**Corporations**

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**A. Introduction to the Law of Enterprise Organization**

* Basis for corporation law: encourage creation of wealth thru facilitation of voluntary, ongoing collective action (reduce transaction costs)
  + Searching for an efficient system
    - Efficiency generally: minimization of waste; production of max output
    - **Kaldor-Hicks efficiency** leads to overall improvement in social welfare
* **Coase**: firms exist bc w/ transaction costs, sometimes more efficient to organize complex tasks within a hierarchical organization, with estab’d auth and compensation structures, than on a market
  + Organization law: standard set of legal relationships between participants
* **Transactions cost theory**: owners of various resources are seen as committing to some contractual governance arrangement in order to reduce transaction costs and share the resulting efficiency gains
* **Agency cost theory**: incentives of agent differ from those of the principal 🡪 **agency cost**
  + Jensen and Meckling say 3 sources:
    - **Monitoring** costs – costs expended to ensure agent loyalty
    - **Bonding** costs – expend to ensure owners of their reliability
    - **Residual** costs – arise from differences of interest that remain after monitoring and bonding costs are incurred
* Problem of management inefficiency: can lead to excessive costs (inflated mgmt salaries) and shady dealings (self-dealing)
* Fiduciary duty – instead of clear (& manipulatable) rules, have the fiduciary principle
* With corp law efficiency and morality line up bc when address fairness, refers to fairness to shareholders which is generally consistent with increasing total corporate wealth and moving toward Kaldor-Hicks efficiency state

**B. Acting Through Others: The Law of Agency**

* **1. Introduction to Agency**
  + Agency: fiduciary relationship that arises with agreement between two people (Principle and Agent) where the P bestows legal power to act on the P’s behalf and subject to the P’ control on the A and it is accepted by the A
    - **Special agents**: agency limited to single act or transaction
    - **General agents**: agency contemplates a series of acts or transactions
  + Principals may be
    - **disclosed**: when third parties transacting with the agent understand that the agent is acting on behalf of a particular principal
    - **undisclosed**: when third parties are unaware of a principal and believe that the agent herself is a principal
    - **partially disclosed**: third parties understand that they are dealing with an agent but do know identity of the principal
  + Key question: Authority (the power of the agent to affect the legal relations of the principal)
    - **(1) Actual authority:** delegated by the principle (judged from perspective of reasonable A);
      * *Express authority­ –* A’s authority stated explicitly
      * *Implied authority* – what A reasonably believed that P meant when authority was delegated; comes up when creditors assume too much control in relationships that ostensibly contain debtor-creditor relationships
        + ***Jenson Farms v. Cargill*** (1980) (p**.**18): Cargill manifested consent that Warren would be its agent by directing to implement recommendations (control), other factors

“Agency results from manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act”

Factors here:

Constant recommendations

right of first refusal

agent’s inability to enter into mortgages etc

principal’s right of entry to check on / audit

P’s criticism regarding finances, salaries

P’s determination that A needed strong guidance

P’s provision of drafts and forms to A on which P’s name printed

Financing of all of A’s purchase and operating expenses

P’s power to discontinue financing

Different than bank lending situation bc was central to P’s business activity

* + - **(2) Apparent authority:** authority that P never meant to give but that a 3rd party would reasonably believe A had (judged by the acts of a reasonable 3rd party)
      * Equitable remedy designed to prevent fraud or unfairness to third parties who reasonably rely on P’s actions or statements in dealing with A
      * Black letter law: not reasonable for 3rd party to rely on the statements of an A as basis to establish the authority of the agent (need contact with P)
      * ***White v. Thomas*** (1991) (p.22) – *people bought land from agent who told buyers had powers she didn’t*
        + H: No apparent authority bc P’s actions didn’t indicate an agency, only A’s
    - **(3) Inherent authority** (“authority of position”): situations with no actual or apparent authority; gives agent power to bind a principal, whether disclosed or undisclosed, to an unauthorized contract as long as a general agent would ordinarily have the power to enter such a contract and the third party does not know that matters stand differently in this case
      * ***Gallant Ins. Co. v. Isaac*** (2000) (p.26) – *insurance agent signed contract; payment not made as dictated in the policy though made in may that usually accompanies similar transactions*
        + H: Inherent authority bc acted within usual and ordinary scope of authority
        + Third party had no reason to doubt that agent could make binding contract as did
    - **Scope** is that which a reasonable person in position of A would infer from conduct of P; includes incidental authority to do those implementary steps that are ordinarily done in connection with facilitating the authorized act
    - Either principal or agent can terminate at any time
      * If contract fixes a set term, then principal’s decision to revoke or agent’s decision to renounce gives rise to a claim for damages for breach of contract
    - There’s also **estoppel - change of position**
      * P liable to person who have changed their positions bc of their belief that the transaction as entered into by or for him, if
        + He intentionally or carelessly caused such belief, or
        + Knowing of such belief and that others might change their positions because of it, he did not take reasonable steps to notify them of the facts
      * Owner of property who represents to others that is another is the owner or recklessly allows to believe so is subject to loss of the property if the other disposes of it to third persons who, in ignorance of the facts, purchase the property or otherwise change their position with reference to it
    - **Ratification**: if P knows about action done by A on P’s account, even if A acted beyond scope and thus did not bind P, and either allows a benefit to accrue or detriment a 3rd party without notifying the 3rd party (R2d says if manifests that is authorized or conduct justifiable only if so)
      * Another way to affirm that a K is binding – fundamental fairness
      * Encourages people to act promptly to prevent further damage or to voluntarily assume damages that accrue to them
      * Different if undisclosed principal: then, agent is liable on K
    - Quick hits on liability:
      * General A for undisclosed P auth’d to conduct transactions subjects his P to liability for acts done on his account, if usual or necessary in such transaction, although forbidden by the principal to do them
      * An undisclosed P who entrusts an A with mgmt of his business is subject to liability to 3rd persons with whom the A enters into transactions usual in such businesses and on the P’s account, although contrary to the directions of the P
  + Agency can be terminated by either party at any time
* **2. Tort Liability**
  + Agents may be
    - **employee/servant**: agent controlled by principal in way in which goes about task
    - **independent contractor**: when control less extensive, exercises independent judgment
    - R §220: Servant is person employed to perform services in the affairs of another and who with respect to the physical conduct in the performance of the services **is subject to the other’s control or right to control**; consider
      * Extent of control
      * Whether employed is engaged in a distinct occupation or business
      * The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision
      * The skill required in the particular occupation
      * Whether the employer or the workman supplies the instrumentalities, tools ,and the place of work for the person doing the work
      * The length of time for which the person is employed
      * The method of payment, whether by the time or by the job
      * Whether or not the work is a part of the regular business of the employer
      * Whether or not the parties believe they are creating the relation of master and servant; and
      * Whether the principal is or is not in business
  + Principals liable for torts committed by **employees** (vicarious liability), but not **independent contractors**
  + R § 219: P subject to liability for torts of servants committed while acting in the scope of their employment and when
    - Master intended the conduct or the consequences, or
    - Master was negligent or reckless, or
    - The conduct violated a non-delegatable duty of the master, or
    - The servant purported to act or to speak on behalf of the principal and there was reliance upon apparent authority, or he was aided in accomplishing the tort by the existence of the agency relation
  + ***Humble Oil & Refining Co. v. Martin*** (1949) (p.30) – *car injury bc negligence at service station owned by Humble, run by agent Schneider*
    - H: Humble responsible (agent was emp) bc had power to control details of station work and employees there, required performance of activities, controlled hours; leverage against Humble was minimal
  + Contra ***Hoover v. Sun Oil*** (1965) (p.32) – *service station suit after fire*
    - H: No liability; independent contractor
    - Owner had no control over day to day details, though was required to purchase stuff, sales were restricted to using owner label
    - DE judges are more likely to reach a hard result (one that doesn’t seem as fair) as a result of legal formalism
* **3. Fiduciary Relationships**
  + **Fiduciary**: legal power over property held by fiduciary is held for sole purpose of advancing the aim of a relationship pursuant to which she came to control the property
  + Fiduciary is bound to exercise **good-faith judgment** in an effort to pursue the purposes established at the time of creation of the relationship
  + Fiduciary **Duty of Loyalty**
    - **Duty of Loyalty**: obligation to exercise legal power in manner that believes in good faith is best to advance the interest of the principal and not to exercise for personal benefit
    - Trusts are strictest forms of fiduciary obligation
      * Trustee holds legal title to trust property, which trustee is under a fiduciary duty to manage for benefit of the beneficiary
      * If a trustee breaches and court enforces some liability, severe damages; courts not sympathetic
      * Damages: under K law, difference btw value and what was paid; under trust law, difference btw the highest intermediate point and what was paid
      * **In Re Gleeson** (1954) (p.38) – *P executor of estate also co-tenant of trust real estate and did not account for share of profits received*
        + H: Any profit made through personal tenancy of land must be paid to the trust
        + Trustee cannot deal in individual capacity with the trust property, even if in good faith
    - All profits made by an A in course of agency belong to the P, whether fruits of performance or violation of agent’s duty; doesn’t matter whether principal has suffered damage
      * **Tarnowski v. Resop** (1952) (p.36) – *P-P relied on advice of A-D in purchasing business; D attested to conditions that proved untrue; P able to rescind contract, now alleges D collected secret commission which seeks to recover + losses suffered in operating, time, expenses*
        + H: Ps may recover from agent who has breached trust after a successful prosecution of an action for rescission against 3rd parties with whom A dealt for P
      * RST 407(1): If agent has received benefit as result of violating his duty of loyalty, principal is entitled to recover from him what has so received or its value plus the amt of damage thereby caused, except that if violation consists of wrongful disposal of principal’s property, the principal cannot recover its value and also what the agent received in exchange therefore
  + **Duty of obedience**: to docs creating the relationship / principal’s commands
    - Trustee subject to the terms of the trust, *not* the beneficiary
  + **Duty of care**: duty to act in good faith, as one believes a reasonable person would act, in becoming informed and exercising any agency or fiduciary power

**C. The Problem of Joint Ownership: The Law of Partnership**

* **1. Introduction to Partnership**
  + Partnership (UPA §6(1)): Association of two or more persons to carry as co-owners of a business for profit
    - Purpose: raise capital, specialization of roles, provide incentives to mgmt (ie options)
      * at some point selling an ownership stake may simply be a cheaper way to raise capital than attempting to borrow more funds
      * Whatever the costs of co-ownership, after certain point lower than agency costs of the debt contract
    - Aspects: temporal dimension, social identity, and separate pool of dedicated business assets
      * Property held by partnership is “tenancy in partnership”
      * The partnership, rather than the individual partners, exercises true ownership rights over partnership property
    - Three significant aspects of ownership:
      * (1) Right to **control** (mgmt): can control things you own (“right to exclude others in property”)
      * (2) **Agency**: partners are agents to each other and the business; each can bind the partnership when acting in usual course of business
        + Principle of *fairness* as fiduciary obligation of duty of partners
      * (3) **Liability**: each may be held personally liable for partnership debts
        + Rights to residual returns from asset: return that is left after you pay obligations (profit) – can be freely assigned; right to participate in assets on dissolution
    - Doesn’t have to be in writing (“partnership at will” – no terms), unlike corporation, which has to be filed with the state; partnership is just btw people and requires no formality
  + Uniform Partnership Act (UPA, adopted in all 50 states); Revised Uniform Partnership Act (RUPA, 1997, being adopted in many)
    - Significant change in RUPA is that not only is partnership an entity, but there is a provision that makes it a more stable form (doesn’t have to be reorganized with each partner change)
  + Partnership formation; multi factor determination for if is a partnership/partner
    - **Vohland v. Sweet** (1982) – *former emp was now to receive 20% of net profit*
    - Division of profits (aka interest in net income) is most important
    - Note: partnership has separate kinds of taxes, but no form filed here
    - Lack of daily involvement by one is not per se indicative of no-partnership
  + Agency conflict among co-owners
    - Partners in a business owe fiduciary duties to one another where a business opportunity arises during the course of the partnership
    - **Meinhard v. Salmon** (1928) – *managing co-venturer resigned lease without telling passive co-venturer*
      * H (Cardozo): Managing must have informed passive co-venturer about new opportunity because it belonged to the joint venture
      * Duty of loyalty breached where party appropriates to himself a benefit arising from status as a partner without allowing co-partner an opp to compete
      * Dissent: opp was outside scope of partnership bc dealt beyond 20 year lease partnership was created to manage
      * Law and Econ take: what would they have done if decided at beginning? Meinhard would likely bid against Salmon, helping the landowner; more K-H efficient
* **2. Relations with Third Parties**
  + General partnership form includes unlimited personal liability for partners; rights of creditors key thing then
  + Since partners are jointly liable for partnership debts, it’s important to know who the partners are:
    - (1) Who is a partner for liability purposes?
    - (2) When a partner withdraws from the partnership, how does it affect continuing liabilities?
    - (3) What’s the relationship btw creditors of a partner personally and creditors of a partnership? (important bc a partner’s liability on partnership debt can be satisfied from a partner’s non-partnership property)
  + Who is a partner? **UPA** stuff on this ie §§ 7, 12-16, 18; text p.56
  + 3rd party claims against departing partners
    - Dissolution of a partnership does not itself affect a partner’s individual liability on partnership debts
    - Continuing liability for existing obligations leaves the withdrawing partner in a tricky situation
    - **UPA §36(2):** partner is discharged from any existing liability upon dissolution of the partnership **by an agreement** to that effect **btw himself**, the partnership **creditor** and the person or **partnership continuing** the business; such agreement **may be inferred** from the course of dealing btw the creditor having knowledge of the dissolution and the person or partnership continuing the business
    - **UPA §36(3):** When **person agrees to assume** the existing obligations of an absolved partnership, the partners whose obligations have been assumed shall be **discharged from any liability to any creditor** of the partnership who, **knowing** of the agreement, **consents** to a material alteration in nature or time of payment of such obligations
      * AKA releases when creditor renegotiates debt with the continuing partners after receiving notice of the departing partner’s exit (as in ***Munn v. Scalera***)
    - strike balance btw making easy to escape 🡪 incentivizing partners to leave when trouble on horizon and making too difficult for departing partners to escape, externalizing risk of current partners
  + 3rd party claims against partnership property
    - fundamental char of all business entities is a segregated pool of assets available to secure business debts
      * without segregated assets, all of the business and personal assets of investors would be available to both business and personal creditors
    - UPA §25(1): Partner is co-owner of specific partnership property holding as a **tenant in partnership**
    - “Tenancy” affords individual partners virtually no power to dispose of partnership property, transforms into de fact business property; UPA §25(2) regulates:
      * partner cannot possess or assign rights in partnership property, partner’s heirs cannot inherit it, partner’s creditors cannot attach or execute upon it
    - Partner retains a transferable interest in the profits arising from the use of partnership property and the right to receive partnership distributions
      * Own rights to net financial returns that these assets generate, as well as governance or mgmt rights
      * UPA §26: A partner’s interest in the partnership is his share of the profits and surplus, and the same is personal property
  + Claims of Partnership Creditors to Partner’s Individual Property
    - Partners are liable for the partnership and personally liable when debts not fully satisfied by partnership property; how do individual assets get divided?
    - Bankruptcy Act of 1898 had common law **jingle rule:** partnership creditors have priority in all partnership assets but partner’s creditors are assigned first priority to the separate creditors of individual partners in the individual assets of those partners
      * **UPA §40(h):** “When partnership property and the individual properties of the partners are in possession of a court for distribution, partnership creditors shall have priority on partnership property and separate creditors on individual property”
    - Bankruptcy Act of 1978 modified so that creditors have priority of partnership assets (as always) but for personal assets, they have the same priority as others
      * 723(b): court may require partner to provide indemnity for any deficiency or may order a partner not to dispose of property
      * 723 (c): trustee’s claim (trustee is acting on behalf of partnership creditors) against the assets of any general partner is on a parity with individual creditors of the partner
    - What about when partnership not being liquidated, but the estate of an individual partner is itself being administered in bankruptcy?
      * No problem if partnership is sound, but partnership creditor could assert claim in the partner’s bankruptcy case.
      * Bankruptcy law creates no special rule; distributes assets according to applicable state law
      * UPA and RUPA diverge on Q of how an insolvent partner’s assets should be distributed
        + UPA: jingle rule; gives **partner’s** creditors priority over **partnership** creditors
        + **RUPA §807(a):** parity treatment rule
    - Summary:
      * In all cases, partnership creditors get first priority in the assets of the partnership
      * As to claims against the individual assets of partners:
        + Partnership creditors are subordinated to claims of partner’s credits in allocation of the partner’s assets if (1) UPA is controlling state law *and* (2) §723 does not apply (aka partnership is not in Chapter 7 or the individual partner is not in bankruptcy
        + Partnership creditors receive parity treatment if *either* (1) the RUPA is controlling state law *or* (2) §723 applies (the partnership is in Chapter 7 or the individual partner is in bankruptcy
* **3. Partnership governance**
  + Activities within the scope of the business should not be limited, save by express will of the majority
  + ***National Biscuit v. Stroud*** (1959) (p.61) – *Freeman makes deal, Stroud tells them to stop*
    - one partner’s purchase and sale of broad bound the partnership, the other partner because was an ordinary and legitimate business during its continuance as a going concern
    - each partner has authority to act as agent within scope of partnership
    - if say that any partnership deal can be intercepted by another partner, would have hyper-unstable form
  + **UPA § 18**: If ordinary matter of partnership, only a simple majority required; no act in contravention of any agreement btw the partners may be done rightfully without the consent of all the partners
* **4. Termination (Dissolution and Dissociation)**
  + **UPA §29**: Dissolution of the partnership is the change in the relation of the partners caused by any partner ceasing to be associates in the carrying on as distinguished from the winding up of the business (partners can leave whenever)
  + Dissolution caused by
    - **UPA §31(1):** 
      * termination of term or undertaking specified in agreement or, if no agreement, by the express will of any partner when no definite term or particular undertaking is specified
      * or by express will of all partners
    - **UPA §31(2):** In contravention of the agreement btw the partners if not allowed and done by express will of any partner at any time
    - **UPA §32:** dissolution by decree of court in certain circumstances
  + UPA §30: On dissolution the partnership isn’t terminated, but continues until the winding up of partnership affairs is completed
  + Rights of partners to **application of partnership property**, **UPA §38(1):** When dissolution caused, except when in contravention of the partnership agreement, each partner, unless otherwise agreed, may have the partnership property applied to discharge its liabilities, and the surplus applied to pay in cash the net amount owing to the respective partners; if dissolution caused by expulsion of a partner, expulsed will receive in cash only the net amount due him from the partnership
  + ***Adams v. Jarvis*** (1964) (p.65) – *Med partnership btw 3 docs; validity of withdrawal agreement disputed*
    - H: Parties intended that even though partner withdrew, the partnership and the business would continue for the purposes for which it was organized (UPA §38 – was “otherwise agreed”)
  + **Dreifurst v. Dreifurst** (1979) (p.69) – *Brothers, partnership, feed mills; one leaving and wants dissolution and auctioning of assets; others want to just divide property*
    - H: Gotta sell, can’t just divide or pay out ct determined value (in-kind alternative) bc UPA §38(1) says so
  + **Page v. Page** (1961) (p.73) *– partnership agreement seems to say is at will*
    - H: Partners expecting to meet current expenses from income and recoup investment does not imply that was to continue for a term, only expresses a common hope
    - Bc at will can be dissolved unless P acted in bad faith (fiduciary duty)
* **5. Limited Liability Modifications of the Partnership Form**
  + General partnership form has bare minimum of features necessary to establish an investor-owned legal entity
    - 1) dedicated pool of business assets
    - 2) class of beneficial owners (partners)
    - 3) a clearly delineated class of agents auth’d to act for the entity (partners)
    - Can also add limited liability – business creditors cant proceed against personal assets of the firm’s equity investors; law moving this way because makes contracting cheaper – you know what they assets of the company are and are able to contract based on that
  + **Limited partnership (LP)**: general partners (as under UPA) and limited partners (rights as under agreement but no managerial voice and limited liability)
    - Combines tax advgs of partnership with limited liability
    - Must have at least one general partner with unlimited liab + one or more limited partners
    - Evolution of ULPA indicates progression away from control test for liab; RULPA adds that limited partner who participates in control of business is liable only to persons who transact business with the limited partnership reasonably believing, based on limited partners conduct, that is a general partner
    - Nonetheless, most LP agreements vest complete control of enterprise in hands of general partners
  + **Limited Liability Partnership (LLP):** General partnership in which partners retain limited liability at least for certain liabilities and limited periods
    - Limited liability only with respect to partnership liabilities arising from negligence, malpractice, wrongful act, or misconduct of another partner or agent of partnership not under partners’ direct control
  + **Limited Liability Company (LLC)**: most elegant and corporate-like form, but no mandatory terms
    - Strives to combine partnership taxation with corporate limited liability
    - Corporation has double-taxation (corporation tax and personal income tax); partnership and LLC have pass-through taxation (income tax only)
    - Legal person, limited liability, members (not shareholders), agreement (states terms)
    - Taxing authority began “box checking” in 1997 to ask if LLCs want pass-through taxation
    - Forms differ because of differences in state statutes
    - Internal relations among investors in the LLC are to be governed more or less by general or limited partnership law: members may operate the firm and serve as its agents or elect managers to do so
    - Resignation of member may or may not lead to dissolution
    - Members enjoy limited liab even when exercise control over the business in same way that general partner would

**D. The Corporate Form**

* **1. The Corporation and Capital Markets**
  + **Corporation**: entity (legal person with indefinite life) that has limited liability, free transferability of shares interests and centralized management
    - Importantcharacteristics of corporations:
      * **perpetual entity**
      * **centralized mgmt**
      * **limited liability**
      * **transferable interests**
      * **appointed by equity investors**
    - Default is that all partners participate in mgmt; stockholders have voice but little to do with the business decisions – those made by professional managers
    - No permission needed to trade shares; led to growth of public markets and permitted capital to diversify
      * *Basket theory*: higher return on lower risk with diversification
    - Two distinctions
      * (1) **Public** corporations
        + Shareholder control is in the market
        + Law issues of outside investors who like power and insiders who control assets
      * (2) **Closely held** or close corporations
        + Controlled by singe shareholder or small group vs. lack controlling shareholders or group (practical control resides with managers)
        + Incorporate for tax or liability purposes rather than for capital-raising
        + Shareholders likely officers and directors
        + May be restrictions on transfers of shares, and not adopt characteristics of corporate form
    - Corp is separate person in the eyes of the law
      * Enables to do lots of stuff, own assets, lower transaction costs
      * Reduces cost of contracting for credit bc owning assets delimits the pool of assets upon which corp creditors can rely for repayment
      * Status of corp allows it to have an indefinite life – enhances stability
  + **Governance**: statutes, corporate charter, bylaws, sometimes shareholder agreements
    - Statues not so important bc DE is the de-facto national law
    - Charter
      * Only few things mandated:
        + Voting stock
        + Board of directors
        + Shareholder voting for certain transactions
      * Establishes the capital structure of the firm
      * Also many indemnification provisions
      * Estab size of board or include governing terms
      * Can’t be amended easily (only with board suggestion and shareholder approval)
      * Sets bylaws that fix the operating rules for the governance of the corporation, existence and responsibility of corporate officers, etc.
      * Contractual freedom is the overriding concept
    - Charter can be supplemented by **shareholders’ agreements**
      * Formal agreements btw shareholders important to legal gov structures of many close corps and in some controlled public cos
      * Restrictions on disposition of shares, etc
    - Mandated topics for shareholder voting:
      * amendment to charter
      * changes to bylaws
      * mergers / sale of substantially all company’s assets
      * dissolutions
      * fundamental changes to structure
  + **Law of dissolution**: winding up; board has to pass a resolution and get shareholder approval
    - Directors become trustees – collect assets, pay debts, distribute any excess to shareholders
    - If creditor is forgotten, disaggregated shareholders are potentially liable, but only to the extent of their individual distribution
  + **Limited Liability**: shareholders cannot lose more than amt they invest, unlike general partner
    - Chief rationale: encourage investment in equity securities, making capital more available for risky ventures
    - Simplifies job of evaluating an equity investment
    - Increase incentive for banks/creditors to monitor their corporate debtors more closely
    - Reduces cost of operation because decreases need to monitor managers
    - Reduces cost by making no need to monitor other shareholders
    - Promotes free transfer of shares 🡪 gives managers incentives to act efficiently
      * so long as shares are tied to votes, poorly run firms will attract new investors who can assemble large blocs 🡪 incentives to operate efficiently
    - limited liability makes it possible for market prices to impound additional information about the value of firms
      * with unlimited liability, shares wouldn’t be homogeneous commodities so would no longer have one market price
    - allows more efficient diversification – investors can minimize risk by owning diversified portfolio of assets
  + **Transferable shares**
    - Requires that legally own something distinct from any part of the corp’s property: a **share interest**
    - Share is personal legal property – transferable with all rights it confers
    - Permits firm to conduct business uninterruptedly as IDs of its owners change, avoiding complications of dissolution and reformation of partnerships
    - Transferability linked to limited liability – without limited liability, creditworthiness of firm as a whole could change, perhaps fundamentally, as IDs of shareholders changed
    - Value of shares would be difficult for potential purchasers to judge
    - Transferability 🡪 active stock market, which in turn facilitates investment
  + **Capital markets** – price based on supply and demand; with good information, prices directed better
    - Need social conditions: Transparency; disclosure; standard forms of reporting and accounting; competent and accountable market agents (ie brokers, distributors); efficient and fair mechanisms for trades (ie stock exchanges); relatively low trading costs; restrictions on insider trading
    - U.S. System – capital markets provide equity capital
    - 1915-1985: accepted fact that mgmt was autonomous; people are buying a risk/reward interest and not really interested in the company
    - Growth of pension funds and mutual funds in 2nd half of 20th C led to large stockholders who do more monitoring
* **2. Markets**
  + Constraints
    - Product market: in competitive market, you have less room to “steal”; in a more relaxed (uncompetitive) market, more room to “steal” (ie do a bad job)
    - Capital market: if you want funding, you have to do a good job
    - Labor market: incentive compensations can create the right incentives
  + Two problems
    - (1) Ensuring the integrity of information to markets and mechanisms that run the markets
    - (2) Agency problem
      * less supervision/control of managers; one result is empire-building (large firms)
      * reduced agency costs: we only want to reduce in an optimal way - don’t want to do this if hurting the productivity of central management (ie separating Chairman from CEO)
  + U.S. – dual notions of sovereignty (states and federal gov)
    - Early: Federalists move to consolidate power in federal government
    - Late 19th C: SC grew more conservative, tending towards deregulation
    - 20th C: Court will not allow states or federal gov to regulate labor laws, etc
      * Police power created out of interstate commerce clause under FDR
    - 1933: Securities Act passed to regulate capital markets
    - 1934: regulation of secondary market
      * requires disclosure; makes it illegal to manipulate/deceive; regulates proxy solicitations
    - Sarbanes-Oxley and others have further federalized over the years
    - After competition, DE wins battle of the states (for big companies)
      * One view is that state legislatures are groveling for $, and result will be weakest standards
      * Gaines looked at “Tolbin’s Cube” (ratio of book value to market capitalization); ran regression and found DE companies worth more than companies incorporated in other states
      * DE attuned to needs of corporations
        + Quality of court system probably the most important thing
* **3. Centralized management**
  + Centralizing achieves economies of scale in knowledge of the firm, its technologies, and markets
  + Problem: Setting of rules most likely to ensure that
    - 1) managers will strive to advance the financial interest of investors
    - 2) without unduly impugning on mgmt’s ability to manage the firm productively
  + 3 aspects to the problem
    - 1) what can law do to encourage managers to be diligent, given that shareholders (not judges) choose directors who designate managers
    - 2) how can the law assist shareholders in acting collectively vis a vis managers, especially in the case of widely held companies with many small shareholders?
    - 3) how can the law encourage companies to make investment decisions that are best for shareholders?
  + The Board
    - Use of the board to address the agency problem
      * Mgmt appointed by board of directors that is elected by holders of common stock in company
      * Board is the ultimate locus of managerial powers
      * Board acts by adopting regulations at duly called meetings
      * Few companies modify default rule that all stocks vote at one vote per share
      * Empowering to act in opposition to the will of shareholder majorities can provide check on opportunistic behavior by controlling shareholders vis a vis minority shareholders or other constituencies, such as employees or creditors
        + **Auto Self-cleansing filter syndicate co. v. Cunningham** (1906, Eng) (p.103) – *55% of shareholders wanted mgmt to sell co’s assets*

H: Directors not bound to accept, in sub of their own view, the views contained in the resolution of the company; board represents the shareholders as set out in the charter, not this majority

Merger must be originated by the board, but cannot be implemented without shareholder approval

* + - Structure
      * Charter sets forth structure in very general terms
      * Default is all members of board are elected annually to one year terms
      * Charter may provide that board seats are to be elected by certain classes of stock
      * All directors still owe their fiduciary duty to the corporation as an entity and to all its shareholders
      * Specially elected directors do not owe a particular duty to the class that elected them
      * All directors have one vote on matters before the board
      * Corp statutes generally permit corporate charters to create staggered boards, in which directors are divided into classes that stand for election in consecutive years
    - Formality in board operation
      * Corporate directors are not legal agents of the corporation; governing power resides in the board of directors, not in individual directors who constitute it
      * Legally speaking, directors act as a board only at duly constituted board meetings and by majority vote (unless charter reqs supermajority vote) that is formally recorded in minutes of the meeting
    - Critique of boards
      * Most directors cannot in the time available consider the merits of any significant number of complex corporate decisions or second guess judgments of company’s full time officers
      * For large corps usually meet only for a single day btw 4 and 8 times a year
      * Receive information through docs and presentations put together by the corp’s officers
    - Corporate officers: Agents of the corp
      * Corp charter empowers board to appoint and remove officers, with or without cause
      * Corp officers, unlike directors, are unquestionable agents of the corporation and are therefore subject to the fiduciary duty of agents
      * **Jennings v. Pittsburgh Mercantile Co.** (1964) (p. 110)– *apparent authority issue involving a director*
        + H: No apparent authority, point here that should not have assumed had authority because individual directors are not agents of the corp, only the board as a whole; one member cannot bind the board

**E. Debt, Equity and Economic Value**

* **1. Sources of capital: debt and equity**
  + Capital structure: the mix of long term debt and equity claims that a corp issues to finance operation; corporation raises capital to fund its operations by selling legal claims to its **assets** and **prospective cash flows**
  + **Equity**
    - managers like a lot of equity bc can’t be pulled back and easier to withstand losses
    - Want enough equity to avoid bankruptcy in down business cycle and avoid **equity opportunism** – when equity investors have so little at stake that they will take outside risks (bc feel that they’re playing with the bank’s money)
    - usually common stock though can be customized
    - holders have no right to periodic payment, demand return of investment, or tell managers what to do
    - merely have a right to vote
    - common stockholders can expect to receive dividends, but get those only when corp’s board of dirs so declare
  + **Debt**:
    - Supplies most of the capital (more than equity)
    - Buyers have a contractual right to receive a periodic payment of interest and to be repaid their principal at a stated maturity date
    - If the corporation fails, has legal remedies
      * sue and have property seized
      * acceleration clause in the contract requires payment of the principal amount if the debtor defaults in paying an interest payment; must pay creditors before can distribute funds or other things of value to equity owners
  + **Legal character of equity**
    - **Common stock**
      * Contractual in nature but law has clear default rules on the contract
      * Most important characteristics: can **vote** **to elect directors and on important matters**
      * Control rights in form of power to elect the board of directors
      * Any deviation from one vote per share must appear in corp’s charter
      * Charter contains specs of firm’s equity securities, including whether there are multiple types of stock with different voting rights, preferences upon liquidation, or other terms that affect the co’s stock, ie:
        + Co’s redemption and call rights and the shareholder’s exchange, conversion, and put rights
        + **Redeemable stock** – one that the corp may redeem on terms stated in the charter, either at election of the board or some set time
        + **Exchangeable right**: right to switch one security for another
        + **Conversion right**: right to convert one security into another at a stated conversion rate
        + **Put right**: shareholder’s right to force the co to buy her security at a fixed price
        + **Call right**: corp’s option to force shareholders to surrender their stock at a fixed price

Difference btw call right and redemption right relates to the status of the security after the right is exercised – stock that is called becomes the company’s treasury stock that continues to be issued but is no longer outstanding in the market; stock that is redeemed is cancelled and may not be reissued

* + - **Residual** claims and residual control
      * Stock contain **residual claim** on corp’s assets and income
      * After co has paid its expenses (met its payroll) and paid interest to those creditors whom we have considered in the preceding section, whatever is left over can belong to the stock holders in the sense that is available for the payment of dividends
    - **Preferred stock**
      * Equity security on which corp charter confers a special right, privilege, or limitation is a preferred stock
      * Just as malleable as bonds
      * Generally carry a stated dividend payable only when declared by the board
      * Usually enforced indirectly by provision stipulating that any unpaid dividends accumulate and that all must be paid before any dividend paid to common stockholders
      * Sometimes also get votes, or designated board seats, if preferred stock dividend skipped for long enough
      * Less risky because has preference over common stock in liquidations – if corp fails and plans to close, designated amt of money must first be paid to the preferred stockholders before liquidating corp can distribute any property to holders of common stock
      * Preferred stock doesn’t vote so long as dividend is current
  + **Legal character of debt** (general patterns)
    - Debt securities are contracts – loan agreements with terms, heavily negotiated, flexible design
    - Loan agreement allocates risks and responsibilities btw debtor and creditor, or each of several classes of creditors
    - terms can range from low risk for creditor (must repay) or lower risk for equity holder (no need to repay in certain circumstances)
    - **maturity date**
      * legal obligation to repay at a stated date – usually the principal plus outstanding interest
      * zero coupon bonds – no interest paid but much larger amount at maturity
      * if any interest of principal is not paid when due the bonds are said to be in default – debtor has defaulted on its debt; allows acceleration
      * investors choose btw investing in debt by lending money to the debtor, or buying a bond of the debtor
      * advantages: less risk bc right to periodic payment of interest and priority claim over co’s shareholders on corp assets in event of default; can also sue on their contract
      * agreements can be constructed to reduce financial risk of default thru devices like protective covenants, monitoring, or security interests
    - **tax treatment**
      * **Cost to corp of debt is less** than that of equity because interest paid by the borrower is a deductible cost of business when the firm calculates its taxable income
      * Corp pays tax only on its taxable income – roughly net income after costs
      * Net cost to corp of capital it arranges through borrowing is approximately half of the stated interest rate on the bonds that it sells: if corp tax rate is approx 50% then for each dollar the corp pays in interest, its taxable income is reduced by a dollar, and its saves $0.50 on taxes
      * By contrast, no deduction available for dividends or distributions paid to the corporation’s stockholders
  + Basic Concepts of Valuation
    - 4 basic concepts important for understanding value in corporate law:
      * 1) time value of money
      * 2) risk and return
      * 3) systematic risk and diversification
      * 4) capital market efficiency
    - Time value of money
      * **present value** – value today of money to be paid at a future point
      * **discount** – tells us how to calculate present values; **rate** that is earned from renting money out for one year in the market for money
        + rate of 10% means earn 10 cents for lending $1 for one year
      * **FV = PV + r(PV)**
      * **PV = FV/(1+r)** [for PV of $ in one year]
      * **Rate of return** – percentage that you would earn if invested in a particular project
      * **Positive net present value projects** – projects for which the present value of the amt invested is less than present value of amt received in return
    - Risk and return
      * **Expected return** – weighted avg of the value of the investment; sum of what returns would be if an investment succeeded, mult by prob of success, PLUS what returns would be if invest failed, mult by prob of failure
      * **Risk neutral** if all concerned about is the expected return of investment
      * most investors are **risk averse** – volatile payouts worth less to them
      * additional amt that risk averse investors demand for higher risk investment is the **risk premium**
      * **Risk-adjusted rate** – discount cash flows at rate that reflects both he time discount value of money and the market price of risk involved
      * Diff btw the risk adjusted rate the **risk free rate** is the risk premium – more risk in expected cash future yields higher risk premium and higher risk-adjusted rate
      * Diversification and **systematic risk** (risk across the board; cannot remove)
      * If two investments can be packaged together, they can become less risky
      * This is what mutual funds do, make diverse portfolios
      * But not every risk is diversifiable
      * **Idiosyncratic risk**: risk unique to a given company (controllable)
      * **Volatility**: more varied prices = more volatility, willingness to pay less
    - **Efficient Market Hypothesis**: in efficient markets, info is instantaneously disseminated and reflected in stock price; 2 types of market efficiency:
      * **Informational efficiency**: information is integrated
      * **Fundamental efficiency**: Prices that the market comes up with are fully rational
      * Arbitrageurs / financial people are the heroes of the efficient market by driving market towards efficient value
    - **Discount Cash Flow (DCF)** Approach (WTF)
      * Requires a prediction of all future cash flows, and a discount rate to bring those cash flows back to the present to yield a **net present value (NPV)**
      * First, estimate all future cash flows generated by the asset
      * Second, calculate the discount rate
        + Most popular is the **weighted-average cost of capital (WACC)**

Weighs avg of cost of debt and cost of equity, weights are the relative amts of debt and equity in the capital structure

Cost to company is not interest rate, but the after-tax rate

Cost of debt: market will tell you the increase in risk by the new price of the bond

ie $1,000 bond with 12% interest, now $960

original after-tax rate: 12%\*(1-35%) = 7.8%; Now 12%\*65%\*1000/960 = 8.13%

Cost of equity: more of an estimation – usually done now with **CAPM method**: relationship btw a particular stock and the market

If is different discount rate for the Debt and the Equity, then blend them (based on % of each, usually not 50/50 – more debt than equity)

* + - * + **Before tax cost of debt** is the interest rate the firms would pay if were to seek new debt financing today
        + Other technique is the **historical avg equity risk premia data** – equity has been priced at cost that is approx 8% higher than before tax cost of debt on average
      * Courts usually use 5 year DCF to valuate
        + Balance statement: net gross income minus operating costs and non-cash expenses

To reach accounting statement, add back in non-cash expenses

Cash flows = accounting profits plus/minus non-cash charges

* + - * + To find out the value of the equity, take the assets and subtract the debts
    - Debtors can externalize costs to involuntary creditors such as tort victims by incurring liabilities that exceed the value of their assets
    - financial statements
      * accounting is standardized method for describing a firm’s past financial performance
      * generally accepted accounting principals (GAPP) set by Financial Accounting Standards Board auth’d by the SEC
      * **Balance sheet** represents the financial picture of business org as it stands on one particular day, as opposed to an **income statement**, which presents results of operations of business over specified period
      * Balance sheet limited in that typically reflects historical cost instead of current economic market values
        + Assets listed at acquisition cost – book value, not current economic value
        + Same with liabilities
      * In sum, income statement does not reflect the amt of cash available to owners, just as balance sheet does not reflect current economic values
      * Despite limits, financial statements remain highly important to investors and others who wish to evaluate economic performance and estimate company values
      * Components of balance sheet
        + Two columns: **assets** on left, **liabilities** on right (debts of the business and stockholders’ equity)

**Working assets** are those that are constantly cycling thru firm’s production process

**Fixed assets** are those not intended for sale, used for lengthy periods to manufacture etc

Liabilities divided into **current liabilities** (due within a year) and **long term**

* + - * + 3rd thing: **Stockholder equity**: book value of the owner’s economic interests
        + also:

stated capital / capital stock: the corp’s legal or nominal capital

**F. The Protection of Creditors**

* **1. Introduction**
  + Rationale: protect creditors from corporate debtors who misrepresent or dilute income or assets, increase riskiness of debt - perhaps due to expanded notions of limited liability that opens opps for express and tacit misrep w voluntary creditors
  + Creditors can minimize costs of shareholder opportunism by exercising vigilance and negotiating for contractual protections (ie early warning)
  + **Protections** available to creditors and makes possible to shift assets out of corp after a creditor has extended credit to corp
    - (1) **Mandatory disclosure** of corporate capital
    - (2) Rules regulating **amount and disposition of corporate capital**; ie statutory dividend restrictions (doesn’t do much today)
      * Distribution constraints
        + Idea of representing a particular fund on balance sheet as permanent capital – called legal capital or stated capital account (weak + loose cause can restructure stuff)
        + Laws that bar distributions that would render the corporation insolvent
        + Laws that say dividends may only be paid out of surplus, not out of stated capital (again weak cause can restructure things)
      * Minimum capital and capital maintenance requirements
        + Req shareholders to commit a stated amount of capital to the firm
        + Not effective bc normal business activity can dissipate; not really used in the US
    - (3) Duties on corporate participants (directors, creditors, shareholders)
      * Director liability
        + Sometimes directors owe obligation to creditors not to render firm unable to meet obligations by making distributions to shareholders or others without receiving fair value in return
        + DCC has suggested that insolvent firm directors owe a duty to consider the interests of corporate creditors, and maybe in the vicinity of insolvency
      * Creditor protection: **Fraudulent conveyance restriction** – most important remedy
        + Fraud conveyance law imposes obligation on parties contracting with insolvent debtor to give fair value for the cash or benefits they receive
        + Similar to bankruptcy – all assets paid into court
        + Uniform Fraudulent Transfer Act (UFTA): 2 types of fraudulent transactions

Transactions w/o consideration: fraudulent if transferor rendered insolvent, transferor believes/intends to incur debts can’t pay, transferor left with unreasonably small capital

Transactions with actual intent to hinder or delay

* + - * + AKA voids transfers by debtor that are made under circumstances unfair to creditors – cant be to delay, hinder, defraud
        + Constructive fraud deals with reasonable expectations of creditors when negotiating with debtors – debtors implicitly rep their assets will be available to creditors in event of default
        + Modern times been applied to leveraged buyouts
        + Claims: if a sale of assets, creditors will claim below market value, debtor will claim forced sale – had to get the $, so got a little less than market

If arms length sale and below market price, debtor has a decent argument

**2. Equitable Doctrines**

* Equitable doctrines are flexible; court goes on intuition of fairness (not legal doctrines)
* Shareholders can be liable to corporate creditors under two doctrines: equitable subordination and corporate veil piercing
  + **Equitable subordination**
    - 1) creditor must be equity holder and typically an officer of the company
    - 2) insider-creditor must have behaved unfairly or wrongly toward the corporation and its outside creditors
    - Protects unaffiliated creditors by giving them rights to corporate assets superior to those of other creditors who happen to also be significant shareholders of the firm
    - Courts use when feel compelled to in equity recharacterize debt owed by the company to its controlling shareholders as equity
    - Rarely invoked outside of bankruptcy context
    - **Costello v. Fazio** (1958) (p.145) – *Fazio & other investors made business, incorporated, took out bunch capital in shares* 🡪 *bankrupt and claimed against the estate of the company to get money back; other creditors objected that should be subordinated bc Fazzio, others left company undercapitized*
      * H: Fazio, others subordinated; use test: do circumstances of the transaction carry the earmarks of an arms length bargain or can be justified within bounds of reason and fairness? Here, they knew what was up.
      * Note: Equitable subordination here actually not so bad…could have been debt cancellation under UFTA
  + **Piercing the corporate veil**
    - Equitable power of the court to set aside the entity status of the corporation to hold its shareholders liable directly on contract or tort obligations; guidelines vague
    - **Lowendahl test**: (1) existence of shareholder who dominates corporate policy and (2) uses control to commit fraud or wrong that prox causes P’s injury – domination includes failure to treat corp formality seriously
    - Alternate test: disregard corp form whenever recognizing would extend the principle of incorporation beyond its legitimate purposes and produce injustices or inequitable consequences; look for:
      * Disregard of corp formalities
      * Thin capitalization
      * Small numbers of shareholders
      * Active involvement in mgmt
    - All that is necessary to avoid piercing is that corporate formality are observed: meetings, stock issued, stock paid for, separate bank accounts, minutes of meetings
    - **Sea-Land Services v. Pepper Source** (1991) (p.152) – *allege hide behind veils of alleged separate corp existence for purpose of defrauding P and other creditors*
      * Will pierce when
        + (1) is unity of interest and ownership such that separate personalities of corporation and individual no longer exist; consider:

(1) failure to maintain corporate records or comply with corporate formalities

(2) Commingling of funds or assets

(3) Undercapitalization

(4) One corporation treating assets of another corporation as its own

* + - * + (2) circumstances are such that adherence to fiction of separate corporate existence would sanction fraud or promote injustice

don’t need fraud; maybe when wrong beyond a creditor’s inability to collect would result if don’t pierce, possibly

rules of adverse possession are undermined

former partners are able to skirt legal rules or obligations

unjust enrich, etc

* + - * H: Met step 1, not step 2 (fraud)
    - **Fraud**: false statement that is material and relied upon to detriment
    - **Kinney Shoe Corp v. Polan** (1991) (p.157) – *Polan is sole shareholder of sublease btw Kinney and IRC, which has no assets, income, or bank account*
      * H: Peirce it
      * (1) **Unity of interest** and ownership such that separate personalities of the corporation and individual no longer exist
      * (2) **Inequitable result would occur** if acts were treated as those of corp alone
      * **permissive prong: (3) should P have known** stuff that a reasonable credit investigation would show (ie undercapitalized), then will have said to have assumed the risk
        + D had just use for purposes of veil, not corp benefits: “nothing in, nothing out, no protection”; gotta at least maintain a real corporation
    - **Veil piercing** on behalf of involuntary creditors
      * Tort creditors differ in two key respects
        + (1) don’t rely on creditworthiness of corp
        + (2) can’t negotiate ex ante for contractual protections
      * **Walkovsky v. Carlton** (1966) (p.161) – *taxis incorporated as separate businesses, 2 cabs per, all owned by same guy, person hit by cab*
        + H: CANNOT pierce veil
        + Two separate circumstances where can pierce veil:

(1) corp is a fragment of a larger corp which actually conducts business 🡪 larger corp liable

(2) corp is a dummy for individual stockholders who are in reality carrying on business in personal capacities for purely personal rather than corporate ends 🡪 Stockholder liable

* + - * + In this case neither (not first bc larger corp does not exist)
        + Dissent: would hold that the participating shareholder of a corporation vested with the public interest, organized with capital insufficient to meet liabilities which are certain to arise in the ordinary course of business, may be held personally responsible for such liabilities
      * Substantive consolidation: equitable remedy in bankruptcy that consolidates assets among corporate subsidiaries for the benefit of creditors of various corporate subsidies – **horizontal veil piercing**
      * Law and Econ and Limited Liability
        + Limited liability effectively subsidizes firms that are unable to pay the full costs of the torts that they may commit
        + Some argue for ex post shareholder liability for corporate torts if shareholders faced pro rata rather than joint-and-several liability – after firm’s assets exhausted in bankruptcy, shareholders would be compelled to pay pro rata for any remaining tort liability
        + Other alternatives

Direct state regulation to make safe

Impose mandatory insurance reqs

Accord first priority in corporate bankruptcies to tort creditors

**G. Normal Governance: The Voting System**

* **1. The Role and Limits of Shareholder Voting**
  + 3 default powers of shareholders:
    - Right to **vote** (on designation of board and certain fundamental corporate transactions)
    - Right to **sell**
    - Right to **sue** (directors for breach of fiduciary duty)
  + Collective action problem bc dispersed shareholders, low individual incentive
    - Today, increasingly active institutional shareholders exhibit more voting power; result of growing institutional portfolios, cheaper costs of communication, and the evolution of shareholder organizations as new agents 🡪 ownership and coordination structures that fall between the two extremes
  + Things that can be voted on:
    - **Electing Directors**
      * Right to vote to appoint the board is more valuable to common stock investors than to any other class of investors – is a greater need for default protection of voting rights
      * Election of directors facilitated by creating flexible framework for holding annual meeting of shareholders
    - **Removing Directors**
      * DGCL §141(k): board can be removed with or without cause by majority of shareholders then entitled to vote at an election of directors except if provided for in charter
      * Common law: could only be removed for cause (poor judgment didn’t count)
      * State law bars directors from removing fellow directors without express shareholder authority
      * If board uncovers cause for removal, can petition a court to remove the director
      * Generally conceded that any court of equity supervising the performance of any fiduciary has an inherent power to remove for cause
      * Stockholder removal more difficult when a board is classified
      * Staggered boards may make more difficult for shareholders to gain control; might have way to disassemble a staggered board to avoid tow-election problem
    - **Mergers**
    - **Sale of substantially all assets**
    - **Dissolution**
    - **Bylaws**
    - **Shareholder resolutions that may ratify board actions**
    - **Request the board to take certain actions**
  + Who votes? Look to charter; in default, go to DGCL §212:
    - Generally one vote per common share
      * Almost always common stock is voting stock
    - Preferred generally doesn’t vote, but must be stated in charter (if silent, they do get to vote)
      * Like bond holder – as long as getting paid, don’t need a vote (but can if no dividend paid)
    - Can have dual voting stock (A stock – 1 vote per share) (B stock – 10 votes per share)
    - DGCL §222: how to give **notice** of meeting; record date is in advance of the meeting
  + **Class Voting** – protection for minority against exploitation by the majority; each class has to approve a proposal with a majority vote of that class’ stock [Done when?]
  + DGCL §214: Cumulative voting: X = (Y + N’ + 1) / (N + 1), where:
    - Y = # of shares outstanding
    - N = # of people to be elected; N’ = # of directors sought to be elected
    - Ex: owner of 510 of 1000 shares needs 5 of 9 directors to control board; X = 100.6
      * 100.6\*5 < 500, so can remove 5 (but not 6)
  + Shareholder meetings and alternatives
    - Framework for holding
      * DGCL §211: have to have an annual meeting; shareholder can force one if isn’t one within 13 months
      * DGCL §216: quorum: 1/3 of shares unless higher number established in certificate
      * DGCL §228: Consent statute: action can be taken with written approval of right # of voting shares
    - Special meetings
      * Other than annual meeting
      * Called to permit shareholders to vote on fundamental transactions
      * If able to call frequently 🡪 more monitoring 🡪 lower waste through agency costs 🡪 lower cost for capital
      * BUT meetings costly; charter specifies who can call and how
      * Revised Model Business Corp Act example is typical:
        + Hold if such charter or bylaws say so, or holder of at least 10% of all votes entitled to vote (?) demands
        + DE law doesn’t have 10% rule
    - Shareholder Consent Solicitations
      * Alternative to special meetings
      * Permit shareholders to act by filing written consents
      * DE provides any action that may be taken at meeting of shareholders can be done through written concurrence of holders of number of voting shares required to approve that action at a meeting attended by all shareholders
* **2. Shareholder Information Rights**
  + 2 kinds of information that you can get:
    - (1) Stock list (DGCL §219)
      * Discloses ID, ownership interest, and address of each registered owner of common stock
      * By law available to registered owners of corporate stock
      * Proper purpose is broadly construed
      * DE courts permit only limited discovery in litigation in which a stock list is sought
      * Management usually doesn’t want to give stock list bc its usually used in takeover bid
      * If request denied, can bring an action in DE; courts sympathetic and quick
      * If contested, burden on D to prove lack of proper purpose
    - (2) Books and records (DGCL §220)
      * Shareholder can ask for when something is fishy – thinks something wrong and wants to investigate
      * Places legit interest of the corp at risk – expensive, jeopardize proprietary or competitively sensitive info
      * Purpose-plus screening of motives, burden on P

**H. Proxies**

* **1. Proxy Voting and its Costs**
  + How voting really gets done – don’t have meetings crowded with people
  + Public shareholders unlikely to actually attend shareholder meetings
  + Board and officers permitted to collect voting authority from shareholders in form of proxies; management acts on behalf of and at expense of the corp
  + State rules about sending proxies (DGCL §212):
    - §212(b): stockholders may authorize person to act for him (proxy)
    - §212(c): formalities (ie can authorize through writing, email, etc.)
    - §212(e): agencies can be made irrevocable if says so and is coupled with interest sufficient to support an irrevocable power; otherwise revocable (ie interests in stock that has the vote attached)
  + Other reqs:
    - Generally, proxies must record the designation of the proxy holder by the shareholder and authenticate the grant of the proxy; called a “proxy card”
    - Proxy holder is bound to exercise the proxy as directed
    - In most cases proxy holders may exercise indpdt judgment on issues arising at the shareholder meeting for which they have not received specific instruction
  + Proxy solicitation firm: each side hires to contact individuals and encourage to vote their way
    - Can vote at any time before the meeting and can also revoke – later dated proxy takes precedence over earlier one
  + Voting still relies on one or more person to incur the initial expenses of soliciting proxies; since costs are substantial, shareholders face serious impediment to collective action
    - On one hand costs of soliciting proxies are matter of normal gov bc subsidizing costs from corp treasury is essential for operation of annual shareholders meetings
    - Other hand, auth the board to expend corp funds on its own reelection seems to permit a kind of self-dealing – raises Q whether law ought to encourage insurgent shareholders to solicit proxies by reimbursing their reasonable expenses as well
    - Are new rules on issue of reimbursement
  + ***Rosenfeld v. Fairchild Engine & Airplane Corp.***, (1955) (p.179) – *Old board reimbursed for proxy fight; new board reimbursed itself and put to shareholder vote was approved; shareholder P says waste*
    - H: expenditures reasonable, in good faith and shareholder approved
    - Mgmt can be reimbursed for reasonable expenses in contest over policy (issue about what’s reasonable); ok to spend to persuade stockholders of their position and solicit their support
  + “**Rosenfeld doctrine**”: win or lose, incumbent managers are reimbursed for expenses reasonable in amt and attributable to deciding issues of principle or policy
    - Any disagreement (I am better manager than you) tends to satisfy the difference in policy requirement for reimbursement
    - Insurgents only reimbursed if they win – rationale of win means was good faith, loss means possible self dealing
* **2. The collective action problem**
  + **Easterbrook and Fischel** on voting
    - None of voters has appropriate incentive at the margin to study the firm’s affairs and vote intelligently
    - Those who have more shares (invest cos, trusts) do not face collective action to same extent
    - Problems overcome by aggregating shares thru acquisitions, mergers and tender offers
    - Voting to serve principal role in permitting those who have aggregated equity claims to exercise control
    - Short of aggregating, some sort of collective info-generating agency is necessary
      * Managers serve this function, so unlikely that voters would think themselves able to decide issues for themselves better
  + **Black** on proxy reform
    - Laws discourage large percentage stakes in cos
    - Banks, insurers, and mutual funds face legal limits on ability to hold large percentage stakes
    - No shareholder can cross trigger percentage for a firm’s poison pill, often only ten-15 percent, without management approval
    - Tax rules discourage
    - H: Would be better if bigger shares, more incentive to monitor
  + **Kahan** on hedge funds in corp gov
    - Possibility that hedge funds will overcome agency problem of corps
    - Beneficial, but not silver bullet
      * Hedge funds incentivized to max returns to fund investors
      * Strive to achieve high absolute returns, rather than returns relative to a benchmark
* **3. The Federal Proxy Rules**
  + 1934 Act: disclosure in regulatory filings, regulates proxy solicitation in public companies
  + 4 major elements
    - 1) **disclosure requirements** and mandatory vetting regime that permit the SEC to assure the disclosure of relevant info and to protect shareholders from misleading communications
    - 2) substantial **regulation of process of soliciting** proxies from shareholders
    - 3) **“town meeting” provision** (R 14a-8) that permits shareholders to gain access to the corp’s proxy materials and thus gain a **low-cost way to promote certain kinds of shareholder resolutions**
    - 4) **general anti-fraud provision** (14a-9) that allows courts to imply a private shareholder remedy for false or misleading proxy materials
  + (1) §10 (b): fraud with sale of stock; reason for most shareholder suits
  + (2) §14: Proxy solicitation; result is that all communications get expensive; 1992 amendments reduce scope of “solicitation”
    - Rules 14a-1 thru 14a-7: Disclosure and shareholder communication
      * Made unlawful to “solicit” any “proxy” to vote any registered “security” in contravention of the act – broad interpretation
      * Basic scheme is to state with great detail the types of information that any person must provide when seeking a proxy to vote a covered security; unintended consequence of discouraging proxy fights
      * 1992 SEC amendments limited some so less discouraging
      * R14a-1,2: released institutional shareholders from req to file a disclosure form before could communicate with other shareholders about a corporation
      * R14a-3: what you have to furnish in proxy statement; details of ID of soliciting parties + holdings and financing of campaign
      * R14a-4,5: proxy requirements
      * R14a-6: SEC and fining; lists filing reqs
      * R14a-7: stock list (equivalent to DE §219); list-or-mail rule under which a company must provide list or undertake to mail dissident’s proxy statement and solicitation materials to record holders
    - R14a-8: town meeting rule - entitles shareholders to include certain proposals in the co’s proxy materials
      * Low costs for shareholder – can adv proposal for vote without filing with SEC or mailing own materials to shareholders
      * Corps see as annoying and infringe on autonomy; lose control over communications
      * Lists grounds to permit corps to exclude shareholder requested matters
        + Gotta satisfy formal criteria (ID of shareholder, # of proposals, etc.)
        + 14a-8(i) lists 13 grounds that permit firms to exclude, ie:

if approval would be legally improper

if proposal relates to a matter of ordinary business

correctly regarded as the province of the board under the design of the corp form

* + - * Most R14a-8 shareholder proposals are:
        + **corp governance proposals** (most common today)

issue of extent of shareholders’ ability to enact bylaws that limit the range of options open to the board in managing the firm

Important with 14a-8s bc SEC will not mandate access to the company’s proxy statement if matter on which action is sought is not a proper subject of shareholder action

Less controversial proposals often impose structural reforms on the board (ie elect directs by majority rather than plurality vote)

* + - * + **corporate social responsibility** (rarely win more than 10% of shareholder vote)

SEC generally supported gov proposals, but waffled on social resp props

Use case by case analytic for determining whether issues relating to employment practices are excludable as “**ordinary business matters**” or sufficiently important to the corp to be an appropriate subject of resolution (ie ***Cracker Barrel*** sexual orientation non-discrimination rejected under earlier “bright line” rule for employment-related proposals but reversed under case by case standard

Rule: A proposal must focus on **significant social policy** issues and **not seek to micromanage**

* + - * Corps that wish to exclude proposal generally seek SEC approval in form of “no-action letter” – states that SEC div of corp finance will not recommend disciplinary action against co if proposal is omitted
    - R14a-11
      * Proposed 2003 rule that would have allowed long-term shareholders the power to place own nominees in pubic corp’s proxy materials under limited circumstances
      * Opponents said would shift dangerous amt of power into hands of institutional shareholders
      * Others said no shareholder directors could be elected without receiving a majority of the shareholder vote
      * Under new proposed rule, shareholder that owns more than 1% of pubic company would have ability to place noms on proxy statement for up to one-quarter of total board seats; yet to decide
  + DESC examined validity of 14a-8 expense reimbursement provision (about possibly giving reimbursing expenses for insurgent candidates to increase competition) in ***CA, Inc v. AFSCME Emp***, (2008) (p.220)
    - F: Proposed bylaw would cause corp to reimburse stockholder for reasonable expenses incurred in connection with nominating candidates in contest election of directors to the board so long as (a) election of fewer than 50% of the directors to be elected is contested in the election, (b) one or more candidates nominated are elected, (c) stockholders not permitted to cumulate votes
    - H:
      * Proper function of bylaws is not to mandate subst business decisions but to define the process and procedures by which decisions are made; this proposal fits scope even though requires expenditure of funds
      * However, it would violate DE law because would prevent directs from exercising full managerial power where fiduciary duties would otherwise require them to deny reimbursement to a dissident slate

**I. Threats to the Integrity of Voting and Legal System Responses**

* **1. Circular Control Structures**
  + Power to vote shares in the corporate treasury; DGCL §160:
    - (a): corporations can buy, sell, etc. its own shares subject to some limits
    - (c): shares of capital stock **“belonging”** to the corp shall neither be entitled to vote nor be counted for quorum purposes
  + What about voting by subsidiary or joint venture in which corp owns only a minority interest?
    - ***Speiser v. Baker***, 1987 (p.186)
      * Q: whether Speiser could vote shares at annual meeting
      * H: 160(c) says can’t vote in certain circumstances; didn’t mean to imply that can vote in all other circumstances
      * Stock held by a corporate subsidiary may in some circumstances “belong” to the issuer and thus be prohibited from voting, even if the issuer does not hold a majority of shares entitled to vote at the election of directors of the subsidiary
      * Effect is to muffle voice of pub shareholders of chem in the governance of chem
* **2. Vote Buying**
  + Shareholder may not sell vote other than as part of a transfer of the underlying share
  + why limit the separation of control rights (the vote) over cash flow rights (the dividends)?
  + **Easterbrook**: Ensures that unnecessary agency cost will not come into being (holder of votes may invest too little bc doesn’t have dividend interest)
  + ***Schreiber v. Carney***, Del Ch. 1982 (p.193) – *P stockholder of TIA challenged it’s loan to D Jet Corp, which owned 35% of TIA’s stock; loan made to secure Jet’s approval of transaction, approved by TIA stockholders*
    - H: vote buying only illegal if purpose is to defraud or otherwise disenfranchise other stockholders
    - **Vote buying** simply voting agreement supported by consideration personal to the stockholder, whereby stockholder divorces his discretionary voting power and votes as directed by the offeror
    - In modern context doesn’t make sense to over-protect judgment of every stockholder
* **3. Board Manipulation** 
  + Legal power held by a fiduciary may not be deployed in a way that is intended to treat a beneficiary of the duty unfairly; the franchise has been given special protection
  + **Schnell v. Chis-Craft Industries**, Del 1971 (p.598) – *petition of stockholders for injunctive relief to prevent mgmt from advancing date of annual stockholders’ meeting*
    - H: mgmt cannot utilize corp and DE Law for purpose of perpetuating itself in office and for purpose of obstructing the legit efforts of dissident stockholders in exercise of their rights to undertake a proxy contest against mgmt
  + **Blasius Industries v. Atlas**, Del Ch. 1988 (p.599) – *Atlas added 2 people to board to thwart Blasius (big stockholder) but no contention of bad faith*
    - Q: Can board take defensive action intended to interfere with shareholder exercise of the franchise?
    - H: cannot take action designed to interfere with vote unless is a compelling justification
    - If board had taken action out of indpt motivation with incidental impact, then unlikely that such action would be subject to judicial nullification
    - Cases stab **central importance of the franchise** to the scheme of corporate governance
    - Matters involving the integrity of the shareholder voting process involve consideration not present in any other context in which directors exercise delegated power; cannot just say business judgment rule; must show **compelling justification**

**J. Normal Governance: The Duty of Care**

* **1. Duty of Care and Need to Mitigate Director Risk Aversion**
  + **Duty of care** – must act with “care of an ordinarily prudent person in the same or similar circumstances”
    - litigated much less than duty of loyalty bc law insulates officers and directors from liab based on negligence in order to avoid inducing risk-adverse mgmt
  + Issue of liability of directors who had not participated in wrongs but whose inattention had permitted them to occur
  + 1700s case said by accepting a trust the person is obligated to execute it with fidelity and **reasonable diligence**, no excuse to say that had no benefit from it – reasonable diligence req been around for a while
  + ALI states as officer req to act with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances
  + But in practice not the standard policy reason: corp directors and officers invest other peoples money – they bear the full costs of any personal liab, but they receive only a small fraction of the gains from a risky decision
    - Liability under neg standard would predictably **discourage officers and directors** from undertaking valuable but risky projects
  + **Gagliardi v. Trifoods Int Inc**., (1996) (p. 241)
    - Q: standard for finding liability for mismanagement unaffected by directly conflicting financial interests?
    - H: **Business judgment rule** applies; holds that **where a director is independent and disinterested**, there can be **no liability for corporate loss**, unless the facts are such that **no person could possibly authorize such a transaction if he or she were attempting in good faith to meet their duty**
    - Is in shareholders’ interest to offer sufficient protection to directors from liability for neg etc., for directors to know there is no risk that if they act in good faith and meet min proceduralist standards of attention
* **2. Statutory Techniques for Limiting Director and Officer Risk Exposure**
  + **Indemnification**
    - Statues make mandatory and allow broader range of indemnification rights
    - Statutes auth corps to commit to for reasonable expenses for losses of any sort arising from any actual or threatened judicial proceeding or investigation
    - Only limits are that losses must result from actions undertaken on behalf of the corporation in **good faith** and **cannot arise from a criminal conviction**
    - DGCL §145: Indemnification
      * (a): Grants discretionary indemnification power as long as good faith and in manner reasonably believed to be in best interest; if settles does not show wasn’t in good faith
      * (b): “no indemnification shall be made in respect of any claim … as to which such person shall have been adjudged to be liable to the corporation”
      * (c): affirmatively requires corps to indemnify for “successful” defense
    - ***Waltuch v. Conticommodity services inc****.,*(1996) (p.243) – *civil suit settled, criminal suit settled for buncha money, was bad faith*
      * Corp cannot allow indemnification despite lack of good faith contrary to §145(a)
      * For §145(c) “success” is sufficient, so settlement is ok (doesn’t mean can’t indemnify); escape from an adverse judgment
    - Risks in indemnification:
      * Friends aren’t on board to protect you
      * Bankruptcy – if insolvent, then need money
  + **Directors and Officers Liability Insurance**
    - Purchase insurance rather than raising salaries and fees and then allowing directors to take money and purchase ins on their own accts; why?
      * transaction costs; ins cheaper to co bc central bargaining agent; uniformity standardizes, avoids negative signaling that would arise from directors having different levels of coverage; tax law; disguise amt of compensation
    - World Com and Enron directors paid a bunch – where was the insurance?
      * Bankrupt so could not indemnify
      * Well doc’d paper trials of director inattention and inaction
      * Activist pension funds intent on making examples
      * Enormous potential liabs could have exceeded policies
    - Post-Enron, severability clause; as long as not fraud by directory, they’re ok
    - Order of payments: directors have 1st claim, company only gets leftover on policy limit
* **3. Judicial Protection: the Business Judgment Rule**
  + Courts should not second guess good faith decisions made by indpt and disinterest directors
  + **Kamin v. Am Exp Co** (1976) (p.250) – *board chose to spin off stock as dividend rather than sell to reduce taxes; no claim of fraud, self-dealing, bad faith*
    - H: mere errors of judgment are not sufficient as grounds for equity interference, for the powers of those entrusted with corp mgmt are largely discretionary
  + ABA BJR definition:
    - 1) is made by financially disinterested directors or officers
    - 2) who have become duly informed before exercising judgment and
    - 3) who exercise judgment in a good-faith effort to advance corporate interests
  + why necessary?
    - 1) procedural
      * converting a question of fact (whether direct exercised same care as would a reasonable person) into a question of law – so insulates disinterest directors from jury trials
    - 2) convert question of was standard of care breached into related Q of whether the directors were truly disinterested and indpdt and whether actions were not so extreme as not to be good faith
    - Maybe good for social value to announcing a standard that is not enforced with a liability rule; nonlegal sanctions such as personal reputation may affect some directors
    - Also people want to do the right thing, sets standard of what the right thing is
* **4. The Duty of Care in Takeover Cases: Note on Smith v. Van Gorkom**
  + ***Smith v. Van Gorkom*** (1985) (p.255) – *merger w/ synergy bc of unused loss; stock at $37, Pritzker offered $52*
  + H: directors been grossly negligent in accepting Van Gorkom’s offer, didn’t act in informed manner, and could not claim protections of business judgment rule
  + First DE case to actually hold directors liable for breach of duty of care in case where board had made a business decision
* **5. Additional Statutory Protection: Auth for Charter Provisions Waiving Liability for Due Care Violations**
  + **Van Gorkom** Caused D&O insurance rates to go up and caused legislatures to react:
  + DGCL §102(b)(7): can waive liability for director’s duty of care in charter
    - Waiver of damages only; can still seek injunction
* **6. DE’s unique approach to adjudicating due care claims against corp directors: from Technicolor to Emerald Partners** 
  + Directors duty of care can still be basis for equitable order, like injunction
  + DE has adopted a unique approach to adjudicating such claims
  + ***Cede & Co. v. Technicolor, Inc*.** (p.259) – *LBO offer 🡪 stock price low, so can talk a lender into loaning $ and buy stock with borrowed money; they sign up a 2-part deal; tender offer; once 80-90%, merger;* *arguable breaches of duty of care by Technicolor’s board of directors*
    - H: Breach of duty of care is sufficient to rebut the business judgment rule – rebuts presumption that dirs have acted in best interest of the shareholders and requires dirs to prove entire fairness
  + *Malpiede*: Complaint must allege a breach of duty of loyalty in order to survive a motion to dismiss, when company has a §102(b)(7); cant be generic allegations –must have particularized facts
  + Once Ps have overcome presumptions of the business judgment rule, section 102(b)(7) offers less protection
    - ***Emerald Partners v. Berlin*,** (2001) (p. 260) – *Rollup transaction: taking bunch of entities and doing bunch of mergers and ending up with 1 entity; negotiated by committee of independent directors, One director went bankrupt, then others left; P says breach of fiduciary duty by*
    - Standard of review for a **transaction in which a controlling shareholder is interested is objective fairness or entire fairness**
    - Under Technicolor rule, director Ds had **burden to prove entire fairness**
    - Also said director Ds can avoid personal liab for paying monetary damages only if they have **established that their failure to withstand an entire fairness analysis is exclusively attributable to a violation of the duty of care**
  + Summing up:
    - (ignoring Technicolor)
    - If have 102(b)(7), P must say duty of loyalty breach (not just care); plead particularlized facts
    - If can get past that, then D must show entire fairness
    - If D fails, can still avoid personal liaiblity if was only violation of duty of care
    - Problem: tends to require trials if allegation of bad faith – only after court finds on evidence that no bad faith can it apply waiver
* **7. The Board’s Duty to Monitor: Losses “Caused” by Board Passivity**
  + What is scope of director liability for losses that arise not from business choices but rather from causes that the board might arguably have deflected?
  + **Business judgment rule** protects boards that have made decisions
  + How to create incentives for director attention that do not deter service?
  + 5 cases dealing with directors who are charged with breaching their duty of care by not sufficiently monitoring the corporation and thus by not preventing a loss that the corporation incurred
  + **Francis v. United Jersey Bank** (1981) (p.262) – *small, family business; sons steal $, company goes bankrupt; Director Mom paid no attention*
    - Q: can Mom’s inattention be said to be cause of the loss 🡪 liability?
    - H: liable; confident that her objection would have prevented the loss
    - Dir should acquire at least a rudimentary understanding o the business of the corporation; cannot plead ignorance to duty of care claims
    - Review of financial statements may give rise to a duty to inquire further into matters revealed by those statements
    - Upon discovery of illegality, gotta object and resign if no change
    - But need extreme case for liability like this
    - Note: case law unsettled if sophisticated dirs have greater duty
  + Boards of pub companies have particular obligation to monitor their firm’s financial performance, the integrity of its financial reporting, its compliance with the law, its mgmt compensation, and its successful planning
  + **Graham v. Allis-Chalmers Man. Co.** (1963) (p.268) – loss; company indicted for criminal conspiracy to fix prices; pays fine
    - Q: Dirs of corp liable for losses suffered by corp by reason of gross inattention?
    - H: absent cause for suspicion there is no duty upon dirs to install and operate a corp system of espionage to ferret out wrongdoing which have no reason to suspect exists
    - DGCL §141(e): board members protected from good faith reliance on corporate records
  + Securities law and SEC also impose negligence based duties on dirs in variety of contexts; upside dirs are at least as concerned about SEC enforcement actions as are about shareholder suits under state law (**Matter of Marchese**)
  + **In Re Caremark International Inc. Derivative Litigation** (1996) (p.278)
    - Boards have an **obligation to assure a system exists** that is **reasonably** **designed** to **assure** that information respecting the **corporation’s compliance with law plus its performance is reported** to responsible parties
    - Only liability if is systemic failure to observe
    - Here low prob that would be determined that the dirs of Caremark breached any duty to appropriately monitor and supervise the enterprise
  + New independence rules promulgated post-Enron and WorldCom by NYSE and Sarbanes-Oxley
    - S-O §404 codifies ***Caremark***: CEO and CFO have to certify to auditor any weaknesses in the company’s control system; also, have to certify financial statements in a certain way
    - Complaints of compliance costs
    - Proponents: forces hard look at control systems 🡪 long term benefit
    - Caremark clarified in ***Stone v. Ritter***: “necessary conditions predicate for director oversight liability: (a) directors utterly failed to implement any reporting or info system or controls; or (b) having implemented such a system or control, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. … Liability requires a showing that the directors knew that they were not discharging their fiduciary obligations.”
  + **In Re Citigroup Inc Shareholder Derivative Litigation** (2009) (p.285)
    - Twist on *Caremark* claim in that allege failure to property monitor its business risk, specifically its exposure to the subprime mortgage market
    - No allegations of law breaking so this is standard duty of care case 🡪 BJR presumption that no problem 🡪 Ps must show interestness or disloyalty to corp to rebut
    - Warning signs are not evidence that directors consciously disregarded duties or otherwise acted in bad faith; must plead particularized facts that Board was presented with red flags alerting it to potential misconduct

* **8. Knowing Violations of Law**
  + Should corp law go beyond ***Caremark*** and command obedience to positive law? Should shareholders be able to recover?
  + **Miller v. AT&T** (1974) (p.291) – *issue of whether AT&T should collect bill from Democratic convention; if don’t, potentially in violation of campaign finance rules*
    - Intentional violation, but in the company’s best interest
    - H: business judgment rule cannot insulate the D directors from liab if they broke the law
  + Duty to obey the law can be seen as judge-created positive overlay on overall fiduciary duty structure – but what when corp directors did not take unreasonable action but led to law breaking?

**K. The Board and the Fiduciary Duty of Loyalty**

* **1. Duty to Whom?**
  + The **duty of loyalty**: exercise power over corp processes or property (including formation) in a good-faith effort to advance the interests of the company, not to benefit self at its expense; the core of fiduciary doctrine
    - includes self-dealing transactions btw the co and its directors, plus other transactions will get to later (appropriations of corp opps, compensation of officers and dirs, relations btw controlling shareholders and minority shareholders)
    - importance of oblige is greater in corporation bc corp directors and officers tend to exercise greater discretion than ordinary agents
  + Duty is to the **corporation as a legal entity**
  + Easier to ID when solvent – interests of mgmt, creditors, emps, stockholders largely congruent with interests of equity investors
  + But when faces insolvency (may not be enough corp assets to satisfy all of corp‘s obligations) or when contemplates terminal transaction for equity investors, such as a cash merger (when equity investors will no longer have an interest in the future welfare of the corp)
  + **Shareholder Primacy Norm**
    - Dir loyalty to corp is ultimately loyalty to equity investors
    - ***Dodge v. Ford*** (1919) - *Dodge bros held 10% of Ford stock sued to force Ford board to declare dividend out of large pool of earning retained to find new projects and finance price reductions*
      * H: Directors had wrongfully subordinated shareholder interest to those of consumers by holding back dividends
      * Affirmed primacy of shareholders interests
    - But case in an anomaly - board’s decision today to use retained earnings to fund investments, price reductions, or increased emp wages would easily be justified to increase long term earnings, be immune from shareholder attack
    - Competing norm: view that dirs must **act to advance the interests of all constituencies** in the corp, not just shareholders
      * Corp can justify charitable giving by reference to long term corp benefits then deference
      * ***AP Smith Manufacturing Co. v. Barlow*** (1953) – *Corp donated to Princeton*
        + H: Ok to give; Common law rule that corps may not disburse funds for philanthropic or other worthy causes unless would benefit corp, but has been applied broadly to enable donations with indirect benefits
  + **Constituency Statues**
    - Context of hostile leveraged buyout transactions of the 1980s
    - Buyers offers shareholders a high premium price for shares and then when had control sell of assets, lay off workers, increase debt, and replace senior mgmt
      * Creditors (face increased risk of default and bankruptcy) and employees as losers
      * Shareholders winner – paid in excess of market price
      * Managers couldn’t oppose as bad to shareholders, so put forth rationale that directors owe loyalty to the corporation understood as combo of all its stakeholders – creditors, shareholders, managers, workers, suppliers customers
      * State legis tried to help, enacted statues that provided dirs with power to balance interests of nonshareholders constituencies w those of shareholders
* **2. Self-Dealing Transactions**
  + Law must balance btw cost of preventing mutually beneficial transactions and allowing abuse; balance btw making regime simple yet still discriminating
  + Default rule: no self-dealing; General rule: can do if disclosed and intrinsically fair
  + Trust beneficiary rule: couldn’t deal with trust at all, but could deal with trust beneficiary and was full disclosure and substantively fair
    - 19th C: trust rule was the corporation rule – no interested transactions
    - 1880-1910: valid if fair to corporation, disclosed & approved by disinterested majority of Board (interested party doesn’t count towards quorum)
  + **Disclosure requirement:** Interested director must make full disclosure of all material facts of which she is aware at the time of authorizing interested transaction
    - ***State ex rel Hayes oyster co v. Keypoint oyster***, (1964) – *Sale of oyster beds approved by board & shareholders but had no knowledge that benefited director*
      * H: fair not just about price, but also disclosure; nondisclosure by an interested director or officer is, in itself, unfair
      * Shareholders and directors entitled to know that interest director might be in position where must choose btw the interest of two corps
    - **Eisenberg:** Rule that fairness of price enough (no disclosure needed) would remove decision making from corp’s hands and place it with the court, that can do no more than say that it was or was not within range at which parties dealing at arms length would have concluded a deal
    - What exactly must be disclosed? DE standard: director or controlling shareholder must disclose all material information relevant to the transaction
* **3. The effect of approval by a disinterested party**
  + Principle legal Qs raised by disinterested review mechanisms concern
    - (1) whether the disinterested approval has **sufficient integrity to be accorded some affect** by reviewing courts
    - (2) **the standard of judicial review** to be employed after disinterested review and approval
      * business judgment?
      * More searching? Fairness?
      * Matter if shareholders / directors approved it?
  + Judicial Review of Self-Dealing Today: The Limited Role of **Safe Harbor Statutes**
    - **Safe harbor statues** sought to permit boards to authorize transactions in which a majority of directors had an interest; allowed corps to allow interested directors to be counted towards quorum if:
      * DGCL §144(a)(1): Disclosed and **approved by disinterested directors** (even if less than quorum); not voidable simply bc interested person was there; or
      * §144(a)(2): Disclosed and **shareholders approve**
      * §144(a)(3): is **fair** when authorized by board or shareholders
    - ***Cookies Food Products v. Lakes Warehouse*** (1988) – *minority owners of small BBQ sauce company complain about lack of dividend*
      * In reading Safe Harbor statute, courts could use four possibilities:
        + (1) End of inquiry – approved by disinterested directors or shareholders, so claim is extinguished
        + (2) Business judgment review – ok unless no reasonable person...
        + (3) *Cookies* rational: not void outright, but investigated under fairness standard; fiduciary has burden of coming forward and showing that is fair; acted in good faith and honestly
        + (4) Burden-sharing – make P prove was unfair
      * H: fairness shown; Dissent: no it wasn’t, should have to show fair market value of services and that royalty was fair
  + Judicial Review When Transaction Has Been Approved by A Disinterested Majority of the Board
    - Safe harbor statute has effect only of authorizing trans, not of foreclosing review for fairness
    - **Eisenberg:** Two reasons why should be subject to fairness test
      * 1) directors, bc of collegial relationships, unlikely to treat selves with degree of wariness as would a transaction with third party
      * 2) difficult to utilize a legal definition of disinterestedness in corp law that corresponds with factual disinterestedness
    - ***Cooke v. Oolie*** (2000) – *indpt director & shareholder approval; P says 2 are both creditors and shareholders*
      * H: under §144(a)(1) court will apply BJR to actions of an interested dir, who is not the majority shareholder, if interested dir fully discloses his interest and a majority of the disinterested directors ratify the interested transaction
  + **Shareholder Ratification** of Conflict Transactions
    - Not treated as a full answer to a complaint that deal is unfair
    - ***Lewis v. Vogelstein*** Del Ch(1997)
      * Draw from agency concept of ratification - ex post confirming of legal auth of an agent in circumstances in which agent had no auth
      * 3 complicating factors when applying to shareholder ratification
        + 1) no single individual acting as principal, but rather a class or group of divergent individs; collective action problem
        + 2) ratif will not be directed to lack of legal auth in agent but relate to consistency of some authorized dir action with the equitable duty of loyalty
        + 3) statutory law complications
      * shareholder ratif may be held to be ineffectual
        + 1) bc majority of those affirming had conflicting interest
        + 2) bc transaction ratified constituted corp waste (only ok by unnanimous shareholder vote)
      * Have to look to integrity of the process
    - ***In Re Wheelabrator Tech*** Del Ch (1995) – *merger btw 2 companies where one owned 22% of other; approved by majority of shareholders*
      * Parent-subsidiary mergers have most control and threat of abuse; compliance with §144 shifts burden to P to show that was unfair
      * Vice-Chancellor Jacobs decided as matter of fact that not controlling; BJR:
        + If transaction is fully disclosed and ratified by shareholder and claim is simply negligence, shareholder approval essentially extinguishes claim
        + If claim is breach of loyalty (unfair self-dealing), effect is to change test to the BJR – director doesn’t have to prove fairness
        + BUT if is interested transaction btw corp and controlling shareholder, then entire fairness despite shareholder vote
  + Process questions for safe harbor:
    - (1) Does pass requirements for safe harbor / ok to be authorized?
    - (2) If passes, can still be voided; judicial review will be:
      * Cookies: D must show fairness
      * Cooke: if disinterested directors approve 🡪 BJR
      * Eisenberg: should still review for fairness
      * If shareholders ratify
        + Lewis: still reasons to be skeptical
        + Wheelabrator: BJR, unless controlling shareholder, then entire fairness
* **4. Controlling Shareholders and the Fairness Standard**
  + Fiduciary duty on part of controlling shareholders to the company and its minority shareholders
  + Shareholder with less than 50% of outstanding voting power of firm may have fiduciary obligation by reason of exercise of corporate control
  + Shareholder with 50% or more of vote will prob owe such a duty, despite evidence that did not in fact exercise control
  + Two values collide:
    - dominant value: controlling shareholders gives rise to a duty to consider interests of other shareholders fairly whenever the corp enters into contract with controller or affiliate
    - Subsidiary value: entitlement of all shareholders to sell or vote in their own interests
  + ***Sinclair Oil Corp v. Levien*** (1971) – *stockholder of Sinclair sues to require corp to account for damages sustained by subsidiary Sinven; Chancery said intrinsic fairness test*
    - In parent-subsidiary situation with parent controlling transaction and fixing terms, the test of intrinsic fairness, with resulting shifting of burden of proof, is applied
    - **BUT** apply only when fiduciary duty is accompanied by self-dealing (parent causes subsidiary to act so that parent receives something from subsidiary to exclusion of, and detriment to, the minority stockholders)
    - Doesn’t meet test here 🡪 BJR
  + ***Weinberger v. UOP*** Del (1983) – *majority owner (Signal) (51%, 6 of 13 directors) bought out minority (UOP);* *directors of UOP (also of Signal) did price study saying higher price would sill be good for Signal that did not disclose to UPO shareholders*
    - Controlling shareholder required to demonstrate utmost good faith and most scrupulous inherent fairness of the bargain
    - Problems:
      * Director not disclose material facts of agreement (that higher price would be ok)
      * Intrinsic fairness means fair dealing and fair price
      * Not **fair dealing** (when transaction was timed, how it was initiated, structured, negotiated, disclosed to directors, and how the approvals of the directors and the stockholders were obtained)
        + did not fulfill duty of **candor**
        + was all initiated by Signal and at their schedule
        + didn’t disclose
      * Possibly not **fair price**
        + In non-fraudulent transaction, price may be preponderant consideration outweighing other features of merger
        + Must determine based upon “all relevant factors”; remand
      * Court proposal: UOP should have appointed an independent negotiating committee of outside directors to deal with Signal at arms length; in parent-subsidiary context, showing that action as taken as though each of parties had in fact exerted its bargaining power against other is strong evidence of fairness
        + Eds. ID problems – would not have solved knowing about $24 thing, wouldn’t have leverage
  + Approval by a Board Minority of “Independent” Directors
    - Post Weinberger evolved standard template for controlled transactions btw a subsidiary corp and its parent or affiliates: formation of special committee of disinterested independent directors to consider and recommend the transaction
    - Reqs:
      * Must be properly charged by the full board, comprised of indpt members, and given resources
      * Must try to obtain best deal available
    - Has real bargaining power bc courts skeptical if deal forced on minority shareholders without the committee’s approval
    - Buyer does not have to reveal its reservation price
    - Qs of whether buyer has to disclose why seeks transaction, how fair price determined, etc
    - Remember, only shifts burden of proving fairness form the defendant to the P (ie P must now show unfairness) in a controlled transaction
* **5. Duty of Loyalty in Close Corps**
  + Enormous latitude allowed in customizing the form of the close corporation
  + Problems arise 🡪 Qs about proper role of courts in superintending ongoing business
  + Difference is that equity participants in close corps have selected the corp form to frame their long term deal
  + **Donahue v. Rodd** (Mass.) (1975) – *Stock redeemed for majority shareholder (80%) but not minority (20%)*
    - H: Was an unlawful distribution of corporate assets to controlling shareholders; constitutes a breach of fiduciary duty because failed to accord minority equal opportunity to sell shares to the corp
    - Ps get choice btw repayment by majority and buying their stock
    - Holding limited to close corps
    - Stockholders in the close corporation owe one another **substantially the same fiduciary duty** in the operation of the enterprise **that partners** owe one another
    - In any case in which controlling stockholders have exercised their power over the corporation **to deny the minority such equal opp**, minority shall be entitled to appropriate relief – **right of participation**
    - What is a close corp?
      * Small number of stockholders
      * No ready market for the corp stock
      * Substantial majority stockholder participation in the mgmt, direction and operations of the corporation
  + **Easterbrook**: ***Donahue*** dumb
    - Is true that because business decisions in close corps more likely in fact way to manipulate shares so does makes sense to have higher scrutiny
    - But should always construe fiduciary duties to approx the bargain the parties themselves would have reached had been able to negotiate at low cost
    - Sort of business decision made in ***Donahue*** would probably have been allowed; buy-outs are common
  + DE SC seems to endorse Easterbrook over ***Donahue***, and SC of Mass clarified duty, saying if controlling shareholder can demonstrate a legitimate business purpose for its actions, then there is no breach of fiduciary duty unless the minority shareholder can demonstrate that the same legitimate objective could have been achieved through alternate action less harmful to minority
  + **Smith v. Atlantic** (Mass. App. 1981) – *Close corp of 5 shareholders gives each a veto over business decisions; One (Wolfson) refused to allow payment of dividends 🡪 IRS penalties against corp*
    - Q: Whether Wolfson owes other shareholders the same fiduciary duty a majority would owe a minority shareholder?
    - H: Wolfson liable because was unreasonable and did not demonstrate good faith and loyalty to business as necessary by shareholders in close corp; breached fiduciary duty
    - Note: DE does not subscribe to minority oppression idea; 2 ways to address similar problems:
      * DGCL §226: appointment of custodian or receiver
      * §273: dissolution of joint venture
* **6. Compensation**
  + different test; if approved and ratified by shareholders, use BJR – hard to meet
  + Golden parachutes (contracts entered into before a hostile takeover): triggered 2 ways: change of control; change in responsibilities
  + CEO pay is hard problem to deal with; US has highest ratio of executive to worker compensation in the world, and rising
  + Often tied to incentive compensation (options); don’t see repricing any more, but now do see regrants (new grants), though institutional investors don’t like that either
* **7. Corporate Opportunity Doctrine**
  + When may a fiduciary pursue a business opportunity on own if might arguably belong to the corporation? 2 basic Qs:
    - Is it an opportunity?
    - Is it wrong for corporate officer to take it?
  + Generally look at 2 things to decide whether corporate opp:
    - How close to the business of the corp is it (core v. unrelated)?
    - How did the opp come to the officer (b/c officer or independently)?
  + 3 lines of doctrine on whether corporate opportunity:
    - 1) **Interest / Expectancy** test: expectancy or interest must grow out of an existing legal interest
      * gives the narrowest protection to the corp
      * ***Lagarde*** (1900): signed contract and therefore legal expectancy so it’s a violation (if no contract, then no expectancy)
      * recent cases look to the firm’s practical business expectancy or interest, but still narrow
    - 2) **Line of business** test: any opp falling within co’s line of business
      * aka anything corp could be expected to do is a corporate opportunity
      * factors:
        + 1) how matter came to attn of the director, officer, or employee
        + 2) how far removed from the core economic activities of the corp the opp lies
        + 3) whether corporate info is used in recognizing or exploiting the opportunity
      * ***Guft v Loft***: (Del. 1939)
    - 3) **fairness** test: cannot take opportunity unless first presented to company and rejected and fair/disclosed, etc.
      * more diffuse, mult factors: how manager learned of the opp, whether used corp assets in exploiting it, other fact-specific indicia of good faith and loyalty to the corp, in addition to a co’s line of business
  + When may a fiduciary take a corporate opportunity?
    - Some say **if corp is not in financial position** to do so – implies that corp board has determined not to accept the opp
      * But see ***Irving Trust Co. v. Deutsch*** (1924): proposed rigid rule that can’t take a corporate opportunity on basis of financial incapacity (since can’t tell if is good faith effort to raise funds, etc.)
    - What is critical is **whether the board has evaluated** the question of whether to accept the opp in good faith
    - Most courts **accept a board’s good faith decision not to pursue** an opp as a **complete defense** to a suit challenging a fiduciary’s acceptance of a corp opp on own acct
    - Ct must be persuaded that the decision to reject is genuine business judgment of disinterested decision maker
    - Fiduciary who takes opp bears burden of estab’ing defense
    - If dir never presented business opp to board in good-faith belief that was not a corp opp? ***Broz v. Cellular Infor Systems, Inc.*** (1996):
      * Not required
      * Presenting to board **simply provides safe harbor** for director
    - DGCL § 122(17): authorizes waiver in the charter of the corporate opp constraints for officers, directors, or shareholders
      * Motivated by growing culture of interlocking boards ie in Silicon Valley
  + Remedies: flexible; judge can do bunch of stuff

**L. Shareholder Lawsuits**

* **1. Two principal forms of shareholder suits**
  + **Derivative** suits
    - corporate claim against an officer or director charging them with a wrong to the corporation
    - only if harm indirectly/derivatively harms shareholders
    - two suits in one: shareholder suit against board for breaching duty to bring a lawsuit; suit on underlying wrong
      * typically allege that corps directors have failed to vindicate its claims bc they themselves are the wrongdoers and so would e the dfendants in the resulting suit
  + **Direct actions**, usually as class actions, to recover damages suffered by individuals directly bc they are shareholders
  + **Pros**: bring claims of fiduciary breach to court on behalf of disaggredgated shareholders
  + **Cons**: may encourage the plaintiff’s bar to bring too many or the wrong sort of fiduciary claims to court
* **2. Distinguishing Between Direct and Derivative Claims**
  + Alleged breaches of corp law obligations most often arise in context of derivative suits
  + Suits arising under federal securites laws are direct actions
    - Injury alleged is personal interest, such as right to vote shares, rather than to a corporate interest
    - Class action alleging securites fraud
  + May bring one or both kinds of actions
  + Derivative suit advances a corp claim, so recovery 🡪 corporation itself
  + Derivative suits have procedural hurdles designed to protect board’s role as primary guardian of corp’s interests
  + Derivative suit may be dismissed if doesn’t satisfy provisons of Rule 23.1 of fed rules
  + Commonalities
    - Ps must to give **notice to absent interested parties**
    - Permit **other parties to petition to join** suit
    - Provide for settlement and release only after **notice, opp to be heard, and judicial determination of fairness** of the settlement
    - Plaintiffs **compensated from the fund that their efforts produce**
  + ***Tooley v. Donaldson, Lufkin & Jenrette*** (Del 2004) - *Claimed that extention of time to close on merger deprived of time value of the merger proceeds for the period of the delay; Chancery dismissed – only potential claim belonged to the corp (bc was a claim held equally by all shareholders; no special injury allowing direct suit)*
    - H: Affimed, Q turns on 2 questions:
      * 1) **who suffered** the alleged harm (the corp or the suing shareholders)
      * 2) **who would receive the benefit** of any recoery or other remedy (corp or stockholders generally)?
    - Thus removed from the analysis the question of special injury as being the mark of a direct claim
* **3. Solving a Collective Action Problem: Attorneys’ Fees and the Incentive to Sue**
  + Plaintiffs bar initiates shareholder suits usually, looking to earn fees from positive outcome; whether receives a fee turns on whether suit is dismissed or a judgment is entered in the suit, either thru litigation or settlement
  + When derivative suit succeeds on merits or settles, corp is said to benefit from any montary recovery or gov change resulting from litigation
  + Corporation and insurer also generally bear bulk of costs on both sides
  + ***Fletcher v. AJ Indust Inc*** (Cal App 1968) (p.367) – derivative suit settled, as result board reorganized, director ousted, other director’s contract amended; monetary recovery to be determined in future through arbitration
    - Q: can give attny fees if no monetary award / common fund thing?
    - H: attorney’s fees may be awarded and paid from a common fund where derivative action on behalf of corp has recovered, but existance of the fund is not a prereq to the award
    - Fees if benefit is **substantial**: results of action maintain the health of the corp and raise the standards of fiduciary relationships and of other economic behavior or prevent an abuse which would be prejudicial to the rights and interests of the corporation or affect the enjoyment or protection of an essential right to the stockholder’s interest
    - Dissent: If don’t req a common fund, officers and directors of corp may be faced with a liquidation of assets to pay fees, even tho resulting harm to the corp might be disproportionate to the subtantial benefits derived from lawsuit
  + Agency costs in shareholder litigation
    - How balance interest of lawyer to get fee with corp/shareholders to get best outcome?
    - Problems: Strike suits, premature settlement, or if decouple fees from recovery incentivize spending too much time litigating relative to likely settlment outcomes
    - Demand reqs and law of dismissal by indpt board committees can be understood as judicially created measures to manage incentives of plaintiffs’ lawyers; also federal Private Securities Litigation Reform Act 1995 to discourage nonmertorious suits; but really fundamentals like stock market volatility and good/bad corporate governance are most important drivers
    - Also, if litigation is meritorious and managers face serious prospect of liability, is incentive to settle on terms that are mutually adventageou but allow the Ds to fully escape personal liability for their conduct
  + How determined?
    - Many methods, including hourly and multipliers; DE uses multi-factorial approach (usually approve < $3M
    - PSLRA has alternatives – preference to largest shareholder
    - Auctioning off lead attny position (ie % fee; amt at which you’d take nothing)
    - Most suits settled for low amts, D&O insurance pays
* **4. Standing Requirements (Fed. R. Civ. P. 23.1; also DE statute)**
  + 1) P must be a shareholder for the duration of the action
  + 2) P must have been a shareholder at the time of the alleged wrongful act or omission
    - contemporaneous owenershoip rule - don’t want people to “buy a lawsuit”
  + 3) P able to fairly and adequaely represent the interests of shareholders – no obvious conflicts of interest
  + 4) Must specify what action the P has taken to obtain satisfaction from the corp’s board or state with particularity t reason for not doing so
* **5. Balancing Right of Board to Manage and Shareholders’ to Judicial Review**
  + Balancing issues comes up when:
    - Corp moves to dismiss derivative suit bc court has **refused sharehodler’s presuit demand** – when to defer to board’s judgment to not take action?
    - Shareholder **does not make a demand** on the board, saying board could not exercise disinterested business judgment
    - When board seeks to **terminate suit at later point** in litigation
    - Settlements
    - Rare case when derivative case is settled over objection of shareholder
  + Demand Requirment of Rule 23
    - Have to make a demand on board or plead why you’re excused (self interested, conflict of interest)
    - ***Levine v. Smith***, Del 1991 (p.376) – *GM paid off Perot; GM made motion to dismiss under §23.1 – said should have brought it to the board and could have exercised business judgment*
      * **2 prong test** for claim of futility of demand; must:
        + **(1)** **Rebut threshold presumptions** of director disinterest/independence by well-pleaded facts

for **disinterest**: show majority has financial interest

for **lack of independence**, must show board is either dominated by an officer or director or so under infludence that no discretion

* + - * + if not, **(2)** plead particularized facts sufficient to create a **reasonable doubt** that the challenged transaction was the product of a valid exercise of business judgment
      * H: Majority of the board was not subject to any allegations of manipulation or interest; did not plead facts to create doubt
      * Note: Sort of a relaxed mode of the BJR to screen suits – do facts alleged create a reasonable doubt of the soundess of the challenged transaction?
        + Accused of confusing matters bc focuses in part on ID of directors at the time of the occurrence of the alleged decision
        + What is really relevant is the board’s capacity to decide at the time that the suit is brought
    - ***Rales v. Blasband*** (Del 1993) (p.381) – *Gist of complaint is that invested in Drexel Bonds not for a good business purpose but as a favor to Michael Milken and Drexel, who had been helpful to the Rales brothers*
      * Since board had changed, depart somewhat from **Aaronson/Levin rule**/BJR; here decision challenged was made by board of a different corporation (Could have also been that (1) decision was made by board by directors been replaced or (2) subject of derivative suit is not a business decision of the board)
      * **Test:** examine whether the board that would be addressing the demand can impartially consider its merits without being influneced by improper considerations
      * Here Rales bors and Caplin cannot be expected to exercise indpdt business judment without being influenced by adverse personal consequences resulting from the decision
    - Variations on presuit demand rule
      * ALI proposed a **rule of universal demand**
        + P required to always make a demand and if not satisfied with response could sue
        + If Ds seek dismissal court reviews board’s exercise of busines judgment
      * DE **rule of universal nondemand**
        + Infer that whenever a P makes presuit demand, concedes that board is independent and disinterested
        + Only prog that P can then contest in event that demand is deneid is the 2nd (whether bad faith or gross neg may be intfered from decision itself)
        + Practical effect of rule is to discourage any presuit demand at all
      * ALI approach allows court to rule on board’s ability to fairly deal with issue with more info
  + In response to DE system, boards create **special litigation committees** of independent board members that will always decide not to sue; have to decide if are more suspicious of Ps bringing the suit or Ds creating a committee
    - SLC is now standard feature of derivative suit doctrine
    - Chief divide is btw:
      * DE Zapata line: court itself judges the appropriateness of SLC’s decision to dismiss
      * NY, others: if SLC independent and informed 🡪 entitled to BJR deference without any judicial second guissing
    - **Zapata v. Maldonado** (Del 1981) (p.389) – *SLC created, concluded that actions should be dismissed bc against corp’s interests*
      * DGCL §141(c) allows board to delegate its authority to a committee; properly delegated SLC would have power to move for dismissal
      * Q here is whether board, tainted by the self-interest of a majority of its members, can legally delegate its authority to a committee of two disinterested directors (SLC)
      * Best not to just use BJR, or alternatively give SLC’s no credence
      * **Two-step process:**
        + (1) Inquiry into independence and good faith of committee and process

If committee deemed not independent or not shown reasonable basis for conclusions 🡪 motion to dismiss denied; if satisfied 🡪

* + - * + (2) Court makes own business judgment of fairness of decsion

Consideration of law and public policy in addition to corp’s best interests

Recognition that directos are passing judgment on fellow directors, often who designated them for SLC; look to invalidate results that do not appear to satisfy spirit of the rule

* + - **Zapata** Note:
      * Zapata holds a court may second guess the board’s evaluation of a derivative action when demand is excused
      * But why can’t do when demand was required but board rejected suit?
      * Academics have criticized “demand required/demand excused distinction, arguing courts should be able to exercise own judgment in both classess
      * **In re Oracle Corp. Derivative Litigation** shows highly individualized inquiry Chancery Court may pursue in probing the independence of the SLC that requests dismissal of shareholder derivative action
    - ***In re Oracle Corp. Derivative Litigation*** (Del. Ch. 2003) – *motion of Oracle SLC to terminate action; Oracle alleged of insider trading*
      * H: SLC failed to demonstrate that no material factual question exists regarding its independence
      * Standard: whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind; must persuade that:
        + (1) members were independent
        + (2) they acted in good faith
        + (3) they had reasonable bases for their recommendations
      * Analysis is specific, fact-driven: ie distinguished backgrounds of SLC members, why exactly may or may not fear response of corp (and also consider human nature)
      * Concludes not independent beyond reasonable doubt bc ties among SLC, Ds, and Stanford are so substantial; infers “that a person in [SLC member’s] position would find it difficult to assess [D’s] conduct without pondering his own association with [him] and their mutual affiliations”
      * Note: problem of SLC members must come from board of directors, but of course they’re going to have social and institutional connections
    - What meant by exercise business judgment? Does judgment of court resemble that of a corporate manager, or must weigh matters of public interest too?
    - ***Joy v. North*** (2d cir 1982) (p.403)
      * Q: how to apply 2nd prong of Zapata test
      * H: Judges can apply business judgment; should look to:
        + Probable liability and extent of recovery
        + If determines likley recoverable damages discounted by the probability of liability are less than costs to the corp of continuing the action, it should dismiss the case
        + If finds likely net return to the corp which is not substantial in relation to shareholder equity, it may take into account impact of distraction of personnel and lost profits
        + Should not consider negative impact on morale and corporate image
      * Dissent: Analysis is too complicated, indefinite, and subject to caprice to be workable; judges not equipped for this
      * Note: this test is diffent than what Zapata said
      * Note: alt view is should instead work to ensure the independence of the directors who sit on SLC; MI tried
    - Allen view (from ***Carlton Investments***): Is a difficult test to apply; should be seen as offering “protection for cases in which, while court could not consciously determine on the first leg of the analysis that there was no want of independence or good faith, it nevertheless “felt” that the result reached was “irrational” or “egregrious” or some other such extreme word. My opinion is that courts should not make such judgments but for reasons of legitimacy and for reasons of shareholder welfare.”
* **6. Settlement and Indemnification**
  + Settlement by class representatives; parties strongly driven to settle in tupical derivate suit
    - Costly litigation for Ps
    - Ds could face personal liability at trial but but indemnified if settles
    - Directors and officers (D&O) insurance will exclude losses that arise from fraud or self-dealing, while settlement allows D&O to apply
    - DGCL §145(b) gives corp borad latitude to indemnify
      * If action favorable 🡪 director can be indeminfied for any settlement payment + litigation expenses
      * Corp cannot indemnify directors adjuded to be liable to it – except if auth’d by ct of chancery; though can purchase liability insurance (§145(g))
    - Virtually all public co’s purchase D&O insurance; two parts to policy:
      * (1) provides coverage to the corp for expenses in defending and indemnifying its officers and directors
      * (2) provides coverage directly to officers and directors when corp does or cannot indemnify
      * Generally excludes criminal penalties and civil recoveries for fraud of fiduciary breach that resulted in personal gain
    - Most suits settle and lead to award of attny’s fees; of settling, about half result in monetary recovery; D&O pays for most or all of settlement in most cases; officers and directors never face out of pocket costs
    - Federal Rule 23.1 details settlement procedure: notice to class/shareholders of nature of claim being made; maybe summary of evidence; statement of settlement consideration plus statement of the lawyer’s fees; finally, notice of a time and place for hearing into fairness of proposed settlement (usally approved)
  + Settlement by Special Committee
    - Rare for SLC to settle, but happens
    - ***Carlton Investments v. TLC*** (Del Ch 1997) (p.409) – *approval of SLC proposed settlement*
      * In evaluating proposed settlement, court **doesn’t make substantive determinations** concerning disputed **facts or the merits** of the claims alleges; instead considers whether the proposed settlement is **fair and reasonable** in light of factual support for alleged claims and defenses
      * If negotiated by SLC, do ***Zapata*** review
      * H: SLC proceeded in good faith; SLC conclusions were well informed; settlement falls within range of reasonable solutions; passes 2nd prog that was reasonable business judgment
* Summing all up - Derivative suit is brought (assuming have standing) 🡪
  + - if shareholders demand decision from board 🡪
      * board says sure 🡪 suit goes forward
      * board says no 🡪 shareholder can contest 🡪
        + if in DE, court will use only 2nd prong of Aaronson/Levine (in DE) 🡪

court will not allow suit

court will allow it

* + - * + if under ALI universal demand, court will use full Aaronson/Levine test 🡪

court will not allow suit

court will allow it

* + - if sharehodlers do not demand 🡪 company will motion to dismiss on basis on lack of demand 🡪
      * if follows NY line of cases 🡪 dismiss because must demand
      * if DE, Court will use Aaronson/Levine Qs 🡪
        + motion granted, or
        + denied 🡪 might set up SLC to try and get dismissed again 🡪 Zapata test 🡪

motion granted, or

(almost always) settle

**M. Market Transactions in Corporate Control**

* **1. Share transactions/regulation generally**
  + Share transactions traditionally escaped legal regulation, but over past 50 yrs been recognition that they cannot be wholly isolated from core agency problems
  + Exchanging or aggregating blocks of shares large enough to control corps raises problems that resemble those of self-deling and appropriations of business opps
  + Controlling blocks **sell at a premium** – why?
    - Payment for private benefits of control
    - Public/shared benefits of buyers believing have a superior business plan
    - Simply costly to create so command premium
  + Transactions are infrequent enough that control is feasible to monitor
  + Investors can acquire control over corps in two ways
    - 1) Purchasing a **controlling block** of shares from an existing control shareholder
      * Reg that hinders the purchase of control at a premium price will
        + Mitigate risks of opportunistic transfers of control to bad aquirers
        + Hinder the efficient transfer of control to acquireres who will use corp assets in more profitable ways
    - 2) Purchasing **shares of numerous smaller shareholders**
      * trade off again btw law’s ambition to protect shareholders from opportunism and its ambition to foster efficient transfers of control
      * if no reg, looter could exploit collective action problem of disaggregated sharehodlers by buying 51% at high price and later appropriating a large part of value of remaining 49% as private benefits
      * managers could abuse defensive power by selling firm to inefficient acquirer who offers a side deal, or refusing to sell firm regardless of potential buyer’s price
* **2. Sales of Corporation Control: The Seller’s Duties**
  + Three aspects of the issue of governing control block sales
    - 1) extent to which law should regulate **premia** from the sale of control (ie difference btw market price of minority shares and the price obtained in the sale of a control block)
    - 2) the law’s response to sales of managerial power over the corporation that **appear to occur without transferring a controlling block of stock** (ie sale of corporate office)
    - 3) the seller’s **duty of care to screen out buyers who are potential looters**
  + Regulation of **control premia**
    - 2 views: sharing of premium is right thing (fairness norm) vs property-rights view
    - When someone buys corporate control, it’s almost always to do something (not just to buy stock), so can reason that have created a fiduciary duty in this case
    - ***Zetlin v. Hanson Holdings*** (NY 1979) (p.416)
      * “Market rule”: sale of control is a market transaction that creates rights and duties btw the parties, but does not confer rights on other shareholders
      * Absent looting of corporate assets, conversion of a corp opportunity, fraud, or other acts of bad faith, a controlling stockholder is free to sell, and purchaser free to buy, that controlling interest at a premium price
    - Some attack fairness and efficiency of market rule; propose **“equal opportunity rule”** under which minority shareholders would be **entitled to sell shares to a buyer of control on same terms** as seller of control
    - ***Perlman v. Feldmann*** (2d Cir 1955) (p.417) – *Steel shortage bc of war; can make extra $ bc prices up; “Feldman Plan”: Controlling shareholder has plan to get cheap loans to invest in capital*
      * Q: should control premium paid for corporate asset be shared
      * H: corporate opportunity was traded way; when the sale necessarily results in a sacrificie of this element of corporate good will and consequent unusual profit to the fiduciary who has caused the sacrifice, he should acct for his gains
      * To the extent that the price received by Feldmann and his coDs incldued such a bonus, he is accountable to the minority stockhodlers who sue here
      * Dissent: Controlling shareholder acts on own behalf when selling, not as an agent of the corp; can do what wants
      * Notes: Ruling not really so broad
  + **Easterbrook**: Defense of the Market Rule in Sales of Control
    - Investros’ welfare maximized by legal rule that permits unequal division of gains from corp control changes
    - Sales of control blocs reduces costs to purchasers of control, thereby increasing number of benefiical control tranfers and increasing incentive for inefficent controllers to relinquish positions
    - Sharing requirement would raise price, stifle tranfers of control
    - Perlman promlem: no reason that gain resulting from the plan was not reeflected in the stock price
    - Difficult to forsee looters, so better to deter than try to detect that would slow efficient transfers
  + How much do DE courts really believe in controller’s right to a control premium?
    - DE courts don’t always fully support the doctrine
    - Controller often requires corporate action to facilitate the sale; these actions could provide docrinal hook for a duty on part of board to try to help the minority benefit from the transaction
    - ***In re Digex*** distinguishes btw controller’s shareholder right to exercise voting power for private beneft and the mgmt duty to exercise corporate power for benefit of all shareholders
      * H: Controller violated duty of fairness to minority shareholders when presured the subsidiary’s board to waive rules to facilitate sale
      * R: board may waive the 203 constraint only for the benefit of the corp and all of its shareholders – not just its controlling shareholder
      * but if vigorously construed, norm seriously weakens a controlling shareholders entitlement to the whole of a control premium
* **3. Sale of Corporate Office**
  + Sale of relatively small block of stock in a widely held firm at premum price by the officer, who simultaneously promises to resign from board in favor of buyers appointees
  + Can’t sell low control % for big premium, then change board
  + ***Carter v. Muscat*** (1964) (p.428): ct upheld the *reelection* of new directions at annual shareholders meeting
  + Contra **Brecher v. Gregg** (1975) (p.429): *sale at premium + promise to secure appt of buyer’s candidate as new CEO and election of two of buyers’ candidates to the board of directors; but corp board rebelled and fired buyer’s CEO*
    - would be buyer sued seller for premium refund unsuccessfully
    - but stockholder successfully sued derivatiely and forcec to disgorge control premium to the corp
    - Paying a premium for control while purchasing only 4% of shares is **contrary to pub pol and illegal**
* **4. Looting**
  + Duty law imposes to screen against selling control to a looter
  + ***Harris v. Carter*** (Del Ch 1990) (p. 429) – *Carter induced by Mascola to transfer him stock in Atlas + resignation of Atlas board so Mascola could have; after got control, Mascola diverted value to him and buddies; Atlas sued Carter*
    - Q: Does controlling shareholder owe a duty of care to the corp in connection with the sale of a control block of stock
    - H: Is a duty to not transfer control to somebody who’s going to loot
    - A sale of controlling interest, at least where coupled assuring buyer’s designees assume corporate office, invokes fiduciary duties
    - When circumstances would alert a reasonably prudent person to a risk that buyer is dishonest, a duty upon the seller to make reasonable inquiry and generally to exercise care
* **5. Tender Offers: The Buyer’s Duties**
  + Investor who wishes to purchase control of large public company must do so by aggregating the shares of many small shareholders (approach largerst singly or make general tender offer open to all shareholders)
  + **Tender offer**: offer of cash or securities to the shareholders of a public corporation in exchange for their shares at a premium over market price
  + Before Williams Act 1967 offers unregulated; Act sought to
    - provide shareholders sufficient time and info to make an informed decision
    - warn market aobut an impending offer
    - maybe also to assure shareholders equal opp to participate in offer premia and discourage hostile tender offers
  + **Reg structure** of Williams Act (§14d-g of 1934 Securities Act) has 4 elements
    - (1) **Early warning system** under §13d – alerts public and the co’s managers whenever anyone acquires more than 5%
    - (2) §14(d)(1) mandates **disclosure** of the identity, financing, and future plans of a tender offeror, including plans for any subsequent going-private transaction
    - (3) §14(e) **antifraud provision** prohibits misreps, nondisclosures, and any fruadulent, deceptive, or misrepresentative practices in connection with a tender offer
    - 4) **substantive terms** of tender offers (ie how long offers must be left open, when shareholders can withdraw previously tendered shares, how bidders must treat shareholders who tender)
      * §14e-1 madates tender offers be left open for at least 20 business days
      * §14d-10 bidder open tender offers to all shareholders and pay all who tender the same best price
  + What is a tender offer? Williams Act doesn’t define; led to law on **de facto tender offers**
    - **Brascan Ltd. v. Edper Equities**, (SDNY 1979) (p.435) - *to increase influnce over Brascan, Edper decided to purchase an additional 3 mil Brascan shares; got brokers to arrange and brought; never announced or anything*
      * H: Not a tender offer
      * SEC’s 8 criteria in determining whether acquisitions constitute a tender offer under the Williams Act
        + 1) active and widespread solicitation of public shareholders
        + 2) solicitation is made for a substantial percentage of the issuer’s stock
        + 3) a premium over the prevailing market price
        + 4) terms of the offer are firm rather than negotiable
        + 5) whether the offer is contingent on the tender of a fixed minimum number of shares
        + 6) whether the offer is open only for a limited period of time
        + 7) whether ther offerees are subjected to pressure to sell their stock
        + 8) whether public announcements of a puchasing procgram precede or accompany a rapid accumulation
* **6. Hart-Scott-Rodino Act Waiting Period**
  + Intended to give FTC and DOJ proactive ability to block deals contra antitrust laws
  + If no antitrust issues, HSR Act affects only the timing of transactions
  + Real significance: **waiting periods** it imposes before a bidder can commence offer
  + HSR filings must be disclosed immediately, and bidders can’t close deal until relevant waiting period (15 days after filing for cash tender offers) elapsed
  + Williams Act created de facto auction period of at least four weeks 🡪 allowed target mgmt to build defenses and permitted other acquirers to look over firm
    - **Easterbrook** said auctions likely to reduce total number of value-increasing takeovers
    - Other said enhances efficiency of individual takeovers, while having little impact on number of value-enhancing transactions
* **7. Duties in context of tender offers**
  + What effect to be accorded the act of a well-functioning special committee in a controlled merger context
    - ***Kahn v. Lynch Communications Systems, Inc.***(Del. 1994) (p.497) – *Alcatel had control of Lynch; Lynch wanted to buy Telco; Alcatel proposed to buy Celwave instead; special committee disagreed with deal, but eventually agreed because figured going to be done anyway to get best deal*
      * H: standard of review for cash out merger is entire fairness; burden on controlling shareholder
      * Shows judges don’t want to have to figure out if price is fair, rather look at process
  + Controlling shareholder fiduciary duty on first step of two-step tender offer
    - **In re Pure Resources, Inc., Shareholders Litigation** (2002) (p.504) – *Pure owns 65% of Unocal, directors some, public rest; Pure springs tender offer on public as part of short-for merger*
      * Q: what standard of fiduciary conduct applies when a controlling shareholder seeks to acquire the rest of a company’s shares?
      * Lynch cases: when controlling stockholds negotiate merger to buy out minority 🡪 protect minority shareholders from unfairness
      * Solomon cases: controlling stockholder seeks to acquire rest of shares though tender offer followed by short term merger 🡪 **DE facilitates sale** so long as consent of sellers **is not procured by inadequate or misleading info or compulsion**
      * In context of tender offer freeze-out, will **adhere to flexible Solomon** **approach**
      * Acquisition tender offer by controlling shareholder non-coercive when:
        + (1) subject to majority of the minorty tender condition
        + (2) the controlling stockholder promises to consummate merger on same terms
        + (3) controlling stockholder has made no retributive threats; if coercive, then follow ***Lynch*** entire fairness standard
        + plus (4) complete disclosure (Securities Act §14)
        + And majority stockholder owes duty to permit indpdt directors on target board free rein and adequate time to react to tender offer
* **8. The Poison Pill**
  + 1983-84: invention; board can force hostile takeover person to come and negotiate
  + Popular and effective
  + Function:
    - Today looks like a dividend distribution: board just passes a resolution saying that have a right due to “rights plan,” to buy a new/different security
    - Right is fictious right to buy: maybe 1/100 share of proferred stock at $100/100th sahre
  + Type:
    - **Flip-over** (original way): purports to give shareholders the right to buy shares in another company
      * When event occurs, rights become irrevocable and unamendable; right to buy happens when a 2nd step occurs (merger, sale of assets)
      * Theory must be that there’s a right in the capital structure of the target company to purchase some of the stock once the event occurs, so the board can’t do a deal with this in place unless purchaser agrees to these terms
    - **Flip-in:** gives rights to buy stock in your own company
      * If an event occurs (ie some shareholder acquires more than X% of stock), then it triggers rights to buy stock at a bargain price, excluding the “bad guy”
      * Sounds like 50% dilution, but actually much more – no one ever triggered
      * Puts board in position to act as central bargaining agent in tender offers; had this power in mergers, sale of all assets – now with tender offers also
    - **Dead hand** (invalid in DE)
      * Concept of “continuing director” – pill only redeemable by people presently in office or nominated by them
      * VC Jacobs says can’t do this because creates two classes of directors; must be done in charter – *Mentor Graphic*
  + Pros/Cons
    - hostile tender offers possibly useful device for disciplining corp mgmt
    - managers themselves believe that vlnerability to hostile bids is profound weakness in corp gov structure bc exposes disaggregated and disorganized shareholders to abusive tender-offer tactics; board as loyal bargaining agent
    - concern that pill misued to protect status qup; boards do not need shareholder approval to adopt rights plans and generally don’t seek it
    - tho corps charer must auth enogugh shares to cover the exercise of the rights
  + **Moran v. Household International** (Del 1985) (p. 525) – *Household put in flip-over pill*
    - H: Board can do it; §157 says can issue securities and these aren’t a sham
    - May be time when board forced to redeem the pill
    - Note: Pill really powerful tool; what effects of pills on shareholder value?
      * loyal managers 🡪 helps by providing power to bargain on behalf of shareholders and overcome collctive action problem
      * If disloyal 🡪 can intrench
  + Court has forced boards to redeem pills when used to protect company-sponsored alternatives to all-cash tender offers (*City Capital Associates*; *Grand Metropolitan Public*)

**N. Extraordinary Tactics: Mergers and Acquisitions**

**1. Intro**

* + Transactions that pool assets of companies into either a single entity or a dyad of parent co and a wholly owned subsidiary
  + Three legal forms for such transactions
    - (1) **Merger:** legal event that **unites two existing corps** with a public filing of a certificate of merger, **usually with shareholder approval**
      * Ordinarily one absorbs other and is termed the **surviving corporation**
      * Then owns all property and assumes all obligations of both parties
    - (2) **Purchase / sale of all assets**
      * “Acquisitions”; comprise generic class of nonmerger techniques for combining companies
      * the acquirering corp may or may not assume liab for the obligations of the acquired corp
    - (3) In RMBCA jurisdictions, the **compulsory share exchange**
      * closely resembles certain kinds of mergers
  + Issues of role of shareholders in **checking the board’s discretion** and the role of **fiduciary duty** in checking the power of **controlling shareholders**
* **2. Economic motives for mergers**
  + Sources of M&A efficiency gains:
    - **Economies of Scale**: when fixed cost of production is spread over a larger output, reducing avg fixed cost per unit of output - explains **horizontal mergers** btw firms in same industry
    - **Economies of Scope:** spreading costs across a broader range of related business activities
    - **Vertical integration:** merge co backward towards suppliers or forward toward its customers (special form of economies of scope); expensive to contract thru the market
    - **Tax**
      * Corps with tax losses (deductible expenses greater than income during the tax year) can set lossess off against income in subsequent years for up to 20 years
      * Ability to carry a **net operation loss** (**NOL**) forward is itself a valuable asset but only if owner has suficent taxable income to absorb it
      * Corp that lacks sufficient income might prefer to find a wealthy merger partner rather than waste its NOL
      * Shareholders of the NOL’s owner and its merger partner would implicitly share the NOL’s present value
    - **Agency cost**
      * Can replace underperforming mgmt team
      * Outside buyer can profit if stock price depressed bc of bad mgmt
      * Merge instead of tender offer to realize max econ returns
      * 80s was hostile takeover time
        + acquirer bids for controlling block in public tender offer and then arrange for merger to cash out minority shareholders
        + In friendly acquisition, pay off managers to leave
        + Share takeover premia with managers thru golder parachute contract,
        + Or compensate with stock option plan
    - **Diversification**
      * Diversify business projects, smoothing corp earnings over the business cycle
      * Ensure stable year-round earnings
  + Suspect Motives for Mergers
    - Opportunistic motives that increase shareholder value or mgmt compensation at **expense of another corporate constituency**
    - **Squeeze-out merger** – controlling shareholder acquires all of co’s assets at a low price, at expense of minority shareholders
    - One that allows the postmerger entity to charge **monopoly prices** for output
    - Exploit **irrational markets**
    - **Mistaken mergers** – misjudge difficulties of realizing merger economies
  + Do Mergers create value?
    - Generally increase in combined wealth of 1.8%
    - Targets generally win, acquirers break even or lose on average – tho don’t have counter factual if just mitigating losses
* **3. Evolution of U.S. Corporate Law of Mergers**
  + History of constantly loosening constraints driven by dynamic markets and technological change
  + 5 merger waves
    - Late 19th C: result of “ruinous competition”
    - Roaring 20s
    - 1960s: conglomeration idea; mgmt: “we have expertise and can apply it to any field”
    - 1980s: breaking up of some of enterprises put together in 60s
    - Late 1990s: astonishing level of merger activity
  + Modern era
    - Today for merger need only bare majority of outstanding shares of each class of stock entitled to vote
    - Shareholders have right to dissent and demand an appraisal as an alternative to continuing as a shareholder in the new, merged enterprise
    - Old days: shareholders of merging corp could receive only equity in the surviving company in exchange for old shares 🡪 now all forms of property, including cash 🡪 **cash out mergers**: shareholders can be forced to exchange their shares for cash if procedural requirements for a valid merger are met
  + Features needed:
    - **Capital markets**: allocate savings to users
    - **M&A**: fast easy way to rearrange ownership structures; can be rearranged in 1 step
    - **Bankruptcy law**: if arrangement isn’t working, can restructure to better one?
* **4: The Allocation of Power in Fundamental Transactions**
  + How draw line btw transactions completely delegated to board & those that require shareholder approval?
  + Universal requirement that sharholders approve **material amendments** of the articles of incorp / **charter 🡪** shareholders must approve both corp **dissolution** and **corporate mergers**, in which surviving corp’s charter may be amended
  + **Sale of substantially all of a corporation’s assets** may not occur unless it has been approved by a vote of the company’s shareholders (no vote for purchase)
  + Two major consids to determine the allocation of decision-making power within organizations: who has the **best information**, and who has the **best incentives**
    - Managers have better info, but incentive problems
    - Dispersed shareholders will wish to decide at most only very large issues and decide only issues that they can be expected to decide with some competence
  + Mergers require a shareholder vote on the part **of both the target and the acquiring** company, **except** the acquiring co’s shareholders do not vote when the acquiring co is much larger
  + Generally then, M&A transactions that require shareholder approval are those that **change the board’s relationship to its shareholders most dramatically**, reducing the ability of shareholders to displace their managers after the transaction is completed
* **5. Overview of Transactional Form**
  + Three principal legal forms of acquisitions
    - 1) acquirer can **buy the target co’s assets**
    - 2) acquirer can **buy all of the target co’s stock**
    - 3) acquirer can **merge itself** or a subsidiary co with the target on terms that **ensure its control** of the surviving entity
  + (1) **Asset Acquisition**
    - Pros: No holdout problem; do not have to take on liabilities
      * But when assets constitute integrated business, may be responsible for liability associated with those assets - **successor liability**
      * liab for envoronmental cleanup expenses imposed under fed statutes – **environmental liability**
    - Cons:
      * Costly: many assets 🡪 high transaction costs
      * §271: need board and shareholder approval for sale of “all or substantially all” assets
    - What meant by substantially all assets? Must vote under **§271**
    - **Katz v. Bregman** (Del Ch 1981) (p.453) – *agreement to sell large subsidiary (basically half the company); party complains that it’s not the best available price for company*
      * Q: Is substantially all such that shareholders must vote?
      * H: yes it is
      * How to value? Book value, market value, income generation, profit?
      * Allen: smallest % you’ll see called “all or substantially all” (45-51%, depending on method); courts 🡪 towards more conservative stance
      * RMBCA §1201 favors technicality/predictability over fairness norms
      * Note: Prob just court reaching result it thought was fair; ***Thorpe v CERBCO*** – measured not by size of sale alone, but also on qualitative effect upon the corp; relevant to ask whether a transaction is out of the ordinary course and substnatially affects the existence and purpose of the corporation
  + **(2) Stock acquisition**
    - Tender offers and purchase of a contolling block may be thought of as acquisition transactions, though technically just a shareholder transaction that does not alter legal ID of the corp
    - To aquire a corp in the full sense acquirer must purchase 100% of its target’s stock, not merely a control block
    - Corp law recognizes legitimacy of desire to eliminate small public minority by creating the easy-to-execute **short form merger statutes**, allow 90% shareholder to simply cash out a minority unilaterally (§253)
    - Also device of **compulsory share exchange transaction** – tender offer negotiated with the target board of directors that, after approval by requisite majority of shareholders, becomes compulsory for all shareholders 🡪 form of acquision that receives the tax treatment of tender offer without the attendant hold up problems of a true tender offer or awk residue of a minority of public shareholders
    - DE has no compulsory share exchange statute; instead hybrid acquisition form that produces almost same result
      * **Two step merger** – boards of target and acquirer negotiate two linked transactions in a single package
      * First: **tender offer for most or all** of the target’s shares at agreed-upon price, which target board promises to recommend to shareholders
      * Second: **merger** btw target and subsidiary of acquirer, which is to follow the tender offer and remove minority shareholders who failed to tender their shares (often at same price as the tender offer)
      * Second step sometimes cash 🡪 **cash-out merger**
  + **(3) Statutory Merger** §251
    - Legal act where 2 corps become 1 and survivor owns assets & liabs of both
    - Consummated when **certificate of merger** is filed with Secretary of State; requirments:
      * Shareholder vote: 50% of outstanding shares (not voting shares)
        + all classes of stock vote unless charter states otherwise (prefered usually not)
        + DE statute gives class-voting rights to preferred stock if rights are adversely affected by a charter amendment, but only triggered when charter amendment alters the formal rights of the preferred stock
        + Common stock will not vote only if:

(1) surviving corp’s charter not modified

(2) security held by surviving corp’s shareholders will not be exchanged or modified

(3) surviving corps outstanding common stock will not be increased by more than 20%

* + - * Consideration: can be other stock, bonds, cash, etc.
    - How to do merger:
      * Negotiate / get information
      * Merger agreement; exceptions list: reps and warranties
      * Board recommendation to shareholders
      * Shareholder vote (§251)
        + Shareholders of each corp vote; majority of outstanding stock needed
        + Appraisal rights available if vote no
      * No vote necessary for large company when absorbing small
    - **Triangular Mergers** (merger with liability shield)
      * Acquirer (A) creates NewCo (N); merger btw N and Target (T); A retains N as wholly owned subsidiary
      * Liability shied bc separate company; no holdout problem bc merger
      * A gives merger consideration to N; through merger, T shareholders given A stock; A stockholders are A’s and T’s
      * N can merge into T (**reverse triangular merger**) or T into N (**forward**)
* **6. Structuring the M&A Transaction** 
  + Consider many variables: costs, speed, liabs, info, accounting, regulatory, threats for alt acquireres, etc
  + Merger agreements have specialized provisions, two imp:
    - 1) **lock-up provisions**, designed to protect friendly deals from hostile interlopers
    - 2) **fiduciary out provisions**
    - also standstill agreements (bar hostile activity before agreement closed) and confidentiality provisions
  + Timing
    - **All cash multi-step** **acquisition** usually fastest way to lock up target and assure its acquisition (tender offer – can be consummated in 20 days)
    - Merger will generally require shareholder vote of at least target shareholders, which will invovle **months of clearance of proxy materials** with SEC and solitation of proies under proxy rules
    - If stock contitutes any part of deal consideration, two step structure genrally does not provide significant timing advantage bc stock to be issued must be registered with the SEC pursuant to R 145 under Securities Act, takes several months
    - Most deals using 100% stock are structured as one step direct or triangular mergers
  + Regulatory Approvals, Consents, and Title Transfers
    - In sale of assets, title transfers may impose substantial cost and delay
    - Reverse triangular mergers are cheapest and easiest methods of transfer bc leave both preexisting operating corporations intact
    - Stock purchases entail stock transfers and the corresponding costs of documentation (stock certificates, stock powers) but they are nevertheless much simpler to conclude that asset purchases
  + Planning Around Voting and Appraisal Rights
    - Shareholder votes and approraisal rights are costly and risky
    - Planners may condition transactions on shareholder approval or provide appraisal rights, even when not tech required, but ordinarily will chose structure that avoids or minimizes such reqs
  + Due Diligence, Representations and Warranties, Covenants, and Indemnification
    - Due dil / reps and war
      * Public cos have SEC filings etc so warranties and reps have greatest use in private deals – where control acquired thru any method from a single entity or small group
      * Hostile takepvers rarely provide much opp for due diligence - risk and uncertainty will be greater
      * In negotiated transactions, reps and warranties contained in merger agreement will facilitate due diligence process by forcing disclosure of all target’s assets and liabs
      * Estab condidtions necessary for closing the transaction as well as allocating btw the parties the risks arising from the property subject to the transaction
      * Target warranties and reps are particularly useful when there is a solvent corp or individual to stand behind them
    - Covenants
      * Tool for controlling risk
      * Covenant offered by a target in a merger agreement will provide that business will be operated only in normal course from deat of signing to closing and may req target to confer with acquerer before undertaking mateiral transactions
      * Or req target to notify the buyer if learns of any event or condition that consts breach of any rep or warranty
      * Or pledge by target to use best effors to cause merger agreement to close
        + Recoomend to stockholders
    - Indemnify each other for any damages arising from any misrepresentation or breach of warranty
      * Makes every representation a covenant to hold harmless
      * Agreement will effectively allocate the burden of undiscovered noncompliance to the party makign the representation
      * This sort of protection generally not feasible in a public co acquisiton unless can be negotiated from a large block holder
    - Deal Protectiosn and Termination Fees
      * 1985 revolution in corp law of mergers and acquisitions
      * in light of changes, among most important terms of friendly merger agreement are those designed to assure a prospective buyer that its investment in negotiating in good faith with a target will result in a closable transaction
* **7. The Appraisal Remedy**
  + Purposes:
    - Liquidity: invested in Company A and now getiing B; right to get out
    - Price protection: if think deal isn’t fair, get 2nd chance on price
    - Invoked in nonpublicly traded firms or when are structural reasons to think not fair (ie interested shareholders)
  + Types of transactions:
    - Sale of all assets, Charter amendments, Mergers
      * DE: just mergers; if want appraisal rights for Sale of all assets or Charter amendments, put it in the charter
    - §262 (Appraisal Rights Statute): no problem if you’re getting a stock-for-stock merger
      * §262(b)(1): **market-out provision**: if getting a security in the merger that has a market, don’t get appraisal
        + get appraisal if compensation other than stock, shares traded on nat’l exchange, cash
      * If have a right to vote on the merger, propably have a right to appraisal; otherwise, no
      * §262(h) (value): after eligibility, court will determine fair value *exclusive of any element of value arising from the merger*; concept: proportionate share right before merger
        + No minority discount – proportionate interest in going concern (value)
        + Traditionally determined value by looking at number of factors relating to firm’s value
        + Now use discounted cash flow method
    - DE SC said appraisal is exclusive remedy of minority shareholders cashed out in §253 short-form merger
* **8. The De Facto Merger Doctrine**
  + Should merger be regarded as a functional concept or a formal or technical concept precisely defined by the corporation statute?
  + Functional reasons for treating the concept of a merger formally?
  + Some courts take functionalist approach and accord shareholder voting and appraisal rights to all corp combinations that resemble mergers in effect
    - Con: formality good, for unity and predictability
  + DE courts like most take formalist side of argument
  + ***Hariton v. Arco Electronics*** (Del. 1963) (p.481) – *sale of all assets*
    - H:**Doctrine of Independent Legal Significance** legitimizes the transaction (an act or transaction is valid if it meets the statutory requirements of one section of the code even if it reaches an economic reslt that if reached thru another section would require additional steps or recognition of additional rights)
    - No de facto merger doc in Del (and not in PA anymore)

**O. Evolution of BJR in judicial review of “defensive” actions**

* **1. Board Defenses**
  + Put **debt on the balance sheet**: makes more difficult to get financing to complete deal
  + **Sell assets**: get rid of things that make company attractive target
  + **Self-tender** at good price and exclude purchaser (*Unocal*)
  + **Borrow money**: puts debt on the balance sheet and can have terms in agreement that make it unattractive to takeover person
  + **White knight**: find a friendly person; not 2st option, since still be giving up control
    - **White Squire**: investor who wants to buy a block of stock (maybe 10%); tends to get preferred tock with stated dividend and conversion right to common stock (if desired)
      * Can give the preferred stock enhanced voting rights and “blank check preferred” in charter
  + **Poison Pill**
* **2. *Smith v. Van Gorkom*** (Del. 1985) (p.533) - *merger w/ synergy bc of unused loss; stock at $37, Pritzker offered $52*
  + H: directors been grossly negligent in accepting Van Gorkom’s offer, didn’t act in informed manner, and could not claim protections of business judgment rule
  + First DE case to actually hold directors liable for breach of duty of care in case where board had made a business decision
* **3. *Unocal Corp. v. Mesa Petroleum Co.***(Del 1985) (p.515)
  + Facts:
    - stock selling ~$40; Pickens makes offer for 37% at $54 (to bring to 50.1%); in disclosure doc, says that intends to do a 2nd step of merger where will give subordinated debt that he claims is worth the same thing
    - 1st step: Goldman says not fair price; worth more than offer; come up with **discriminaory self tender** plan at $72; conditional on Pickens closing transaction
    - Effect is that no one tenders; effect would be to sell to Pickens at $54, but if wait and others tender, you’ll get $72
    - They wanted to get to a price that would harm Pickens but leave the company solvent
      * Would hurt Pickens’ ability to get financing
  + Chancery said not fair to discriminate among holders of a particular class of stock (self-tender offer excluded Pickens)
  + Court
    - Board has obligation to **determine whether takeover bid is in best interest** of the corp and its shareholders; because specter of entrenchment, is an **enhanced duty** which calls for judical examination before protections of BJR conferred
    - New standard for reviewing defensive tactics: **enhanced BJ review**
    - Must demonstrate informed, good faith, and independent; two steps:
      * (1) Directors must show that had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person’s stock ownership
      * (2) Defensive measure must **be reasonable in relation to the threat posed**; in analysis of nature of takeover bid, examine
        + Inadequacy of price offered
        + Nature and timing of offer
        + Questions of illegality
        + Impact on constituencies other than shareholders
        + Risk of non-consummation
        + Quality of securities being offered in exchange
    - What Pickens did was coercive measure designed to stampede shareholders into tenering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end
    - Ok that board’s exchange offer was selective given nature of threat
  + Post Qs:
    - What makes an offer coercive?
    - What to make of discriminatory self-tender
* **Unitrin v. American General Corp.**, (Del 1995) (p.521) – *Amgen offer; Unitrin thought to do* 🡪 *provisions (poison pill, self-tender, and advance notice bylaw)*
  + Claim: board owns 23% and by buying back will increase share from 23% to 28% and company has bylaw that says in transaction with this % need 75% approval bvote by shareholders; with 28% board will be able to block AmGen deal
  + Court of Chancery said mind threat: 23% has prety good chance of blocking anyway
  + Reversed: doesn’t make sense to pay high price to prevent deal when already owns 23%
  + New *Unocal* formation: when have a threat, target’s directors have burden of showing defensive action was proportionate:
    - (1) Is it draconian (coercive and preclusive)? If so, ba*d*
      * Here wasn’t because AmGen could still run a proxy contest to replace Unitrin board
    - (2) Is it withing “range of reasonableness”? Ok if within wide range
      * result is limting the “enhancement” of BJR by *Unocal* – action sustained if attributable to any reasonable judgment
  + Remember how shifting of burdens works:
    - If court concludes that was proportionate and reasonable 🡪 Shifts burden back to P (doesn’t mean game over; must show unfairness)
    - If court says doesn’t pass *Unocal* 🡪 D’s have burden (entire fairness)

**P. “Selling” the Company: Revlon and Evolution of Auction Idea**

* **1. *Revlon, Inc. v. MacAndrews and Forbes Holdings*** *(Del 1986) (p.541)*
  + F:
    - Revlon sellin ~$40; Perelman made offer in low $50s; board responds; Perelman says no problem, so board has to do something else; look for white knight, find Forstmann Little (private equity firm); bidding war
    - Forstmann says $57.25 and also wants:
      * **Asset lock-up**: assets sold to Forstmann if anyone gets 40%
      * **Termination fee**: if Forstmann doesn’t get the deal, get $25M
      * **No-shop** provision: basically, not going to go out and shop the deal
      * **Fiduciary out**: if lawyers tell them to do something, they’ll do it (back out)
  + Court: 1st part (poison pill and note exchange deal) is okay, but 2nd part violates duty of care
    - Note: it’s unclear exactly what duty was violated – discuss care and loyalty
    - Board thinks offer is low and looking for alternate deal; then, objectives change from defenders to auctioneers; cannot rig the bidding
    - No long-term value (“what can I get now”); therefore obligation to get the highest price
    - Once they found the lock-up deal invalid, they also found the termination fee invalid
  + ***Revlon* duty**: duty to get the highest price on sale of the company
    - When sale or break-up of company is inevitable, the fiduciary obligation of the directors of a target corp are narrowed to singular responsibility of maximizing immediate stockholder value by taking highest price
    - When you have a *revlon* duty, you have the duty to take the highest price now – unusual duty and gives rise to question of which of two transactions optimize price
    - Evaluated review; not under BJR, but reasonablenes
    - Bottom line is is it credible that they are making a good faith decision in shareholders’ interest
  + Qs of when Revlon duties are triggered and what exactly they are haunt DE law
    - Hard to distinuish btw transactions in which company is sold and those in which board merely defends against a hostile takeover bid – would board get Unocal standard of reasonable in relation to a threat or found to have Revlon duty?

**Q. Revlon and Unocal applied**

* **1. *Paramount Communications v. Time***, (Del. 1989) (p.547) – *strategic stock-for-stock merger btw Time and Warner; Paramount comes in and offers $175/share for Time; Time and Warner decide that instead of stock-for-stock deal that would require shareholder vote, will do a two-step tender offer by Time for Warner, then merger*
  + Nature of fiduciary obligation is not following shareholder wishes about what they want to do, but exercising an informed judgment about what is best of the company
  + Paramount: Unocal argument
    - Step 1:
      * Paramount says what’s the threat? Offering $250/share for something selling in $50s
      * Court agrees with Time – not just threat of inadequate value, but (1) shareholders would mistakenly think deal strategically beneficial; (2) timing meant to upset, confuse the Time stockholders’ vote
    - Step 2:
      * Paramount says Time unreasonable
      * Court says have a right to defend their original plan that thought was best
  + Shareholders: Revlon claim
    - Shareholders say *Revelon* invoked because dealing with sale/auction
    - Court: No, nothing shows Time’s board made the dissolution or breakup of the corporate entity inevitable
    - Board not under per se duty to maximize shareholder value in the short term, even in takeover context, unless
      * If company deliberately puts itself up for sale (“change in corporate control”)
      * If company engages in break-up transaction (“break-up”)
    - Key for court that Time was retaining control – held despite old Time shareholders will own 38% and Warner shareholders 62% of surviving company
* **2. *Paramount Communications v. QVC***, (Del. 1994) (p.554) – *Paramount/Viacom merger structured carefully in light of Time-Warner, lots of strong defensive measures; then bidding war btw Viacom and QVC*
  + H: *Revlon* duties exist here
  + Real reason that *T-W* wasn’t a *Revlon* case was that there was no sale of control; after the merger, everyone owned stock in fluid aggregation (before and after)
    - In this case, there will be a controlling shareholder 🡪 new minoirty shareholders will have no leverage 🡪 Paramount directors had **obligation to get best value reasonably available** to stockholders; enhanced scrutiny triggered by:
      * Threatened diminution of current stockholers’ voting power
      * Fact that asset belonging to stockholders (control premium) is being sol
      * Traditonal concern for actions which impair voting rights
    - Note: strategic vision argument much less convincing here because shareholders won’t have power to make it happen
    - Features of enhacned scrutiny test:
      * (1) Judicial determination regarding adequacy of decisionmaking process, getting information
      * (2) Judicial examination of reasonableness
      * Directors have burden of proving informed and reasonable
    - When selling a control block 🡪 *Revlon* duties:
      * (1) Diligence and vigilance in examining both offers
      * (2) Good faith
      * (3) Obtain all material information reasonably available, including that (4) necessary to compare offers
      * (5) Negotiate actively and in good faith
    - *Revlon* obligations (from Allen):
      * Increased emphasis on being informed
      * Increased emphasis on dealing with all potential parties
      * Standard of review where courts actively determine if deal protections are reasonable
    - As part of these *Revlon* duties, Paramount had to consider what aspects of the Viacom transaction were reasonable an in best interests (stock option, termination fee, no-shop, etc); consider whether:
      * (1) adversely affected value provided to Paramount stockholders
      * (2) inhibited or encouraged alternate bids
      * (3) were enforceable contractual obligations in light of fiduciary duties
      * (4) would advance or retatrd director’s obligation to secure best value
      * To extent that provisions were inconsistent with fiduciary dutes, they are invalid and unenforceable
    - Violated here by not fully considering QVC deal or modify defensive measures; wasn’t acting in good faith to get the best deal
    - No-shop provision and stock option agreement were improperly designed to deter potential bidders so invalid
  + Notes:
    - What if Viacom had been widely held?
    - Revlon duties likely to be triggered under this test when mergers creat shareholdings with btw 30 and 35% of voting rights in widely held corp
    - Result is that stock-for-stock mergers should not trigger *Revlon* and cash merger will unless already a controlling shareholder in target corp
    - Still not clear how board should balance long term synergistic benefits and maximizing current value
* **3. Lyondell Chemical v. Ryan** (Del 2009) (p.568) – *Basell made low offer for Lyondell; rejected, L said taking “wait and see” approach. Later B made much more generous offer, directors approved and recommended, stockholders approved; Stockholder Ryan sued, saying didn’t attempt to obtain best possible price, should have solicited other offers*
  + *Revlon* don’t arise when company put in play, but when “embarks on a transaction – on its own initiative or in response to an unsolicited offer – that will result in a change of control”
  + *Revlon* inquiry is not whther directors did everything should have to obtain best sale price, but whether they utterly failed to attempt to obtain it; do not need to seek out competing bids, only to **“get the best price for the stockholders at a sale of the company”**
  + Here directors had good idea of what corp was worth and drove har bargain in good faith
  + Note: was a §102(b)(7) waiver here, but unclear how important this was
* **4. Ways of protecting the deal**
  + **Lock-up:** any contract, collateral to an M&A transaction, designed to increase likelihood that parties will be able to close the deal
  + Formerly two major categories:
    - **Options to a target’s assets**
      * Create rights to acquire specific corporate assets that become exercisable after a triggering event (ie shareholder vote disapproving merger, board’s decision to sign alternative merger agreement)
      * Virtually non-existent since *Revlon* (struck down lock-up granted to Forstmann Little)
    - **Options to a target’s stock**
      * Options to buy a block of securities of the target company’s stock (ofter 19.9%) at stated price
      * Popular in 90s, have disappreared after 2001 bc of regulation
  + Now: **Termination fees / breakup fees:** cash payments in event that seller terminates or otherwise fails to close merger; Justified as:
    - Necessary to compensate friendly buyer for time, money, reputation
    - Minimize possibility of third party breaking up deal (rejected by courts in transactions that trigger *Revlon* duties)
  + Are lock-ups permissible to protect a merger of equals?
    - In theory, when no change in control is involved, the board is free to hoose a lower value merger over higher value if concludes is in best interest
    - But courts more likely to use *Unocal* version of BJR since the protective provision serves an obvious defense function
    - Whether a lock-up is consistent with board’s duties in a *Revlon* transaction – courts way how early in process lock-up was given and value enhancing nature of its specific terms
  + Range of legitimate triggers for lock-ups and termination fees; commonly
    - (1) failure of board to recommend deal to shareholders in light of emergence of higher offer)
    - (2) rejection of negotiated deal by target’s shareholders
    - (3) later sale of assets to another firm
* “No Shops/No Talks” and “Fiduciary Outs”
  + Buyers can also protect against risks of deal not going though by seeking covenants from seller that will protect their deal; for example, covenant:
    - Not to shop for alternative transactions or supply confidential information to alternative buyers
    - To submit the merger agreement to the shareholders for approval
    - To recommend that shareholders approve this agreement
  + Q: what happenes when director’s fiduciary duties require going against because third party makes a better offer?
    - Smith v. Van Gorkom: board had no fiduciary right to breach a contract (so would be liable for damages for breaching contract)
    - **Fiduciary out** clauses specify that if some triggering event occurs that places board under fiduciary duty to go against covenant then it can avoid the contract without breaching
    - Buyers resist, but is much ado about not so much because, if *Revlon* duties apply, no contract term can protect a negotiated deal from an alternative buyer who is willing to pay significantly more 🡪 DE SC has seemed to declare contracts unenforceable that violate a fiduciary duty, but still uncertainty
* **5. *Omnicare v. NCS Healthcare*** (Del. 2003) (p.579) – *Omnicare offered to acquire NCS but negotiations broke down; Genesis proposed merger w NCS on more favorable terms but insisted on no-shop clause, shareholder lock-up (majority shareholders to agree); provisions presented NCS minority shareholders with fait acocmpli; Omnicare tried to reenter negotiations with higher offer, NCS refused*
  + First off, everyone agrees *Unocal* review mandated here – (was a threat, acted proportionately); court says does not pass
  + Exception to general approach that court does not mandate specific terms of merger agreements – only requires process that is informed and honestly pursued in interests of corporation and its shareholders
  + H: **exclusive merger agreement (ie no shop clause) must include a fiduciary out**, at least where agreement presents target shareholders with “fair accompli”
  + Based on notion that board has ongoing fiduciary duty to constantly reevaluate its decision
  + Here coercive stockholders committed corp to the merger 🡪 directors had duty to protect interests of minority shareholders
  + Dissent: provisions don’t mean agreement won’t be intensely bargained; no-shop provisions can be result of informed, good faith decision that deal at hand is best will get and can lock up with provisions
  + Dissent restates rule: A merger agreement entered into after a market search, before any prospect of a topping bid has emerged, which locks up shareholder approval and does not contain a fiduciary out provision, is per se invalid when a later significant topping bid emerges. Applies regardless of (1) circumstances leaing up to agreement and (2) fact that stockholers who control voting power had irrevocably committed themselves, as stockholders, to vote for the merger
    - Different from Unocal bc still could have made these provsions as long as good faith and inforedly decied was a threat to corporate policy and effectiveness
    - Here was reasonable because based on indpdt assessment of merits
    - Proportionality inquiry must account for reality that contractual measures protecting merger agreement were necessary

**R. Trading in the Corporation’s Securities**

* **1. Common Law of Director’s Duties When Trading in the Corp’s Stock**
  + Fraud was actionable, but prosecuting claim not easy; had to prove: (1) a false statement (2) of material fact (3) made witht eh intention to deceive (4) upon which one reasonably relied and which (5) caused injury
  + 19th C: Caveat emptor: if someone didn’t tell you something, too bad for you
    - Only trustees had duty to disclose
    - Majority view: if director bought stock from shareholder, no obligation to make disclosures; obligation to not defraud (say false things)
    - Minority view: director is like a trustee; if he’s going to deal with a shareholder, he has to make disclosure of relevant information (“special facts”) (*Strong v. Repide*; U.S. 1909)
  + ***Goodwin v. Agassiz****,* (Mass. 1933) (p. 616) – Directors able to trade in stock as long as no misstatment, though if seeks out and doesn’t disclose the scrutiny (director knew about possibilty of copper deposits)
* **2. Corporate Law of Fiduciary Disclosure Today**
  + Corporate Recovery of Profit from “Insider” Trading
    - Corp brings claim against officer, director, or employee for trading profits made by using info learned in connection with corporate duties
    - Agency law says stockholders should be able to sue insideres to capture their profit on behalf of the corporation
    - But only recently been used
    - Two notable things:
      * (1) Since corp is seen as “owning” its nonpublic info, it could allow its agents to trade on it if there were no other legal considerations
      * (2) fiduciary duty theory does not attempt to compensate the ninformed stockholder with whom the insider deals
    - **Freeman v. Decio**, (7th Cir. 1978) (p.622) – *Alleged that directors sold stock knowing price would drop*
      * Refuse to say was breach of fiduciary duty, largely because no element of loss or opportunity that is generally present when corporate fiduciary must account to the corporation
      * Suggests that preventing insider trading might be overrated – efficiency loss, and better remedied by federal securities laws
      * Declines to follow NY case *Diamond*
    - DE found for P corporation in *Brophy*
  + Board disclosure obligations
    - Shareholders invoke state fiduciary duty to callenge the quality of the disclosure that their corporation makes to them
    - Board has duty to provide candid and complete disclosures to shareholders; parallels federal disclosure duty in 10b-5
    - Directors required to exercise honest judgment to assure the disclosure of all material facts to shareholders, but failure to disclose material fact is unlikely to give rise to liability unless was intent to mislead
* **3. Exchange Act §16(b) and Rule 16**
  + §16 the only attempt of 1934 Act to regulate insider trading
  + §16(a) requires filing of reports about trading been doing (now required to file within two days)
  + §16(b) requires statutory insiders to disgorge to the corporation any profits made on short-term turnovers in the issuer’s shares (purchases and sales within six-month period)
    - underinclusive bc insider trading can occur over period longer than six months; overinclusive because short-swing transactions need not involve insider info
    - administrative problems:
      * (1) How to calculate profits?
        + First, covered person looks back six months and matches # of shares sold (or purchased) with same # of shares purchased (or sold)
        + Then repeat looking forward six months
        + Deduct lower total purchase price from the amount realized on the reportable sale to determine the profit, if any, that is payable to the corporation
      * (2) Delimiting class of “covered persons”
        + explicitly includes 10% shareholders, officers, directors
        + titles are not dispositive – practical approach
      * (3) Criteria for “purchase or sale”
        + SEC rules bring all derivative combinations that track financial characteristics of an issuer’s securities under §16(b) (in respose to using deriatives, options, futures to mask)
        + Mergers – what if shareholders receive stock in consideration for sale, then cash out?

***Kern CountyLandv. Occidental*** (1973 (p.628): option grant not a sale of stock; merger not a sale because was unorthoxox transaction, didn’t give rise to risks that §16 sought to remedy

* **4. Exchange Act §10(b) and Rule 10b-5**
  + Act empowered SEC to promugate rules regulating rading of securities on national exchanges; §10(b): ulawful to employ, in connection with purchase or sale of any security registered or not, any manipulative or deceptive device or contrivance in contravention of rules and regs as SEC may proscribe as necessary in public interest or to protect investors
  + SEC promulgated Rule 10b-5 – made unlawful:
    - (a) to employ any decvice, scheme or artifice to **defraud**,
    - (b) to make any **untrue statement** of a material fact or **omit to state a material fact** necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading, or
    - (c) to engage in any act, practice, or course of business which operates or would operate as a **fraud or deceit** upon any person, **in connection with the purchase or sale of any security**
  + Private right of action implied recognized in *Kardon v. National Gypsum*
* **5. Elements of a 10b-5 claim**
  + **(1) Standing:**  P has to be buyer or seller of stock
    - if seek injunction, then maybe just if suffered through making financial decision and relying
  + **(2) Materiality:** Must be a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote / would view as significantly altered the total mix of info made available
    - Fact-specific inquiry
    - **Basic Inc. v. Levinson**, (US 1988) (p.672) – *private merger negotiations, buyer made public statements denying negotiations taking place, shareholders acted; merger and price went up, shareholders sued*
      * Reject agreement-in-principle approach that info concerning any negotiations not yet at agreement-in-principle state could be withheld or misrepresented because doesn’t reflect significance of info upon investor’s decision
      * Info concerning existence of preliminary merger discussions can be significant
      * Materially will depend upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity
    - **Texas Gulf:** would reasonable person consider info when deciding whether to buy/sell
  + **(3) Scienter:** Guilty knowledge or intent to defraud; failure to disclose information or lies/deception is enough, even if not guilty knowledge
    - Some say can infer from reckless conduct
    - Various pleading standards
      * 9th Cir permissibe: onl that had acted with scienter
      * 2nd cir: facts that give rise to a strong inference of fraudulent intent
      * PSLRA 1995: state with particularity facts giving rise to strong ingerence that D acted with required state of mind
  + **(4) Reasonable reliance**
    - Omissions: reliance presumed where there is a duty to disclose and matter is material
    - **Fraud on the market theory:** misleading statements will defraud purchasers of stock even if the purchasers do not directly rely on the misstatements because in open securities market the price of a company’s stock is determined by available material info
      * **Basic v. Levinson** (US 1988) (p.679)
        + Presumption because of fraud on the market, but any showing that severs the link btw the alleged misrepresentation and either price or decision by P to trade will be sufficient to rebut presumption of reliance
        + Plurality though, not binding, but has been followed by lower courts
  + **(5) Causation:** Must show two things:
    - *Transaction causation*: lie had something to do with me going into this transaction; he told me it was good, and I bought; I relied and it caused me to act
    - *Loss causation*: damage suffered had to do with fact that it was a lie (not an external factor, such as market crash); more than just drop in stock price
  + **(6) Duty** (to disclose)**:**
    - Current law:
      * SC decides under **misappropriation theory**: person commits fraud “in connection with” a securities transaction, and therby violates §10b and 10b-5, when he misappropriates confidential information for secruites trading purposes, in breach of a duty owed to the source of infromation
      * Premises liability not on fidicuary relationship btw insider and purchaser, but on fiduciary-turned-trader’s deception of those who entrusted him with access to confidential info
      * Set forth in ***US v. O’Hagan*** (US 1997) (p.667) – *lawyer overhears infor and acts on it; prosecuted under 10b-5*
  + Remedie***s***
    - **Elkind v. Ligett & Myers** (2d Cir 1980) (686)
      * 3 potential remedies:
        + “Out of pocket”: difference btw purchase price and post-trading price
        + Compensate investor for loss in market value (disgorgement)
        + Post-purchase decline in market value limited by tippee’s gain
* **6. Development of Duty**
  + 3 different approaches have evolved:
    - (1) intially SEC and 2nd cir took aggressive position that any possession of relevant, material, nonpublic info give rise to duty to disclose or abstain from trading (**equal access theory**)
    - (2) SC took more traditionalist approach in ***Chiarella***, saying necessary that the insider breach a fiduciary duty in trading on inside information in order to find 10b-5 liability
    - (3) SC recently intermediate stance of augmenting **fiduciary duty theory** with more far-reaching **misappropriation theory**
    - tension btw intutive udnerstanding that prohib of insder trading is essential and fact that §10b is concerned with fraud and manipulation
  + **Equal Access Theory:** all traders owe a duty to the market to disclose or refrain from trading on nonpublic corporate information
    - Basis in **inherent unfairness**; *Cady, Roberts*: (1) existence of relationship giving access to info inteded to be available only for a corp purpsose and (2) inherent unfairness where party takes adv knowing is unavailable to those with whom is dealing
    - Advantages:
      * Reaches all “insider trading” conduct
      * Victims are easily identified: uninformed traders to whom insider should have disclosed
    - Weaknesses:
      * Policy: chilling useful trading
      * Not obvious why “unfairness” defrauds others in absence of misrepresentation or preexisting disclosure duty – is always differential access to info
    - ***SEC v. Texas Gulf Sulphur Co.*** (2d Cir 1968) (p.633) – *corp directors find that land in Canada is rich in minerals; insiders take info and buy stock; rumors get out; then not-so-revealing disclosure statement*
      * Rule: if access to info intended to be available only for corporate purpose may not take advantage of such information knowing it is unavailable to those with whom he is dealing (ie the investing public)
      * 🡪 anyone in possession of material inside info must disclose or abstain from trading (**strong equal acess theory**)
      * cites **In re Cady, Roberts & Co** (SEC 1961)
  + **The Fiduciary Duty Theory**
    - Advantages:
      * Supports analogy to common law fraud; eases assimilation of insider trading into statutory prohib against securities fraud
      * Allows case by base review – can selectively target
    - Weaknesses:
      * Still weak support for equating insider trading with conventional fraud
      * Fails to answer how trading disparies defraud uninformed traders?
      * Dramatically underinclusive – cannot reach wrongdoing like that in Chiarella
    - **Chiarella v. US** (US 1980) (p.649) – *printer learns of stuff, started buying stock or calls in target stock; SEC says inherent unfairness in allowing to use info*
      * Reads Cady as premised on being relationship of trust and confidence
      * **you need a relationship**; concern about duties to sellers
        + Don’t want to imply broad duty absent evidence of congressional intent
        + Not every instance of financial unfairness is fraudelent activiy
        + Restricts SEC’s policy orientation
      * Dissent (Burger): **misappropriation theory** – if violated a duty in acquiring, doesn’t matter to whom the duty is owed
      * Q of with whom exactly are shareholders in a “relationship of trust and confidence”
    - **Dirks v. SEC** (US 1983) (p.653) – *Dirks trader who finds out about fraud; he calls his clients and tells them to sell; based in part on clients selling price goes down*
      * Made clear in Chiarella that can be no duty to disclose when person whop has traded was not corp’s agent, a fiduciary, or person with whom sellers of the securities had placed their trust and confidence
      * Does not mean tippees are always free to trade on the info
        + Insiders may not give info to ouside for improper purpose of exploiting for personal gain
        + Some **tippees assume an insider’s duty to shareholders because it has been made available to them imporperly** (aka where would violat Cady Robers duty)
        + Tippee assumes fiduciary duty to shareholders not to trade only when insider has breached his fiduciary duty to the shareholders by disclosing the info to the tippee and tippee knows or should know has been a breach
        + Test is whether the insder personally will benefit, directly or indirectly, from disclosure; **absent personal gain, is no breach**
      * Here neither violated duty to seller (he didn’t trade), nor put himslef in shoes of fiduciary bc no personal benefit
      * Dissent (Blackmun): makes no diffeence to the shareholder whether corp insider gained from transaction
    - Response to Dirks: **Missapropriation**
      * 2nd Cir extended misappropriation theory to reach outsiders who trade illicitly on confidential information; theory that deceitful misappropriation of market-sensitive info is itself a fraud when occurs in connection with securities transaction
      * relationship that triggers 10b-5 and the resulting unfairness both refer to insder’s source of information
      * Advantages
        + Reaches almost all forms of insider trading commonly condemned, regardless of whether involve traditional insiders
        + Locates a real duty and a fraud by focusing on putative insider’s illicit conversion of info rather than on fictional relationship btw insider and uninformed traders
        + Reflects intutive basis for proscribing insider trading – wrong bc involves private appropriation of info rights
      * Con: no doctrinal basis for recovery by other than entity who owns the info
  + Question of how 10b-5 could be used in context of corporate conduct usually regualted by fiducitary duty stuff
    - ***Santa Fe Industries Inc. v. Green*** (US 1977) (p.639) – *Santa Fe owned 95% of Kirby Lumber; wanted to do §253 cash-out merger; difficult to valuate; Morgan Stanley option that fair price was $125; fraud?*
      * Transaction was neither deceptive nor manipulative 🡪 didn’t violatie 10b-5
      * **Private cause of action should not be implied where unneceassary toensure fulfillment of Congress’ purposes**
      * To extend here would bring within Rule wide variety of corporate conduct better left to state regulation
    - Disclosure of unfairness: ***Goldberg v. Meridor***
      * Despite Santa Fe, lower courts didn’t abandon effort to transmute breach of fiduciary duty case into a 10b-5 violation
      * Ie what if controlling shareholder causes corp to issue stock to him at unfair price not through false statements but dominating directors? Manipulation in connection with sale so under 10b-5?
      * *Schoenbaum v. Firstbrook* (1969): 2nd cir held minority shareholder could bring derivative action under 10b-5
      * *Goldberg v. Meridor* (2d Cir 1977) – *allege controlling shareholder caused to acquire assetrs in exchange for stock and agrement was unfair*
        + H: derivative action could be brought under 10b-5 on basis that transaction btw corp and fiduciary or controlling shareholder was unfair if involved stock and **material facts that transaction had not been disclosed to all shareholders**
        + There is deception of the corp when corp is influenced by its controlling shareholder to do stuff against corp’s interests and is nondisclosure or misleading disclosures as to the material facts of the transaction
        + Different than Santa Fe because alleged deceit
      * To succeed under Goldberg, P mus show
        + **(1) misrep or nondisclosure that**
        + **(2) caused a loss to the shareholders**

if shareholder vote easy to show

courts divided on whether can show loss by allegeing that remedy was forgone as result of lack of disclosure