 agency costs of attorney who is motivated to settle for $ and nominal award to corp.
        4. Policy – Standing must be reconciled with board’s authority to manage firm 🡪 strike suits vs. board’s ability to make disinterested decision
           1. Authority to sue resides in board unless they can’t exercise that authority
           2. Agency Cost – Allows single SH to bring suit, doesn’t really bear cost

Strike suit – survive motion to dismiss, most firms will settle

* + 1. **Two-Step Law Suit – Important re: Demand Requirement**
       1. SH action against the corporation to compel it to sue another
       2. Actual suit by the corporation against another party
    2. **Standing**
       1. Π must be a beneficial SH for the duration of the suit
       2. Π must fairly represent the corporation – Competitor SH is often inadequate
       3. Contemporaneous Ownership Rule – SH must have been SH @ time of wrong
    3. **Bond Requirement**
       1. NJ – (SH < 5%) or (SH < $50k in shares) will be liable for the reasonable expenses and attorney’s fees of the Δ for failure to make a good complaint
       2. Federal court sitting in diversity applies the state bond requirement statute (*Cohen*) 🡪 exception to the internal affairs doctrine

**Question:** Are the directors capable of making a disinterested decision about the litigation?

* + 1. **Demand Requirement**
       1. **Analysis** – Π can allege particularized facts that create a reasonable doubt:
          1. Π should use §220 right to books/records, SEC filings/media reports (pg. 42)
          2. ***Rales*** – Majority of the board is interested in (receive material benefit) or dominated by someone interested in:

Transaction: Self-dealing, or domination

* If it is just a normal board decision, not interested

Litigation: Successful suit can hurt them, and the litigation has a decent chance of success (no BJR)

e.g. SD-X with non-director CEO is not demand excused

Prong #1: The underlying transaction – Board is interested or dominated

Director Interest – Majority of board has direct and substantial financial interest in the transaction – entrenchment

Domination – (1) By someone who gets personal benefit from transaction and (2) has ability to directly threaten directors (beholden)

Prong #2: The litigation – Board is being sued or dominated by sued

Self-dealing transaction that is not cleansed, Controlling SH SD X

Board breach of DoC/DoL/Good Faith (BJR doesn’t attach)

Waste, *Caremark* claim

* + - * 1. ***Aronson*** – Special case of *Rales* – Challenging decision by current board

Step 0 – Not decision made by board of different corporation

Suing under claim where BJR can attach (board made a decision)

AND majority of current board is named in the suit

Π can allege particularized facts creating a reasonable doubt that

Prong #1: Majority of board are disinterested and independent or otherwise can’t exercise independent judgment OR

Direct and substantial financial interest in transaction or

Dominated by someone who does – must be *beholden*

Prong #2: Challenged transaction was the product of valid BJ

SD not cleansed, Breach of DoC/DoL/GF, Waste, CSH SD transaction

* + - * 1. **Effect of §102(b)(7)**

If cert. exempts board from liability for DoC, then suit for breach of DoC doesn’t disable the board from considering the suit

Need facts alleging bad faith, intentional misconduct, etc.

Or suit is for injunction arising from breach of DoC

* + - * 1. Effect of Making Demand – If required 🡪 BJR of board, must show wrongful

Π waives right to claim demand is excused on claims arising from same circumstances (*Grimes*)

See pg. 38

Demand required:

Δ makes SLC, burden on Π to show not independent, else BJR

Π concedes the **reason** the majority of the board is independent, can come up with something else

Π brings **wrongful refusal of demand** 🡪 Board gets presumption of BJR

Π concedes majority of board is independent (*Spiegel*) (BJR Prong 1)

Challenge that board breached DoC, bad faith or committed waste

Failed to investigate whether bringing suit is in board’s interest

Mathematics – Demand excuses *majority* of board (*Spiegel*)

*FLI Marine* – Suggests Π can find another reason minority directors interested 🡪 can get back into excused land

Preclusion – Doesn’t preclude another SH, but persuasive (*Pyott*)

* + 1. **Cases** – Note NY eliminates “reasonable doubt” 🡪 just particularity
       1. *FLI Marine* – Special committee has 2 interested directors, Π makes demand
          1. Small board, making demand concedes reason why majority is interested

Dominated by controlling SH

* + - * 1. Court indicates that if Π can find another reason minority is interested, can challenge demand refusal
      1. *Grimes v. Donald*
         1. Manager K: “Constructive termination without cause” agreement where interference with manager can result in golden parachute for manager
         2. Abdication claim

Director can’t delegate duties at heart of corp. management (§141(a))

Direct claim 🡪 breach of K to run corp. 🡪 Relief: Injunction

NOTE: Damages would run to firm 🡪 Derivative

BJR kicks in 🡪 This agreement wouldn’t preclude board from exercising powers, just would cost corp. $60mil+ to do so (*See Disney*)

* + 1. **Special Litigation Committees**
       1. **Statute**
          1. § 141(a) – Board power to act for the firm
          2. § 141(c) – Power to appoint disinterested committee
       2. **Analysis**
          1. If demand required

Board will make SLC

Burden is on **Π** to show that the SLC members are not independent

SLC gets presumption of BJR – Still can challenge under DoC/DoL!

* + - * 1. If demand excused (*Zapata*) (*Auerbach* NY – SLC gets BJR unless SH rebuts)

Did SLC act independently, in good faith, and with reasonable investigation (Burden on SLC)? If no 🡪 case proceeds, if yes 🡪 step 2

Not even 1 person can be interested – taints the whole committee

Burden is on SLC under *Zapata*

Is there any substantial reason that an SLC member is incapable of making a decision with only the corporation in mind? (*Oracle*)

Can be impaired by lesser affiliations so long as they present a material question of fact of whether SLC can make unbiased decision

Independence impaired if SLC feels he owes something to Δ (*London*)

Does dismissal pass independent judicial inquiry into business judgment?

Can’t prejudge case, must conduct genuine investigation (*London*)

* + - 1. ***Disney* Demand Hypo**
         1. B1: ABCDE, B2: ABFGH
         2. Assume FGH are law professors, and A has donated to their law school

Π sues for breach of DoC/bad faith; assume Π can show reasonable doubt B1 acted in good faith – *Aronson* prong #2 –doubt BJR will attach

* + - * 1. Demand excused? Question is whether B2, @ time complaint filed can exercise independent and disinterested business judgment evaluating demand

Prong #1: No facts showing interest of B2 in transaction

B2 not interested in B1 transaction

A’s donations probably insufficient to show FGH have material financial interest or are dominated by A 🡪 Demand likely required

But Prong #2: Interest in litigation

Can create reasonable doubt re: B1

Question: Same for B2? 🡪 if yes, demand excused

* + - 1. **Policy**
         1. We look at independence closely because

It is easier to refuse a self-dealing transaction (§144) than to sue someone

The board is already suspect because demand is excused

Different case if demand required

Burden is on SLC, not Π

* + - * 1. Harmonics of the situation are important
      1. **Cases**
         1. *Auerbach* (NY)

GTE management conducted internal investigation, found evidence of illegal payments implicating some directors; reported to SEC 🡪 fines

SLC made of 3 disinterested directors who joined after bribes

Holding: Nothing to suspect SLC is interested/dominated, and no proof of bad faith investigation 🡪 dismissed

Factors to assess SLC independence

Non Δ’s

Not dominated by interested parties

Given full power and access to counsel

Have no direct financial interest in the outcome of the litigation

Test – Two types of scrutiny

Procedural – What procedures were used to make decision?

Court well positioned to assess

Reasonably complete analysis?

Substantive decision – BJR – Board free to weigh various factors

* + - * 1. *Zapata v. Maldonado* (DE)

Demand excused SH derivative action against 10 board members, since then, 4 directors gone, 2 new step in 🡪 SLC

NOTE – for step 2

Consider corporation’s interest and matters of law and policy

Thwarts situation where SLC may meet step 1, but result doesn’t satisfy the spirit of the inquiry

* + - * 1. *Oracle* – Suit against 4 board members for insider trading, 2 member SLC insufficiently independent – both Stanford proffs, one accused is huge donor, other is a proff and co-committee member @ school, etc.
        2. *London*

Test

Is the SLC independent in composition?

Burden on SLC, Biased if incapable for any substantial reason of making a decision with only interests of corp. in mind

Impaired if the SLC member feels she owes something to Δ

Is the SLC independent in action?

Must take Π’s claim seriously, conduct genuine investigation

Analysis

One SLC’s wife is Δ’s cousin, another Δ employed an SLC for 6y

SLC testimony he “attacked” Π’s claims 🡪 prejudged the suit

1. **CORPORATE GOVERNANCE AND SHAREHOLDER VOTING**

**See Page 43 Flow Chart!**

* 1. **Proxy Contests**
     1. **Policy** – SH voting allows control of directors and reduces agency costs
        1. Collective Action Problem
           1. Costs of becoming informed are high and rarely result in returns

i.e. Amount stock value increases is small compared to costs

* + - * 1. Cost of convincing other SH to vote your way is high, must be discounted by likelihood of success and benefit is shared by all

Create incentive to act – Reimbursement

Reduce barriers to act – List of SHs and Access to corporate proxy

* + 1. **Shareholder Voting**
       1. Election/removal of directors (Note effect of § 141(d) classified board)
       2. Charter/bylaw (if proper) amendments
       3. Mergers (required) – Sale of substantially all firm assets/firm dissolution
       4. Shareholder precatory (suggestion) proposals (if proper)
       5. Say-on-pay – Advisory vote on executive pay – At least every 3y, purely advisory
    2. **Shareholder Voting Mechanics – Generally**
       1. § 211 – Shareholder Meetings
          1. Annual meeting must be held, but can be anywhere designated in bylaws
          2. Directors elected @ meeting or by written consent (§ 228) if in cert.
          3. Board can call special meeting (§ 211(d)), SHs can call if cert./bylaws allow
       2. § 212 – Voting Rights
          1. 1 share, 1 vote default; Majority voting most decisions, directors by plurality
       3. § 212 – Proxies – (b) each SH can vote @ meeting, or express though a proxy
          1. Can only last 3y unless otherwise provided in proxy
          2. (e) Proxy is irrevocable if it says so, if and only as long as it is coupled with an interest sufficient in law to support irrevocable power. Can be irrevocable even if interests something unrelated to the corporation generally
       4. § 213 – Record Date – Date that fixes SH identities
       5. § 216 – Quorum – In cert., must be > 33%, default 50%
       6. SHs for the meeting are fixed @ record date (§ 213) – does not change even if those shares are bought/sold
          1. Can’t be closer than 10d or longer than 60d from meeting
          2. Must be in future, can’t back-date
       7. § 219 – Shareholder List – Available to SHs for purpose germane to meeting
       8. § 220 – Books and Records – Available to SHs for purpose related to SH interest
          1. Burden on corp. for SH list, burden on Π for all else
  1. **Reimbursement**
     1. **Analysis** (*Levin*, *Rosenfeld*)
        1. Management may be reimbursed for costs in a proxy contest

**See Page 43 Flow Chart!**

* + - * 1. Must concern a corporate policy and **NOT** a personal fight for control
      1. If incumbent wins
         1. Reimbursed for expenses that are reasonable, proper, and in good faith
      2. If insurgent wins
         1. Reimbursed for expenses that are reasonable, proper, and in good faith
         2. Majority of board must approve and be ratified by SHs
      3. Reasonable Expenses
         1. Consider size of firm (how difficult to get quorum?), amount of firm’s assets
         2. Typically covers proxy soliciting companies, PR firms, outside lawyers, courting large SHs
    1. **Policy** (*Levin*)
       1. Corporate resources should be spent informing SHs – preference for fully informed SHs
       2. Board is in charge of flow of info until ousted
       3. Without reimbursement, even good directors wouldn’t inform SHs
    2. **Cases**
       1. *Levin v. MGM*
          1. Battle between two opposing groups, policy battle, Π sues Δ complaining Δ used corporate assets to wage proxy battle
          2. Proxy stated that corp. will bear costs, disclosed outside firms (proxy solicitor, PR firm, attorney), and estimate of costs
          3. Holding: Board can be reimbursed for reasonable costs
       2. *Rosenfeld v. Fairchild Engine and Airplane Corp.*
          1. Insurgent group wins proxy fight, reimbursed old board then asked to reimburse themselves 🡪 SH ratify
          2. Holding: Incumbent can reimburse (*Levin*), insurgent can reimburse, but must be approved by board and ratified by SHs
          3. Two claims

Self-Dealing – Vote of SHs cleanses

Waste – No consideration, reimbursement is only after win 🡪 normally requires unanimous SH approval but court creates policy exception based on *ex ante* benefits provided by proxy contest

* 1. **Shareholder Inspection Rights**

**See Page 43 Flow Chart!**

* + 1. **§ 113 – Proxy Expense Reimbursement**
       1. (a) Bylaws may provide for reimbursement of SH for soliciting proxies subject to:
          1. (1) Eligibility (#/% shares, duration), (2) Limitation on reimbursement based on % votes in favor of nominees, (3) Limitations concerning cumulative voting (§ 214), (4) any other lawful condition
       2. (b) No bylaw can apply to elections occurring before adoption of bylaw
    2. **§ 112 – Access to Proxy Solicitation Materials**
       1. Bylaw may provide that company soliciting proxies may be required to include one or more nominees of a SH subject to:
          1. (1) Eligibility (#/% shares, duration), (2) Required info about the nominees, (3) Limitation on #/% of directors on board or whether SH previously nominated people, (4) Provision precluding nomination by/for someone that will buy shares in a period before election, (5) Indemnification for losses resulting from any false or misleading info from SH, (6) Any lawful condition
    3. **§ 219** – 10d before SH meeting, list of SHs entitled to vote must be open to any SH for any purpose germane to the meeting (NOTE: 10d impossible to do anything)
       1. Stock Ledger – On-going list of SHs
       2. SH List – SHs entitled to vote at the meeting
    4. **§ 220** – SH has right to inspect & copy stock ledger, list of SHs & other books and records for any proper purpose
       1. NOTE: NY has stake and holding requirement, DE does not
       2. Proper purpose – Reasonably related to interest as a SH
       3. Burden – For SH list, burden on firm, otherwise burden on SH
          1. NOTE: NY burden on firm for both
    5. **§ 216** – Quorum – SHs can adopt bylaw to require majority of outstanding stock for election 🡪 directors cannot change it
    6. **Cases**
       1. *Pillsbury v. Honeywell* (DE Law)
          1. Anti-war group wants SH ledger/records dealing w/ munitions manufacture
          2. Δ refuses as improper, SH argues that any SH disagrees w/ board has absolute right to inspect records for purpose of soliciting proxies
          3. Holding: No inspection without proper purpose

Petitioner must have *bona fide* investment interest in long/short term profit

* + - * 1. *Compare Napalm Cases* – Frame moral crusade under financial purpose
      1. *Crane v. Anaconda* (NY Law)
         1. SH list battles are under state law
         2. SH seeking list for hostile take-over can access list for proper purpose
      2. *Seinfeld* (DE)
         1. SH burden to inspect books is preponderance
         2. Must present some evidence establishing credible bases to infer entitlement

i.e. Legitimate issues of possible waste, mismanagement, etc.

* + - 1. *King v. Nerifone*
         1. SH that files derivative suit can file § 220 later for proper purpose
         2. Suit dismissed because demand required does not preclude subsequent SH suit
      2. *Sadler v. NCR* (NY)
         1. AT&T attempt to acquire NCR @ $90/share rejected
         2. Under NCR charter, need 80% of shares to replace board @ meeting
         3. CEDE List – List of brokers holding street name stock in name of depository
         4. NOBO List – List of SH who don’t object to having their names disclosed
         5. Holding: Sadler can demand NOBO list

Subsequent development: NY brought in line with DE

Can only get NOBO list if firm has already generated it

**Reimbursement**

|  |  |
| --- | --- |
| **Board** | **Shareholders** |
| **Incumbent Board**  (*Levin*)  Management can be reimbursed if:   1. Contest is over policy 2. Expenses are reasonable and proper   **Insurgent Board**  (*Rosenfeld*)  (1) & (2) +   1. Insurgent wins seats 2. Approved by board 3. Ratified by SHs | **Proxy Expense Reimbursement § 113**  Bylaw may provide for reimbursement of SH for proxy solicitation  **Limitations**   1. #/% shares/duration 2. Required info re: nominees 3. Limitations concerning cumulative voting (§ 214)   No bylaw can apply to elections occurring before the adoption of the bylaw |

**Annual/Special Meeting - § 211**

Date specified in cert./bylaw (*Airgas*)

Directors elected @ meeting or by written consent (§ 228) if in cert.

Board can call special meeting (§ 211(d))

**§ 213 – Record Date**

Set identities of SHs

Not retroactive

**SH Proposals/Access to Company Proxy**

|  |  |
| --- | --- |
| **Federal** | **State** |
| **Rule 14a-8**  Enables SHs to submit proposals to be mailed in firm’s proxy @ firm’s expense  (b) Eligibility – 1% stock or $2k value for 1y & through meeting  (c) 1 proposal/meeting  (d) 500w, board response unlimited  **14a-8(i)** – Exclusions   1. Improper under state law    1. §109(a) bylaw must be procedural/precatory    2. Can’t amend cert/do merger 2. Illegal act 3. Misleading statements 4. Personal grievance 5. Small stakes - <5% assets/revenue or not otherwise significantly related (*Lovenheim*) 6. Relates to office election    1. Can be procedural, but can’t affect individual election outcome (*AFSCME*) | SH attending annual meeting can offer any proposal on a proper subject that SHs can vote on  **Access to proxy § 112**  Bylaw may provide that company soliciting proxies be required to include 1+ SH nominees  **Limitations**   1. #/% shares, duration 2. Required info re: nominees 3. #/% of directors on board or whether SH previously nominated 4. Indemnification for false/misleading statements |

**SH Inspection Rights**

|  |  |
| --- | --- |
| **Federal** | **State** |
| **Rule 14a-7**  Board can disclose SH list or mail materials at SH expense | **SH List § 219**  10d+ before meeting, SH list is open to any SH “for any purpose germane to the meeting”   * Even if purpose is hostile take-over (*Crane*) * Burden on corp. to prove not proper purpose   **Books and Records § 220**  SH can inspect/copy stock ledger, SH list, & other books for any proper purpose   * Burden on corp. for list, else SH * NY – Corp. for both * Not solely for political goals (*Pillsbury*) |

* 1. **Federal Law: Shareholder Proposals**

**See Page 43 Flow Chart!**

* + 1. **S.E.A. of 1934 § 14** – It shall be unlawful for any person to solicit a proxy in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest of for the protection of investors
    2. **S.E.C. Rules**
       1. 14a-7 – Disclose or mail rule – Board can either mail SH material or disclose SH list 🡪 most boards mail material and keep the list confidential
       2. 14a-8 – Enables SHs to submit proposals to be mailed to SHs in firm’s proxy @ firm’s expense – Solution to collective action problems
          1. 14a-8(b) – Eligibility requirements – 1% or $2k value for 1y, must hold through meeting.
          2. 14a-8(c) – Number of proposals – 1 proposal/SH
          3. 14a-8(d) – Length of proposal – 500wds (Management response unlimited)
          4. 14a-8(e) – Timing requirement – Not < 120d before proxy sent out
          5. 14a-8(i) – Grounds for company to exclude

(1) Not proper for action by SHs under state law

Anything violating § 141(a), 242 (amend cert), 251 (merger)

Solution – Make statement “precatory’ (advisory) or amend bylaws

Limitation – bylaw cannot violate 141(a) (must be procedural)

(2) Would require illegal act if implemented

(3) Misleading/fraudulent under 14a-9

(4) Relates to personal grievance

(5) Concerns “small stakes” matter

Proposal accounting for < 5% of firm’s total assets or net earnings and **isn’t otherwise significantly related to firm’s business**

(6) Matter beyond the power of the firm to effectuate – unrelated to firm

(7) Relates to ordinary business operations

(8) Related to election to office (Can’t nominate directors) exclude if:

(i) Would disqualify nominee standing for election

(ii) Would remove a director from office before term expired

(iii) Questions competence, BJ, or character of nominee

(iv) Seeks to include specific individual for election to board

(v) Otherwise could affect the outcome of election

(9) Conflicts with a company proposal

(10) Proposal has been rendered moot

(11) Proposal is duplicative of another

(12) Proposal submitted previously and lost

(13) Proposal relates to specific amounts of cash or stock dividends

* + - * 1. 14a-8(j) – Request for SEC no action letter on decision to exclude SH proposal
    1. **State Law**

**See Page 43 Flow Chart!**

* + - 1. Under DE, SH in attendance @ annual meeting can offer proposal for SH vote
         1. Must be on proper subject that SHs can vote on
      2. SH may obtain SH list to communicate with SHs about proposal and to obtain proxies @ SH’s expense
    1. **Analysis – SH Proxy Nominations**
       1. Cannot get to proxy through federal (14a-8(i)(8))
       2. Implement two bylaws – nominate short slate and get reimbursement if they win
          1. State law does not allow these two bylaws on the company proxy
          2. BUT 14a-8 lets you get the proposal to SHs unless excludable under (i)(8)

Also not excludable under (i)(1) 🡪 not contrary to state law (112/113)

* + 1. **Cases**
       1. *Lovenheim v. Iriquois Brands* (Interpretation of 14a-8(i)(5))
          1. Request for study of French production techniques for *foie gras*
          2. Management attempts to exclude under 14a-8(i)(5) 🡪 Sales were $79k (loss of $3k) out of $141mil in total and $78mil in assets
          3. Holding: 14a-8(i)(5) is “otherwise significantly related to issuer’s business”

Cannot exclude if socially significant & has nexus to firm’s business

* + - 1. *AFSCME v. AIG* (2nd Cir.)
         1. SH proposal to amend bylaws to require company to include SH nominated candidates on its ballot – Board moves to exclude under 14a-8(i)(8)
         2. Bylaw allowed, excluded if related to “an” election not elections generally
      2. *CA v. AFSCME*
         1. AFSCME proposal requiring reimbursement of expenses to nominate candidates if fewer than 50% contested and SH gets 1+ candidate elected
         2. Test

Is bylaw one that established or regulates the process for substantive director decision-making or mandates the decision itself?

If so, it violates § 141(a), no? – does it simply regulate process/procedure?

Bylaw must have a fiduciary out

* + - * 1. Analysis

Can’t exclude under 14a-8(i)(8)

Bylaw is requiring reimbursement

§ 109 says SH can adopt bylaws

Board could certainly adopt this bylaw

SH power to adopt a bylaw is not the same as board

Can’t invalidate simply because it costs $

Can’t simply regulate process because can still cross § 141(a)

SH can put in bylaw to get short-slate but needs fiduciary out

NOW! §§ 112, 113 eliminate the fiduciary out problem

* 1. **Federal Anti-Fraud Statutes and Regulations Governing Proxies**

If there is materially misleading proxy:

1. 14a-9 injunction/damages
2. State law breach of FD – SDX/DoC/DoL/etc. 🡪 fairness/damages
   * 1. **Generally** – 14a-9 forbids false/misleading statements (or omissions) in proxy solicitation materials, *Borak* creates implied right of action
     2. **Elements**
        1. **Breach of cognizable securities law duty**
           1. False/misleading statements of material fact or “correction omissions” in proxy solicitation (i.e. omission with duty to disclose)
           2. False or misleading opinions are also proscribed
        2. **Materiality** (Similar to 10b-5 actions, pg. 64)
           1. Need materially misleading statement or misleading because of an omission
           2. Test – *TSC v. Northway*

Material if there is a substantial likelihooda reasonable SH would consider it important in deciding how to vote

Fact must have assumed actual significance in SH *deliberation* (does not have to affect outcome)

Substantial likelihood omitted fact would be viewed by reasonable SH as having significantly altered the “total mix” of available info

|  |  |
| --- | --- |
| **§ 14(a) Liability – Test for materiality** | |
| Statement of Fact (*TSC v. Northway*, *see Mills*) | Statement of Opinion (*Virginia Bankshares v. Sandberg*) |
| 1. Objectively false – Statement of fact is incorrect at the time it is made or very soon after 2. Scienter – Board was at least negligent in arriving at relevant facts | 1. Objectively false – Statement of opinion implied something false or misleading about state of mind 2. Subjectively false – Board knew they were misstating the facts |
| **NOTE:** Requires **BOTH** (1) and (2) for liability! | |

* + - 1. **Scienter** – Intentional wrongdoing or reckless indifference
      2. **Transaction Causation**
         1. Reliance (*Mills v. Electric Auto Lite Co.*)

Must show **BOTH** (1) Materiality (type is again and refer above!) and (2) Proxy was an essential link in the transaction

Proxy is an essential link if you need to get votes for quorum or actual vote; CSH has enough shares for quorum – SOL, no shaming argument.

Vote Causation – If vote of minority SHs required to accomplish merger (*Sandberg*)

**CAREFUL** – Must alter what you would have done – i.e. if you already knew the board had a conflict of interest, it is irrelevant knowing the identity of the person that nominated them

* + - 1. **Loss Causation**
         1. Transaction causes the loss – Where fraud goes to factors influencing vote outcome, *ex post* damages are awarded if SHs can show loss

Reduction of consideration to SHs

Terms of the merger unfair to SHs

SHs that win get attorney’s fees

* + 1. **Cases**
       1. *J.I. Case Co. v. Borak* – Creates private right of action under 14a-9
          1. Concurrent with state law action (CSH merger, or CSH-SD-X)
       2. *Virginia Bankshares v. Sandberg*
          1. Proxy solicitation containing conclusory misleading statements: “The plan of merger has been approved by the board because it provides an opportunity for the SHs to achieve a high value for their shares” which was not the basis of the merger
       3. *Mills v. Electric Auto Lite Co.*
          1. Firm failed to disclose in its recommendation of merger to SHs that the board was dominated/controlled by the acquirer

1. **CONTROLLING SHAREHOLDERS** – See also CSH-SD-X (pg. 32)
   1. **Generally – 3 Situations, first see (b)/(c) on this page, then move to appropriate page**
      1. **If CSH is simply selling control, no liability w/out managerial breach (See below)**
      2. **If CSH merger, subject to *Weinberger*/*Kahn* fairness burden shifting (pg. 50)**
      3. **If CSH-Tender Offer, subject to modified *Pure* test for coercion (pg. 54)**
   2. Course of Action – **Minority Shareholder**
      1. Vote against the merger to allow perfecting of appraisal rights
      2. Enjoin merger based on fiduciary duties (*Weinberger*, pg. 50)
         1. Too late? Seek damages
      3. Claim merger violates express contractual right (*Rabkin*, pg. 53)
      4. In some jurisdictions (NOT DE), enjoin merger for “no proper business purpose” (*Coggins*)
   3. Course of Action – **Board of Directors**
      1. Create independent committee
         1. Give them **full** authority to bargain (Including walk-away/seek other offers)
         2. Advised by investment bankers that do a thorough job
         3. All directors serving the subsidiary and no one else
         4. Serious deliberation and negotiations – evidence of pushing the price up
      2. Majority of the minority vote
   4. **CSH Sells Control – No board decision, no BJR**
      1. **Analysis**
         1. Must have a CSH (pg. 32)
            1. *De jure*, or *de facto*
         2. Breach of managerial power
            1. SH acting *qua* SH there are no fiduciary duties
            2. **Notice** of a looter is sufficient to invoke duty to investigate (*Perlman*)
         3. CSH profits from a wrong against the minority SHs
      2. Equal Opportunity Rule – US does not have EOR (*Zetlin v. Hanson Holdings*)
         1. Would essentially require a tender offer
         2. Operation: Each SH sells pro rata percentage 🡪 buyer wants 51%, each sells 51%
         3. Result
            1. Minority SH has no right to be part of the deal, and no right to know about it 🡪 not a corporate opportunity, this is a personal opportunity to CSH
            2. No board vote, no board control = no fiduciary duties
         4. Policy
            1. Rule would deter CSH from selling to looters – still have skin in game
            2. Rule is more “fair”
            3. BUT decreased incentive to *ever* sell control

CSH can’t extract control premium – no incentive to acquire control

* + 1. **Cases**
       1. *Perlman v. Feldman*
          1. Feldman sells his 37% in Newport to buyer during big steel shortage
          2. Buyer is trying to lock up steel @ market price
          3. Argument is Feldman is getting cut in the wrong that buyer is going to commit against SHs 🡪 doing away with the “Feldman plan”
          4. Feldman plan – Get around government price controls by pre-selling steel for later delivery and investing the $ 🡪 time value of money
          5. Holding: CSH is getting financial benefit at the expense of minority (beyond control premium)
          6. Damages – Π get their share of the premium Feldman got even though this is a derivative action – Otherwise Newport gets a piece of the wrong they committed against the minority SHs
       2. *Delphi Financial*
          1. 7/9 board members are independent
          2. Class A/B stock 🡪 B has 49.9% of voting rights, *de facto* control

On merger, B converts to A so no control premium

* + - * 1. Firm forms IC, advised by counsel/bank – advised this is excellent deal
        2. Rosenkranz is intransigent, votes down any deal he can’t get premium
        3. Harmonics – Used corporate resources to find out how to mess up minority
        4. Analysis

CSH threat over board was to walk on deal – as CEO he is happy to stay

Prevents board from exercising BJ

Holding: Use of power in direct violation of a “deal” Δ made – breach of good faith/fair dealing

* + - 1. *DiGex*
         1. DiGex controls subsidiary worth a lot, DiGex worth jack
         2. WorldCom wants sub, DiGex won’t vote for merger (no breach)
         3. BUT WorldCom buys DiGex and asks sub to waive § 203 🡪 Minority SHs have claim of waste in the board waiving § 203 without consideration
  1. **Freeze Out Mergers (And Appraisal Rights) – CSH Forces Merger Into Itself**

Note: Usually direct suit 🡪 no demand

* + 1. **Analysis (CSH Merger – Fairness Burden Shifting) (*Weinberger*)**
       1. **BJR** – Rebut presumption of disinterestedness (interested directors)
          1. CSH-SD-X and board is interested
          2. Must show SD aspect (*Sinclair*)
       2. **Is there a CSH?** (*See Kahn v. Lynch and Wheelabrator*)
          1. Portion of shares

Majority (*de jure*), less than majority (see below to determine *de facto*)

* + - * 1. Control over board

Power through committees, especially compensation committee (*Lynch*)

* + - * 1. Past history

Historic evidence board capitulated to CSH

Veto power alone is not sufficient – combine w/ evidence of domination

* + - 1. **Self-dealing transaction?** 🡪 CSH-SD-X automatically kicks to FD/FP!
         1. Directors/CSH on both sides – DoL kicks out BJR, burden on interested to show fairness

Fair Dealing: Transaction timing, initiated, structured, negotiated, disclosed to board, how board and SH approval is obtained, duty of candor

Fair Price: economic factors, price a disinterested board would get (includes synergies from the merger)

* + - 1. **Burden shifting**
         1. Approval by board committee? (*Kahn v. Lynch*)

Was committee disinterested and fully informed?

Did committee exercise bargaining power at arm’s length?

CSH didn’t dictate terms of the merger

Special committee had *real bargaining power* that it used

Could board walk from the deal?

Use advisors?

Mandate to negotiate?

* + - * 1. Vote of *fully informed* minority SHs (essentially required in DE)
        2. If yes to either, burden shifts to Π to demonstrate fairness
      1. Duty of Candor (**Harmonics**) – CSH can’t use resources of the subsidiary to prepare reports/get inside information that is not shared with SHs (*Weinberger*)
    1. **Statutes**
       1. § 251 – Normal Merger Procedure
          1. Board approval of each firm to recommend merger to SHs
          2. Seek SH votes by proxy
          3. SHs vote – merger passes with majority of outstanding shares (including interested) (§ 251(d) – Board reserve the right to cancel even with approval)
          4. SH approval means all must sell shares under merger terms (exception: appraisal)
       2. § 251(f) Merger
          1. Rights of SHs in acquiring corp. remain unchanged

No change in charter, same # of shares, etc.

Non-target issues < 20% of shares outstanding before merger

* + - * 1. Can do merger with directors of both corp. & SHs of only target
      1. § 271 – Sale of firm assets
         1. Approval of directors and SHs of target
         2. Approval of board of acquitting firm
         3. NO APPRAISAL RIGHTS FOR MINORITY SHs
    1. **Appraisal Rights**
       1. § 262 – Appraisal is the right of any SH to have court calculate the value of the shares in the merger – SH is stuck with the valuation by the court
          1. **Eligibility** – Minority SH, holding shares on date of demand, cannot sell until merger is effective
          2. **Perfecting rights**

File notice of dissent during 20d window before SH vote on merger

Vote against merger

File petition for appraisal within 120d after merger becomes effective

Within 60d SH can withdraw and get merger consideration

Court determines who pays attorney’s fees

* + - * 1. **Valuation (§ 262(f))**

Court appraises shares, determines value exclusive of merger synergies together with fair interest rate

* + - * 1. Problems – SH pays own costs, no class action, limited remedy (no injunction, no merger synergies, etc.)
        2. Market out exception

No appraisal if shares are on an exchange, or company has at least 2k SHs

OR SHs have no right to vote on transaction

EXCEPT! SHs get appraisal if merger has consideration other than shares in surviving company or third company that has exchange-traded shares

* + - 1. Exclusivity – Appraisal is not the exclusive SH remedy
         1. If there is fraud, misrepresentation, self-dealing, deliberate waste of assets, or gross palpable overreaching
         2. *Glassman* – Appraisal only if no fraud or illegality

*Berger v. Pubco Corp.* – Full disclosure required otherwise SH appraisal class action available – recover difference between fair value and merger price with no down side and no need to opt in

* + 1. **Cases**
       1. *Weinberger v. UOP* (Fair Dealing includes duty of candor)
          1. CSH owns 50.5% - *de jure* CSH, Controls 6/13 directors and president
          2. FD Class Action

Solves collective action problem

Can file before merger is complete – can get fair price, rescission, value of alternative bid (if available), etc.

Low risk – Get damages or can still take merger value on loss

* + - * 1. CSH-SD-X is always under fairness, BUT use of committee acting at arm’s length, or vote of fully informed majority of minority will shift burden
        2. Fair Dealing – How transaction is timed, initiated, structured, negotiated, disclosed to board, and how director/SH approval is obtained

Includes Duty of Candor

Mainly turns on using UOP directors to generate report with UOP resources about firm valuation that isn’t disclosed to independent directors or SHs

Outside bank report doesn’t cure because it was sloppy

* + - * 1. Fair Price – Economic factors – assets, market value, earnings, future prospects, any other elements that affect intrinsic/inherent value of stock

DE “block” method

Fair value of firm as going-concern (as an operating business)

Per-share value of whole firm, not just minority interest

Includes non-speculative synergies from the merger

* + - * 1. When there is no fraud, price is the focus
      1. *Rabkin v. Philip A. Hunt Chemical Corporation*
         1. Olin buys 63.4% of PHC for $25/share, waits 1y and tenders at $20 to get around agreement 🡪 Breach is fraud/misrepresentation/SD
         2. *Cede* – SH class action challenging merger where Δ owed FD to SHs and SD

Not exclusive even if sole complaint is price and even if seeking appraisal damages (*Andra*)

* + - * 1. Holding: No dismissal (though X eventually fair) if CSH action was precisely contemplated in the K and but-for strategic behavior, CSH wouldn’t have done this
      1. *Kahn v. Lynch*
         1. Alcatel has 30.6 then 43.3% of Lynch, amends cert for 80% SH vote 4 merger
         2. Board – 5/11 board, 2/3 exec. Committee, 2/4 compensation (*de facto* control)
         3. Alcatel blocks Lynch merger w/ Telco, favors merger with Celwave – threatens hostile take-over during negotiations with independent committee
         4. Control

Evidence of board capitulating to Alcatel historically

CSH-SD-X, Alcatel on both sides, used control of board, not just voting

* + - * 1. Analysis (Fairness burden shifting)

Was committee disinterested and fully informed? (**BJR**)

Did committee exercise bargaining power @ arm’s length?

CSH didn’t dictate terms of merger

Special committee had *real bargaining power* which it can use

Can board walk away?

If yes, burden shifts to Π for fairness – not here!

* 1. **Short Form Merger**
     1. **Requirement** – Parent owns 90%+ of stock (§ 253)
        1. Merger can be consummated on approval of directors of parent (if surviving)
        2. If subsidiary surviving, requires approval of subsidiary board
     2. Appraisal is sole remedy if no fraud/illegality (*Glassman*)
        1. Disclosure is required so SH can decide re: appraisal (*Berger v. Pubco Corp.*)
           1. Failure to disclose material facts 🡪 *quasi* appraisal class action 🡪 can get difference between fair value/merger price, must opt out, no downside
  2. **CSH Third Party Merger**
     1. *In re Synthes*
        1. Start with BJR
        2. Π can get to fairness if CSH-SD-X
           1. CSH is on other side of the deal or
           2. CSH gets materially different terms from 3rd party than what minority gets
        3. If neither, then only fairness if CSH is forcing crisis sale to get cash
  3. **CHS Tender Offer**
     1. *Solomon v. Pathe*
        1. CS can do tender offer without fairness if
           1. Not structurally coercive
           2. Does not mislead minority SHs
        2. No duty to offer fair price
     2. *Pure* – **TEST**
        1. CSH tender offer is not coercive if
           1. No disclosure violations
           2. Nonwaivable majority of the minority requirement
           3. CSH promises that if > 90% then pays same consideration to remainder
           4. CSH makes no threats
           5. Board has free reign to react, get advisors, advise SHs
        2. Otherwise 🡪 FAIRNESS
        3. If passes – only remedy is appraisal §§ 253, 262 (pg.52)
     3. *Cox Communications*/*CNX*
        1. Adds to *Pure* limitation that the duly empowered committee of the board must be proactive 🡪 must act like this is any tender offer from any other party

1. **BOARD DUTIES DURING CONTEST FOR CONTROL**
   1. **Generally**
      1. Friendly Acquisition – Negotiate with management, statutory merger/sale of assets
      2. Hostile Acquisition – “Creeping” acquisition/tender offer (may require control premium) – replace board and proceed with statutory merger
      3. **Policy – Mergers and Corporate Value**
         1. Mergers Increase Value
            1. Bidder would only pay above-market if they can profit w/ long run value
            2. Replace bad management, new synergies between firms
            3. Bidder won’t bust a firm if whole is greater than the parts
         2. Mergers Decrease Value
            1. Winners Curse
            2. Inefficiencies in capital markets – High risk debt at low prices
            3. Bidder can get gains from other constituencies – Raiding pensions, etc.
         3. Justifications for Allowing Takeover Defenses
            1. Managers right to manage (§ 141(a))

Defenses to protect long-run firm strategy

* + - * 1. Manager ability to protect SHs

Coercive bids, paternalism (inadequate SH info, free rider problems)

* + - 1. Agency Costs
         1. Entrenchment – officers have long-run wealth linked to the firm
         2. Firm specific human capital investments
      2. Bebchuck – SHs must be allowed to vote once a bid is made. Board can educate the SHs about the bid, institutional investors are able to make educated choices
      3. Kahan/Rock – Board is in the best bargaining position, reduce agency costs through golden parachutes and other incentives
      4. Arlen/Talley – Boards will do things pre-bid that will replicate poison pill, etc. such as change of management clauses in contracts, that are protected by BJR
      5. Summary

|  |  |
| --- | --- |
| Reasons for Deference to Board | Reasons to Scrutinize Board |
| * Managers should make day-to-day decisions & long-term strategy * Managers are in better position to bargain * Worry that constraints will push managers to do something worse * Board/officers may protect long-run firm interests * SHs may sell at too cheap a price, fall prey to coercion * Defenses enable management to bargain for higher price | * Managers have strong self-preservation incentives * TO is usually worth it because managers are doing a poor job * Role of institutional SHs |

* + 1. **Summary of Defenses – Agency costs/reason to allow board defenses**

|  |  |  |
| --- | --- | --- |
|  | Pre Bid | Post Bid |
| Pure Defense | Poison Pill + Classified Board | Poison Pill/Scorched Earth |
| Embedded Defense (Mixed Motive) | Change of control clauses – BJR – Clauses in debt/contracts that mess everything up if company changes hands | White Knight |

* 1. ***Unocal* Test – Board Response to a Hostile Threat**

NOTE: After you pass *Unocal* – back under BJR, remember to look for challenges to BJR

* + 1. **Standard of Review** – Intermediate to BJR and Fairness due to inherent conflict of interest for the board when engaging in defensive strategies during a takeover
    2. **Analysis – 3 parts: Articulate threat, reasonable investigation, proportional**
       1. To justify a defensive measure, the board must show
          1. There was a **threat to corporate policy and effectiveness** (BJR-like analysis)

Board acted in good faith after reasonable investigation

And concludes there is a danger to corporate policy/effectiveness

Board must adequately investigate the threat (No battle of the experts)

* + - * 1. **Proportionality** – Action is reasonable in relation to threat posed

Cannot be preclusive or coercive (*Unitrin*)

Preclusive – Completely blocks anyone from purchasing the company

Is the response within the “range of reasonableness” (*Unitrin*)

Is the response designed to eliminate/ameliorate the threat?

Must be related to the threat – doesn’t have to be the least bad thing

Can “just say no” to a particular bidder (*Time*)

Board can refuse to redeem pill even if SHs want the deal (*Airgas*)

* + - * 1. If (a) and (b) satisfied 🡪 BJR!
    1. **Legally Cognizable Threats Under *Unocal* (*Unitrin*)**
       1. Opportunity Loss – Hostile offer deprives SHs of superior alternative (*Time*)
       2. Structural Coercion – *e.g.* 2-tiered bid with weak back-end (*Unocal*)
       3. Substantive Coercion – Risk that SHs can mistakenly take a low offer because they don’t believe management’s claims of intrinsic value of the alternative
          1. These are the paternalistic situations (*Time*, *Airgas*, etc.)
       4. Factors
          1. Coercive offer (2-teir offer with weak back-end) (*Unocal*)
          2. Inadequate price (*Airgas*) – Board is more informed about long-run value
          3. Nature/timing of the deal

Hostile offer threatens long-run plans of the firm (*Time*)

Timing of the offer can confuse SHs who don’t have adequate info

* + - * 1. Risk of nonconsumation
        2. Quality of instruments/exchanged
        3. Questions of illegality
        4. Impact on other constituencies (equity must be indifferent) (employees, customers, creditors, etc.)

Focus must be on long-run value of the firm

*RJR v. Nabisco* – Board can consider other constituencies when it is unclear which bid will help SHs more

* 1. ***Revlon* Test**

Trigger?

* Bust up sale of firm
* Abandon long-run strategy
* Selling control

Don’t want liability? 🡪 Don’t un-level the playing field

* + 1. **Rule** – Once the break-up of the firm is inevitable, the board’s duty shifts to maximizing SH value since there is no possible threat to corporate policy/effectiveness that would trigger *Unocal*
    2. **Triggering *Revlon* Duties (*QVC*)**
       1. Corporation initiates an **active bidding process** seeking to sell itself or effect reorganization involving a clear breakup of the company (*Revlon*)
       2. In response to bidder’s offer, a target **abandons long term strategy** and seeks alternative transaction involving the breakup of the company (*Revlon*)
       3. The board is **selling control** 🡪 Alienating the control premium (*QVC*)
          1. Deal creates a CSH when there wasn’t one before (*Compare Time with QVC*)
          2. Merging two companies with dispersed SHs doesn’t trigger *Revlon*
    3. **Test – Enhanced Scrutiny (*QVC*) – Get Highest Value for SHs**
       1. Judicial determination about adequacy of decision making process
          1. *Smith v. Van Gorkom*/*Disney* DoC examination

*Revlon* changes board duty from maximizing value of firm to maximizing value to SHs 🡪 includes DoC

*Revlon* is usually direct class action

*Unocal* is usually derivative

* + - 1. Judicial determination of reasonableness of board actions under the circumstances
         1. Defensive measures must be designed to maximize SH value
      2. Directors must obtain best value reasonably available – Factors
         1. Be diligent/vigilant in examining the deals
         2. Act in good faith
         3. Obtain/act with due care on all material information reasonably available
         4. Negotiate actively and in good faith with all bidders
      3. Synergies with the new firm can only be considered if SHs are receiving an interest in the new firm 🡪 All cash deal cannot consider synergies
    1. **The Board CANNOT**
       1. Can’t protect other constituencies – White Knight, note holders, creditors, etc.
       2. Can’t prefer White Night without reason why it protects SHs
          1. Preferential treatment of one bidder is only valid if it is necessary to benefit SHs – White Knight can’t enforce preferential agreements adopted in breach of fiduciary duties
       3. *Del Monte* Enhanced Scrutiny – Court uses enhanced scrutiny when directors face structural or situational conflicts that don’t rise to entire fairness
          1. Unreasonableness, undue favoritism/distain for a bidder, non-SH motivated influence that calls process into question
          2. Board can rely on experts, but if experts are deceiving the board, they can’t be relied on anymore

*Revlon* Remedy: Enjoin transaction, or unravel deal

* Not fairness if board fails *Revlon*
  1. **§ 203 – Moratorium Statute**
     1. Creates much the same effect as a classified board with a poison pill
     2. Rule – Firm may not engage in a “business combination” for 3y with an “interested SH” (15%+) unless
        1. Bidder gets 85%+
        2. Target board approves tender offer/combination before bidder acquires 15%
        3. Target board approves merger after 15% **AND** 2/3 of remaining SH approve
     3. Corporation can opt out in bylaws or cert
        1. Doesn’t take effect for 12mo
        2. Doesn’t apply to bidder that buys before amendment
     4. Response – Toe-hold purchase, replace board, merge. Counter: classified board
  2. **Poison Pills**
     1. **Generally** – Adopted by board without SH action, gives SHs an economically irrational right contingent on a triggering event (4.9% of shares has been held ok)
     2. **Flip In** – Entitles each SH, except acquirer, to buy 2 shares of issuer’s common stock/security at half price
     3. **Flip Over** – If, after trigger, target is merged into acquirer, each right holder is entitled to purchase common stock of the acquiring company at hald price
     4. **Dead Hand** – Can be redeemed only by board that puts it in place (invalid under § 141(a) in DE) (*Carmody*)
     5. **No Hand** – Cannot be redeemed for duration of the pill
  3. **Cases**
     1. *Unocal v. Mesa*
        1. Mesa owned 13%, 2-teir, front-loaded tender offer at $54 to get 37% more
        2. Second step was highly subordinated debt
        3. Board strategy was to trigger buy-back of shares from remaining 49% at $72
           1. Mesa not included 🡪 “Scorched Earth”
        4. Holding: Unocal board was independent directors, acted in good faith, after reasonable investigation and found Mesa’s offer inadequate and coercive
           1. Device adopted was reasonable in relation to the threat posed
        5. Unless it is shown by preponderance of evidence that board decisions were primarily for entrenchment or other breach of fiduciary duty (fraud, over-reaching, lack of good faith, under informed, etc.) the court will not substitute its judgment for that of the board
        6. Aftermath
           1. SEC Rule 16b: 10%+ SH that buys/sells stock within 6mo must forfeit profits
           2. SEC Creates Rule 13e-4(f)(8) – No discriminatory self-tenders
     2. *Revlon v. MacAndrews and Forbes Holdings Inc.*
        1. NOTE: Majority of the board not truly independent
        2. Pantry Pride attempted take-over of Revlon
        3. Board adopts Poison Pill & White Knight (Forstmann)
           1. Company does buy-back of shares in exchange for securities

High interest, covenants tying firm’s hands, waive-able by management

* + - * 1. Forstmann offers cash-out merger for $57.25 and to shore up the market value for notes they traded in the buy-back
        2. Lock ups – No shop, $25mil cancellation fee, call option on Revlon’s 2 best subdivisions at a discount
      1. Analysis
         1. Initial poison pill and share repurchase plans are under *Unocal*

Threat – Low bid price – cognizable threat

Investigation – Investment banker established price estimate

Proportional

Protected SHs from low price

Enabled board to bargain and resulted in raising tender offer

* + - * 1. After Forstmann White Knight deal 🡪 Break up of firm is inevitable

Board’s duty shifts to maximizing SH value – no possible threat to corporate policy/effectiveness 🡪 no more firm

*Smith v.Van Gorkom* heightened scrutiny at firm dissolution

NOTE: No auction requirement

Preferential treatment of one bidder is only valid if necessary to benefit SHs, can’t enforce preferential agreements made in breach of FDs

* + - 1. Summary – Nature of board’s duty changed when context switches from corporate preservation to corporate sale/dissolution
         1. Two problems: (1) Consideration of interests other than maximizing SH value (protect board from litigation from note holders), (2) Favoritism instead of open auction (lock up meant to deter, one bidder privy to special info to exclusion of other bidders, etc.)
    1. *Paramount v. Time, Inc.* (Just say no! You’ve got the right to say no!)
       1. Time-Warner stock-for-stock merger in the works, Warner SHs would own 62%
          1. Covered by BJR – Not a defense so no *Unocal*, doesn’t create CSH
       2. Paramount approaches with tender offer for time
          1. $175 then $200/share fully negotiable – i.e. awesome offer
       3. Time board restructures the deal so that Time buys Warner ($7-10bil in debt)
       4. Trigger *Revlon*?
          1. Time-Warner merger was part of firm’s long term strategy
          2. “Sale” of Time was not inevitable (indeed it is not happening anymore)
       5. No *Revlon*, so restructured deal is under *Unocal*
          1. Threat – Offer threatens firm’s long-run plans to merge with Warner

Concern that SHs would reject a “superior” deal with Warner in ignorance or mistaken belief that Paramount bid is better – bid serves to confuse SHs

Investigation – Board refused to negotiate with Paramount, still valid because board had considered Paramount before pursuing Warner

* + - * 1. Proportionality – Reasonable since the change in structure wouldn’t kill Time, and would guarantee the deal goes through because no longer need SH vote
    1. *Paramount v. QVC*
       1. Paramount seeking merger with Viacom, QVC offer to Paramount
       2. Paramount locks up merger with Viacom
          1. No sop
          2. $100mil termination fee if board doesn’t recommend or *SHs don’t approve*
          3. Lock up – Option to purchase ~20% of stock at $64.14/share

Viacom can pay with subordinated debt, or Paramount can pay Viacom the difference between $64.14 and market value

* + - 1. Trigger *Revlon*?
         1. Distinguish *Time* – T/W deal didn’t alienate control premium
         2. This deal results in Viacom (owned 85.2% by Redstone) as CSH
      2. Analysis
         1. Process – Board didn’t diligently pursue QVC, didn’t get all information, didn’t consider impact of defenses on ability to get a better deal, board can’t pre-commit to not negotiate
         2. Substance – Lock-ups, etc. were draconian, far beyond what was necessary
    1. *Air Products and Chemicals v. Airgas*
       1. Airgas board refuses to redeem pill facing non-coercive, all-cash, fully financed tender offer, and board has already lost one election contest (classified)
       2. Holding
          1. If board has a good faith, reasonable basis to believe a bid is inadequate, sufficient to show a threat and invoke *Unocal*
          2. Board can use poison pill to block inadequate bid even if SHs want to accept
       3. NOTE: Air Products own directors that joined the board also disapproved offer
    2. Hypo: Bidder A wants to get target T, offers $*X* for T, T wants $*X*+10, A goes to $*X*+5 but indicates final offer
       1. A does proxy contest, gets 3 seats on classified board
       2. SHs clearly want the offer, board refuses indicating inadequate price
       3. A sues
       4. **Step 1**: Contest for control, so enhanced scrutiny, no BJR – *Unocal* or *Revlon*?
          1. No sale of control, break up of firm, or change in long run strategy 🡪 *Unocal*
       5. **Step 2**: Is there a cognizable threat to corporate policy and effectiveness?
          1. Board indicates low price, has investigated and determined in good faith
       6. **Step 3**: Is response proportional?
          1. Preclusive? No, can always redeem the pill
          2. A will argue can’t always say know – no risk SHs will rush, have had a long time to consider, have lots of info, etc.
          3. *Airgas* – Same situation, SHs had a long time, lots of info, etc.

While the court has reservations, this falls under § 141(a), pass *Unocal*, get BJs

* + 1. *In re Del Monte*
       1. Barclays playing both sides of a deal
          1. Sell-side advising DM, Buy side financing
          2. Puts together two highest bidders to stifle further bidding
          3. Continues to seek sale of Del Monte against their instructions, etc.
       2. Barclays comes clean about working both sides
          1. Board doesn’t leverage permission to get better deal
          2. Board spends $3mil on additional fairness opinion due to conflict
          3. Board has Barclays run “go-shop” despite massive conflict
  1. **Contest for Control in Proxy Contest – SH Voting Control**
     1. **Creeping Tender Offer – Spot the issue**
        1. Buy toe-hold, proxy contest to replace board, redeem pill, merger
     2. **Acceptable Defenses**
        1. Issue stock to friendly hands
        2. Put classified board and best assets into spin off company
        3. Sell off best assets
        4. Debt covenants to impede corporate combination with raider
        5. Proxy contest
     3. **Analysis (*See Blasius*)**
        1. Does the board have procedural power to do what it did (DGCL)?
        2. Does the board have substantive power to do what it did (cert/bylaws)?
        3. Is this an exception? 🡪 Do they get BJs? (see iv/v)
     4. **Prerequisite – Almost Impossible to Trigger *Blasius***
        1. Primary purpose of the board must be to interfere with voting
        2. SHs must not be given full/fair opportunity to vote
     5. **Test (*Blasius*)**
        1. Did the board primarily act for the purpose of impeding SH voting power?
           1. Is the action taken to prevent SHs from electing new directors?
        2. If yes, board bears a heavy burden of demonstrating a compelling justification
     6. **Cases**
        1. *Schnell v. Chris Craft*
           1. Proxy contest for firm control
           2. Management amends bylaw to move up annual meeting
           3. Procedure? – yes, § 109; Substantive? – yes, bylaw specifies date of meeting; Exception? – No BJs for trying to interfere with specific SH vote in specific election 🡪 rebuts BJR
        2. *Blasius v. Atlas Corp.*
           1. Blasius is largest Atlas SH, proposes restructuring, management objects
           2. “Wounded Bird” – Charter sets max directors @ 15, bylaws set actual @ 7

Blasius solicits proxies to amend bylaw to 15 and elect 8

Board responds by amending bylaws to 9 and appoints 2

* + - * 1. Procedural/substantive (same as *Schnell*)
        2. Exception?

BJR – This is not under § 141(a) – SHs and board are equally good at deciding who should manage

No *Unocal* because there is no take-over 🡪 restructuring

* + - * 1. Distinguish *Time* – SHs only had right to vote on merger because board suggested the merger – otherwise no inherent voting right there

1. **FEDERAL REGULATION OF DISCLOSURE & INSIDER TRADING**
   1. **Generally**
      1. When a manager makes a public statement, they cannot mislead SHs/lie
      2. Lies – Actual false statement, or true statement that omits a material fact making the statement misleading
   2. **Rule 10b-5**
      1. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange
         1. (a) To employ any device, scheme, or artifice to defraud
         2. (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
         3. (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
         4. In connection with the purchase or sale of any security
   3. **Elements**
      1. **Material Misstatement of Fact**
         1. Underlying misstatement/omission must involve a “fact” or opinion about a fact
         2. Materiality – Substantial likelihood reasonable SH would consider the information/omission significant in deciding whether to buy shares (*TSC*)
            1. SH would deem omitted fact to alter the total mix of available info
      2. **Scienter** – Knowing/intentional misstatements (*Ernst & Ernst v. Hochfelder*)
         1. At least Recklessness – deliberate indifference to knowledge
         2. Must know that statement is false/misleading, irrelevant why you say it
         3. Must plead with particularity
      3. **Standing**
         1. Must purchase/sell securities during relevant period (*Blue Chip Stamps*)
      4. **Causation**
         1. Transaction Causation – Fraud caused Π to do the transaction which caused harm
         2. Loss Causation – Transaction caused the harm
      5. *Basic v. Levinson*
         1. Combustion negotiating to buy Basic
         2. Basic denies rumor circulating about merger in 2 statements
         3. Merger goes through
         4. People that sold stock between announcement/merger sue
         5. Reasoning
            1. Rejects agreement-in-principal – i.e. can lie about merger until finalized
            2. Probability/Magnitude – Something is uncertain but not irrelevant

Materiality can depend on probability of the occurrence

* + - * 1. Harm – Π was harmed because lie caused them to sell stock at a particular price 🡪 In open market, Π relies on the market price being a “fair price” based on public info 🡪 not distorted by fraud

Efficient market hypothesis – Price is unbiased estimate of firm value based on publicly available info

* + - 1. Holding – Creates rebuttable presumption fraud affected price and SH relied
         1. Rebutting presumption

Shares are not trading on efficient market

Market price was unaffected by the fraud

Market didn’t believe it

Truth must enter market in sufficiently credible way to eliminate the effect of the lie

Π didn’t rely on the market price 🡪 did his own research, etc.

1. **Business Judgment Rule Check List**
   1. Requires an affirmative act of the board
   2. 3 Presumptions – Π has the burden of rebutting the presumptions
      1. **Prong 1** (DoL): **Disinterested** (Objective standard)
         1. Rebut (*Bayer* – Celanese hour) (pgs. 28-33)
            1. At least 1 director is SD or has material financial interest
            2. Is dominated/controlled by someone with a material financial interest
            3. Or owed FD to someone with a material financial interest in the transaction
         2. Cleansed? (pg. 28)
            1. § 144(a)(1): Approved by majority of fully informed, disinterested directors

*Benihana* (pg. 29)

* + - * 1. § 144(a)(2): Approved by a majority of fully informed disinterested SHs

*Fliegler* – SHs are disinterested, *Wheelabrator* (pg. 29)

If vote is required, need cleansing and approval votes (*Gantler*)

* + - * 1. If cleansed, go to Prong 2
    1. **Prong 2** (DoC): Board took **due care** and made an **informed decision**
       1. Rebut (*Van Gorkom*) (pg. 22)
          1. Show gross negligence in board’s decision making process
          2. Test: Did directors inform themselves prior to making decision of all material information reasonably available to them?

Material: Information a reasonable SH would consider significant (*TSC*)

* + - 1. Ratified? (pg. 22)
         1. § 144(a)(2) – Majority of fully informed, disinterested SHs

*Fliegler* – SHs are disinterested, *Wheelabrator* (pg. 29)

If vote is required, need cleansing and approval votes (*Gantler*)

* + - 1. § 102(b)(7)?
         1. Board/directors, not officers, not liable for money damages
         2. Can still get injunction
    1. **Prong 3** (DoL): Acted in **good faith** (Subjective Standard)
       1. Rebut (*Kamin*, *Wrigley*) (pg. 20)
          1. Board didn’t act in rational good faith belief that action was in the best interests of the corporation (pg. 24)

Δ must articulate a rational basis regarding the firm why Δ did the action

* + - * 1. Δ cannot commit waste (pg. 20)
      1. Ratified?
         1. Requires unanimous vote of fully informed SHs
      2. Not Ratified? 🡪 § 124 – Can enjoin and get damages from board
  1. **Entire Fairness** – If BJR is rebutted, Δ must show transaction was fair (pg. 22)
     1. Fair Dealing
        1. Aggressive bargaining, fiduciary’s knowledge of the business, outside valuation/advice, importance of decision, timing of transaction, how transaction is initiated/structured/negotiated, how approval of directors and SHs is obtained
     2. Fair Price
        1. Magnitude of premium over market, surmountability of lock-ups, firm assets, market value, earnings, future prospects, synergies, variations in financing