CORPORATIONS OUTLINE

Table of Contents

I. EXAM CHECKLIST / BIG PICTURE

A. **Answering questions**

1) **Disclosure? and Fraudulent Conveyance Act?**
2) **Tie together the procedural aspects of shareholder litigation with the substantive duties of the directors in a given issue spotter. – GO THROUGH THE STEPS!!!**
    a) **What legal wrongs are there? -** Identify the claim of the creditor or shareholder
        i. Mergers & Tender Offers
            (1) If you don't like a merger, then you can just sell the stock. Otherwise, 2 options:
                a) you try to generate some enthusiasm to get others to vote against,
                b) you get an appraisal remedy.
            (2) Look at the Williams act tender offer regulations as the first step in a series of responses to defend against takeovers.
            (3) In ***Weinberger***, **you need entire fairness whether there is a conflicted transaction.** The **burden is on the self-dealing defendant** who has to show that he was dealing fairly. So, class action suit is more attractive than the appraisal. **THAT SHOULD BE MENTIONED IN THE EXAM.**
            (4) *Unocal* ask 1) is there a legitimate threat? 2) was this a reasonable response?
            (5) *Revlon* means in any change of control, or break up, or sale of assets, there is a duty to try to get the best price.
            (6) *Time-Warner* means you can have a strategic vision and opt not to sell at all, you can take defensive measures to defend that strategic vision. Passes *Unocal* and doesn't trigger *Revlon* because there was no change in control.
                a) What if its stock for stock where one is very huge and one is very small? That's unresolved, but some people say Revlon
            (7) *QVC* says that SHs should get a premium for giving up control, and distinguishes *Time-Warner*. Here, triggers *Revlon* because they're going to sell to Viacom. No strategic vision argument because they are selling their ability to make corp policy
            (8) DGCL §203. Business Combinations with Interested Stockholders
                a) if you do a tender offer and you get more than 15% and less than 85% of the stock without board approval and you do a second stage approval to go private, you have to get a 2/3rd supermajority vote.
                b) The corporate charter can elect not to be subject to this rule.
        ii. **Insider Trading**
            (1) Is it material
            (2) Is there a duty to disclose?
            (3) Is there a continuing pre-existing buying pattern? does that constitute a purchase?
            (4) Did they actually use the information?
        iii. **Proxy misstatements**
        iv. **Loyalty Issues**
    b) **Identify the procedural mechanism for bringing suit – who is the right π?**
        i. Appraisal
            (1) **Three Steps in a Delaware Appraisal**
                a) *Preserve the Appraisal: §262(d)(1)* says that you have to preserve the right to appraisal before voting on the merger.
                b) *Exercise the right to Appraisal: §262(d)(2)* says that if the merger is approved, you notify the board that you want an appraisal.
                c) *Bring the Appraisal*: You then have to bring it to court to get the court to appraise the shares.

- **ii. Derivative – If Derivative, then go through demand motions.**
  - **(1) Pre-Suit Demand**
    - a) Raise the issue of whether or not there is a reasonable doubt about the board's ability to respond to a demand before a derivative suit.
    - **b) By making the board demand, you concede board independence.**
  - (2) Must have a stake in the company at the time of board action.
  - (3) Attorney's fees & Indemnification for directors?
- **iii.** Class Action**:** Common facts and question?
- **c) Is this suit worth pursuing?**
  - i. Recissory damages, if there is a breach of fidu duty, then you get the transaction is voidable, and you get the value as if the transaction never happened.

3) Proxies & Voting

- **a) SEC regulates proxy voting.** There are rules, its not nam. Especially about false statements.

4) When a lot of SHs accept a tender offer, it might make sense to just swallow the pill?

5) **You cant issue a new class of stock without modifying the charter = requires SH approval**.

6) Modifying the charter requires board initiation and SH approval. By-laws, can be done by either?

B. **Shareholder Rights**

1) §211: Elect the board
2) §141(k): Remove directors
3) Vote on *some* mergers
4) Right to vote on sales of all assets
5) Right to vote on amendments to charter
6) Vote on dissolution of company

C. **Time Value of Money**

1) PV of a promise to get $1.10 in 1 year with DR of 10% = 1.10 / 1.10 = $1
2) PV of a promise to get $1 in 10 years if dr is 10% = 1 / (1.1^10) = $0.39

D. **Protections / Inducements for Risk-taking for Directors**

1) D&O Insurance
2) Indemnification
3) Business Judgment Rule
4) § 102(b)(7) p. 163 supp
5) Performance pay: stock options

E. **Recurring themes**

1) As corporations are less constrained than they were in the 19th century (ultra-vires), the duty of loyalty becomes more important: higher agency costs, because agents are freer to do more.

2) courts are not good at finding fair prices, but are good at finding fair process. so they look for ways to get comfortable with these transactions. so we start with the legal test of entire fairness. they have an obligation to show its fair. so even a transaction by one director in a little piece of business, he has to show its fair.

II. LAW OF AGENCY

A. Agency Cost

1) **Agency cost theory –** agents maximize own wealth not that of investors – costs arise when incentives of agent differ from those of principal, since they are doing what is best for them, and not the principal. –3 sources of agency costs
    - **a)** Monitoring – ensuring loyalty of manager(s)
    - **b)** Bonding – manager(s) demonstrating loyalty
    - **c)** Residual costs – any other costs
2) **3 Problems with Agency**
    - **a)** Conflict between manager(s) and principal(s)
    - **b)** Maj. shar.'s discriminating against minority shar.'s
    - **c)** Third parties acting opportunistically
3) **3 Legal Techniques for limiting these**
    - a) Voting rights – doesn't work completely b/c shar. passivity but makes takeovers possible
    - b) Selling – makes takeovers possible
    - c) Suing – derivative suits, etc.
4) More competitive market = less agency costs
5) Explicit costs (such as advertising) vs. implicit costs (such as the value of time).

B. Two questions:

1) **Was there an agency relationship?**
2) **What is the scope of authority under the agency?**

C. Forming an agency relationship:

1) Control is an important part of the agency relationship.
2) **A reasonable understanding of the words or actions of the principal from the agent's point of can create the agency relationship. There is no requirement for a writing or seal.**
3) ***Jensen v. Cargill***: we see that the courts can interpret something as an agency even when neither party would characterize it as such.
4) ***Humble Oil & Refining Co. v. Martin (Tex. 1949) p. 30:*** ∆ liable b/c operator was an agent. Someone parks a car in the gas station and it rolls off and hits pedestrians. Humble has an independent contractor relationship with gas station operator, but court says that this is an agency relationship, not independent contractor. In fact, Humble owns the property. The court says that it is as if Schneider was a store clerk, or an employee, not in his own business. Humble is liable then.
5) ***Hoover v. Sun Oil Co.*** (Del. 1965) p. 32: Sort of the same as Humble case, only different result. The court says that this guy is more like an independent outfit that happens to sell Sunoco products. There was less control, no day to day decision making by Sun, and a different lease arrangement, more like a contract.
6) **In a contract, they can't say something isn't an agency relationship in the K when it might affect 3rd parties.** the court will find how they want and not be told how to find.

D. Scope of agent's authority

1) **Actual authority**: delegated by the principal (judged from perspective of reasonable A);
    - **a)** *Express authority* – A's authority stated explicitly
    - **b)** *Implied authority* – what A reasonably believed that P meant when authority delegated
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)
    - **a)** Required: **Third person reasonably believes agent is acting on behalf of principal.**
    - **b)** **Black letter law**: not reasonable for 3rd-party to rely on the statements of an A as a basis to establish the authority of the agent (need contact w/the P)
        - **i.** Two reasons for variations: intuition of fairness and idea of *ex-ante* efficiency

c) ***White v. Thomas (Ark. App. 1991) p. 22***: Agent can't just claim authority and go ahead and the 3rd party can't just rely on A's verbal warranty of authority. The Agent bid too high on a property then sold land to someone else w/o authorization.
   i. White gives A authority to bid not more than $250,000 on a property. She overbids though, freaks out, and then tries to sell some of the 217 acres to the Thomases. When Mr. White finally hears about this, he doesn't want to honor the sale contract for 45 acres to the Thomases. The Thomases then sue Mr. White.
   ii. The lower court said this was all one act and if White wants to take the purchase, he has to take the sale too. The appeals court says its two different things.
   iii. If the Thomases had more **reliance**, the court might have found the other way.

d) In corporate practice, there aren't many questions of authority. The authority of every officer in a corporation is established by a board.

3) **Inherent power** ('incidental authority'): situations w/no actual or apparent authority:

a) **R§161 [20]:** *General A* for disclosed/partially disclosed P subjects P to liability if other party reasonably believes A is authorized (e.g., other similar As would be authorized) and has no notice that A is not authorized.

b) **R§161(a):** *Special A* for disclosed/partially disclosed P, A has no power to bind P by Ks or conveyances if not authorized or apparently authorized unless P is estopped or unless the A's only departure from given authority is for [examples]

c) **R§194 [11]:** *General A* for an undisclosed P authorized 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 P to do them.

d) ***Gallant Ins. Co. v. Isaac (Ind. App. 2000) p. 26***: Δ bought a new car and wants to switch auto insurance to the new car from the old car. Insurance agency says to come in on Monday to pay for it, but in the meantime, she crashed the car. The insurance company denies the claim because she hasn't paid for the policy yet and the broker only had authority to make insurance contracts when it is paid. So there is no actual authority.
   i. But the pattern of conduct was usually beyond the actual authority. You might ask, did Δ act reasonably and did she detrimentally rely? (Apparent authority)

e) **NOTE: in the third restatement, they got rid of this idea and replaced it with estoppel and restitution doctrines.**

f) **Restatement §205 (3d?): Estoppel to Deny Existence of Agency Relationship**
   i. Where P has not given an A authority, they are only liable if: (1) Pintentionally or carelessly caused reasonable belief of A's authority; or (2) having notice of the belief, P did not take reasonable steps to notify them of their mistake.

4) is an undisclosed principal ever liable?
   a) if the contract is in the scope of Agent's authority, he is ALWAYS liable.
   b) if you're an A, and they think you are the principle, then you're liable.

5) is a partially disclosed principle every liable in a K? §§144,186 in the restatement

E. **Torts in agency**

1) If within the scope of the agency, then the P is liable.
2) But if outside of the scope of the agency, then P is not liable.
3) **Restatement (2d) Agency §220**. **Definition of Servant** (p.13 supp.):
   a) lists factors in determining whether someone is an employee or not.
   b) Note that this list is not in the 3rd Restatement.
4) **2nd Restatement of Agency § 228**. General Statement. defines whether something is within the scope of employment. p. 14 of supp. Or **see § 7.07 of 3rd Restatement. Employee Acting Within Scope of Employment.** p. 35 of supp.

5) ***Policy:*** The person who controls the situation, is the person who gets incentives to prevent torts. So, if its an agent doing agent work, then its P who is liable. if its someone doing their own thing, then it is the actor who is liable.

F. **Agency Termination:** we usually say that you can terminate an agency at any time. but if your agreement is that it goes on for one year, maybe the fired agent can sue for contract breach. but what would the damages be? there is no good or easy answer here.

1) P will make the argument that he couldn't trust the agent to perform his fiduciary duties.

2) if the P (P=principal) cancels the agency, the agent continues to work though, and makes a contract on P's behalf, but P likes the contract, even though he fired A, can he enforce the contract?

- **a)** in that case, if enforced, there would be a one-way right for the P to sue the 3rd party for enforcement, but the 3rd party couldn't sue him for enforcement, which **the court is probably not going to like**.
- **b)** 3rd party could sue the A over misrepresentation.

G. **Liability of Agent to Principal: Fiduciary Duties**

1) The **fiduciary duties** are:

- a) to **act with reasonable care**
- b) to **act loyally**.
  - i. The obligation to exercise power of the property or information in a good faith effort to advance the purposes of the original grant
  - ii. It is the most important aspect of corporation law.
- c) We think of them as default provisions of agreements.

2) **Agency Restatement (2d) §379 Duty of Care and Skill – p. 15**: (1) Unless otherwise agreed, a paid agent is subject to a duty to the principal to act with standard care and with the skill which is standard in the locality for the kind of work which he is employed to perform and, in addition, to exercise any special skill that he has. (2) Unless otherwise agreed, a gratuitous agent is under a duty to the principal to act with the care and skill which is required of persons not agents performing similar gratuitous undertakings for others.

3) **Agency Restatement (2d) §381 Duty to Give Information – p.15:** Unless otherwise agreed, an agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty to a third person.

4) **Agency Restatement (2d) §385 Duty to Obey – p. 15:** (1) Unless otherwise agreed, an agent is subject to a duty to obey all reasonable directions in regard to the manner of performing a service that he has contracted to perform. (2) Unless he is privileged to protect his own or another's interests, an agent is subject to a duty not to act in matters entrusted to him on account of the principal contrary to the directions of the principal, even though the terms of the employment prescribe that such directions shall not be given.

5) **Agency Restatement (2d) §387 General Principle – p. 16:** Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency.

6) ***Tarnowski v. Resop (Minn. 1952) p. 36:*** π wants to buy a jukebox business. Hires an agent to investigate. The Δ, A, works both sides, lies to the π, gets a kickback from the seller. π sues, gets a 95% refund, but he also wants attorney fees and the value of the kickbacks from Δ, the agent. π gets it, because the A can't profit off of this breach of fiduciary relationship. **See Restatement 2d of Agency, §407(1)**. There can't be unjust enrichment.

7) ***In Re Gleeson (Ill. App. 1954)***: p. 38: Someone dies and appoints her tenant as her agent. He rents to himself and increases his own rent for $10. He gets sued. He should have ended tenancy or ended trusteeship. This seems like an unfair result, but the point is that there are serious demands on trustees.

III. THE GENERAL PARTNERSHIP, LLPs & LLCs

A. **Uniform Partnership Act (1914) p. 42: § 6 Partnership Defined** (1) A partnership is an association of two or more persons to carry as co-owners a business for profit.

B. **Uniform Partnership Act (1997) Article 2 § 201. Partnership as Entity:** (a) A partnership is an entity distinct from its partners. But the owners of a partnership are personally liable through the partnership.

C. **Economic Reasons for Partnership Form**

1) Partnerships are about gaining capital. Its cheaper to create a partnership than it is to borrow money. Also, banks don't want to create a situation where the owner of the company bears no risk.
2) And its also about banks wanting to get all their money back.
3) Ownership = Right to control, and a right to residual returns
4) The fact that there is partnership property means that business creditors get preference on the partnership assets, rather than creditors having to go after each partners personal assets and get on line with their personal creditors.

D. **Formation – Contractual in nature;**

1) To form a partnership requires no formality.
2) It's a contractual form where there are mostly default provisions.
3) Partnerships share control, in default its equal control. They get profits, and again, by default, it is equal. They also have shared obligations.
4) **§ 7 UPA (1914). Rules for Determining the Existence of a Partnership p. 42.**

   (4) receipt of a share of the profits is prima facie evidence of a partnership unless"

   (a) As a debt; (b) As wages of an employee or rent to a landlord; (c) as an annuity to a widow or rep of deceased person; (d) As interest on a loan; (e) as the consideration for the sale of a good-will of a business.
5) Look for subjective beliefs of the partners

E. **Rights and Duties**

1) **UPA §18. Rules Determining Rights and Duties of Partners – SEE FOR PARTNERSHIP GOVERNANCE!!**
2) **UPA §21. Partner Accountable to a Fiduciary**
3) **UPA §24. Extent of Property Rights of a Partner**
   a) "The property rights of a partner are (1) his rights in specific partnership property, (2) his interest in the partnership, and (3) his right to participate in the management"
4) **UPA §25. Nature of a Partner's Right in Specific Partnership Property**
5) ***Meinhard v. Salmon***, p. 45 → Salmon and Meinhard became partners in leasing and operating a hotel. Meinhard provided capital and Salmon ran the business. They had a 20 year partnership. Then Mr. Gerry comes along and wants to build something even bigger. He contacts Salmon about taking the Bristol. Salmon was interested, and he made a deal with Gerry and cut Meinhard out of it. Meinhard finds out and claims that they had a partnership and that both partners are agents of the partnership. Salmon says that the partnership was for 20 years and had ended.
   a) The heart of this case is whether this opportunity came to him because of his role in the partnership? Or was it because of his reputation as a real estate developer? The case could turn out differently depending.

F. **Partnership Accounting / Operations**

1) **UPA §8 Partnership Property** Supp. p. 42
2) **UPA §9. Partner Agent of Partnership as to Partnership Business**
   a) Partners are agents and every act within the scope of the partnership the partner binds the partnerships unless the partner has no authority AND the 3rd party doesn't know he has no authority. (2) An act of a partner which is beyond the usual scope of the partnership does not

bind the partnership. (4) No act of a partnership that is beyond his authority is binding if the 3rd party knows he has no authority.

3) **UPA §10. Conveyance of Real Property of the Partnership**
4) **UPA §15. Nature of Partner's Liability**: Partners are liable jointly and severally for wrongful acts and breach of trust to 3rd party, but just jointly otherwise.
5) any partners who extends money to the partnership has the right to be reimbursed w/ interest
6) goodwill is the difference between the market price and the acquisition price. value not attributable any identifiable asset. when you dissolve wrongfully, you don't get a share of goodwill.
7) Goodwill can be ascertained if you are selling the business, but not if you aren't selling the business, so that's another reason you don't get a share of goodwill.
8) ***Vohland v. Sweet (1982) p. 50***: This case was a question about whether Sweet was a commission-only employee or whether he was a partnership in this nursery. He got 20% of the profits in this business. He got the 20%, now he wants the proceeds of the business as its sold.
    a) The cost of acquiring new nursery stock was an expense that cost Sweet money, because he only got profit. So, investing in the business comes out of his pocket.
    b) When they went to the bank, Vohland was the only name on the liability. On the other hand, Sweet had title to the truck. But they probably didn't see themselves as partners. But its not required that they think of themselves are partners. Its enough that they agree to do the acts that a court would regard as reflecting a partnership arrangement.
    c) Why is the receipt of net profits such an indicator of partnerships? § 7 UPA (1914)
9) ***Dreifuerst v. Dreifuerst (Wis. 1979)*** p. 67: two brothers are partners with two feed mills. the partnership dissolves and the trial court divides the mills in-kind. meaning they each got one of the mills, rather than liquidating the assets.
    a) CoA reverses and says that the statute requires that the assets be liquidated, not split in kind. There are good reasons for this, mostly having to do with fairness, but also, IT'S THE LAW.
    b) If this was a wrongful dissolution, it would be a little different.
10) What happens when you yourself add a lot of value to a business partnership, but you want to leave the partnership and get a fair value? It's hard to say.
11) ***National Biscuit Co.***: has to do with ability of Partners to make contracts unilaterally.
    a) ***You need a majority to restrict the ability of a partner to make Ks.***
    b) If one partner go to a third person to buy an article on the time for the partnership, the other partner cannot prevent it by writing the third person to sell to him on time.
    c) What either partner does with a third person is binding on the partnership. It is otherwise where the partnership is not general, but is upon special terms, as that purchases and sales must be with and of cash.
12) **Article 6 of UPA 1997, revised act, is about Partner's Dissociation supp p. 70**
    a) Instead of saying that dissolution happens, it says that dissociation happens.
13) **Article 7 is Partner's Dissociation When Business Not Wound Up**

G. **Partnership Dissolution; Modern Forms:**

1) **A partner can withdraw at any time and cause the dissolution of the partnership. But this is just the default provision, it can be modified by contract, of course.**
2) It can be for a term of years or at will, but it is always subject to dissolution by the withdrawal of a partner. They can withdraw at any time.
    a) Any partner has the power but not the right. That means that he can withdraw, but he might be liable for some damages or something.
    b) If we have a 5 year partnership and one partner withdraws in 3 years, that is a **wrongful dissolution**.
3) You can contract with respect to liability among yourselves, but third parties cannot be affected by these contracts.

4) The power to withdraw creates a situation in which practical business realities are going to shape power. So you might not have management power, but if you are important enough, you can threaten to dissolve, and you'll get what you want.

5) Most modern partnerships say that withdrawal of a partner, will not terminate the business. The whole thing is going to be more valuable if it's a stable arrangement. If the partnership could dissolve when one person decides to, then clients might be less willing to deal with the partnership.

6) Originally any time a partner died/quit the partnership had to dissolve (See UPA 29 and following)

7) RUPA creates an option for disassociation which allows a partner to leave with the partnership intact (RUPA 601, 701, 703)

8) UPA (1914) §29. Dissolution Defined: The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business.

9) UPA (1914) § 30. Partnership Not Terminated by Dissolution: On dissolution the partnership is not terminated, but continues until the winding up of partnerships affairs is completed.

10) §31 UPA (1914) Causes of Dissolution (§601 in 1997 UPA Supp p. 70**):** Dissolution is caused:

(1) Without violation of the agreement between the partners,

(a) By the termination of the definite term of particular undertaking specified in the agreement,

(b) By the express will of any partner when no definite term or particular undertaking is specified,

(c) By the express will of all the partners who have not assigned their interests or suffered them to be charged for their separate debts, either before or after the termination of any specified term or particular undertaking,

(d) By the expulsion of any partner from the business bona fide in accordance with such a power conferred by the agreement between the partners;

(2) In contravention of the agreement between the partners, where the circumstances do not permit a dissolution under any other provision of this section, by the express will of any partner at any time;

(3) By any event which makes it unlawful for the business of the partnership to be carried on or for the members to carry it on in partnership;

(4) By the death of any partner;

(5) By the bankruptcy of any partner or the partnership;

(6) By decree of the court under § 32.

11) § 33: if you have a contract that needs to be completed when dissolution takes place, you might still be authorized to complete this. but another partner says that it wasn't necessary to wind up things, so you might have some litigation.????

12) **UPA §36, effect of dissolution on Partner's existing liability:** dissolving a partnership does not discharge the existing liability of any partner

13) ***Adams v. Jarvis*** p. 63 (Wis. 1964): They had a medical partnership. A partner wants to leave the partnership and they had made arrangements so that when a partner leaves, they don't dissolve the business.

   a) at the fiscal year in which you withdraw, we'll divide the profits for the part of the year that you were there, and after that, divide among existing partners. But the contract also specified that accounts receivable were the property of the partnership and did not transfer to the withdrawing partner.
   b) But the withdrawing doctor looks at § 33 of the UPA and says that it was a partnership at will, not for a term, and that he is rightfully withdrew. he says under § 38(1) he has a right to have the property sold. The trial court says, yes, this is true, but the appeals court reverses.
   c) Pship agreement specifically said withdrawal of one P doesn't mean dissolution of pship – no reason not to honor agreement since gives P his share & doesn't jeopardize creditor's interests

    - d) UPA for distribution of assets applies only unless otherwise agreed
    - e) Court follows terms P's agreed to
  - 14) The 1997 Act (also in Stat Supp.) makes some important changes especially in (1) treating the partnership as an entity (see 1997 Act Section 201) and (2) in the dissolution provisions…e.g. compare 1914 Act Section 29 and 30 with 1997 Act Sections 601-603.

H. **Liability in Partnership**

  - 1) A partner is liable for all partnership indebtedness.
  - **2) 5 questions to ask:**
    - a) is X a partner? (UPA § 7)
    - b) is the liability a partnership liability? (§9.1 UPA)
      - i. Is it the act of a partner that is binding on the partnership?
      - ii. § 17, a person admitted into a partnership, is liable for all liabilities even before his partner status, except that its taken only out of partnership assets.??????????????
    - c) is there indemnification from other partners available?
    - d) if he's a retiring partner, what circumstances are there available to get him off the hook? does he continue to be liable endlessly for partnership debts? partner wont be held liable for a breach by the partnership after the contract was modified.
    - e) If he is liable for debts of his partnership, who gets priority, personal creditors or partnership creditors?
      - i. **The CL Rule: The Jingle Rule**:
        - (1) Creditors of the partnership has priority with respect to assets of the partnership. This allows the partnership to be treated a little more like an entity of its own.
        - (2) Personal creditors take priority with the personal assets.
        - (3) **This rule changed in 1978**: no more priority for personal creditors.
          - a) Partnership creditors have first crack at partnership assets, but personal assets are on a level priority field with the partnership creditors.
          - b) **Policy seems: Encourages lending in partnerships**
          - c) Maybe recognition that partnerships are not appropriate where the partnership is bound to take on a lot of liabilities.
  - 3) You can't throw a partnership in bankruptcy. But if a partner owes you, you can sue for their interest in the partnership. This is §504 of the 1997 revised Uniform Partnership Act, p. 71.
  - 4) **UPA §13. Partnership bound by Partner's Wrongful Act**
  - 5) **UPA §16. Partner by Estoppel**
  - 6) **UPA §17. Liability of Incoming Partner**

I. **THE LIMITED LIABILITY PARTNERSHIP (LLP)**

  - 1) You've outlined none of the useful parts of LLP law.
  - 2) There are limited partners and a managing partner.
  - 3) Look it up
  - 4) Limited Partners generally have a contract right, as a class, to remove the General Partner.
  - 5) Limited Partners can assign their right to receive payments, but not their right to vote.
  - 6) ***DRULPA §17-803*** p. 109 supp

J. **THE LIMITED LIABILITY COMPANY (LLC)**

  - 1) Pretty much offers you everything. It's a contractual form in which you have a membership agreement and you can define the rights of the members as broadly or narrowly as you like in terms of participation.
  - 2) LLCs can be taxed as a partnership unless the membership units are publicly traded, then it looks too much like a corporation. It's an easy flexible, limited liability form.

3) ***DLLCA §18-803 Winding Up*** p. 150 Supp.: prosecute & defend suits, settle and close business, dispose of and convey Pship property, discharge or make provisions for liabilities, and distribute to members any remaining assets.

4)

IV. THE CORPORATE FORM BASICS

A. Economic reasons for corporate form:
  1) We don't expect the LLC to replace the corporate form. If you want to raise capital on the public markets, then the corporate form continues to be dominant. Debt is cheaper to the company than equity, but you need enough equity for people to be willing to lend you money
  2) What's good about the corporate form is that it has less contractual freedom: The fiduciary obligations cannot be contracted away and this is comforting for many investors.
  3) The corp form allows capital to perform just the risk bearing functions and managers to stick to what they're good at, which is managing.
  4) The corporate form: 1) makes the capital markets possible, 2) makes the cost of capital lower.

B. **4 CHARACTERISTICS OF THE CORPORATE FORM**
  1) Entity separate from the investors or managers.
    a) the advantage is that it's a stable form, it wont fall apart if a partner leaves.
    b) it can own its own property
  2) Limited liability for investors
    a) investors have no liability beyond the loss of their investment
    b) This is an element of entity status.
    c) Attracts more potential investors. the investors knows what's on the line.
  3) Centralized management
    a) managerial expertise and skill has a profound effect on the development of the economy
    b) specialization of function
  4) Free transferability of shares
    a) Remember that in the partnership form, the only thing you could transfer is your partnership income, but in a corporate form, you can assign your dividends but you can also assign your entire shares, your managerial control, governance rights.

C. **Governance Role of the Certificate and Bylaws**
  1) Charter / Certificate of Incorp. / Articles of Assoc.
    a) DE General Incop. Law §102: What content of document should be.
      i. allows you to have any structure, unless it conflicts with a few express provisions
      ii. §102(b)(7) Directors have liability for breaches of duty. You can release directors from duty of care in corp. charter, but NOT duty of good faith.
        (1) And shareholders approved these amendments when 102(b)(7) came into effect! Because it allows directors to take risks!
    b) §241: Amending charter
      i. Board has to *initiate* amendment. Shareholders get to vote.
  2) **Bylaws**
    a) Lists # of directors, *capital structure* (how much of what kind of stock)
    b) Power of officers, committees of board
    c) §109(b): Power to make bylaws is in *shareholders*
    d) Can make rules determining how board can act in event of takeover, etc.
  3) Management
    a) Between ***Business Judgment Rule*** and proxy voting, management has the most control
    b) Powers defined by bylaws

V. RAISING CAPITAL

A. Capital structure: legal characteristics of debt and equity

1) Debt is tax deductable
2) But, the stated interest rate must be paid. It's a cash flow drain.
3) If you don't pay, debt can put you into bankruptcy.
4) The more debt you have, the more risk there is. Eventually the creditors say, I paid everything and you, the shareholder, gets all the profits? There is too much of an incentive for shareholders to take tremendous risks, because it's not their money.
5) Equity is more expensive because of the time value of money and expected rates of return for investors. So, you'd pay $.30 for a stock that you think is worth $1 in 5 years, but maybe $.80 for a loan that is worth a $1 in 5 years. This is because of the legal protections of debt, mostly.

B. The concepts of risk and return that are linked in markets.

1) Systematic risk vs. Individual risk?
   a) Individual/Company Specific Risk: Take Berkshire Hathaway depending on Buffet.
   b) Systematic risk: In a well functioning market, people will not demand an extra return. risk is unpleasant, so the more risk, the more investors demand returns.
2) All equity is riskier than debt.
3) The senior management does not want bankruptcy, because they lose value and they lose human value. Management wants more equity because they can't really diversify as much as investors.

C. **ASSET VALUATION**

1) Capital Asset Pricing Model (CapM)

2) Discount Cash Flow (DCF)
   a) The first step is the estimation of all future cash flows generated by the asset.
   b) The second step is calculating an appropriate discount rate
      i. Often they use *weighted-average cost of capital*
   c) Go out 5 years, and for each year you look at Net Cash Flow (profit + non-cash expenses)
   d) The main non-cash expense is depreciation. You do a terminal value (what its worth at year 5).
   e) You take all of the values + the terminal value and then you discount them by the weighted average cost of capital

3) They figure out the cost of capital by looking at what bond prices are going for, and they estimate what their bond should cost (fly by night, inc. vs. General Electric).

D. **Stock Market Pricing Theories**

1) Efficiency of modern markets in shares: **The Reasonably Efficient Market Hypothesis**: because market players are so smart and correct information so widely distributed, the price determined by 'supply and demand' in this efficient market must be the same as the intrinsic value of the securities traded.

2) Modigilani & Miller "Irrelevance Hypothesis" and the problem of excessive leverage: firm value in a full information and taxless world stems entirely from the production function and is independent of capital structure. so they don't think it matters whther you are a corp or a partnership.

VI. PROTECTIONS FOR CREDITORS

A. **Protective Strategies for Creditors**
   1) Convertibility
   2) Security Interest
   3) Protective Covenants

B. We divide between commercial creditors and involuntary creditors: Not all creditors are sophisticated creditors and they need protections, this is especially true of tort creditors ie. involuntary creditors.

C. When the company is insolvent, the directors' obligation is to the corp and its creditors.
   1) Normally you'd think it would be to the corp and its shareholders.

D. **Contracts:** the most important protection of creditors
   1) In a contract for credits, you give borrowers covenants (promise to the bank, you will keep an amount of $ on hand, equal to, 2% of your sales)
      a) you might also have negative covenant, that says you CANT do something
   2) "Covenant light lending": the banks made loans for equity buyouts with very few covenants from the banks. There was too much competition between the banks.
   3) When a company has so many covenants with a lender that the lender becomes associated with the company and it can become liable for it. Lender liability. We saw that in the *Cargill* case.

E. **Disclosure:** Warranties of certain conditions (no material pending litigation, you own all the necessary assets for the operation of your business, which ones are leased)
   1) Public companies have forced disclosure through **SEC filings:** The filings are for shareholders, but creditors can still find it useful.

F. **Minimum Capitalization**
   1) Companies in the U.S. don't have minimum capital requirements, except for banks and insurance
   2) It's hard to say what is the right amount of capital for a business. If you make it too much, then it's not an efficient use of capital, just sitting there.

G. **Dividend Protection**
   1) Del. Gen Corp. Law §174 -> willfull or neg. payment of dividends, directors are personally liable.

H. **Fraudulent Conveyance Act**
   1) The most effective remedy for creditors.
   2) ***Uniform Fraudulent Transfer Act.*** p. 143 in the casebook, & p. 389 supp.
      a) is there an attempt to hinder or delay any creditor?
      b) Is the consideration not fair consideration?

I. **Equitable Subordination - (Equitable Remedy)**
   1) Subordinates (lowers its priority is regard to other creditors) corporate insiders if the claim arose from a transaction that constituted a breach of a fiduciary duty.
   2) It is rare but it's when the court lets some creditors to be paid before or after another.
   3) Equitable subordination is a much more mild remedy than piercing the corporate veil.
   4) There has to be some inequitable conduct with equitable subordination.
   5) ***Costello v. Fazio*** (9th Cir. 1958) p. 145: people had a business, some of them had more money in there than others. they started to lose money, so they re-organized, created lots of debts to the principals to get their money back, and messed up their balance sheet. The company had to be liquidated and their creditors were going to get screwed out of the money owed to them because the company says it has to pay the notes of the principals.
      a) Allen says it looks like closing up a partnership and opening up a corporation. but the court here sees this as a company just re-organizing and transfer where the owners got something and gave nothing. It might be covered by fraudulent transfers act.
      b) there are good reasons why this is not the black letter rule, you want principals to be able to loan money to their companies.

J. **Piercing the Corporate Veil - (Equitable Remedy)**

1) Look for a lack of formalities.
2) ***Sea-Land Services, Inc. v. The Pepper Source*** p. 151 (7th Cir. 1991)
    a) A company ships peppers, and then they don't pay. π sued the pepper company and the owner of the company and all of the other companies that he owned.
    b) **The Test:**
        i. *failure to maintain adequate corporate records or to comply with corporate formalities*
        ii. *commingling of funds of assets*
        iii. *undercapitalization*
        iv. *one corporation treating assets of another corporation as its own*
    c) you can see that in this situation that the corporation was really just this guy. they don't have formal meetings, its just an alter-ego of the owner. you cant use the corporate form to commit fraud. it's a complete disrespect for formalities.
3) ***Kinney v. Polan*** (4th Cir. 1991) p. 156: Kinney seeks to pierce the corporate veil of Industrial so as to hold Polan personally liable on the sublease debt.
    a) **Totality of the circumstances**
    b) **Two-prong Test**
        i. Is the unity of interest and ownership such that the separate personalities of the corporation and the individual shareholder no longer exist?
        ii. Would it be inequitable if the acts were treated as those of the corporation alone?
    c) Allen is not sympathetic to Kinney, but he notes that there are no formalities and says how can you ask the court to respect the corporate form when the owners do not?
4) ***Walkovsky v. Carlton*** (N.Y. 1966) p. 160: **Veil Piercing for Involuntary Creditors**
    a) A set of businesses run together as one economic unit should run liabilities that way.
    b) There are two theories of liability here: the first is an agency theory. each company is an agent for the other ones. the second is: getting Carlton on piercing the veil?
    c) The court says that there is no cause of action stated against Carlton that is adequate.

K. **Balance sheets and real economic value.**

1) Par Value -> we did away with par value, so that stock can be issued at 0 par value.
2) Excess –Surplus -> I think this is the money that you start out with, or have?
3) Retained Earnings -> if you make x dollars, that is your retained earnings.
4) You pay dividends out of excess/surplus?
5) **Del. Gen. Corp. Law § 154 Determination of Amount of Capital; Capital, Surplus and Net Assets Defined p. 184**

VII. PROTECTIONS FOR SHAREHOLDERS

A. SHAREHOLDERS ENFORCING THEIR LEGAL RIGHTS:

1) The business judgment rule: you can only say that an action of the board was in bad faith. .
2) **Class Actions**
   a) Damages go to the shareholders
   b) F.R.C.P. Rule 23. Class Actions

> (a) PREREQUISITES TO A CLASS ACTION. One of more members of a class may sue or be sued as a representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties will fairly and adequately protect the interests of the class.
>
> (b) CLASS ACTIONS MAINTAINABLE. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:
>
> (1) the prosecution of separate actions by or against individual members of the class would **create a risk of**
>
> **(A) inconsistent or varying adjudications** with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, **or**
>
> **(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests**; or
>
> (2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or
>
> (3) **the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy.** The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.
>
> See p. 385 of the supp for more..

3) **Derivative Suits**
4) **Two kings of Derivative Suits**
   a) Against the directors on behalf of the corporation
   b) Against a 3rd party with Corp as π
   c) Rule 23.1 Derivative Actions by Shareholders

> In a derivation action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, **the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which the π complains**

or that the π's share or membership thereafter devolved on the plaintiff by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. **The complaint shall also allege with particularity the efforts, if any, made by the π to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the π's failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the π does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholder or members in such manner as the court directs.**

d) **Requirements**
  i. **Pre-suit Demand** *(The complaint shall also allege with particularity the efforts, if any, made by the π to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for the π's failure to obtain the action or for not making the effort.)*
    (1) The directors run the business, the shareholders do not.
    (2) Bringing a lawsuit is a part of running a business, so its for the board to do.
    (3) You have to plead: I have gone to the board with this problem, asked them to bring the suit, and they wrongfully said NO.
    (4) A key contention in trial will then be whether the refusal was wrongful.
    (5) Alternatively, demand is excused when the board is so implicated in the wrong, any decision by the board would not be required to be followed by the court.
  ii. **Stake in the Company**
    (1) Have to have owned the stock at the time of the wrong EXCEPT by operation of the law, like if you inherit it.
    (2) You don't want people buying shares just to bring the suit.
    (3) You have to own the stock at all times until the end, you can't continue to press the lawsuit if you've sold the stock.
    (4) Once you have no interest in the outcome, you settle it too cheaply. its too easy to get a side deal
    (5) If there is a derivative suit and the companies merge and *cashes out* the shares? The case gets dismissed because he doesn't have the shares anymore. Weird but true.
      a) But, there might be an M&A suit available in that case.
    (6) If he gets *stock* in the merger? He still has an interest. It's diluted though. This is caused a double derivative suit. He now owns stock in a company that owns the claim against a company that he used to want to litigate against.
  iii. Directors must have committed a *legal wrong*, not just a mistake.
    (1) *Self-dealing,*
    (2) *Conspiracy.*
    (3) Can they be guilty of negligence? Probably not.
    (4) You won't see a derivative suit brought against a third party that the directors are not in cahoots with.

  - iv. ***"The derivative action may not be maintained if it appears that the π does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association."***
  - v. ***Levine v. Smith*** p. 383: In determining the sufficiency of a 23.1 complaint, there are two questions.
    - *(1) are threshold presumptions of director disinterest or independence rebutted by well-pleaded facts?*
    - *(2) has π plead particularized facts sufficient to create a reasonable doubt that the challenged transaction was the product of valid exercise of business judgment*
- **e)** Two motions to dismiss**:**
  - **i. 12(b)(6) – failure to make a claim upon which relief can be granted**
  - **ii. Rule 23.1 Motion - motion to dismiss for failure to make a demand.**
    - (1) Is there is a reasonable doubt that the board is not in a position to make the judgment they want? You don't have to prove it they just have to raise a reasonable doubt. It's a matter of judgment, therefore it could go either way.
    - (2) Lots of factors will matter in this inquiry: the size of transaction, whether it's an unusual transaction, the relationship with the directors and the party at issue, depending on these things, there might be no way for the director act without a conflict of interest?
- f) The target of the suit is the board that was there when the suit was brought.
- **g) Settlements and Awards**
  - i. **Recovery goes to the corporation**! The defendant has to pay a big enough damage award that its worth it for the shareholder who brings the suit on behalf of the corp.
    - (1) Usually the insurance company pays, not the directors.
    - (2) More typically in derivative suits you get non-monetary settlements. changes in the deal terms, if the suit attacks the deal, or governance changes, new processes for audit committee or nominations committee.
  - ii. Attorney's fees are always a big issue
    - (1) The Lindy rule has been adopted by most of the jurisdictions: it says that you have to look at the amount of time that the lawyers invest in the case and then look at the complexity in the matter, the difficulty, specialization, expertise, and put some sort of loadstar, and you multiply their normal hourly rates with their hours and this loadstar.
    - (2) Someone else came up with the idea to auction up the right to be the π lawyers. A bunch of firms who bid on a percentage and you give it to the lowest bidder.
  - iii. The suits are brought by attorneys who specialize in derivatives. In private companies, there is more of an incentive to correct a wrong, but in public companies, you don't have big enough stakes. Those attorney's do it for the attorney's fees rather than shareholders doing for the remedy.
  - iv. The big risk in the derive suit is the strike suit. The threat of the strike suit informs many of the decisions of the court. **Most derivative cases are settled**.
  - *v.* ***"The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholder or members in such manner as the court directs."***
- h) **Collective action problem for public shareholders:** There isn't a huge incentive to do much once they've already bought a stock. All they can do is sell the stock, vote their stock, or sue someone. How could they even know that management is underperforming? There isn't much incentive to sue because they only have a few shares and the remedy goes to the corporation.

i) ***Tooley v. Donaldson*** (Del. 2004) p. 372: "[I]n determining whether a stockholder's claim is derivative or direct. That issue must turn *solely* on the following two questions:"
  i. who suffered the alleged harm (the corporation or the sueing shareholders)
  ii. who would receive the benefit of any recovery or other remedy (the corporation or the stockholders individually)

j) ***Gentile v. Rosette*** p. 372: Del Sup. Ct. holds that the π's claim was *both* direct and derivative.

k) ***Fletcher v. A.J. Industries, Inc. (Cal. App. 1968)*** p. 374: About getting attorney's fees.
  i. π brings a derivative suit for mismanagement. There was a settlement about the reorganization of the corporation and governance changes. π wants attorney's fees.
  ii. *Substantial benefit rule*: successful π in a derivative action may be awarded attorneys' fees against the corporation if the latter received "substantial benefits" from the litigation, even if the benefits are not pecuniary.
  iii. Substantial benefit is found when the results of the action "maintain the health of the corporation and raise the standards of "fiduciary relationships and of other economic behavior" or "prevent an abuse".

l) ***Zapata v. Moldanato*** (Del. 1981) p. 396:
  i. Court considers the independence of the committee and whether the investigation was reasonable for the board to have the suit dismissed.
  ii. Then the judge adds his business judgment on the merits to make sure its fair.

m) ***Carlton v. Beatrice*** p. 418 (Del. Ch. 1997)
  i. π in a derivative suit, and the board settles it without the π's knowledge.
  ii. Applies Zapata test of independence of comm. & good faith, then judicial biz judg.

n) The Disney case went to trial because they fired the CEO within a year, they could have fired him for cause and didn't because they had to pay him $148mil if they fired him without cause. The chancery court said it was business judgment rule, but the Delaware Supreme Court reversed after the Enron debacle. It didn't settle because the numbers were so big, and the plaintiffs felt they had a strong case, but the insurance company wouldn't pay much.

5) *Reading:* AKS 369- 401; 417-422;

B. **SHAREHOLDER VOTING**

1) **AS A CONSTRAINT ON AGENCY COSTS**
    a) It takes a lot of time to understand a business, and you cant really affect the outcome much if you only have a few shares. So the right to sell is more important. The Wall St. walk says if you don't like what is happening, then you can walk. The advent of institutional investors makes this less true, because they can actually affect the outcome. SH voting is more than important than it used to be.
    b) Management can develop expertise and centralize management of the company. But, I think also, shareholders aren't accountable and they aren't firable. ALSO, shareholders have no fiduciary duties
2) **Legal Solutions to the Collective Action Problem**
    a) Proxy Voting
    b) Management can spent company $$ to collect proxies
    c) Prevailing challengers can get reimbursed for reasonable expenses
3) **Del Statutes on Shareholder Voting Rights**
    a) ***DGCL § 211. Meeting of Stockholders*** . supp p. 202
    b) ***§212. Voting Rights of Stockholders; Proxies; Limitations***
        i. (a) Default rule is one share one vote
        ii. (c) allows others to act as proxy for shareholder
    c) ***§ 220. Inspection of Books and Records***: allows SH access to list and books for any "proper purpose"
    d) ***§ 222. Notice of Meetings and Adjourned Meetings***: you have to give notice of the meetings to all
    e) ***§ 223. Vacancies and Newly Created Directorships***: board can elect new director until next meeting
    f) ***§225. Contested Election of Directors; Proceedings to Determine Validity***: Chancery can hear and determine validity of any contested election, appointment, removal or resignation.
    g) ***§ 228. Consent of Stockholders or Members in Lieu of Meeting***
    h) ***§ 241. Amendment of Certificate of Incorporation Before Receipt of Payment for Stock*** supp. 217
    i) ***§ 251. Merger or Consolidate of Domestic Corporations and Limited Liability Company*** supp. 221
4) **First Issue: Who votes?**
    a) First, Look to charter; then...
    b) The default rule, DE §212, is that all shares are voting shares. All shares have one vote per share unless the corporate charter provides otherwise.
    c) You shouldn't separate the voting power from the rest of the bundle of sticks in a share, but it is possible.
    d) **Power to vote shares in the corporate treasury**
        i. ***§160(c):*** **shares belonging to the corporation can't vote and don't count for quorum**
        ii. ***§161(a):*** after being bought, it can be cancelled or held in the treasury
5) **Second Issue: On what issues do shareholders vote?**
    a) **Amendment of charter: DGCL § 242(b)**
        i. Narrow interpretation under DE law (per *Harford v. Dickey Company*, 1943)
        ii. §242(b)(2): shareholders can vote as a class in 3 ways [185]:
            (1) Increase or decrease # of authorized shares of the class
            (2) Increase or decrease par value of the share of the class
            (3) Alter or change powers, preferences or special rights

    - b) elections
    - c) sale of all assets
    - d) dissolution
    - e) bylaws
    - f) precatory matters (not obligatory, for example: Not doing business with South Africa)

6) **Third Issue: Where and when votes are taken:** They have to be at special meetings, and then there is a question about who can call special meetings. § 228 in Delaware
    - a) **"Advance Notice Bylaw"** if you're going to bring up something at the annual meeting or you want to make a resolution, you have to say so in advance.
        - i. Proxy fights, when they come up at all, regard elections mostly. So the Advance Notice Bylaw, says you have to give advance notice before you can run a slate of directors. It might also require you tell them who the candidates you're running are and info.
        - ii. It started out around 45-60 days notice, which seems reasonable. Then they went to 90 days. Allen thinks tht 90 days are the outer limit
        - iii. They work as impediments to shareholders, but they also have some reasonable justification.
    - b) ***Del. Corp. § 216. Quorum and Required Vote for Stock Corporations*** p. 207 Supp.
        - i. Quorum can be defined by the by-laws as long as its not less than one-third of voting shares.
        - ii. In the absence of by-laws defining quorum:
            - (1) **A majority of the shares entitled to vote constitutes a quorum** at a meeting. (includes proxy representations).
            - (2) Unless it's an election of directors, **a majority vote by those present** and entitled to vote is an act of the stockholders.
            - **(3) Directors are elected by a plurality of the present voting shares.**
            - (4) Where a separate vote by a class or series is required, a majority of the outstanding shares of that class or series constitutes a quorum and a majority of present shares of that class or series is an act of that class or series.
    - c) ***§ 211(b)***: requires that every Del Corporation shall hold an "annual meeting of stockholders for the election of directors".
    - d) Consent statute DE § 228 (allows shareholders to vote or act on any matter they could have voted on at a mtg through a consent solicitation)

7) **Who wins?**
    - a) I guess we have plurality voting.
    - b) Disney wanted majority voting because Eisener was so powerful. So why not enact a by-law? They can't do it by charter amendment because the board would say no.
    - c) **Cumulative Voting:** if you have 8 board members, you'd have 8 votes per share, and you can vote however many times you want for the same person. So minority shareholders can put all of their shares in one person.
        - i. One disadvantage of this, however, is that you don't really want a contentious board. Boards like to be unanimous.
        - ***ii.*** See ***DGCL § 214***

8) Electing and removing directors
    - a) Default rule: may be removed with or without cause by the shareholders – except if you have a staggered Board then the shareholders have to show cause for removal DE 141k
    - b) What is good cause?
        - i. Generally must relate to self-dealing or some other stealing
        - ii. Any crime relating to honesty would be cause
    - c) See **Campbell v. Loew**'s pg 174

        i. director must get notice and opportunity to argue
        ii. this decision was excessively legalistic and led people to stop removing for cause in DE
    d) Board has no power to remove a fellow director – only shareholders
    e) Can be removed by the court if a substantial breach of fiduciary duty is found.

9) **Staggered Boards:** It is an anti-takeover device. But, when it first came around, they didn't justify it as an anti-takeover device.
    a) Requires shareholder approval.
    b) Must be specified in charter or in some states in the by-laws. See MBCA §8.06

10) Class Voting
    a) ***§ 151 DGCL: Classes and Series of Stock; Redemption; Rights.*** p. 180 supp
    b) You want to link control rights to cash rights. If somebody controls through high vote stock, it gives him lots of control, but not a lot of dividends. It would create incentives to channel cash flow out somewhere else and the means to do it.
    c) Dual-class voting structures have two categories:
        i. Small category: Newspapers are controlled by high vote stock. Academics will say that value in a newspaper is set by the political control of an editorial board. You might think there is value in the stance of the board and you don't want to mess that up.
        ii. The controllers might be the thing that offers value: People invest in Google because they like the google geniuses being in charge. Google geniuses don't want to own the whole thing though because they need to diversify just like everyone else.
    d) Once you transfer the high vote stock to someone else, it turns into common stock.
    e) ***§ 242(b)(2)*** is the class vote provision

C. **INFORMATION RIGHTS**

1) §219: 2 kinds of information that you can get:
    a) Stock list
        i. Management usually doesn't want to give stock list b/c it's usually used in takeover bid
        ii. If request denied, can bring an action in DE; courts are sympathetic and quick
        iii. ***General Time Corp. v. Talley Industries, Inc***.; Del. 1968; (p. 193, not assigned) only have to have a ***proper purpose*** to get list (communicating to stockholders); secondary purpose doesn't matter.
        iv. Burden on Δ to prove lack of proper purpose (if contested)
    b) Books and records
        i. Shareholder can ask for this when something is fishy – thinks something is wrong and wants to investigate the business of the company
        ii. Burden on Π to show a proper purpose

D. **PROXIES AND PROXY SOLICITATION**

1) Proxy voting versus tender offers:
    a) Proxies say: Hey, vote for me. I can do a better job.
    b) Tender offer says: "Hey, I can do better, stocks goes for $30, I'll give you $40.

2) Just because there aren't many proxy fights doesn't mean that voting doesn't work, it just means that people *buy* the shares instead and use the voting power of the shares.

3) You cant just solicit some people, you have to solicit everybody.

4) Proxies are necessary where there are many public shareholders as opposed to just a few investing institutions. Institutions can send a representative.

5) **Federal regulation of proxy solicitation.**
    a) The theory of those acts is **disclosure of truthful information**, not substantive regulation.
    b) ***Securities Exchange Act of 1934 § 240.14a-9 False or Misleading Statements***
        i. There is a common law tradition of per se negligence when statutes are violated, which led courts to imply causes of action on the part of persons injured by actions that violated

when the court assumed that the person who was injured in the class of person that the statute was meant to benefit or protect.

  - **ii. Elements of the misleading statement**
    - (1) false statement
    - (2) in a proxy
    - (3) material fact
    - (4) that causes injury
- c) ***J.I. Case v. Borak*** (1964) –
  - i. private cause of action for violation of 14a9 inferred by the court
  - ii. elements of cause of action
    - (1) false statement or omission in a proxy
    - (2) of a material fact
    - (3) made with intent to defraud (or recklessness)
    - (4) that causes injury
- d) ***Virginia Bankshares, Inc. v. Sandberg*** **(1990)** p. 232: It's a cash out merger.
  - i. The management said that they think that its fair and that it's a good opportunity for you. That was the issue. They got sued for a false statement. but they said, hey, its our opinion, its not a false fact. Is an opinion a material fact that could be false? Not to mention that the management HAS to think its fair in order to recommend it because of their fiduciary duty.
  - ii. The Court said, sure, an opinion can be false. its possible that you might believe something different than what you say you believe. A jury might be able to conclude that no person could have believed that this was a good deal.

6) Reimbursement of proxy expenses

- a) ***Rosenfeld v. Fairchild Engine and Airline Corp*** *(*N.Y. 1955) pg 183: "The test is clear. When the directors act in good faith in a contest over policy, they have the right to incur reasonable and proper expenses for solicitation of proxies and in defense of their corporate policies, and are not obliged to sit idly by."
  - i. "It is also our view that the members of the so-called new group could be reimbursed by the corporation for their expenditures in this contest by affirmative vote of the stockholders"
- b) Has to be a contest over policy (even, "I'm a better manager than you"), rather than a personal power contest. Boards have the right to be reimbursed for their proxy fight, and shareholders have a right to reimburse victors by shareholder vote.

7) SEC lets the board exclude these types of shareholder proposals from the slate

- a) not appropriate under state law
- b) violation of state law
- c) violation of proxy rule
- d) personal grievance
- e) concerning less than 5% of assets or less than 5% of earnings.
- f) absence of power and authority
- g) if proposal relates to company ordinary business practices (under § 141, the board manages the company, not the shareholders)
- h) relates to an election (if you want to run a slate for an election, you have to run your own proxy)
- i) conflicts with a company proposal

8) In Delaware, if there was an adopted by-law by shareholders, then the board could not amendment it. and also a provision that said agreements by a director to resign from the board if he got a plurality but not a majority is enforceable.

9) There is also something called broker voting. it is rule 452 of the new York stock exchange rule. The rule there is that if you don't hear back is that you can vote. the brokers always voted for the company slate.

10) *Reading:* 177-191 and 217-240

E. **JUDICIAL PROTECTION OF THE VOTE FROM MANIPULATION:**

1) **You cant issue a new class of stock without modifying the charter = requires SH approval**.

2) Management Controlling the Vote

- a) DGCL 160c (pg 190)
  - i. Treasury stock is not voted – stock that is held by the company itself
  - ii. A subsidiary controlled by the company cannot vote its shares
  - iii. These shares are also not counted for the quorum
- b) ***Schnell v. Chris-Craft Industrial Inc*** (Del. 1971) pg 559
  - i. Management wanted to move their meeting up so that the proxy contest people will not have time to get their materials out
    - (1) They had the legal power to do it according to the by-laws
    - (2) But it could be enjoined as a result of the fiduciary duty
  - ii. They cannot advance the mtg because it is done with the intent of "**obstructing the legitimate efforts of dissident stockholders**"
- c) ***Blasius Industries Inc v. Atlas Corp*** (Del. Ch. 1988) pg 560
  - i. Shareholders want to sell assets and have a big dividend and the management did not want to do this
    - (1) Shareholders wanted to expand the board and put their people in to take control
    - (2) Management preemptively puts two new people on the board who support their positions (preventing the shareholders from taking control)
  - **ii.** But even though they were acting in good faith it is an **invalid act since they were trying to impede the shareholders franchise**
  - **iii. Cannot impede shareholder franchise without a compelling reason.**
- d) ***Speiser v. Baker*** (Del. Ch. 1987) pg 191
  - i. Fight over control of a corporation. There was a subsidiary controlled by the two directors of the larger company.
  - ii. Did the structure violate either ***160c*** or a general prohibition against manipulating structures to interfere with the vote?
  - iii. Yes, this was a manipulation of the public shareholders right to vote – no justification/public benefit
- e) ***Hilton Hotels Corp. v. ITT Corp.*;** D. Nev. 1997; argument that board violated obligation
  - i. Facts: ITT stock price low (badly managed); Hilton attempts tender offer; Hilton needed to control board to remove ITT poison pill; ITT put off meeting and split into 3 subsidiary corporations to put in staggered board
  - ii. Court: violates Duty of Loyalty by disenfranchising shareholders (usually used in self-dealing transactions)

3) Vote Buying

- a) **Schreiber v. Carney** (Del. Ch. 1982) pg 199
  - i. One of the shareholders had a large stock and they wanted him to vote for something which would be good for the company, but have bad consequences for him in taxes. In order to induce him to vote for it, they gave him a loan which would offset the loss. Then they subjected the deal to a shareholder vote.
  - ii. Is that okay? Is it vote-buying?

        - iii. The transaction was done for corporate benefit by the board and ratified by the shareholders. The guy was not benefited, just left in the same place as he would have been if the company did not do the deal
            - (1) Look at it first under **fairness standard**
            - (2) Ultimately the court says that the factors lead him to decide under business judgment rule

F. **INSIDERS' DEALING IN THE COMPANIES SHARES:**

- **1) Rule 14(e) says that you cannot have false or misleading statements in connection with a tender offer. 10b5 deals with a purchase or sale. 14(e)(3) is similar and says it shall be unlawful for a person to make an untrue statement or to engage in any fraudulent acts in connection with any tender offer p. 457 in the supp.**
    - a) they are both about fraud, and some courts have accepted the view they should be read similarly. but in the *Chestman* case they didn't.
    - b) It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.
- **2) Common Law Fraud (pg 577)**
    - a) Principle elements
        - i. False statement (actions can be a communicative statement)
        - ii. Material fact (would a reasonable investor rely on it?)
        - iii. Intention
        - iv. Reliance
        - v. Causes injury
    - b) Does not include omission (caveat emptor – buyer beware)
    - c) In a trustee-beneficiary transaction there was an obligation of full disclosure, but in non-fiduciary situations there was no obligation.
    - d) Can an opinion be a false statement? (See Virginia Bankshares above)
        - i. Yes, but difficult to prove that someone did not believe what they said in an opinion.
    - e) **Goodwin v. Agassiz** (MA 1933) pg 578 – **THE OLD LAW**: There was no face to face dealing and the seller was not making a decision in reliance on anything the director said or didn't say. No duty to the shareholders re full disclosure.
- ***3) Section 16. Ban on Short-Swing Profits*** p. 459 Supp.
    - ***a)*** *Disclosures Required*: Directors, officers, and principal stockholders (10% of any class of stock) are required to file with SEC.
        - ***i.*** Must file state of all equity securities, and any changes in ownership.
        - ***ii.*** Can't make short-term (within 6 months) profits on equity purchase of corporation he has a relationship with.
        - ***iii.*** He can't short sell his own stock.
    - ***b)*** Insider trading of **material, nonpublic information** creates a private cause of action against the insider.
- **4) Section 10 of the '34 Act**
    - **a) Elements of 10b-5 claim (private remedy):**
        - i. **Standing**: Π has to be buyer or seller (Δ does not)
        - ii. **Duty**: In omission case, breach of duty to disclose or duty of confidence

iii. **Materiality**: fact question

iv. **Scienter**: guilty knowledge or intent to defraud; failure to disclose information or lies/deception is enough, even if not guilty knowledge

v. **Reasonable reliance**: slight difference b/w misstatements and omissions

(1) *Omissions*: reliance presumed where there is a duty to disclose and matter is material [*Affiliated Youth Citizens v. United States*; U.S. 1976]

(2) *Misstatements*: 2 theories:

a) Some authorities ask *Π to prove* reliance (easy to prove unless Δ can come forward w/evidence that Π didn't rely)

b) *Fraud on the market* theory: reliance on market price alone establishes reliance (market relies on lie and you rely on market, so you're relying on lie even if you never heard it)

vi. **Causation**: 2 aspects; need to be able to show both:

(1) *Transaction causation* – lie had something to do with me going into this transaction; he told me it was good, and I bought; I relied on it and it caused me to act

(2) *Loss causation* – damage suffered had to do with fact that it was a lie (not an external factor, such as market crash); probably affirmative defense, but perhaps element of claim

b) 10b5 is about fraud, you have to have false statements, its not enough to dislike what they did.

c) one of the elements of the 10b5 cause of action is in connection with the purchase or sale of a security. so the federal courts who were really warm for the 10b5 remedy, a case came along where somebody owns stock and there was a transaction, one of the shareholders didn't buy or sell, he just held the stock, and the statement turned out to be untrue, and they tried to use 10b5. you might also have to rely to your detriment. π argued that he would have sold if he knew the true statement, but the court said, no you have to buy or sell, it cant be about holding.

d) **Federal courts have not been open to converting breach of fiduciary duty cases into federal disclosure cases by alleging that a wrong was done but not confessed.**

e) ***Chiarella v. United States* (1980)** p. 663: "**whether a person who learns from the confidential documents of one corporation that it is planning an attempt to secure control of a second corporation violates § 10(b) of the Securities Exchange Act of 1934 if he fails to disclose the impending takeover before trading in the target company's securities**."

i. One of the perks of this printing job was that you get advance notice of deals because you are printing the documents about it. He buys the stock and the SEC prosecutes.

ii. The basic defense here, is that I didn't do anything wrong. I didn't lie.

iii. SCOTUS reverses the conviction. I think it has to do with the Δ not being a corporate insider?? No fiduciary obligation because he wasn't an insider.

f) ***Dirks v. SEC* (1983)** p. 667: dirks is a stock analyst. he got information from a former employee of the company that the company was committing fraud and that Dirks should investigate. He uncovers this fraud and so the SEC indicts him.

i. Dirks argues that he is not a fiduciary of the corporation . SEC says, we don't care, we don't want anyone sharing insider information and facilitating any trades, even if they are not your own.

ii. *Chiarella* would suggest that he is OK, but there is another view, that the insider information came from a fiduciary, and Dirks was a tippee. SCOTUS reverses the court of appeals because "in the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by Dirks"

        - iii. There has to be an inappropriate benefit from the insider information, in that case, the tippee is also bound by duty. Dirks didn't seem to benefit?
        - iv. **Test:** see if 3rd-person (tippee) is standing in the shoes of someone who has a relationship; if there's a breach, then the person to whom it's disclosed takes on the officer's obligation
            - (1) To tell if disclosure is a breach of duty (objective standard); did that officer/director get a personal benefit (directly or indirectly)
        - v. ***Cady, Roberts*** (1961) p. 646: the SEC sidestepped the duty issue by asserting that possession of "inside" information itself gives rise to a duty not to trade on it. But SCOTUS focused squarely on duty in Chiarella, this probably isn't good law.
    - g) ***United States v. Chestman* (2d Cir. 1991)** p. 676: approval of Rule 14e-3 theory. A&P tries to buy out a supermarket, Waldbaums's. The founder, Mr. Waldbaum, tells his wife, who tells her daughter, who tells her daughter, who tells her husband. SEC loses this case.
    - h) ***§ 240.10b5-2 Duties of Trust or Confidence in Misappropriation Insider Trading Cases*** is the response from the SEC to *Chestman*, which they lost.
        - i. What if I have information that is material, and trade on the affected stock, and the SEC prosecutes. Could you say, well, I didn't use it?
        - ii. If you have information, you can, **if you can prove that you didn't rely on it or use it**, you can do trade anyway. that's ***10b5(1)(c)(1)(i)***
    - i) ***United States v. O'Hagan* (1997)** p. 681 Δ is a lawyer, he gets insider information and buys call options for the stock, Pilsbury. His client is a company that wants to acquire Pilsbury.
        - i. "**criminal liability under § 10(b) may be predicated on the misappropriation theory**."
        - ii. the **misappropriation theory** says that a person commits fraud "in connection with a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information".
        - iii. They seem to adopt the dissent in Chiarella
- 5) ***SEC v. Texas Gulf Sulphur Co.* (2d Cir. 1968)** p. 647 directors bought stock in their own company and there was some sort of press release.
    - a) In somes cases there is an implied right of action, but lately the courts have curbed this, especially in the Rehnquist court. That was *Court v. Ash* in 1975. They saw courts creating lots of implied cases of action, even where its not clear there was meant to me. So, the court requires some evidence that Congress intended a private right of action.
- 6) ***Santa Fe v. Green*** (1977) p. 653: involves the reach and coverage of §10(b) of the 34 Act and Rule 10-b5 in the context of a Del. short-form merger. Court says there is no deception or manipulation here, either the minority shareholders accept the offer, or they get a Del. appraisal remedy. Second, since there does exist a Del. appraisal remedy, it seems unlikely that this statute is has a private right of action for these types of cases since there already a remedy for the minority SH.
- 7) When the information is material, you have to disclose or abstain. would a reasonable person attribute significance?
    - a) ***Basic Inc. v. Levinson* (1988)** p. 686. fraud on the market theory
        - i. Theory: people rely on market information, and are injured even if unaware of information
        - ii. one of the elements of fraud is that you have to rely on it. if there is a misstatement, and you don't rely on it, then its not fraud.
        - iii. There is an assumption that a person buying in the market, that they are relying on the market as a price that is effected by full information.
        - iv. There is an important scienter element in the claim, the intent to defaud. the last of these elements is loss causation. SCOTUS decides Dura Pharmaceuticals which reaffirmed that loss causation was important.

        - v. **“an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote”**

8) Hypo: The board gives permission for someone to make an insider trade as compensation for their services. in this case, they aren’t wronging the company.
    - a) We should know that fiduciary duty is nonwaivable. The SEC would be all over it. but its unclear whether they could get away with it.

VIII. FIDUCIARY DUTIES OF THE CORPORATE DIRECTORS

A. Two Standards for the Directors: Objective (a) and Subjective (b)

1) **Model Business Corporation Act (1984) § 8.30 Standards of Conduct for Directors (This is the law nowhere) p. 298 Supp**

   (a) Each member of the board of directors, when discharging the duties of a director, shall act: **(1) in good faith, and (2) in a manner *the director* reasonably believes to be in the best interest of the corporation.**

   (b) The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, **shall discharge their duties with the care that *a person in a like position* would reasonably believe appropriate under similar circumstances.**

   (c) & (d) lets directors rely on the performance and information of others who the board delegates. p. 289 supp.

   (e) Defines who those people are that the board can delegate to.

2) The duty of care is essentially a duty for people who want to be good people. And most directors want to do the right thing. Reputation is at stake. It's not really enforceable, but it's a guide.

B. THE FIDUCIARY DUTY OF CARE:

1) Business Judgment Rule

- a) Courts wont infer negligence from the decision itself. They wont say "this is so bad that it implies you weren't careful enough"
- b) Instead, **courts look at the process taken**. They don't have expertise when it comes to business. If they say a decision was absurdly ill-informed, they're really substituting themselves for directors. **If the process looks rational or regular, that's usually enough.**
- c) Board members don't get much upside to risky behavior. If you made them liable, they would take no business risks at all. Shareholders should be diversified to withstand some risk.
- d) ***Gagliardi v. Trifoods International, Inc.* (Del. Ch. 1996)** p. 243: "what must a shareholder plead in order to state a derivative claim to recover corporate losses allegedly sustain[ed] by reason of 'mismanagement' unaffected by directly conflicting financial interests?"
  - i. "in the absence of facts showing self-dealing or improper motive, a corporate officer or director is not legally responsible to the corporation for losses that may be suffered as a result of a decision that an officer made or that directors authorized in good faith."
- e) There is a theoretical exception... some decisions may be so 'egregious' that liability for losses they cause may follow but it's never resulted in an award to a π.
- f) ***Kamin v. American Express* (N.Y. 1976) p. 252**: AmEx buys a company and the value of the company plummets. There was a derivative action because they opted to distribute shares as a dividend, and the π alleges that if they had just sold it, it "would result in tax savings to the company of approximately $8 million, which would not be available in the case of the distribution of DLJ shares to stockholders."
  - i. The court says that mere **errors of judgment are not sufficient as grounds for equity interference, because the powers of the directors are discretionary**.
  - ii. π calls it corporate waste, which would be a bargain that no reasonable person would make. You'd have to challenge good faith to get past business judgment.
  - iii. **Remember: good faith is questioned in process by the court, not by results.**

2) D& O Insurance (Directors and Officers Insurance): the company buys it, and it's a company asset. In bankruptcy it can be a problem. If a bankruptcy occurs prior to the time the suit occurs, the D&O insurance is an asset of the bankrupt estate. The trustee in bankruptcy may liquidate the D&O insurance to pay creditors. ouch, that could hurt.

3) Indemnification

- **a) Delaware General Corporation Law § 145 Indemnification of Officers, Directors, Employees and Agents; Insurance** p. 177 Supp
  - **i.** (a) A corporation *has power* to **indemnify any person** who was or is a party or is threatened to be made a party to a suit if they are a director, officer, employee or agent of the corp. if they **acted in good faith and in the best interests of the corporation and had no reasonable cause to believe the person's conduct was unlawful.**
    - **(1)** The process of the action serves as a proxy for finding good faith.
  - **ii.** (b) A corporation has the *power to indemnify* a director, officer, employee or agent of the corp for **expenses incurred in connection with the defense or settlement of a suit** if the person acted in good faith, reasonably believed to be in or not opposed to the best interest of the corporation, **except when the person is liable to the corporation (so no derivatives) and only to the extent that the Court thinks that the person is fairly and reasonably entitled to indemnity for such expenses.**
  - **iii.** (c) "To the extent that a present or former director or officer of a corporation has been **successful on the merits or otherwise in defense of any action**, suit or proceeding referred to in subsections (a) and (b) of this section, or in defense of any claim, issue or matter therein, such person **shall be indemnified** against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection therewith."
  - **iv.** (d) indemnification under subs (a) and (b) only upon determining that the person met the applicable standard of conduct:
    - **(1)** if they are a current director or officer (1) by majority vote of the directors who were not parties to such action, even if less than a quorum, or (2) by a committee of such directors designated by majority vote of such directors, even if less than a quorum**,** or **if there are no such directors**, or if such directors so direct, by independent legal counsel in a written opinion, or (4) by the stockholders
  - **v.** (e) Corporations can indemnify their directors in advance as long as director pays the corp back if it turns out that he is not actually entitled to indemnification.
  - **vi.** (g) Corporations can purchase D&O insurance for directors, officers, agents, etc., whether or not corporation would have the power to indemnify.
- **b) § 141(e)** (p. 174 Supp.):"A member of the board of directors or a member of any committee designated by the board of directors, shall, in the performance of such members' duties, be **fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees**, or committees of the board of directors, or by any other as to matters the member reasonably believes are within such other person's **professional or expert competence** and who has been selected with reasonable care by or on behalf of the corporation."
- **c) *Waltuch*** case (2nd Cir. 1996). p. 245: success grants indemnification
  - **i.** Facts: civil suit settled, criminal suit settled for $100k @ $2.2M legal fees
  - **ii.** Court: no good faith for §145(a); good faith requirement read into §145(f) (permissive indemnification); 'success' under §145(c) sufficient, so settlement suffices

4) Waiver of liability for due care

- a) ***Smith v. Van Gorkom*** p. 257.: Van Gorkom brought in modern M&A law in 1985.
  - i. TransUnion had a large tax loss carried forward. It was very valuable but only if you were making enough to set off against it. One way to monetize this asset is to merge the company with someone who is making money and they can use the tax credit.
  - ii. Van Gorkom sold the company and the board approved it and shareholders brought suit.
  - iii. **it was the first case where board had attended meetings, followed process, and were held to be grossly negligent for not informing themselves more about the merger**

before approving it. the D&O insurance rates went way up and for a while people wouldn't serve on boards of directors.

    iv. That's when they changed the law to protect directors more.
    v. DE legis passed stat saying that shareholders can put clause in charter saying directors will not be liable of breach of duty of care but you cannot waive duty of loyalty or good faith. Del 102(b)7.

5) ***Francis v. United Jersey Bank*** **(N.J. 1981) p. 264**: a trustee in bankruptcy brings suit against Mr. pritchard's estate for her lack of directorial oversight. Their sons are really stealing from this company. The suit is against mom for doing nothing and taking no real interest in the company. You have a continuing obligation to monitor management and you have to either learn the business or resign, and have to attend the meetings.
    a) This case is a cautionary tale about what the director has to do. Usually a director can protect herself by voting against something and recording protest.
6) ***Graham v. Allis-Chambers Manufacturings Co.*** (Del. 1963) p. 269: this is a really big company with many separate compartments. The company was price fixing but the board was far removed. they didn't set the price. the theory against the directors was that they should have known from the consent decrees form the 30s and that the board should have been more vigilant. the court said no. the court said that the board is entitled to trust their employees and that there wasn't really notice. π argued that there was a red flag that should have put them on notice. but the court said no.
        a) Creates an incentive to make sure your company IS de-centralized.
7) **The Delaware Approach**: ***Cede v. Technicolor (1993):*** The court said that immaterial conflicts don't matter. If they are really immaterial, they won't affect the decision making. If they are immaterial to a reasonable person AND immaterial to THIS person, then it shouldn't matter.
    a) **That's the test. Both immaterial to a reasonable person AND to THIS PERSON**.
    b) S.Ct. reversed Allen "breach of the duty of care, without any requirement of proof of injury, is sufficient to rebut the biz judge rule...Breach of either the duty of loyalty or the duty of care rebuts the presumption that the directors have acted in the best interests of the shareholders"
8) Passivity: Caremark and the duty to monitor management
    a) ***In Re Caremark International Inc. Derivative Litigation*** (Del Ch. 1996) p. 282: IT was a motion to approve a settlement.
        i. Boards should have a duty to get information and monitor –
            (1) Must put in place information gathering mechanisms (280)
            (2) Only a sustained or systematic failure of the board to exercise oversight will establish lack of good faith (pg 281)
    b) ***In the Matter of Michael Marchese*** **(SEC 2003)** p. 276: a director of Chancellor decides it would be best to consolidate accounting between their company and a company they acquired.
        i. Marchese was on the audit committee, and he knew the auditors were fired. and it's a big deal to fire auditors. the SEC requires that when auditors are fired, a filing is required.
        ii. His duty was to talk to the auditors abt why they left, and when the new auditors said it was OK to consolidate, and check with what is going on. Marchese got in trouble for signing this form that verifies something that isn't right. He should have resigned instead.
9) **Hypo**: **If you have to bribe someone to get a license to do business. Should you do it?** There is one view that the penalty is just a fee that is calculated in the cost of doing business (% change of getting caught * fine + cost of license = true cost of license).
    a) I argued that systemically, where bribery is pervasive, you don't want everyone to resist, otherwise you'd get no development either. If it's really important, up the fines.
    b) You have to really calculate the true cost of the violations, and it's not just the cost of the fine.
    c) The probability of getting caught matters. But I only see how that affects the cost of the fine, not the ethics of it.

        - d) Allen also says though that the directors don't want to put their personal reputation on the line for an activity like that.
        - e) I think you also have to consider that taking a big hit in profit needlessly can result in having to lay people off. So, that confuses the right and wrong of it.
    - 10) *Reading:* 260-292

C. **THE FIDUCIARY DUTY OF LOYALTY:**

- 1) The obligation to exercise all power in a good faith effort to advance the purposes of the corp.
- 2) Duty of Loyalty cases often come in the form of derivative suits.
- **3) We could probably fairly divide loyalty issues into two types:**
    - a) conflicts of interest (this section of the outline)
    - b) entrenchment, preservation of the current board's power (discussed more in the M&A section)
- 4) You need **disclosure** and the transaction was **fair**.
- 5) **TEST: In a self-dealing transaction, the transaction MUST BE ENTIRELY FAIR**.
    - a) has to have a **fair PRICE**
    - b) AND a **fair PROCESS**. -> that includes **disclosure**.
    - c) These two things are not entirely independent of each other.
- **6) Safe Harbor Statutes**
    - a) ***Del. Gen. Corp. Law § 144. Interested Directors; Quorum***
        - i. A contract or transaction is not void or voidable because of interested directors as long as:
            - (1) The material facts as to the directors relationship or interest are **disclosed or known to the board**, and **the board in good faith authorizes the contract or transaction by a vote of the majority of disinterested directors**, even though the disinterested directors are less than a quorum. OR
            - (2) The materials facts about the director's relationship or interest are **disclosed or known to the shareholders** entitled to vote on it, and the transaction is **approved in good faith by vote of the shareholders**; OR
            - (3) The contract or transaction is **fair as to the corporation** as of the time it is authorized by the board or the shareholders.
    - **b) 144 says no K or transaction in a corp shall be void or voidable solely for the reason that dir or officer is present or participates if: 1) disclosure or 2) sh vote or 3) its fair.**
    - c) without that statute, every self-interested deal would be void. so the statute always applies.
    - d) if you have K between director and corp and its approved by independent directors, then its presumptively valid. its still voidable, but not automatically void. but if its not disclosed, its voidable. it always has to be made honestly on full information.
    - e) if there were a number of directors involved in a self-dealing transaction, in CL that said interested dir cant be counted as a quorum, you could never have the K correctly adopted, because it would always be voidable. so, this just said not that its OK in this case, but just that its not automatically void.
    - f) what happens if you meet the safe harbor statute? it just means its not voidable, but the courts are going through a similar kind of analysis. so we know in parent-sub transactions, if you go through a process where the material facts are disclosed to an independent committee of the board, and it looks like it has integrity, then you flip the burden on entire fairness to the π.
    - g) in Ks with a single director, if you have disclosure and no problematic fact, and a transaction that doesn't look like a "bet the company" transaction. if the biggest asset in the company is sold to a single director, and there are no other suspicious circumstances, they will say self-dealing transactions require fairness.
    - h) but if it's a single director and its not hat important of a transaction, its biz judgment.

7) ***Hayes Oyster v. Keypoint Oyster Co.* (Wash. 1964)** p. 302: Company is struggling, so he sells some oyster beds to an employee and helps to set him up in business. But what the Coast board didn't know, was that Hayes, CEO's other company was a partner in the employee's company.
   a) **The court said Verne was wrong for not disclosing.**
   b) You don't want the court saying whether someone did or did not get a fair price. you just want to make sure that board got a chance to make an **informed decision**. So, the court is just trying to find fairness, but **disclosure is part of what fairness means**.

8) ***Sinclair Oil Corp. v. Levien* (Del. 1971)** p. 307: Sinclair owns a subsidiary and had them paying unusually high dividends. The minority shareholders sued by arguing that the dividends were so high that they missed out on other opportunities. The court was unimpressed because the minority shareholders were getting the benefit of the dividends too. The corporate model limited Sinven to operations in Venezuela, took the dividends, and re-invested it in other operations.
   a) **It is not self-dealing if everybody is treated the same**.
   b) They don't cite this case very much, and it's old, and it's not clear that this is still good law.

9) ***Cookies Food Products v. Lake Warehouse (Iowa 1988)*** p. 312
   a) Herrig is the driving energetic force and a minority investor in this company. He makes it successful when it was not otherwise, and he buys majority stocks eventually. He then sets up the business to work through his other businesses and the minority shareholders are mad because they aren't profiting from them.
   b) But Herrig did disclose everything, he's grown the business, he is working hard at it. They don't put the burden on Herrig to demonstrate that it was fair, they just ask him to show that the business is successful.
   c) the case stands for the proposition that you always have to have fairness in a self-dealing transaction. And the burden is always on the self-dealing party.

10) ***In Re Wheelabrator Technologies, Inc* (Del. Ch. 1995)** p. 325: Conflicted transactions &The effect of approval by a disinterested party
   a) wheelabrator went through an analysis that said SH ratification has different affects depending on the nature of the claim being made. so if SHs ratify a claim that is a negligence claim or breach of duty of care claim, that essentially stops the matter. if SHs ratify a duty of loyalty claim, it shift the burden over.
   b) "[I]n only two circumstances has the Del. Sup. Ct. held that a fully-informed shareholder vote operates to extinguish a claim":
      i. where board action is claimed to exceed it's authority
      ii. failure to exercise due care
   c) Shareholder vote does NOT extinguish breach of loyalty claim against directors.
   d) Two kinds of ratification decisions:
      i. "interested" transaction between a corporation and its directors
         (1) Approval by informed, disinterested shareholders pursuant to §144(a)(2) invokes biz judgment.
         (2) Limits claims to gift or waste and puts burden on π
      ii. Interested transactions between a corporation and its controlling shareholder
         (1) **In a parent-sub merger, review is "entire fairness, with the directors' burden to prove that the merger was entirely fair.**
         (2) **But where the merger gets a vote by "majority of the minority" Shareholders, the standard of review remains fairness, but the burden shifts to π to show it was unfair.**

11) Evolution of Special Committees of the Board
   a) The Audit, Compensation and Nominations committees should be made up entirely of outside (non-affiliated) directors.

12) **The Corporate Opportunity Doctrine p. 351**
   - a) ***AMI, Principles of Corporate Governence § 5.05 Taking of Corporate Opportunities by Directors or Senior Executives*** **(p. 372 of the supp.)**
      - i. As long as there is **full disclosure** at the beginning and you do it contractually, it is more permitted where it might otherwise be self-dealing.
      - ***ii. Expectancy Test***: must grow out of an existing legal interest and the appropriation will "balk the corp in effecting the purpose of its creation."
      - ***iii. Line of Business Test***: any opportunity falling within a company's line of business is its corporate opportunity.
         - ***(1)*** *how did the matter come to the attention of the agent?*
         - ***(2)*** *how far removed from the "core economic activities" of the corporation?*
         - ***(3)*** *whether corporate information is used in recognizing or exploiting the opp?*
      - ***iv. Fairness Test***:
         - ***(1)*** *how did the manager learn of the opportunity?*
         - ***(2)*** *did they use corp assets to exploit the opportunity?*
         - ***(3)*** *good faith, plus line of business*
      - v. Going to the board is the best practice, because you don't want to unilaterally decide that you are covered and can take the opportunity.
   - b) ***In Re Ebay, Inc. Shareholders Litigation*** **(2004)** p. 353: Ebay directors took IPO opportunities from Goldman Sachs as reward for giving GS business. SHs sued because Ebay was in the "line of business" of investing as part of their business model. π's win.
      - i. Allen is not convinced they are in the business, but rather the fiduciary was obligated to exercise good faith in who to do business with regardless. GS creates a conflicted dir.

13) ***§5.06 of the ALI principles of corp gov***.: it's a breach of loyalty to compete with the corporation.

14) **Director & Officer Compensation**
   - *a)* paying your managers big $'s is a self-dealing transaction, but it aligns their interests with those of the corp, and *helps the corp. Its going to be self-dealing so matter what.*
   - b) One proposal is that the compensation committee be made up of independent people, instead of multiple comp committees made up of members who sit on each other's committees.
   - c) They tried compensation consultants, but they weren't really independent. so now they are treated more like outside auditors. They put more emphasis on the independence of the auditor. None of this has brought compensation down though.
   - d) Institutional Investors: withholding the vote on Compensation Committee members
   - e) ***Disney*** p. 342: Disney had a big issue with Michael Eisener not having a number two person. His board was very weak. He didn't want a person with big statute standing next to him.
      - i. In that situation, they got a guy who left his own profitable company and negotiated that if he gets fired without cause, he gets all of his options vested. but then there could be an incentive to nitpick anything that goes wrong. but that's what the biz judg rule is for.
   - **f) What are the goals of compensation policy?**
      - i. Recruit good people
      - ii. Motivate people to do good work; incentivize productive behavior
         - (1) But how do you *measure* "productivity"?
         - (2) Production is almost always a *team* effort
   - g) Stock Options
      - i. You get the option to buy 100,000 shares of the company at the current market price --> Now you have 500,000 reasons to raise the stock price $5
      - ii. These are often approved by board and ratified by shareholders
      - iii. As in the *Ovitz* case, if you're fired *without cause*, some deals vest it all immediately
      - iv. Also, companies say that you can't *swap or sell* your stock options (as this would eliminate

    the incentive)
  - v. It's a very *one-way* incentive. If the stock goes up, you win. If the stock goes down, you haven't lost anything.
  - vi. Often, if your corp is taken oven, all your stock vests. Because big company will pay a premium, CEO will get TONS. Incentive to do M&A stuff
- ***h) Lewis v. Vogelstein***
  - i. "I read these old cases and tried to figure out what the hell was going on, and once I figured it out, I wrote it down so noone else would have to look at those cases."
  - ii. Test appeared to be: "sufficient consideration" and steps to "insure that consideration will in fact pass to corp"
  - **iii. CURRENT TEST**
    - (1) If disinterested, independent committee approves, plus *ratification* by shareholders on full information
    - (2) If good process --> BJ rule
      - a) "Waste" standard
      - b) A Tx that *no reasonable person could agree to*
- i) Is there a justification/explanation?
  - i. "CEO skill" --> CEO skill is rare, and CEOs manage lots of assets
  - ii. If you look at the *size* of US Corps since 1960, and extrapolate based on the size of the company, real CEO pay hasn't changed all that much.
  - iii. If a CEO makes a 1% increase in the value of the company, that's worth a hell of a lot more today than 40 years ago.
  - iv. In contrast, the skill of shop-floor workers does not have to vary with the size of the company, AND globalization keeps shop-floor workers wages down
  - v. My view: CEOs are replaceable. The company profits come from EVERYONE’s work, not just the smallest fry.

IX. MERGERS AND ACQUISITIONS

A. Three ways to get control
   1) **Statutory Merger:** A merger is when two companies become one surviving company.
   2) **Sale of all assets**: In an acquisition, have to acquire all or substantially all of the assets
   3) **Tender Offer**: Buy a majority of the shares, and then you can control the board

B. Once you have control
   1) Cash-out Merger
   2) Two-Step, Back-end Offer

C. **What can a merger accomplish?**
   1) A merger is a low-cost way of changing the ownership structure of productive assets, to bring assets together for common management or to overcome bad management.
   2) Three economies:
      a) scale
      b) **scope**: Diversification is one reason for merger. It's is a dubious motive when shareholders can very easily diversify their own portfolios without having to merge.
      c) **vertical integration**? p. 454
   3) There can be bad motivations for mergers:
      a) There are agent/principle problems with mergers.
      b) There are potential problems with the merger negotiations in terms of information sharing. you need information to know that its not a lemon, but if the deal doesn't go through, then they know too much about you.
   4) There are often exclusivity agreements
      a) For breaching an ExAgreement: since you don't have a contract yet, what can a court enforce? You promised to only deal with me for 3 months, but then you dealt with someone else. a court can force you to deal with me.
      b) For a breach of exclusivity agreement, you can get damages, but only damages that you can really show. like legal fees and other costs. MAYBE you could show loss of an opportunity. you can really only get reliance damages, and not any potential gains from the contract.

D. There are both hostile and friendly merger deals. A friendly deal is one where the target company agrees to the transaction. Their motivation is payment. Getting bought out ain't so bad.

E. **parent-sub merger, majority must offer a fair price.**

F. **in a tender offer, the majority is not obligated to make a offer price, as long as not coercive and disclosure.**

G. **Structure of Acquisition Agreement**
   1) You can get an agreement on price in principle, assuming there is no new shocking information.
   2) Article 1: a statement about who the parties are, and what the basics structure of the deal is.
   3) Article 2 is reps and warranties. what is that? what is the difference between a rep and a warranty? no one really knows. the first is a statement of fact, the other is a promise.
      a) You can have little changes in the reps and warranties, but the changes together, cannot be materially adverse. then you have other reps like that all SH and board formalities occurred.
   4) One of the things that the buyer is always worried about is being outbid. So, he tries to do various things to put impediments to keep other potential buyers from stepping in. And the Delaware Court have made it HARDER to lock up a deal at the signing of contract.
   5) The buyer will ask for a promise not to deal with other people, and the courts have said its very important for the board to be flexible. So the board can say yes, but, I need a **fiduciary out**. They can promise a "no shop", which means they wont shop for someone else. but if the lawyers say, I have a fiduciary obligation to talk to someone, then I can talk to someone. That's a fiduciary out.

6) You have a drop dead date where you need government and shareholder approval. so you make an estimate of what time you need to get everything approved, and if you don't have them by that time, then both parties can walk away.

7) Termination payments.

  a) Courts have been very active in trying to constrain these fees. Buyers want them. in the 80s term fee were 2%, but they kept getting higher. at some point,a del judge said that 6% was absurd, and no one tries for more than that. Nowadays, they are stepped, the deeper into the deal, the higher the term fee.

  b) There is also something called reverse termination fees.

8) In some contracts, there is an indemnification article, it's a contractual obligation to pay damages. you don't see them in public deals because of the shareholders. after I close the transaction and I find out that some of the reps and wars were not true, then you have an obligation to pay my damages. you don't see them in public deals because who is going to pay? not the target shareholders

H. **Statutory mergers**

1) Consummated when *certificate of merger* filed with Secretary of State; requirements:
  a. Shareholder vote: 50% of outstanding shares (not just voting shares)
  b. Consideration: can be other stock, bonds, cash, etc.; can do cash-out or freeze-out merger

2) How to do merger:
  a. Negotiate / get information – **Keep it fair!**
  b. Merger agreement [ex, 443]; exception list: representations and warranties [446]
  c. **Board recommendation to shareholders- Required!**
  d. Shareholder vote **SOMETIMES (§251(f)**)

3) § 251. *Merger of Consolidation of Domestic Corporations and Limited Liability Company*
  a. **DGCL § 251(f)** says you don't get a shareholder vote in a merger, as long as it doesn't 1) amend the charter 2) change any outstanding stocks 3) issues more than 20%.
  b. Shareholders of each corporation vote; majority of outstanding stock needed
  c. Appraisal rights available if you 'no' vote, and the payment is in cash, not shares.
  d. No vote necessary by large company SH when absorbing small company (<20% of value)
  e. If a company issues too much of the stock, or if they have to change the charter in the merger, then you have to have a shareholder vote. under sec. **241**, you need a shareholder vote to change the charter.

4) *§ 252. Merger or Consolidation of Domestic and Foreign Corporations;*

5) § 253: *Merger of Parent Corporation and Subsidiary or Subsidiares*. this is the short-form merger statute, that is **when a controller has 90%** already, you can do the merger without vote of other shareholders, and the other shareholders just have a right to appraisal.

I. **Triangular mergers**

J. **Law of Sale of all assets**

1) ***Katz v. Bregman*** (abt p. 460): it was about 50% of assets can called that substantially all of the assets. But it was unclear how 50% of the assets mean substantially all. That seems to be the limit.

2) *Jennings* case, p. 107
  a) Is it reasonable to assume that a VP/Exec comm can authorize sale of all the corp's assets?
  b) No. If he's a lawyer, he knows that only the *board* has this kind of power

3) **DE law §272**: Mortgage or pledge of assets --> **Requires board approval *and* shareholder vote**

4) **Successor liability:** Transfer of tort liabilities to successors. There was an example of a company that made valves that sometimes exploded, they dissolved the company and it was bought out. and sometimes the valves still exploded. the new company's valves still exploded and got sued for the old companies torts, and I think he says that they found that the new company had successor liability. Once business make a deal, they really want to get it closed before any other information comes out.

K. **De Facto Merger Doctrine:** sale of assets, when they have the economic effect that should be accorded a voting right if it were a merger, should be accorded the same legal rights when it's a sale of assets. Those rights might be a right to vote or an appraisal in some states (PA), but in Del. its just the appraisal???

L. **SHAREHOLDER PROTECTIONS IN MERGERS**

  1) The *Weinburger* form of action is more appealing than the appraisal action. In *Weinburger*, the burden is on the self-dealing defendant who has to show that he was dealing fairly. so, class action suit is more attractive than the appraisal. **THAT SHOULD BE MENTIONED IN THE EXAM.**

  2) When a company B is being acquired by company A, B shareholders vote, but A shareholders only get to vote if the company is issuing more than 20% of its stock. It's also the DGCL.

  3) Self Dealing standard in parent sub mergers

    a) ***Weinburger v. UOP, Inc.* (Del. 1983)** p. 499: **The duty of loyalty in controlled mergers**.

      i. Company is trying to merge with a subsidiary, pays $21 per share to the minority shareholders, and gets sued.

      ii. So UOP/Signal directors were completely loyal to Signal, but not to UOP.

      iii. You should never say yes in advance like the way the CEO of UOP did. He might have gotten a good deal, but the court thinks they should have gotten something better.

      iv. The key problem is that they used UOP information to find out how much they should want to pay, and then didn't disclose that information. The court didn't like that.

      v. **The court simultaneously wanted Signal to have real arms-length negotiations AND also disclosure of all of their knowledge about UOP**. Weird!

      vi. In footnote 7, the court says that **UOP could have appointed an independent committee.**

      vii. In all parent-subsidiary mergers, all synergy gains have to go to the subsidiary. That is the result of this kind of opinion. Its not a good rule.

      viii. You can bring a class suit if you're forced out in a parent-subsidiary merger: **there is a fairness rule. its gotta be fair when its self-dealing, and that includes disclosure.**

      ix. where a controlling parent does a parent-subsidiary merger, where a controller controls whether the transaction will occur and the terms of the transaction, you have to prove that its entirely fair. fair process, fair price, etc. you have to prove it, its your burden!!!!

    b) **Who is a controller?** if you're on the board and have 25% of the company: a controller?

      i. **there are two tests:**

        (1) a legal test, do you have 51% of the vote -> formalist

        (2) a factual test, do you have actual control? -> functionalist

        (3) Those are two tests, so make you sure you do the analysis. in fact, someone can control with 15 or 20%.

    c) **Is there any process that can demonstrate to the court that it's a fair transaction**?

      i. one way is to have a committee of independent directors. but did they act in a way that this process was not a charade?

      ii. The court is always looking to make sure that there is a good process and not just good theatre. did they have independent bankers and lawyers and a real negotiation?

      iii. if there is a real negotiation, then the court would like to give **business judgment.** but if your independent committee is just subject to being replaced by the board, then maybe its not so independent.

      iv. if the process looks good, then the court says to the plaintiff, you have the burden to show its fair. but if the process doesn't look so good, then the board will have to show fairness.

    d) **Cook v. Ollie**

      i. Directors were also creditors, and did a deal that helped themselves as creditors more than it helped the corp.

ii. **THE DIRECTORS CAN'T SOMETHING THE SHAREHOLDER IS NOT.**

iii. Court eventually ok'd it, because most of the directors were independent and disinterested.

4) **Appraisal remedy in arms-length mergers** (or cash-out?)

a) **Three Steps in a Delaware Appraisal**

i. *Preserve the Appraisal: §262(d)(1)* says that you have to preserve the right to appraisal before voting on the merger.

ii. *Exercise the right to Appraisal: §262(d)(2)* says that if the merger is approved, you notify the board that you want an appraisal.

iii. *Bring the Appraisal*: You then have to bring it to court to get the court to appraise the shares.

b) **In a cash-out merger, you can get an appraisal if you dissent. But not if you're getting stocks.** It doesn't totally make sense, but that's the rule.

c) In Sale of All Assets, Delaware doesn't give an appraisal remedy.

d) If you don't like a merger between company A and co B, then you can just sell the stock. Otherwise, you do one of two things:

i. you start to try to generate some enthusiasm to get others to vote against,

ii. you get an appraisal remedy.

e) ***DGCL § 262. Appraisal Rights*** (paraphrased)

(a) Any stockholder who holds shares on the date of the making of a demand, who continuously holds them through the effective date of the merger, who has otherwise complied with sub (d) and **who has "neither voted in favor of the merger nor consented thereto in writing pursuant to § 228... shall be entitled to an appraisal by the Court of Chancery of the fair value of the stockholder's shares of stock"**

(b) Appraisal rights are available for *any* shares effected to a merger by §§251, 252, 254, 257, 258, 263, 264. (except not by 251(g)) WITH CAVEATS:

(1) **No appraisal rights for classes of stock that are (i) listed on a national stock exchange** or (ii) held by more than 2,000 shareholders; and **no appraisal rights for shares of surviving corporation's stock if the merger did not require a shareholder vote**.

(2) Notwithstanding, You DO get appraisal rights if your payment for such stock is anything other than:

a. Shares of stock of the surviving corporation or corporation resulting in the merger;

b. Shares of stock of any other corporation, and those shares listed on a national stock exchange or held by more than 2,000 SHs.

c. & d.: cash or stock in lieu of fractional shares that also meet a. & b.

(3) **Appraisal rights are available in a parent-sub merger where the parent doesn't own 100% of the sub before the merger.** (When minority SHs are getting pushed out)- **includes close mergers.**

(c) Corporations can put in their incorporation certificate that SHs get appraisal rights when the charter is changed, it merges, sells all assets. If its in the Corporate charter, then you follow (d) and (e).

(d) Appraisal rights shall be perfected as follows:

(1) "... **Each stockholder electing to demand the appraisal of such stockholder's shares shall deliver to the corporation, before the taking of the vote on the merger or consolidation, a written demand for appraisal of such stockholder's shares**..."

(2) If the merger is approved, the shareholder then has to demand an appraisal on their shares.

(f) There are also notice requirements.

- **f)** **Market out**: another name for withholding appraisal in stock-for-sock mergers when shares are publicly traded, but allowing appraisal in cash-out mergers.
- **g)** **Valuation techniques for statutory "Going Concern Value":**
  - **i.** Statute says you value on "going concern value", which is what a company is worth without doing the merger.
  - **ii.** **Two Valuation Methods**
    - (1) Traditional Delaware "Block" method: no longer used but the appraiser would assign a weight to each of these values and added them to get a weighted value.
      - a) *Past earnings*
      - b) *Market Price*
      - c) *Asset Value*
    - (2) Modern Valuation—Discounted Cash Flow
      - a) While the block method mostly looked backward at the valuation of existing shares/assets/earnings, the modern method considers *future* earnings.
      - b) In *Weinburger v. UOP*, the Del. Sup. Ct. abandoned the "block method" and said to look to elements of future value provided that there is some proof.
      - c) Can't be speculative future earning, has to have some proof.
  - iii. **If the company would go bankrupt and be worthless without the merger, then the appraisal value would be nothing or very little**, BUT one element of going-concern value could be the possibility of a future synergy (merger) gain.
  - iv. ***Vision*** case, where they are arguing over whether or not to discount the debt as a calculation of the value of the company. the Δs win, because even though they got the debt discounted, that is because of the merger, without the merger that the πs are resisting, the debt would be worth face-value because creditors have a full right to demand that amount.

5) **Procedural protections: special committees and their Effect.**
- a) If parent-subsidiary mergers are approved by a good independent committee, it will transfer the burden from the defendant to the plaintiff. That is a hard and fast rule articulated by allen.
- b) Will respect (1) special committee or (2) decision of *disinterested board* when it's only one director who's interested (UNLESS that one director is someone who can wield a lot of authority - CEO, e.g.) (we prefer *outside directors*)
- **c)** ***Kahn v. Lynch***
  - i. Contr. shar. has burden of proving fairness in conflicted deal – approval by informed maj. of min. shar.'s or independent committee of dir.'s will shift burden to pl. if committee can negotiate at arms length & maj. shar. doesn't set terms of merger
  - ii. Here committee was dominated by maj. shar. so burden still on def. to prove fairness
  - iii. Seems like spec. com. doesn't have a lot of power, not like arms length negotiator – can only say no to deal – but a no from com. = powerful signal to court that deal wasn't fair
  - iv. In Kahn com. orig. said no then agreed when maj. shar. threatened tender offer – A says court didn't like this.

M. TENDER OFFERS AND DEFENSES AGAINST THEM

1) What is a tender offer?
- a) ***Brascan Ltd. v. Edper Equities Ltd.*** (SDNY 1979) p. 445 test for de facto tender offer:
  - i. *active and widespread solication of public shareholders*
  - ii. *the solicitation is made for a substantial percentage of the issuer's stock*
  - iii. *a premium over the prevailing market price*
  - iv. *the terms of the offer are firm rather than negotiable*

        v. *whether the offer is contingent on the tender of a fixed minimum number of shares*
        vi. *whether the offer is open only for limited period of time*
        vii. *whether the offerees are subjected to pressure to sell their stock*
        viii. *whether public announcement of a purchasing program preced or accompany a rapid accumulation*

2) **Why is there no entire fairness review for tender offers and second stage mergers after tender offer?**
    a) the notion of tender offer is as long as its not coercive. a common coercive tactic is that once the tender offer closes, the company won't give dividends any more. once that happens, you have to give a fair price? fairness review wouldn't real work, because there isn't a negotiation, there is just an offer.
    b) but normally, no fair price required, because there isn't a fiduciary on both sides. as long as no coercion, its treated as voluntary.

3) **1968 Williams Act: Section 13 & 14 Disclosure.**
    a) Look at the tender offer regulations as the first step in a series of defensive responses.
    b) Management was nervous about the prevalence of overnight tender offers. That's how the Williams Act came about. It said a tender offer has to last 20 days, so it can't be hurried. It gave management a role in advising the shareholders in what to do.
    c) ***Rule 13(d)*** If you acquire more than 4.9% has to make filings with a lot of information.
        i. identity of acquirer
        ii. source and amount of funds used in making the purchase.
        iii. any plans to acquire or control the company
    d) ***Rule 13(e)*** regulates when a tender offer by another person is pending, there is some sort of document that has to be filed?
        i. *13e(3)* the disclosure requirement of federal law.
        ii. ***§240.13e-4 Tender Offers by Issuers*** (p. 418 in supp)
    e) ***Rule 13(g)***
    f) Look at withdrawl rights, rule 14-d7
    g) ***14b(10)*** is the all holders rule and equal price rule. it says **if you make a tender offer, you have to offer it to all holders and you have to offer them the same price**, this rule was enacted to try to moderate or eliminate the effect of the Unocal case.
    h) ***§240.14d***: Lots of provisions, including **pro-ration of shares** if the sellers outnumber the shares willing to be bought.
        i. ***Rule 14d7*** provides withdrawal rights as mandatory, so you can tender and withdraw as you like before the end of the offer.
    i) ***§240.14e-1 Unlawful Tender Offer Practices*** p. 443 (paraphrased)
        (a) You have to **hold the tender offer open for at least 20 days.**
        (b) Can't change the offer $ without keeping the offer open at least more 10 days from change.
    j) 14e-2: The board HAS to give an opinion about the tender offer.

4) **DGCL §203. Business Combinations with Interested Stockholders** Supp. p. 196
    a) A corporation shall not engage in any business combination with any interested stockholder for a period of 3 years following the time that such stockholder became an interested stockholder (15%) unless one of three conditions is met
        i. the board approved the transaction which resulted in the SH becoming an interested SH.
        ii. SH owns 85% of all outstanding shares excluding shares of directors and officers.
        iii. board approves and the shareholders approve by 2/3rd supermajority vote (excludes int SH)
        iv. The corporate charter can elect not to be subject to this rule.
    b) This is waivable by the corporate charter.

5) **Poison Pills**

a) In some cases, you could get flipped-in and then flipped-over with two separate pills. Ouch!
b) Boards can distribute poison pills very easily and very quickly, and they can issue them every day if they want, which would get really diluting for the acquirer.
c) *Important policy question*: is the PP useful from a shareholder point of view, or is it a way to protect boards?
    i. one view says that boards shouldn't be able to defend against a tender offer, and they shouldn't even care about the shareholders so much. they say that the highest and best user of a company should control it. if someone is willing to pay more. that's one view, it's the view that a company is just a commodity and something that should be traded. it's the idea of a market in corporate control.
    ii. another view is the marty lipton view. boards are made up of good people, who have good information, the market for shares are imperfect and can be under-priced, and there can be times when investors don't have enough information and be fooled so boards should be empowered to use the poison pill.
    iii. empirical studies support the view of pill defenders. it cannot protect a company that is underperforming and that someone is willing to pay a premium for.
    iv. Old school boards thought they were part of an institution to protect and that outsiders should be kept out. but now attitudes began to change, and they said that they should look at a deal if it comes to me. and executive compensation changed too. if there is a merger, now your options vest, and in the merger agreement they are treated as stock, so CEOS as a class get tens of millions of dollars in a merger deal.
        (1) more and more firms are redeeming the pills. not to say that they'll never have it again, but they don't seem as worried about it.
        (2) institutional investors have pushed big companies to get rid of staggered boards.
    v. If the purpose of the PP is to put the board in a position to resist the tender offer, you could change the Delaware statute to say that if you buy more than 15% then you have to negotiate with the board. so that's an argument against a poison pill I guess?
d) **The flip-over** is the early version.
    i. a distribution to existing shareholders, distributed as a dividend, it was a right, when triggered, to buy preferred stock at some outlandish price. it was a price no one would pay for. If someone did a tender offer for 30% of the issuers stock, the first thing that would happen, these rights would detach and trade.
    ii. when the acquirer actually does the merger, the person who holds the right, which is now trading freely, to buy the surviving company stock at half-price.
    iii. its not really clear that it would be enforceable, but the whole point of the pill was for it to never to work. the dilution, if it did work, would be so great, it would prevent someone from being able to do a merger, and so there would be little point in making the tender offer in the first place.
    iv. *Moran* tests the validity of poison pills and says its ok, and in that case, its an early type.
e) the **flip-in pill** came after someone waited out the flip-over**.** let's you poison before merging.
    i. originally X percent was 30%, then 20%, then 10%. so if someone acquires 15% of our stock, without the board's approval, then all the rights entitle you to buy shares in our company at half-price. but the person who acquired 15% of the stock, can't buy half-price stock. so the acquirer's investment becomes smaller. you can do it anyway you want, mathematically.

N. **BUSINESS JUDGEMENT RULE IN M&A**
1) In a **conflicted board transaction**, it's the *Weinburger rule*.
2) In a **non-conflict control transaction**, the traditional law was business judgment rule before 1985.

3) ***Scheff v. Mathis*** (pre-1985 law) there the court said, its business judgment rule, but acknowledged that the board is protecting itself somewhat. it's a weak test Allen says: your principal purpose cannot be entrenchment, but its ok if the effect is entrenchment, that's the rule up until 1985.

4) ***Smith v. Van Gorkom*** (1985): a discomfort with biz judgment rule, found breach of duty of care in board not being adequately informed.

5) ***Glassman v. Unocal***: controlling shareholder does a tender offer and gets 90% of the shares. then he does a short-form merger. the people who sold to him had no obligation to get good price, but the people who cashed out at the end had an obligation to get a fair price. in that case, it was held that a 253 short-form merger, there is no obligation to pay a fair price, just a statutory appraisal remedy.

6) ***Unocal and the "enhanced" business judgment rule***:

   a) Unocal took a very strong defensive action, they did a self-tender at a very high price, excluding Mesa (which was T. Boone Pickens' company). they were willing to pay everybody $72, and his bid was for $50 or something like that. the question was whether that was allowed.

   b) There has to be a reasonable relationship to the threat, you can't overreact to the threat. it puts the court in the center. **they convert the subjective test from Scheff v. Mathis (asking what the purpose of the action was), to an objective test, (was it reasonable in relationship to the threat)**. Note that they are not asking whether the board THOUGHT it was reasonable, they said WAS it reasonable (ie. the court will judge)

   c) What constitutes defensive action?

      i. is it an objective test or a subjective test?
      ii. trying to defend, or just have the effect of making it more difficult to get acquired?
      iii. self-tender can be defensive
      iv. acquiring another company can be defensive, creating anti-trust issues for an acquirer.
      v. you can sell a division as a defensive action, if it is the one that the acquirer wants.
      vi. Issuing debt notes puts a big liability on your balance sheet, so by putting a big liability on your balance, you may affect someone's ability to finance the acquisition. because remember, a lot of these people are using the company's own assets to finance the purchase.
      vii. Issuing new shares when a tender offer is pending, that could be defensive

   d) **BIG TEST:**

      i. **Is there a legitimate threat?** *: T. Boone Pickens was trying to coerce shareholders into accepting the tender offer by saying the back end of the tender offer would be fulfilled with junk bonds, so everybody needs to get on board now or risk getting crap.*
      ii. **Is the response reasonable in relation to it?**

7) ***Moran v Household Industries*** p. 539: answers the question of whether the board has to amend the charter in order to create a poison pill. Says the answer is no. They upheld the poison pill, but they said there is a Unocal obligation, they can only keep it in place if its reasonable in relation to some threat.

O. **REVELON DUTY AND THE AUCTION**

1) Two big questions:

   a) What is the Revlon Duty?

      i. Not going with business judgment as usual, now there is less deference.
      ii. Is it a duty to run an auction when you sell the company? Is it a duty, if you are selling the company, not to have lock-ups? favoring one bidder over another.
         (1) Revlon said you give lock-ups when it pulls more bidders in, but not when it locks bidders out and stops the auction.
      iii. Is Revlon a duty to get the highest price? Allen didn't like that idea, it could be to TRY to get the best price, but it cant be to actually get the best price.

    - iv. When it's a cash offer, then maybe it's the duty to take MORE money over less.
  - **b) When is the Revlon Duty?**
    - **i.** Change in control or break-up! That's QVC!
  - c) A cash offer does not trigger Revlon. Revlon cannot be triggered by anything other than a board transaction. If someone offers money to the board, then the board can just say no. so, if board says no transaction, then no Revlon, but if the board is going to accepting some offer, it must accept the Revlonest one.

2) Interco Identifies three threats but said there was no threat in that case. Time-Warner seems to loosen up on that idea.

  - **a) Inadequate price**
  - **b) Coersion**
  - **c) Timing**

3) **Mechanisms at Issue**

  - *a) No-shop clauses*
    - i. When you have a no-shop clause, you limit your ability to get the best price.
    - ii. What is a "fiduciary out term"?
      - (1) It says, I won't shop your deal, provided that if my fiduciary duty requires me to talk to another person because they want to make a superior offer
  - *b) Termination Fees*
    - i. They were on average around 2% at the time, just to give us context about whether it was high. The favored bidder has an incentive to ask for a higher and higher termination fee, and if he's really the favored bidder, there isn't much reason not to give a higher term fee. so they started to creep up.
    - ii. now they have stepped termination fee, depending on how close to the deal they are. so if they are close to closing, then the termination fee is higher.
  - *c) Lock-Up*
    - *i.* the lock-up is impermissible when the takeover is inevitable.
    - *ii.* We don't really seem them too much any more.
  - *d) Auctions*
    - i. a lot of people think that Revlon means that when you're sellin the company, you have to have an auction.
  - e) *Poison Pill:* Under what set of circumstances would the board be required to redeem the poison pill? Interco says when there is no threat, but maybe Time-Warner disputes that.

4) **Information Gathering**

  - **a) If you are selling an asset, you need good information about what people would be willing to pay. so how does the board become informed? it must have sufficient information, even under biz judgment rule, to make a decision. it would be grossly negligent to make a decision without information. it might even be bad faith.**
  - b) so an auction is one way to get information and it has certain costs and certain benefits.
  - c) but there are other ways to become informed about assets. another way is to negotiate a deal that you find acceptable, and check the market. that's the Ford/Howard case? if anybody wants to look at the deal, they just have to sign confidentiality agreement and can come in to a room and look at the deal and bid on it if they want.

5) How do you know whether the action will end the auction or induce the auction?

6) Boards have the power to work for maximizing stock price over whatever time period they want. they have business judgment power to do that. -> Time-Warner

7) **when is there control or loss of control**?

  - a) What if you want to buy another business? you buy it for stock, how much stock are you issuing? what if you issue 51% of your stock? is that a transaction in which you're selling control where you'd have a Revlon duty that requires you to sell to the highest bidder? You're buying a company, but losing control of your company? it doesn't seem right and could be a little confusing. the question would be whether you'd have to open up a bidding process so that someone could bid for your 51% shares for more than the company's value that you are trying to acquire.

  b) does it matter if this acquired company is owned by one person or by the market? if you're selling 51% to one person, then maybe you are giving up control, but if you're issuing 51% to the market, then maybe not. Maybe the Time-Warner case thinks so?

8) **what is the obligation of a controlling shareholder in a tender offer?** you have an obligation to disclose information, but you don't have an obligation to give a fair price.

9) ***Revlon, Inc. v. Macandrews and Forbes Holdings, Inc.*** **(Del. 1986)** p. 554: what's the obligation in an arm-length transaction? **The core Revlon duty case is a cash merger, that where they clearly have the obligation to get the highest current value. But here the company is being sold either way**

  a) Revlon puts in a primitive flip-in poison pill, and re-purchase 20% of the stock with unsecured debt and a covenant that if management changed, they'd have to sell off the assets.
  b) Perelman, the hostile acquirer funds the acquisition with the assets of the company itself to finance it. so by putting this debt on the balance, you restrict Perelman's ability to leverage the assets.
  c) So, Forstmann is the white knight that would be willing to takeover the company but keep the current board. the board gives Forstmann an inducement and special favors. the court says, hey, you're basically ending the bidding at a price lower than what the shareholders might have gotten, and because the takeover was going to happen eitherway, its not fair to the shareholders. this just entrenches the board.
  d) "Favoritism for a white knight to the total exclusion of a hostile bidder might be justifiable *when the latter's offer adversely affects shareholder interests*, but when bidders make relatively similar offers, or dissolution of the company becomes inevitable, the directors cannot fulfill their enhanced Unocal duties by playing favorites with the contending factions".
  e) Allen says he doesn't think this case withstands close analysis.
  f) there are some inducements that will draw bidders into the contest, and there are others that push bidders out. that's the Revlon rule.

10) ***Paramount v. QVC***: ENHANCED SCRUTINY p. 572 has the test stated in QVC for enhanced scrutiny.

  a) It is the law that in a stock for stock transaction, there is no change in control. So, technically there is no change in control, no Revlon duty, and as long as they are exercising a good faith judgment, they can accept a lower bid. This seems to come up in the Paramount case?
  b) Allen is concerned with too much judicial involvement rather than not enough.
  c) Paramount makes a deal with Viacom to merge. They have a fiduciary out, a termination fee, and a stock option (put option). The consideration for the deal is in stock and cash. plus these extra deal protection provisions.
  d) the three provisions:
    i. no shop (with fiduciary out)
    ii. termination fee: it says if the shareholder's don't approve. (why don't the shareholders approve? because there is a better offer!) if the term fee is too big, the shareholders get to vote, but they are sort of being coerced because if they vote against that offer, there are costs on the termination fee. the board is negotiating an impermissible infringement on the shareholder's right to vote. Under Blasius, if that was their intention it wouldn't be OK.

        - iii. put option: if a price goes higher after your bid, then you created some of that, and you want to get some.
    - e) **What triggers Enhanced Scrutiny?**
        - i. **the approval of a transaction resulting in a sale of control**
        - ii. **the adoption of defensive measures in response to a threat to corporate control**
    - f) **Court said certain circumstances in this case mandated Enhanced Scrutiny:**
        - *i. threatened diminution of the current stockholders' voting power*
        - *ii. the fact that an asset belonging to public SHs (a control premium) is being sold and may never be available again*
        - *iii. action which impair or impede SH voting rights*
    - **g) Enhanced Scrutiny Test:**
        - i. ***a judicial determination regarding the adequacy of the decision-making process employed by the directors***
        - ii. ***a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing.***
        - iii. ***The directors have the burden of proving that they were adequately informed and acted reasonably.***
    - h) all of the provisions that Redstone and Viacom gets come very early in the negotiating
    - i) The court is skeptical. They entered into a merger agreement for $80, but didn't change any of the other provisions. So they sign a deal with Viacom, and then it still looks like there is a big risk, so Viacom amends its offer to pay 85, QVC offers 90. What should the board do? QVC is throwing money at them, and the board has all these obligations and decide whether they can even talk to them. They conclude that they don't know enough about their financing to know if they can really close this deal. QVC brings suit to make them redeem the poison pill because they have a Revlon obligation to sell for the highest price.
    - **j) It matters whether there is a change in control.**
    - k) The rational that the court uses doesn't go too far. Its not that you have to pay a premium for change in the control all the time, certainly not if you acquire control slowly and quietly.
    - l) what are the implications of QVC?? it says that when the Revlon duties are triggered, it will result in reasonableness form of review. it brings Unacal and Revlon together and says that whenever control is at issue, courts will look at the reasonableness of what the board does. UNacal was always about reasonable in relationship to something else, and QVC says the Revlon duty is really about the duty to get the best transaction.
    - **m) The problem in the QVC case is that the board resisted really trying to get the best price from QVC. they preferred Viacom, and following the lock-out too closely.**
    - n) The board can't refuse an offer because of "strategic vision" when the offer that they do plan to accept doesn't ensure that their strategic vision is maintained.
- 11) ***Interco*****:** dealt with the question of when if ever would the Unocal case be used to mandate redemption of the poison pill. Interco was a holding company of other companies.
    - a) Rails brothers would buy these companies, and load them down with debt, the balance sheet would become riskier, and the price of the equity would go up because it was more highly leveraged?
    - b) So, the board did that to themselves instead of waiting for the rails brother to do it. they came up with their own transaction, they loaded it down with debt. they paid a big dividend on sale of some assets, and they get more debt, and they have a smaller company that is more levered.
    - c) So the rails brothers increase their offer. So the board puts more leverage out there.
    - **d) The offer was all shares and all cash, so it wasn't obviously coercive in any way.**
    - e) What kinds of threats could the board use the PP against?
        - *i. Inadequate price*

        - ii. *Coersion*
        - iii. *Timing*
    - f) The court said that there may come a time when you have to redeem the poison pill if there is no legitimate threat.
    - g) if in interco, they had offered stock, it would have been more plausible for the board to find some threat. but since rails brothers were offering cash.
- 12) ***Omnicare case:*** if the lock-ups and K expections conflict with the fiduciary obligations of the board, then the lock-ups and Ks are invalid and unenforceable.
- 13) ***Time-Warner***: The culminating case in the period of hostile M&As in the 1980s.
    - a) Time had a strategic vision of consolidating media. They approached Warner about it.
    - b) They consolidated. Everybody gets stock of the new company, there doesn't seem to be a "surviving company" in the traditional sense. So what happened?
    - c) Someone wanted to acquire Time as well. Paramount. They say, we're offer cash. But the Time-Warner board said, no, I have a strategic vision, this isn't about cashing out. I'm going to join this company to Time's great publishing business, I'm building the company.
    - d) Problem is, the market would prefer the money, they aren't convinced about the long term vision, and it requires shareholder votes. That should be clear to us by now.
    - e) So they had to restructure the deal so that Time did a tender offer for 51% of Warner's shares. In order to do this Time had to borrow money, so the balance sheet would have more debt.
    - f) It's a *Revlon* case and a *Unocal* case. Time is selling itself to Warner in this transaction, because after the transaction Time shareholders will actually be a minority. Really this is Warner shareholders acquiring time and they have an obligation to get more money, the money that Paramount was offering.
    - g) The Court of Chancery first said, this is no Revlon deal (allen wrote it for chancery), because there is no change in corporate control. **It doesn't matter if 52% of the stock is going to be owned by Warner shareholders. In Time there is no controlling shareholder, its in the market, or another way of saying it, control is in market. In Warner, control is also in the market. When they merge, control will also be in the market. So, under Allen's view there, there is no change in control.**
    - h) Paramount mistakenly thought there are two triggers for Revlon:
        - i. if you decide to auction the company
        - ii. if you decide to break up the company
    - i) There is structural coercion, like Pickens move. But there is also substantive coercion, that's when shareholders are going to tender their stock not understanding fully what the board understands. It means that boards can protect shareholders from their choices. And that seems to end the poison pill and we have a new test for triggering Revlon.
    - j) Allen was concerned that this substantive coercion idea might spill over into voting. he didn't want it to be the case that the board could stop shareholders from "electing the wrong guy".

exam specifics:

there are 4 questions that take less than an hour altogether, and two questions in two hours.

Indicate on this exam, what is a true statement. there is a statement and a series of 4-10 statements and say which are true and which are not true.

three essays: 1st, will take about 45 minutes, 2nd of the essays is about 45 miunutes and the last is 1 hour. the first is 15, 20, 25 there are word limits. 450-500 words Use an outline answer. not complete sentences. he doesn’t care about adjectives and adverbs. its ok to say, this is a fact question.

he hates the exams in where people answer questions that are not asked. answer the questions that are asked.

assume its in Delaware.