CORPORATIONS: OUTLINE

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# Formation: Law of Agency; Partnerships & Joint Ventures vs. Corporations

\*Def: agent agrees to act on principal's behalf and subject to his control

\*Termination: *either* principal or agent can terminate at any time (if set time period, then damages) (17)

\*Parties' conception does not control, agency relations can be implied

\*Jenson Farms Co. v. Cargill(Minn 1981) (agency relation can be proved by circumstantial evidence)

\*HIST: Cargill gives Warren credit w/ lots of conditions; when W goes belly up, creditors say C is jointly liable for W's debt \*H: Court says, if you're in it for the upside, you can't avoid the downside, too

\*MB: don't want to always hold lender liable, will reduce willingness of banks to give loans

\*Fiduciary Duties: obedience, loyalty, car

\*Rst 3d Agency § 8.01; § 8.02 (shouldn't make a profit); § 8.03 (shouldn't play both sides)

🡪MB: qualifier: full disclosure + fair dealing: fair dealing is a *range*; if full disclosure, principal might have better negotiated his position

\*Tarnowski v. Resop (Minn 1952 p. 36) (jukeboxes case: all profits are owed to the principal, even if K is rescinded)

\*HIST: P employed agent to find him a seller of a chain of jukeboxes; agent did so but misrepresented and accepted $2K from sellers; in earlier suit, P wins against sellers; H: P can recover both agent's secret commission + attorney's fees

\*MB: Arg overcompensation: buyer already got all his $ back; arg not: want to deter the scam artist, hard to detect

\*In Re Gleeson (1954 p. 38) (trustee cannot deal with himself: fiduciary duties higher in trust context)

\*HIST: tenant is trustee of land; stays on and farms the land, raises his own rent to the trust beneficiaries—good guy!\*RULE: trustee cannot deal with himself: violated a procedural rule \*H: trustee made no effort to look for a replacement tenant; should have paid profits to the trust beneficiaries

Joint venture

\*Meinhard v. Salmon (NY 1928 p. 47) (fiducarity duties higher in partnership context: duty to inform other of a business opportunity)

\*HIST: Salmon leases retail space; retains control but gets 50% money from Meinhard; M gets 40% net profits first 5 yrs, 50% thereafter; split the losses. Lease expiring, lessor offers S opportunity to re-up and renovate; S doesn't tell M. M sues.

\*RULE: "Joint venturers, like copartners, owe to one another, while the enterprise continues, the duty of finest loyalty." (49)

\*H: S gets 51% of new venture, M gets 49%

## Mechanics of incorporation

\*Chartering (92-93)

\*articles of incorporation: typically: name of company, address, purpose ("any lawful act"), capital structure (classes, # common shares, rights of preferred SH), etc.

\*Amend: Since its difficult to change (SH and BOD), language tends to be very broad and generic

\*next: electing directors, adopting bylaws, appointing officers (93)

\*Mandatory features of charter (93): must provide for voting stock; board of directors; shareholder voting

\*Goal: max efficiency

\*Bylaws (94)

\*Amend: can be changed by shareholders or BOD

\*will mandate size of board; annual meeting date; etc.

\*Inalienable: can't change charter so only BOD can amend (can't strip that right from shareholders: DGCL §109a)

\*Shareholders' Agreements (95)

\*close corps + controlled public corps (but not widely-held public corps)

\*Address: restrictions on disposition of shares; buy/sell agreements; voting agreements; agreements re: officers and payment of dividends

\*sometimes require special enforcement

### Centralized Management

\*Managers have power, delegated by the shareholders (BOD, too)

\*Self-Cleansing Filter Syndicate v. Cunninghame (UK 1906 p. 103)

\*HIST: Ps own 55% of corp; articles provide that BOD controls it, short of an "extraordinary resolution" (75%); BOD does not want to sell assets; SH vote to sell all assets 55-45

\*H: BOD are *not* agents of SH; if articles give power to the board, then SHs' meeting can't usurp that (DGCL § 141, § 271)

### Powers of the BOD

\*appoint, compensate, and remove officers (105)

\*delegate authority to subcommittees/officers/etc.

\*declare and pay dividends;

\*amend bylaws;

\*exclusive power to initiate and approve extraordinary actions (amendments to articles/mergers/sales/dissolutions)

\*power to make major business decisions

### When is a meeting a meeting?

\*"directors act *as a board* only at a duly constituted board meeting and by majority vote"

\*Fogel v. U.S. Energy(2007 p. 107): directors met right before a meeting to oust the CEO; H: not a valid meeting

### Corporate Personhood

\*Corp can sign binding contracts; can have property that BOD can manage;

\**Citizens United*: Money is speech and a corporation is a person; therefore corporation can spend money to speak

\*Conc: though Const does not give corporations right to speech, it does give the right to associations of individuals

\*Dissent: original intent of the framers was not to apply free speech to corporations; policy reasons: wealth has potential to distort; marginalize and discourage voting cit; BOD can use SH money for political purposes, even though some SH might object

## Ch. 5: Debt, Equity, and Economic Value: How Corporations raise capital

\*def: *capital structure*: a corporation's mix of long-term debt and equity claims

\*Valuation: ideally: price of company stock reflects company & managers' performance (p.115)

\*giving shares to managers will only affect incentives if share value is tied to performance

(1) Debt: borrow through debt instruments (116-18)

🡪advantage of bonds (for creditor): less risk, b/c creditor has right to periodic payment and 1st claim on assets in default

🡪advantage of bonds (for borrower): interest paid to creditor is tax deductible

🡪"zero coupon" bonds: no periodic interest, just big premium at time of repayment

(2) Equity: sell ownership claims by issuing equity securities (118-19)

🡪common stock holders: no right to periodic payment (dividends at discretion of BOD) or to demand a refund

🡪law creates clear default rules: e.g. one vote per share

🡪def: redeemable stock; conversion right; put right; call right (118)

🡪residual claims (on assets and income) and residual control (right to elect BOD)

🡪preferred stock: usually contains a stated divided, though still subject to BOD discretion; preferential treatment over common stock for both liquidation and dividends; sometimes can vote if dividend is in default

# Numbers: Net Present Value, discount rate, etc.

### Time value of money

\*sum: money is worth more today than a year from now, b/c today we can invest it (119-22)

\*present value: e.g. $1 in ten years is worth 38.5 cents today

\*discount rate: rate that is earned from renting money out for one year in the market for money (e.g. 10%: then lending $1 for a year you get $1.10 back; $1.10 in one year has a present value of $1.)

\*TA: PV and discount rate have an inverse relationship. The higher the discount rate, the lower the present value, and vice versa. So $100 one year from now will have a *higher* PV if the discount rate is 7 than if it's 8.

\*Present Value

\*PV is present value; r is annual interest rate; FV is future value; EV is expected value

\*FV = PV x (1 + r)n

\*PV = FV / (1 + r)n

\*r = (FV/PV)1/n – 1

\*EV = (prob 1 x payout 1) + (prob 2 x payout 2)

\*Discounting exercises (121, 122) (*see math in full notes p. 12*)

\*def *rate of return*: invest $1000, receive $1200: rate of return = 20%

\*def *net present value*: present value of revenues minus present value of costs (i.e. amount invested)

\*NPV = PV(r) – PV(c)

\*If it's a loan, costs are in the future (payback); if it's an investment, costs are now (so PV=PV)

\*If rate of return > discount rate, then project has positive NPV (rate of return ≠ discount rate)

### Risk and return

\**EV =* *expected return/value*: (return if outcome 1 x probability of outcome 1) + (return if outcome 2 x probabiliy of outcome 2)

\**certainty equivalent*: how much you'd been willing to pay (varies according to the investor's risk aversion, his diversification)

\**risk premium*: risk averse investors have to be compensated for risking volatility (but risk-neutral investors don’t)

\*remember: compare investor's risk premium w/ the project's riskiness

\*risk averse investors prefer a $9K-$11K coin flip to a $5K-$15K coin clip: same expected value but lower volatility

\*Reasons for risk premium: dislike volatility; loss may incur additional cost: e.g. bankruptcy filing; declining marginal utility of wealth (losses give more pain than identical gains give pleasure)

\*Calcualtion: two options (*see slides 5-7*):

(1) Two-step method: divide CE by r (can only use if CE is a given)

\*r = 6%; CE = $12,500, ∴ NPV = $12,500/1.06

(2) One-step method: divide EV by 1 + r + risk premium (i.e., the risk-adjusted rate)

\*HYPO: r = 6%; risk premium = 2%; EV = $15,000, ∴NPV = 15,000 / (1 + 0.06 + 0.02) = 13,888

\**risk-free rate*: discount rate for future cash flows that are certain

\**risk-adjusted rate*: discount rate that reflects both time discount value of money & market price of risk

🡪risk premium is the risk-adjusted rate minus risk-free rate

🡪only depends on undiversifiable portion of risk (e.g. total economic collapse)

\*problems p.125 (*see math in full notes p. 13*)

### Systematic risk and diversification

\**negatively correlated investments*: whenever one investment does well, the other fails (125)

\**uncorreleated investments*: e.g. coin flips

\**fully diversifiable*: same expected value under all scenarios (could mean various ratios of shares)

\*Questions p. 127 (*see math in full notes*)

# Normal Governance: The Voting System

\*SH rights: right to vote, right to sell, right to sue (169)

## Voting for the board of directors (170)

\*SEC: requires disclosure and proxy rules ("designed to encourage informed shareholder voting")

\*all common stock has voting rights, usually one vote per share

\*board elections must be annual

\**cumulative voting*: SH gets votes for (each director x number of voting shares); top vote getters get seats

\*TA: good for minority SH: can spend all votes on one candidate

\**staggered board*: DGCL § 141(d) (aka classified board: max is 3 classes) 🡪 must be in charter, *initial* bylaw, or bylaw adopted by SH

## Removing Directors + Rules About Board Meetings

\*DGCL 141(k)(1): if board is staggered, need cause to remove directors 🡪 additional entrenchment!

\*increase size of board: default: new directors would be chosen by existing directors (DGCL § 223(a)(1))

\*Campbell v. Loews: director gets certain due process rights

\*PROBLEM p. 174 (*see arguments in full notes p.15*)

### Shareholder Powers

\*adopt/amend/repeal bylaws; remove directors; ratify board actions or request that board take action

\*if no board meeting, shareholders can force one (DGCL §211)

\**special meetings*: DGCL §211(d): special meeting can be called by BOD or person mentioned in charter/bylaws

🡪these are default laws, company can provide otherwise

\**consent solicitations*: DGCL § 228: any action at a holder meeting can be done by same % of req'd members for that action via writing (177)

🡪MB: DE is better for shareholders: tougher to call a special meeting + easier to act by written consent

\**resolutions*: shareholders can bind the Board to do something only if in keeping with state law; also non-binding resolutions (precatory)

### Proxy Voting

\*DGCL § 212b; §212(c)(2) (electronic designation of a proxy); revocable unless used to protect a legal insterest (DGCL § 212(e))

\*Mechanics of a Proxy Fight (slides 7-11, 7-13)

\*Cost of proxy fight can be $100M+ if dissenter must mail own materials

\*arg against: hedge funds are only in it for the short term, don't want to give them too much power

\*Reimbursement rules can differ on at least three dimensions:

1. Amount: reimburse all, part, or nothing?

2. Conditionality: do you need to win to be reimbursed?

3. Bias: favor incumbents, insurgents, or neither?

\*Rosenfeld v. Fairchild Engine (NY 1955 p. 179)

\****The Froessel rule***: incumbents are always reimbursed (though it has to be a contest over "policy," not a personal power struggle, "I am a better manager than you are" is a policy issue!), insurgents reimbursed if they win

\*Super Froessel: reimburse both sides

\*PROBLEM p. 179 (*see math in full notes, slides7-15, 16*)

## SH can be subordinated and can be diluted

\*def: X% of votes in every class that's entitled to a separate class vote must approve of the transaction for its authorization

\*DE law: does not provide class vote for mergers

\*PROBLEM p. 182:

(a) Company wants to issue *senior* cumulative preferred.

\*NBYCL §804(a)(3): both preferred and common stock holders have right to vote on any issuance that would subordinate their shares.

\*DGCL §242(b)(2): does not prohibit this.

(b) Company wants to dilute shares by issuing addition.

\*NYBCL §804(a)(2): does not prohibit this.

\*DGCL § 242(b)(2): does prohibit this.

## Shareholder information rights

\*right to inspect the company's books for a proper purpose: DGCL §220; RMBCA §§16.02-.03; NYBCL §624. (p. 183)

\*e.g. request stock list or "non-objecting beneficial owners" (NOBO) list (only if company has already prepared it)

\*but inspecting the books is more onerous, courts more skeptical

## Circular Ownership and 160c: Separating Control from Cash Flow Rights

\*E.g. mgmt controls a subsidiary which itself owns a large share of stock in the corporation (184)

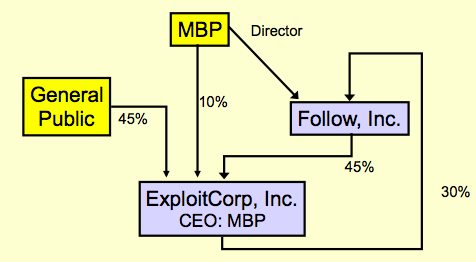
\*DGCL §160(c): Corp can't vote its own shares or shares owned by a subsidiary (if the corp owns a majority of the sub)

\*TA: 160(c) is about company shares being bought by company money, or company has majority in another company that owns shares

\*160(c) literal: Sub buys 20% of Corp, S can't vote those shares if C owns >50% of S

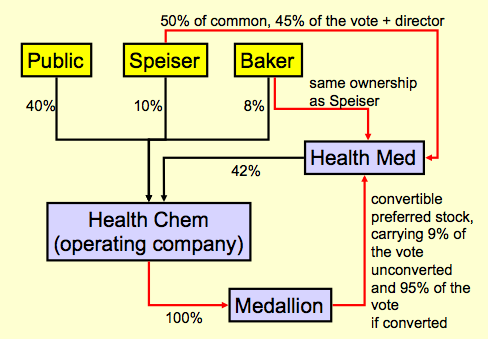
\*160(c) under *Speiser*: S buys 20% of C, S can't vote those shares if C owns 42% of S

\*it is *what corporation owns as a corporation*, not what employees own personally



\*Speiser v. Baker (Decl. 1987 p. 186)

\*HIST: (*see chart p. 187*) Speiser and Baker each own 50% of common stock and 45% of voting shares of Health Med; Health Med owns 42% of Health Chem; Chem owns 100% of Medallion; Medallion has 9% of Med vote in convertible preferred stock, which can become 95% if converted; Speiser wants to force a shareholder meeting and convert the Medallion stock so he can take over Med and force Baker out.



\*H1: annual meeting: Speiser can use Medallion's 9% stock to vote at Health Med annual meeting

\*RULE: Sub may "belong" to a parent even thought it doesn't have the actual majority of shares required by § 160(c).

\*clear violation of 160(c): Health Med owns >50% in Health Chem

\*disputed violation of 160(c): Health Med owns 42% in Health Chem

\*RATI: only reason to set up a structure like this is to violate 160(c): use company money to create voting rights for management

\*N.b. DGCL §211(c): if Baker just doesn't show, Speiser can force a meeting and whoever shows for the forced meeting is a quorum

\*TA: *Speiser* decision is a big stretch! Twisted reading of 160(c).

## Vote Buying

\*General rule: can't sell votes separate from the shares

\*Schreiber v. Carney (Del. Ch. 1982 p. 193)

\*HIST: JCC owns 35% of Texas Int'l (TI); TI is gonna merge w/ Texas Air; JCC threatens to veto merger unless JCC were to exercise warrants (~option) in TI. TI gives JCC a juicy loan in exchange for JCC's approval of the merger.

\*RULE-NEW: If *purpose* of the vote-buying is to defraud other SH 🡪 illegal per se; but vote buying with a "laudable purpose" is still a "voidable transaction subject to a test for intrinsic fairness [to SH]" (197-98)

\*H: TI bought JCC's vote, but not illegal b/c it was good for everyone (and the other SH overwhelmingly approved).

\*TA: This is not a pure hold-up: JCC had a cost that other SH did not have (taxes from warrant conversion)

\*Hedge Fund approach: much greater separation of ownership and control

\*Ex: Hedge fund X is a SH in A; wants A to purchase B; wants B to agree at $40/share; X buys shares in B and short sells B

## Controlling Minority Structures (CMSs): Dual Class Stock, Stock Pyramids, Cross-Ownership

\*Ways to separate control rights from cash flow rights: can control a firm w/ only a fraction of equity

\*α: the degree of separation btw control and cashflow rights that the CMS creates

(1) Dual-Class Share Structures: One share gives its owner large voting rights & small cash flow rights.

\*most common CMS form in U.S., though still a minority of firms; can adopt only at IPO stage

\*NYT, Google, Berkshire Hathaway (public face of corp is believed to create unique value)

(2) Stock Pyramids:

1. E.g. X has 51% of A, A has 51% of B, B has 51% of C.

2. X can nominate the boards of each, even though cash flow rights in C only 12.5% (.51\*.51\*.51)

3. For any α, can create a number of levels to make it possible

4. Agency problem: X may not have C’s best interests in mind

\*Assume: share price C would be much less than price A

\*MYQ: BOD loyalty/agency problem the longer the chain? A: lots of overlapping boards

(3) Cross-Ownership Ties (201):

\*Example: A owns 30% of C, which owns 30% of B, which owns 30% of A.

\*∴X, owner of A, may own more than 30% of C.

\*voting rights used to control corp group are distributed over the entire group rather than concentrated in single SH.

\*Advantage: make locus of control over the company group less transparent.

\*160(c): voting might be a problem, but the structure can exist

## Collective Action Problem and Shareholder Activism

### Federal Proxy Rules

\*'33 Act: regulates disclosure at IPO stage

\*'34 Act: general disclosure requirements post-IPO

\*All public companies subject to proxy regulation under §14(a)

\*Regulation 14A: substantive regulation of the process of soliciting proxies & shareholder communication.

\*Schedule 14A: what you need to disclose in a "full dress" registration statement.

\*§12: defines which corporations these apply to:

(a) Listed on one of the national stock exchanges (e.g. NYSE or AMEX).

(b) Have >500 shareholders AND >$10m in assets.

### Rules 14a-1 to 14a-7: Disclosure and Shareholder Communication

\*Rule 14a-1(l)(iii): "solicitation" is "any communication reasonably calculated to result in procurement of a proxy."

\*Rule 14a-3(a): can't solicit a proxy unless provide proxy statement "containing the info in Schedule 14A"; exceptions:

\*Rule 14a-2(b)(1): solicitation that "does not . . . seek directly or indirectly . . . the power to act as proxy"

\*Rule 14a-2(b)(2): solicitation to ten or fewer other shareholders

\*BUT: Rule 14a-6(g): even if exempt, if soliciting SH owns more than $5 million worth of stock, must still file the comm and "Notice of Exempt Solicitation" after sending it out. (Can do so after comm and don't have to file Sched 14A.)

\*Info required under 14a-3(a): if corp is soliciting, lots of info about corp; if someone else, info about that person

\*14a-4: regulates form of the proxy

\*def: *short slate*: when a dissident solicits votes for some but not all of management's candidates

\*14a-5: regulates form of the proxy statement

\*14a-6: formal filing requirements

\*14a-7: list-or-mail rule: dissident can demand either:

(1) a list of all SH or (2) mail dissident's proxy statement to all SH (via the record holders)

\*14a-12: rules for dissidents' candidates

\*14c: mandatory disclosure even if corp has 80% control and doesn't need votes

### 14a-8: Shareholder Proposals (the "Town Meeting" rule)

\*SH have right to insert proposals in mgmt's materials (save on mail, etc.), but mgmt can exclude some (14a-8)

🡪mgmt can exclude proposals that are: substantive matters + election procedures

\*Req'ts: Must hold $2,000 or 1% of the corporation’s stock for a year ((b)(1)); must file with mgmt 120 days before planned release of proxy statement ((e)(2)); <500 words (d); and valid subject matter.

\*13 reasons firm can exclude proposals (14a-8(i)). Ex: improper under state law ((i)(1)), relates to a matter of ordinary business ((i)(7)), relates to a matter < 5% of business ((i)(5)), relates to election of directors or procedure for election ((i)(8)), conflicts with company’s proposal ((i)(9)) (see HP example, 214-16). Burden is on corp to exclude (g).

\*Precatory request: harder to exclude, but SH less motivated, and even if SH approve, managers can ignore

\*Two main types of proposals

(1) Corporate Governance

\*Ex.: share withholding in plurality v. majority voting systems (e.g. Disney: 95% of voters withheld)

\*sometimes binding, sometimes precatory (mgmt will follow if SH support is high enough)

\*DGCL §141(b): firms can institute a policy that directors have to resign if don't receive X% of vote

\*DGCL §216: prohibits BOD from trying to further amend/repeal such bylaw amendments

\*Trends:

(1) SH propose majority vote: require directors to receive 51% of votes cast in order to stay on the board

🡪reason: incumbents usually have no challengers

🡪Arg it matters: majority vote will increase SH participation, now directors need those votes

🡪Arg doesn't matter: SH participation is so low, maybe why so many corp. (80%) adopt voluntarily

(2) withholding votes 🡪 SH counts towards the quorum

\*TA: both increase incentives for SH participation; adoption is more successful in firms w/ no policy ~ majority vote

(2) Social Responsibility Proposals

\*No Action letter: SEC telling a firm it will not stop it from excluding a proposal

\**Cracker Barrel* No Action Letter: SEC let Cracker Barrel omit a SH proposal calling on BOD to prohibit employ discrim based on sex orientation; SEC wasn't sure if this was "ordinary business exclusion" (14a-8(c)(7))

\*1998 change: (1) ordinary busi proposal can't be excluded if it implicates social policy issues; (2) unless suggests SH "micromanage"

(3) SH Access Proposals (Did not pass but all law professors are in favor; see below)

### Proxy Access Rule

\*two different issues: SH candidates = proxy access, SH proposal = 14a-8 (above)

\*TA: state of the law: default law is no proxy access, SH can propose revision of bylaws to impose proxy access

\*but can't do it through corp's proxy, must send your own (DGCL 112)

\*reason: election procedures are substantive

\*Proposed SEC revision (rule 14a-11): proxy access mandatory

🡪if you have 3%/3y then you qualify and can nominate 1/4 of the board and can tag along on corp's materials

🡪also amends 14a-8 to make it harder for mgmt to exclude proposals trying to implement proxy access

\*DGCL §112: allows change of bylaws to create proxy access (fixes the "proper under state law" problem but still can't piggyback)

\*AFSCME v. AIG (2d Cir 2008, p.219):

\*H: mgmt can't *exclude* proxy access proposal that deals w/ procedure of elections, as long as it deals w/ all elections and not a specific one

🡪Aftermath: SEC adds 14a-8(i)(8): now company may exclude proposals dealing with procedure for election

\*CA, INC. v. AFSCME Employees Pension Plan (Del. 2008 p. 220) (109 can supersede 141 if there's a fid out)

\*HIST: AFSCME is SH in Computer Assoc, wants to amend the bylaws so corp has to reimburse "reasonable" expenses of a dissident BOD candidate, even if it loses.

\*H: Proposal is ok. Bylaw is *procedural*, even though it requires spending corp $$. (223)

\*H: But this bylaw violates DE law b/c might force BOD to violate fiduciary duties.

\*RATI: DGCL §109(b): bylaw can be anything relating to power of BOD or SH, but §141(a), can't interfere with mgmt.

\*TA: proposal would be OK if included a *fiduciary out*

### 14a-9: The Anti-Fraud Rule

\*def: rule against false or misleading proxy solicitations

\*Dual enforcement: either SEC or (implied) private ROX

\*Elements of a 14a-9 violation:

(1) materiality, (2) culpability, (3) causation & reliance, (4) damages.

🡪 ~fraud

\*J.I. Case v. Borak (implied private ROX for fraud)

\*SH has implied ROX to challenge a corp transaction approved by proxy solicitation that violates the SEC antifraud rule

\*private ROX exists under §14(a) and Rule 14a-9 (in addition to SEC) if three factors met

*\**Virginia Bankshares, Inc. v. Sandberg (U.S. 1990 (232)) (false statements of belief/opinion can be material facts for fraud)

\*HIST: FABI owns 100% of VBI, VBI owns 85% of Bank, will give SH $42 for minority shares; Bank board urges that offer is "high" and "fair," though one Bank director is also an FABI director; dissenting SH claims proxy statement was fraudulent

\*PROC: Jury awards $18 more per share, 4Cir affirms

\*H: *Culpability:* Yes, *knowingly* false statements of belief/opinion can be actionable if objective evidence they're K'ly false

\*H: *Materiality*: yes, opinions can be material facts

\*H: *Causation*: SH must show causation; here, can't show causation: their vote wasn't req'd (only had 15% ownership) *and* didn't lose a state claim by voting to approve

\*H overall: Directors misrepresnted but transaction approved.

\*CONC/DISS (Kennedy): *causation*: minority SH can influence deal beyond their votes, and might sway the board to reject

🡪SH might lose their state claim depending on definition of materiality

\*TA: State courts are more suspicious of freeze-outs b/c of majority SH's COI: incentive to pay lowest price possible!

\*TA: Souter concerned about potential litigation, eliminates protection of 14a-9; also, interact btw fed and state law

## Fiduciary Duty of Candor

\*DE duty of candor law modeled on fed law on misrepresentations (14a-9)

\*Control SH making a proxy solicitation or t.o. has fid duty to disclose all germane facts. (Lynch v. Vickers)

🡪limited to circumstances where corp asked SH to take action

\*TA:direc have duty of good faith/loyalty "whenever communicating publicly/directly with SH, w/ or w/o request for SH action" *(*Malone v. Brincat)

# Normal Governance: The Duty of Care

\*Fiduciary duties: a way of controlling managers 🡪 a judicial backup to the voting system

\*Three main duties:

(1) duty of obedience

(2) duty of loyalty

(3) duty of care (relevant for ordinary business decisions but 102(b)(7))

### Business Judgment Rule: Overview

\*ALI §4.01(a): Director/officer has a duty to the corp to act:

(1) In good faith; (2) in the best interests of the corp; *and* (3) as an ordinarily prudent person would act.

\*ALI §4.01(c) (*BJR*) (cf. (RMBCA at § 8.31(a)(2)):

\*Director/officer acts in good faith if he:

(a) Is not self-interested; (b) Is informed; (c) believes the judgment is in the best interests of the corp.

🡪presumption: managers did NOT breach the DOC, short of fraud/illegality/COI/or other form of negligence

\**Gagliardi v. Trifoods Int'l* (Del. Ch. 1996 p. 241) (business judgment rule)

\*RULE: BJR: Director is not responsible to the corp for losses suffered due to a decision made or authorized in good faith

\*RATI: SH should not rationally want directors to be risk averse.

\*H: When directors *are* liable for loss from risky projects, they would be jointly & severably liable.

\*Rationales for the BJR:

(1) We want directors to take on risk

(2) SH can diversify, so volatility doesn’t matter – only expected value matters

(3) Ways to encourage risk taking by managers/directors: (a)Indemnification of costs directors may have to incur; (b)Insurance.

\*Costs of the BJR: Directors may take on too much risk or make worse decisions.

## Framework for D&O Liability

\*BJR (RMBCA §8.31(a)(2))

\*Indemnification (DGCL §145)

\*D&O Insurance (DGCL §145(g))

\*Reimbursement for legal expenses (DGCL §145(c))

\*Waiver of Liability (DGCL §102(b)(7))

### Indemnification

\*DE: corp can indemnify only if D or O: (243)

(1) Acts in good faith *and*

(2) actions provided by statute but still in GF.

\**Waltuch v. Conticommodity Services, Inc*. (2d Cir. 1996 p. 243) (despite indemnification, good faith req't still applies; "success" includes settling)

\*HIST: Waltuch racks up $2M in legal bills, seeks indemnification from former employer

\*P arg: Corp charter requires compensation above and beyond DGCL

\*STAT: DGCL §145(f): indemnification provided in the other clauses is not exclusive.

\*STAT: DGCL §145(c): must indemnify officer "if successful or otherwise."

\*H: §145(f): not entitled to indemnity: provides additional grounds for indemnification, but GF requirement of §145(a) still applies

\*H: §145(c): entitled to indemnity: "successful" includes settlement

### Directors & Officers Insurance

\*DGCL §145(g) (cf. RMBCA §8.57): Corp may buy D&O insurance to insure bad faith acts (indemnification limited to acts in GF)

### DGCL §102(b)(7): Waiver of Liability

\*in charter, corp can opt out of liability for its directors for breach of duty of care (can't protect against breach of duty of loyalty)

🡪SH have to agree to it, but 90% of DE companies adopt

🡪indemnity beyond a DOC standard but short of a DOL standard

🡪explicitly does not protect acts that breach duty of good faith

\*passed by DE as response to *Van gorkom* (which allowed DOC violation to be gateway to EF review)

\*if there's a 102b7 violation you can't raise a duty of care violation (*Malpiede*)

\*TA: if director is negligent, protected by 102b7

🡪if so negligent that behavior amounts to conscious disregard, then it's breach of good faith/DOL and not protected by 102b7 (*Disney*)

🡪*Stone v. Ritter*: breach of good faith = breach of DOL

🡪*Lyondell*: gross negligence ≠ conscious disregard

🡪TAQ: don't really know the idsinction, seems to be awareness of not being informed (e.g. Mrs. Pritchard)

### SOR: The BJR

\**Kamin v. American Express Co.*, N.Y. 1976 (252) (BJR example: Amex did what's best for corp, not for SH)

\*HIST: Amex shares in DLJ drop in value by $25M; wants to distribute shares to SH; SH prefer that Amex sell them on the market and give them the cash, so they can write off a capital gains loss (save $8M in taxes); Amex BOD considers and rejects that option b/c accounting would hurt.

\*H: Self Dealing: fact that the decision will affect firm value isn’t enough, every decision affects firm value.

\*H: Duty of Care: No breach; BOD made an informed decision (even though arguably not "reasonably prudent")

\**Smith v. Van Gorkom*, Del. 1985 (257) (duty of care higher than BJR in takeover situation)

\*HIST: Van Gorkom arranges merger w/Jay Pritzker for $55/share cash. VG calls special meeting: no agenda, board approves.

\*H (DESC): directors were "grossly negligent," not informed, and thus liable for breach of DOC in a business decision.

\*TA: higher standard of fiduciary duty: directors have an inherent COI (entrench) even if don't have an actual COI: may be liable for not fully informing themselves (also: probably only applicable to takeover cases)

### SOR: Entire Fairness

\**Cede & Co. v. Technicolor, Inc.*, Del. Ch. 1993 (261) (entire fairness rule)

\*HIST: Disinterested board casually approves Perelman takeover of Technicolor. SH are not harmed (price > value of shares.)

\*RULE: presumption is that directors acted in best interests of SH (i.e., BJR), but if directors breach DOC or DOL (gross negligence) w/r/t to process (e.g. by not being informed), burden shifts to directors to show "entire fairness"

\*H: directors were not informed, so BJR does not apply. *VG*. But directors still demonstrated EF, so it was fair.

\*RULE: harm is not a requirement for breach of DOC (Cede II)

\*RULE: despite gross negligence, can still be entirely fair

\*TA: shrinks 102b7: instead of needing to assert DOL violation to get around DOC, can now assert DOC violation as gateway to EF review: thus this increases directors' liability exposure

\**Emerald Partners v. Berlin* (Del. 2001) (p.260)

\*(1) determine fairness, (2) evaluate damages, (3) evaluate under §102(b)(7)

## Duty of Oversight

\*Big cases involve not action but inaction; (BJR requires "decision")

\*Courts tend to be tougher on directors in these kinds of cases.

\**Francis v. United Jersey Bank*, N.J. 1981 (p.262) (the Mrs. Pritchard case: duty to not totally drop the ball / monitor)

\*HIST: sons steal $10M in SH money, declare bankruptcy; elderly mother is only D; mother never went to a board mtg

\*H: mother breached her duty; negligence was a prox cause of her sons' corruption (failed to detect + prevent illegal activity)

\*Graham v. Allis-Chalmers Manufacturing Co., Del. 1963 (268) (red flag doctrine: duty to create a system to detect wrongdoing)

\*HIST: A-C is big public corp.; under consent decree to stop fixing prices; 20 years later, A-C and four mid-level managers plead guilty to price-fixing charges, pay big fines; SH brings derivative suit against Ds & Os to recover on behalf of corp

\*H: directors had no obligation to monitor, consent decree was not a sufficient red flag

\*RULE: If a red flag puts you on notice, directors must stop relying on employees and start a monitoring system

\*Std of liability: reckless.

\*RATI: None of the current board had been on the board at time of consent decree

\*TA: Problem: this holding may encourage directors to be uninformed (though of course, directors are also SH)

\*In re Michael Marchese (SEC 2003 p. 272) (liability for recklessly igonring red flags: SEC more aggressive than Delaware)

\*HIST: Marchese is on audit committee, sees report alleging fraudulent docs, but did not follow up. A year later, resigns from BOD and expresses concerns to the SEC.

\*H: Marchese agrees an undisclosed settlement w/ SEC for "recklessly ignoring signs pointing to improper accounting."

\*TA: SEC is more aggressive than DE, post-WorldCom/Enron, and definitely more aggressive than DE courts in *Allis-Chalm*.

\*In re Caremark (Del. Ch. 1996 p.278) (not just any monitoring system will do)

\*HIST: PWC audits and approves Caremark's internal monitoring regime (ethics guidebook, internal audit plan, and ethics hotline). Lower-level officers engaged in misconduct costing $250m. SH file derivative suit seeking recovery from BOD, claiming breach of DOC.

\*H: Duty of directors is higher than *Allis-Chalmers* rule; DOC, not DOL; but no violation here

\*RULE: even a poor monitoring system can be insufficient (much higher than red flag doctrine) (*Stone v. Ritter*)

\*RATI: since *Allis-Chalmers*, sentencing guidelines: any rational, GF director would act in fear

\*the SGs increase costs for not implementing compliance mechanisms (CMs).

\*compliance with SGs allows firms to lower their liability

\*But as with red flag doctrine, directors may prefer head in the sand.

\*bad faith: *Stone v. Ritter*; failing to implement oversight; maybe being uninformed (*Disney*)

\*Sarbox § 404: good internal controls now required by law: burden on officers, not directors

🡪Con: big increase in cost of compliance

🡪Con: SOX puts burden on CEO & CFO, directors may feel *less* duty to monitor. (But: this argument is weak)

\*In re Citigroup Inc. (Del. Ch. 2009 p. 285) (Caremark does not require oversight of business risk)

\*P arg: current/former D&Os failed to monitor and manage the risks in CDOs and properly disclose Citi’s exposure.

\*I: should there be a *Caremark*-style system in place to monitor business risk?

\*RULE: No. BJR.

\*RATI: SH trying to blame D&O for bad business decision; since Citi has a 102(b)(7) provision, SH need to show bad faith

\*H: SHs failed to show bad faith, and anyway there *was* a risk monitoring system in place.

\*POLICY: Imposing liability for failure to monitor risk would mean hindsight evaluations of decisions; leave it to BJR!

\*TA: *Caremark* about monitoring employees for lawbreaking; this is monitoring managers for risky decisions. Big difference.

### Knowing Violations of the Law

Miller v. AT&T (3d Cir. 1974 p. 289) (illegal acts violate fiduciary duty, even if interest of corp)

\*HIST: AT&T loaned $1.5M to the DNC and failed to collect. SHs sue AT&T’s board; arg: illegal campaign contribution.

# DOL and Self-Dealing Tranasactions

\*def: director, officer, or CSH must exercise power over processes/property/info in good faith effort to advance the interests of the company.

\*Rules for self-dealing transcactions: If director transacts with the company:

🡪req't: approval of disinterested representatives

🡪req't: disclosure

🡪req't: dealings must be intrinsically fair in all respects.

🡪req't: officers, directors, and CS may not deal w/ corp in any way that benefits themselves at its expense.

## Duty to whom?

\*Director loyalty to the corp = loyalty to equity investors. *Dodge v. Ford*.

\*Additional constituencies: some state statutes; *Unocal* (constituencies can be considered), *Revlon* (constituencies must be considered 2d to SH).

### The Shareholder Primacy Norm

\*Dodge v. Ford Motor Co.(Mich. 1919 p. 297) (SH interests come first)

\*HIST: Ford eliminates dividends, reduces car prices, says it is for the benefit of car buyers, but really hurting investors.

\*H: Ford CANNOT do this – SH interests must come first. (Now, could probably argue it does benefit SH)

\*A.P. Smith Manufacturing Co. v. Barlow (N.J. 1953 p. 299) (charitable contributions OK)

\*HIST: Corp. gives to Princeton, SH challenges. STAT: ok if "contributes to the protection of the corporate interest."

\*H: donation OK: NJ statute permitted the contribution (DE has similar statute); contribution benefited SH.

## Self-Dealing Transactions

\*Definition: director SH/controlling SH gets personal benefit that doesn’t go to SH/minority SH.

\*Trend: allow self-dealing transactions but with restrictions.

\*Key issues

(1) Disclosure

(2) Duty of loyalty that controlling SH owe to minority SH.

(3) Ratification/Authorization by indy directors and approval by disinterested SH.

\*RULE: If director wants to make a self-beneficial deal with the corp (304)

\*innovation: self-interested director can be counted towards the quorom

\*still must prove that the transaction is fair

\*still must disclose the interest to all disinterested voters

\*disinterested voter can void the transaction *only* if it's unfair or inadequately disclosed (304)

### The Disclosure Requirement

\*State ex rel. Hayes Oyster Co. v. Keypoint Oyster Co. (Wash. 1964 p. 304) (discloure req't; non-disclosure is per se unfair)

\*HIST: Hayes runs Coast Oyster. Owns Hayes Oyster. Hayes Oyster gives Keypoint $$ to buy assets from Coast, gets 50% of Keypoint. Coast’s new mgmt sues for Hayes + Hayes Oyster’s "secret profits."

\*H: D violated his fiduciary duty by keeping the "secret profits."

\*RULE: non-disclosure is per se unfair

\*RULE: must show both (1) disclosure AND (2) fairness (no need to show harm)

\*TA: BJR applies only to disinterested and informed transactions (duty of care), NOT to self-dealing transactions.

\*TA: Harsh! Hayes had to pay back not only his profit but also his (and brother's) investment in Keypoint

🡪POLICY: self-dealing transactions are hard to detect, harsh rule creates deterrence.

\*Cf. Tarnowsky, supra (jukeboxes case): strong language of fiduciary duty

### Self-Dealing Transactions: Control SH's DOL to Minority

\*MODERN RULE (DE & most jurisdictions): Controlling SH (1) has duty of loyalty to the minority, and (2) always review transactions between the controlling SH & the firm for entire fairness (regardless of self dealing).

\*Sinclair Oil Corp. v. Levien (Sinven) (Del. 1971 p. 310) (benefit-detriment test)

\*HIST: Sinclair (D; Parent) owns 97% of Sinven’s stock and dominates Sinven’s board. Sinven minority SH (Ps) sue for paying excessive dividends that prevented Sinven’s industrial development.

\*H: BJR, not fairness, because both controlling SH and minority SH received the dividend

\*RULE: *benefit-detriment test*: self-dealing triggers fairness inquiry only if parent gets something minority SH doesn't (311)

\*MODERN RULE: review all transactions by controlling SH under entire fairness test regardless of "self-dealing"

\*Arg Ben-Det Efficient: permits transactions (like here) that don’t raise concerns w/o having to do a fairness inquiry.

\*Arg Ben-Det Inefficient: risks that in long-term minority SH will be hurt.

### CHART: Self-Dealing Transactions: If disclosure + ratification/authorization, what is the standard for judicial review?

\*DGCL § 144(a): interested transaction is OK if (1) approved by disinterested directors, (2) approved by disinterested SH, (3) fair.

\*Two Possible Interpretations: even if one conditions met: D must still show EF; don’t have to show EF.

\*TA: Directors (Cooke): approval by disinterested directors/SH is sufficient, BJR

\*TA: CSH (Cookies): approval by disinterested directors/SH is insufficient, still must show fairness.

|  |  |  |  |
| --- | --- | --- | --- |
| **Standard of Review (BOP)** | **DGCL §144** | **RMBCA § 8.61** | **ALI § 5.02** |
| Neither board nor shareholders approve | Entire Fairness (Δ) | Entire Fairness (Δ) | Entire Fairness (Δ) |
| Disinterested directors authorize | If interested director, BJR (П) (*Cooke*);  If CSH, EF (*Cookies*) | BJR (П)  §8.61(b)(1) & Comment 2 | Reasonable belief in fairness (П)  §5.02(a)(2)(B) |
| Disinterested directors ratify | BJR (П)  same as above | BJR (П)  §8.62(a) & Comment 1 | Entire Fairness (Δ)  §5.02(c), §5.02(a)(2)(A), §5.02(b) |
| Shareholders ratify | If interested director, BJR + waste (П);  If CSH, EF (П) (*Wheelabrator*) | Waste (П) | Waste (П) |

🡪Authorize v. ratify

\*authorize: before deal is done, board approves it

\*ratify: BOD approves ex post (or while in progress) (n.b.: only ALI treats it differently)

\*Cookies Food Products v. Lakes Warehouse (Iowa 1988 p. 315) (CS deals subject to EF, no matter who approves (Iowa))

\*HIST: CS takes control of board and enters self-dealing Ks. All are successful and approved, but minority SH pissed b/c no dividends and can't sell shares. P arg: self-dealing Ks "grossly exceeded the value of services rendered"; CS didn't disclose.

\*RULE: even if the disinterested BOD approves, still must show fairness

\*H: even under fairness std, transaction is fair: high compensation but big benefit to corp.

\*RATI: difficult to tell when a director is interested/disinterested, ∴ fairness = best evidence.

### Self-Dealing Transactions: What if Disinterested Directors Authorize/Ratify?

(1) DGCL & RMBCA: apply the BJR

\*POLICY: transactions can be mutually beneficial; EF hindsight problem; resource drain (determining EF is expensive!).

(2) ALI: apply fairness rule but burden on P to show unfairness.

\*In line with *Eisenberg*: transactions should always be subject to some kind of fairness review:

\*collegiality: directors unlikely to question other directors; hard to define who is interested/disinterested

\*Cooke v. Oolie (Del. Ch. 2000 p. 322) (If interested director is self-dealing and disinterested directors approve, then BJR)

\*HIST: TNN has four directors, including Oolie and Salkind. O & S were also creditors (may have incentives to choose less-risky projects). BOD votes 4-0 to try to acquire USA. SH claim O & S breached fid duty by doing what's best for them, not for all SH.

\*H: Although § 144(a) doesn’t explicitly apply (fn 39) b/c not self-dealing (O & S are not directors in USA), the same policy/logic applies: approval by the other directors is evidence that the 2 directors acted in good faith.

\*Harvard Corp. Hypo

\*HIST: Harvard, Inc. is a large conglomerate, known for using only the finest ingredients. Bob = CEO and chairman of BOD. H recently needed additional warehouse and factory space, so it contracted for the construction of a new facility w/ a construction company 50% owned by Bob. Bob made full disclosure to the board and the entire board (minus Bob) voted to authorize the contract. SH brings a derivative suit seeking to void the deal and/or force Bob to turn over his profits.

🡪approval by a disinterested board?

(1) Under DGCL & RMBCA, apply the BJR.

(2) Under ALI, P must show that the transaction was NOT fair.

🡪If the BOD did not authorize, but later ratified a decision that was already made:

(1) Under DGCL & RMBCA, apply the BJR.

\*RATI: costly to require prior auth from a disinterested board, and BOD still has power to withhold ratification.

(2) Under ALI, D has the burden of showing entire fairness.

\*RATI: the interested director has more sway of disinterested BOD members in these situations.

\*RATI: Greater costs to stopping something that has already started.

\*TA: Most states follow the RMBCA/DGCL approach.

\*RATI: Cynical Rationale: states want to attract firms, BJR is friendly to controlling SH.

### What makes an independent committee independent

\*Special committee must:

(1) be properly charged by the full board

(2) comprised of independent members

(3) vested with the resources to accomplish its task

\*Goal must be the *best available deal*, not just a *fair* deal

### Self-Dealing Transactions: What if SHs ratify?

\*"Waste" doctrine: exchanging corporate assets for consideration that is so small that it’s basically a gift. (*Vogelstein*; see also ALI § 5.02(a)(2)(D))

\*Lewis v. Vogelstein (Del. Ch. 1997 p. 327) (if SH ratify, conflict transaction gets BJR, subject to waste)

\*RULE: "informed, uncoerced, disinterested" SH ratification is effective except against waste

\*RATI: don't want to let majority force minority to give gifts, even if both sides act in interest of firm (i.e. no self interest).

\*In re Weelabrator Technologies (Del. Ch. 1995 p. 328) (SH ratification effective if director is interested but not for CSH)

\*RULE: if SH ratify self-interested transaction by a(n) . . .

(a) Interested director: BJR, subject to waste (i.e., *Vogelstein*).

(b) Controlling SH: entire fairness w/ burden on P.

## Executive Compensation

\*I: inherently a self-dealing transaction, but must be made. Let market govern or regulate through the courts?

\*Katie Couric rule (SEC 2006): companies have to disclose 3 highest people who make more money than at least one executive

\*Perceived excessive compensation, America v. ROW:

🡪Foreign: much lower compensation (b/c controlling SH have much more power).

🡪US: SH much less active (collective action problem); board (influenced by CEOs) decides compensation.

\*Latest Data

🡪Compensation decreases when the market goes down.

🡪This may indicate that compensation is tied to performance.

\*Lewis v. Vogelstein (Del. Ch. 1997 p. 332): BJR Review for options compensation

### Executive Compensation: Regulatory Responses

\*Loans to officers and directors

\*total ban; DE made it ok, SOX §402 outlawed it again (334-35)

\*NYSE and NASDAQ have new listing standards that require SH approval of equity compensation plans and require that compensation committees consist entirely of independent directors.

\*Other: greater disclosure requirements (Academics disagree over whether this constrains compensation or pushes it higher).

\*Clawback provision (SOX §302): if restatement required, top officers must pay back bonuses (336)

\*Provisions in TARP and ARRA (p.337)

\*$500K cap on deductibility of compensation, no exception for performance-based pay

\*limiting total pay for senior execs to $500K, + restricted stock

\*ARRA: *no* bonus, retention award, or incentive compensation to any TARP recipient

\*ARRA: Say on Pay for TARP

\*TAQ: compare SOX §402 (no loans to D&O) w/ DGCL §145 (corp can take on defense costs even before determination of indemnity)

\*Accounting for stock options (p. 338)

### The Disney Decision

In Re: Walt Disney (Del Ch. 2005 p. 341) (examples for what constitutes bad faith, esp. "conscious disregard" standard)

\*HIST: Ovitz Hiring: other board members only partially informed. Ovitz Firing: Disney board votes to terminate Ovitz’s employment agreement without cause(poor performance). Ps sue for violating of fid duties and waste.

\*I: Hiring (director action)

\*Ps must prove exception to BJR (breach of fid duties; bad faith; unadvised judgment)

\*Ds must then prove entire fairness

\*H: Hiring was in good faith. BOD may have been negligent & uninformed, but no conscious disregard.

\*I: Firing (director inaction)

\*Ps must prove Ds breached fid duties

\*Ds must then prove protected by 102(b)(7)

\*H: BOD did not act in bad faith. BOD did not have a duty to fire, or stop CEO from firing him (instead of reassigning).

\*DICTA: examples of actions in bad faith:

(a) Acting not in the best interests of the corp (i.e., loyalty & good faith are intertwined).

(b) Intentional violation of law

(c) Conscious disregard of the duty to act (classic duty of care).

\*DISC: Spectrum of bad faith (345)

\*obvious bad faith: actual intent to do harm

\*middleground: intentional dereliction of duty (conscious disregard)

\*not bad faith: grossly negligent conduct

**Duty of Good Faith**

**Duty of Loyalty**

**Duty of Care**

\*Stone v. Ritter Del. (2006 p. 345 and supp) (duty of oversight is part of duty of loyalty; failure of good faith suggests failure of DOL)

\*RULE: conscious disregard 🡪 breach of duty of good faith *which is indicative of* breach of duty of loyalty.

\*RULE: if violating both duty of loyalty AND duty of good faith, then not covered by 102(b)(7)

\*RULE: directors are liable for oversight failure if:

(1) directors utterly failed to implement any reporting or information system or controls; or

(2) conscious disregard: despite system in place, "consciously" avoided info to avoid being informed of risks

\*culpability: Knowing (***but consciously sounds like purposeful***)

\*TA: affirms *Caremark* and *Disney*: conscious disregard is just part of DOL, not DOC

🡪this holding shores up 102(b)(7)

## DOL: Corporate Opportunity Doctrine

\*I: fiduciary sees a business opportunity; can he pursue it on his own account or does it belong to the corporation?

### Determining Which Opportunities "Belong" to the Corporation – 3 Approaches Used by Courts

(1) "Expectancy or Interest" Test (*Lagarde v. Annison*)

\**the modern test*

\*"The expectancy or interest must grow out of an existing legal interest, & the appropriation of the opportunity will in some degree 'balk' the corporation in effecting the purpose of its creation."

\*pretty narrow; now: look to the firm’s practical business expectancy or interest.

(2) Line of Business Test (*Guft v. Loft*)

\*anything a corp could reasonably be expected to do

\*factors:  
(a) how the matter came to the attention of the fiduciary

(b) how far removed from the core economic activities of the corp the opportunity lies

(c) whether corporate info is used in recognizing or exploiting the opp

(3) Fairness

\*Factors:

(a) How a manager learned of the disputed opportunity.

(b) Whether he used corporate assets in exploiting the opportunity.

(c) Other fact-specific indicia of good faith & loyalty to the corporation.

(d) The company’s line of business.

### When a Fiduciary May Take a Corporate Opportunity

(1) has BOD declined the opportunity in good faith?

(2) no requirement of disclosure.

\*if fiduciary discloses the opportunity & the BOD declines to pursue it, there is a "safe harbor."

\*Even when the BOD is NOT presented with the opportunity, the court still may approve it. (Broz)

\*DGCL §122: authorizes waiver of corporate opportunity doctrine in the charter (e.g. Dreamworks)

## DOL: Close Corporations

\*RULE (DE): qualified utmost good faith and loyalty (MA: utmost good faith and loyalty)

\*duty applies not only to majority but also to minority

\*boundaries of duties not completely clear and vary across states

\*will try to interpret an ex ante agreement consistent with these duties

\*closely held corps have special rules (e.g. DGCL §§341-356)

\*def: Close Corporations (*Donahue*):

(1) Not a lot of shareholders (in DE <30 shareholders; other states → no clear rule).

(2) No ready market for the stock (no transferability; exit is difficult; no market value for the stock).

(3) There is a greater likelihood of a controlling SH.

(4) The majority SH usually participates in mgmt.

\*Donahue v. Rodd Electrotype (Mass. 1975 351) (equal opportunity rule in close corporations)

\*Legal Background: there is NO equal opportunity rule in the U.S. (some countries do have this).

\*HIST: Corporation bought Rodd's shares at $800/share to get him to retire; Donahue (minority SH) offered to sell her own shares but corp only offered $200/share; Donahue suing to either cancel the deal or buy her shares at same rate.

\*H: Yes, must pay Donahue the full price

\*RULE: fiduciary duty in close corporations is “*the utmost good faith and loyalty*,” ~partnership

\*RATI: The court is applying the duties of partners (*Meinhard*) to close corporations.

\*Counter: minority SH may want freedom to buy back the CEO’s shares at a higher price to encourage him to retire.

\*TA: Wilkes v. Springside, Mass. 1976 (364): controlling SH have right of "selfish ownership" if:

(1) legitimate business purpose, and

(2) least harmful way (to minority SH) of pursuing the selfish interest

\*Smith v. Atlantic Properties (Mass. App. 1981 359) (*equal opportunity rule in context of an ex ante agreement*)

\*HIST: Charter has weird veto provision that makes every minority SH a controlling SH; Wolfson vetoes payment of any dividends (probably; animosity to other SH); IRS penalizes Atlantic; other SH bring suit to remove W as a director and pay

\*H: yes wolfson breached his duty: no valid reason for Wolfson's actions: just acting out of spite

\*DISC: L&E Approach: What would the parties have done ex ante? There *was* an ex ante agreement! The veto in the charter. Court still rejects it. It was reasonably foreseeable that there would be disagreements among the directors, but W pushed it too far

# Deal Protections and Defenses: Unocal, Revlon, Etc.

\*increasing strictness: BJR 🡪 Unocal 🡪 Revlon 🡪 Blasius 🡪 entire fairness

## Unocal-Revlon-Blasius One Pager: how much scrutiny will the court apply to mgmt's defenses?

🡪Unocal: proportionality: when there is a (hostile) bidder and mgmt wants to resist

(1) Is there a threat (Gilson & Kraakman 1989; even a nonexistent threat can be a threat (*Moran*)) that is:

(a) Is the threat *substantively coercive*? (def: inadequate price: risk that SH will mistakenly accept an under-priced offer because they disbelieve mgmt’s promises) (*Unitrin, Time*)

(b) Is the threat *structurally coercive*? (def: SH are afraid they'll get burned in 2d step so pressure to tender in 1st step; *Unocal*)

(c) Is there an *opportunity loss*? (def: "hostile offer might deprive target SH of opportunity to hear mgmt's superior alternative"; *Time*)

🡪if so, then mgmt is right to respond

(2) Is the defense *proportional*? (*Omnicare* 581)

(a) Is it *preclusive* (e.g. the tactic doesn't let bidder conduct proxy fight (*Moran*)), or is its objective just entrenchment?

🡪If yes to either, then defense is not proportional.

🡪Board packing might be proportional b/c not preclusive (*Blasius* dicta; *Blasius* court did not decide under *Unocal*)

🡪pill is proportional (*Moran*)

🡪Revlon: reasonableness: when Revlon duties are triggered, T board must maximize immediate SH value (auctioneer)

(1) Does Revlon apply / what is a "sale"? Triggers (*Paramount*):

(a) sale or breakup of the company is inevitable (*Time Warner*)

(b) sale of control (*QVC*)

(c) corp initiates a bidding process

(d) in response to bidder's offer, target abandons long-term strategy and seeks an alternative involving the break-up of corp

(e) see chart below (whale/minnow, etc.)

\*not a trigger: stock-for-stock merger between two public corps w/ no controlling SH (*Santa Fe*)

\*not a trigger: filing of 13D (*Lyondell*)

(2) If yes, did the managers meet their duties?

(a) level playing field

(b) market check (*Barkan*).

(3) Did the BOD act reasonably?

(a) Factors (*QVC*): BOD must (1) evaluate both offers seriously; (2) act in good faith; (3) obtain, and act with due care on, all material info; (4) negotiate actively w/ both suitors; and (5) consider removing deal protection measures (#5 ~ fid out: very important)

(b) lock ups depend on timing and size

🡪*timing*: beginning of process to attract a bidder, and a fiduciary out: OK (will survive Unocal)

🡪*timing*: if late in process to stop an auction rather than start an auction: not OK (less likely to survive Unocal)

🡪*size*: if too big can prevent auctions (less likely to survive Unocal).

🡪Blasius: compelling justification: when the main goal is to interfere with SH franchise.

(1) What will trigger Blasius?

\*yes: increase the difficulty of outsider's ability to influence SH (*Liquid Audio*)

\*yes: reorganization of all assets to avoid a SH vote (*Hilton v. ITT Corp*) (Nevada)

\*not likely: designed to protect against hostile takeovers and interference is incidental

\*not likely: board buys up shares (affects SH voting indirectly)

(2) What responses will be considered compelling?

\*not compelling: too low price (n.b.: that's a *Unocal* threat but not *Blasius*: ∴ can use other def. tactics, but not tamper w/ SH voting)

### Revlon continuum

\*First thing to ask when you see defensive mechanisms: does Revlon apply? (*chart*)

**Revlon-mode**

**less likely**

**Revlon-mode**

**more likely\***

Whale/

minnow

Merger

of equals

**Consideration**

All

cash

All

stock

Controlling

shareholder

Widely

held

**Size of target versus acquirer**

**Acquirer shareholders**

Sale of Control

Theory (QVC)

Institutional

Competence

Theory

(e.g., Revlon)

\* except when target has a majority shareholder

\*TA: Cash vs. Stock

\*merger for cash: Revlon clearly triggered.

🡪courts won't defer to BOD: will closely review deal protection measures to assure they are in Good Faith

🡪RATI: If all cash, SH don't benefit from value of the merger.

\*merger for stock: Revlon may not be triggered (~*Time Warner*)

🡪courts more likely to defer to BOD: directors' private info will create value for SH

🡪RATI: stock can be hard to value (courts' institutional competence).

\*merger for both cash and stock: the more cash, more likely to get Revlon, and vice versa

\*TA: Size matters: in a whale/minnow scenario, it is more likely that Revlon duties will apply.

🡪RATI: Mgmt of minnow less able to assess value of the whale or influence the whale's long-term plan

🡪RATI: The long term benefits depend on what is going to happen in the large firm.

🡪RATI: Whale can buy off mgmt of minnow, minority SH of minnow at risk

## Transactions in Control: Overview

\*Control premium:

🡪public benefit: buyer believes he has a superior business plan that can raise the stock price

🡪private benefit: how much value controlling SH can extract from minority (probably more relevant)

\*Acquiring control: purchase from CSH (high premium if he exacts a private benefit) or build from lots of minority SH

\*tension: law wants to (a) protect SH from opportunism and (b) foster efficient transfers of control

## Sales of Control Blocks: The Seller's Duties

\*Zetlin v. Hanson Holdings Inc. (NY 1979 p. 416) (market rule)

\*RULE: CSH is free to sell and acquirer is free to buy at a premium, as long as there's no:

(1) *looting* of corporate assets (if there's a red flag; *Harris v. Carter*)

(2) conversion of corporate opportunity

(3) fraud or other acts of bad faith

\*4th: sale of corporate office (esp. if <10%) (*Brecher*)

\*Perlman v. Feldmann (2d Cir. 1955 p. 417) (EOR; probably confined to the circumstances)

\*HIST: SH sue Feldmann for selling corp opportunity in violation of his fid duty.

\*H: Yes, Feldmann Plan belonged to the company, breach of fid duty; Feldmann must distribute his premium to all SH

\*RATI: premium is not a control premium, but an appropriation of corporate opportunity (properly belonged to all SH).

\*TA: assumes that control premium only reflects the value of the opportunity, but it probably also reflects other benefits.

\*In Re Digex Inc. Shareholders Lit (Del. Ch. 2000 p. 428) (control SH's "selfishness" right)

\*HIST: Acquirer wants to buy sub; control SH of parent offers up parent corp instead

\*H: fine, control SH can use voting power to block purchase of subsidiary

\*H: but control SH violated fiduc duty by pressuring subsidiary's board

\*STAT: DGCL §203 (DE's only antitakeover stat): new CSH can't cashout minority for 3 years unless company's board approves ex ante

\*RATI: board may waive §203 but only for benefit of all SH, not just control SH

\*TA: control SH's "selfishness" right: most selfish actions will violate the fiduciary duty to minority SH, but there are *some* that don’t

## Comparing Efficient and Inefficient Sales of Control

|  |  |  |  |
| --- | --- | --- | --- |
|  | Old Controller | Looter | Efficient Buyer |
| Total Firm Value | $1,000 | $900 (worse manager) | $1,350 (better manager) |
| Private Benefit | $100 | $500 (better looter) | $100 (same looter) |
| Net Firm Value | **$900** (min: $450; C: $550) | **$400** | **$1,250** |
| Minority Share Price | $10/share | $4.44/share | $13.89/share |
| Assumption: 90 shares total – 45 (50%) trade in the market, 45 (50%) are held by the controller. | | | |

Inefficient (under K-H) Sale of Control (OC 🡪 Looter): Compare Market Rule and EOR

\*value of corp will go down

\*Assume: buyer is a worse manager but a better looter (can extract more private benefit so willing to pay higher premium)

\*OC values the stake at $450 (½ net value) + $100 (private benefit) = $550 ($12.22/share).  
\*Looter values the stake at $200 (½ net value) + $500 (private benefit) = $700 ($15.56/share).

\*KH efficiency: *will not happen*: pie gets smaller

\*Market Rule: *will happen*: looter will pay < $15.56, OC will sell for > $12.22

🡪solution: (a) rules to limit private benefit or (b) EOR?

\*EOR: *will not happen*.

🡪Looter would have to pay premium price to all SH, no longer efficient for him: costs $1100 ($12.23\*90), which is >$900)

🡪but *will* happen if net firm value under new CSH is *greater than* current net firm value (better manager).

Efficient Sale of Control (Looter 🡪 EB)

\*Concern that it *won't* happen: If owner is a strong looter, efficient buyer will have trouble offering him enough

\*HYPO

🡪Looter values the stake at $200 (½ net value) + $500 (private benefit) = $700 ($15.56/share).

🡪EB values the stake at $625 (½ net value) + $100 (private benefit) = $725 ($16.11/share).

🡪Market Rule: *will happen*

🡪EOR: *will not happen*: have to offer $700 to looter and $700 to minority SH, $1400>$1350

🡪even though minority SH stake is only worth $200, has to pay them $700

🡪Pro rata rule: *will not happen*

## Sale of Corporate Office

\*exception to the market rule: compare *Muscat* and *Brecher*:

|  |  |  |
| --- | --- | --- |
|  | *Muscat* | *Brecher* |
| **size of "control" block** | 9.7% | 4% |
| **Premium received by seller** | "slightly above market" | 35% |
| **Fate of newcomer** | Directors re-elected by SH | CEO fired by board |
| **H** | Upheld | Disgorgement of premium |

🡪TA: When will court reject a sale? Size of block is key and 10% is usually the cutoff.

🡪RATI: if controlling SH has small %, can loot a lot without hurting himself much

## Looting

\*exception to the Market Rule: quite narrow (may be limited to cases where sale requires the board resigns)

\*Harris v. Carter (Del. Ch. 1990 p. 429)

\*P arg: shouldn't have sold, selling to a looter

\*RULE: red flag duty (but weaker than *Caremark* b/c it's a market transaction)

\*TA: duty could be narrow: when sale AND change of board req'd as part of agreement, if there's a red flag, controlling SH has a duty to inquire if buyer is honest (*Allis-Chalmers*, *Caremark*)

# Tender Offers: The Buyer's Duties

\*def: an offer of cash or securities to SH of a public corp in exchange for their shares at a premium over market price.

\*"Market Street" or "Street Sweep": large purchases form large institutional investors.

🡪The SEC has convinced the courts that these are tender offers. *Brascan* (8-factor test).

\*1968: *Williams Act*: RATI 1: SH may tender their shares at a price that is too low b/c they think others will tender (prisoner’s dilemma); SH need time to determine the actual value of their shares. (just b/c there's a premium, might not be a good idea; w/ more time, SH may create a bidding war)

## 4 Elements of the Williams Act

(1) Early Warning System – §13(d): Requires disclosure whenever any acquirer purchases more than 5% of the stock.

(a) Basic Rule (Rule 13d-1(a)): once you hit 5%, you have a window of 10 days to increase the size of your stake before required to file a 13D report (but req't to update) 🡪 makes it harder to accumulate control from various small SH.

(b) Key Definitions:

(i) "Beneficial Owner" means power to vote or dispose of stock (13d-3(a)).

🡪courts look to substance over form

(ii) "Group" is anyone acts together to buy, vote, or sell stock (13d-5(b)(1)).

🡪Each group member is deemed to beneficially own each member’s stock.

(c) Applies whether it's a formal tender offer or not (unlike §14 provisions)

(2) General Disclosure – §14(d)(1): Offeror must disclose identity and future plans, including any subsequent going-private transactions.

(3) Anti-Fraud Provision – §14(e): prohibits "fraudulent, deceptive, or manipulative" practices.

(4) Terms of the Offer – §§ 14(d)(4)-(7): governs the substantive terms of the tender offer (e.g., duration, equal treatment).

(a) 14e-1: t.o. must be open for 20 business days.

(b) 14d-10: t.o. must be made to all holders (but not necessarily same amount); all purchases must be made at the best price.

(c) 14d-7: SH who tender can withdraw while t.o. is open.

(d) 14e-5: Bidder cannot buy "outside" the t.o.

\*Brascan v. Edper Equities (S.D.N.Y 1979 p. 435)

**\*RULE: 8-factor test for what makes an offer a t.o. (SEC)** (*Wellman*) **(**437-39)

(1) active and widespread solicitation of public SH

(2) solicitation is made for a substantial % of the issuer's stock

(3) a premium over the prevailing market price

(4) terms of the offer are firm rather than negotiable

(5) whether the offer is contingent on the tender of a fixed minimum number of shares

(6) whether the offer is open only for a limited period of time

(7) whether the offerees are subjected to pressure to sell their stock

(8) whether public announcements of a purchasing program precede or accompany a rapid accumulation

\*TA: but remember, no bright-line rule: not all privately negotiated block trades are t.o.s

### The Hart-Scott-Rodino (HSR) Act Waiting Period

Gives FTC & DOJ proactive ability to block deals that violate AT if deal > $260M

# CH. 12: Mergers and Acquisitions

Three basic mechanisms for acquisition

(1) asset acquisition (DGCL § 271)

(2) stock acquistion

(3) merger (DGCL § 251)

### Cash-for-stock Merger ≠ Tender Offer

\*Merger: SH vote: if majority, then everyone is cashed out

\*Tender Offer: each SH makes his own choice

\*would choose cash-for-stock merger b/c don't want SH to act as individuals

### RMBCA compulsory share exchange

\*basically just a reverse triangular merger in DE

\*Compulsory Share Exchange: t.o. negotiated with T's BOD: SH vote, if majority approve, all SH cashed out

\*result: tax treatment of t.o. w/o holdout problem of t.o.

\*a form of stock acquisition: acquirer ends up with 100%

\*not in DE: they do 2-step merger instead

### Mergers

\*Merger Process under DGCL §251:

(1) A & T boards negotiate the merger.

(2) Proxy materials are distributed to SH as needed (see below).

(3) T's SH always vote (§251(c)); A's SH vote unless

(a) surviving corp charter is not modified;

(b) security held by A's SH will not be exchanged or modified;

(c) SH of A do not vote if A is much larger than T (DGCL §251(b))

(d) A's issuance of new stock is <20% of existing stock (§251(f)). (major U.S. exchanges require if >20%)

\*How many need to approve?

(a) majority of T’s outstanding shares is required (regardless of how many participate).

(b) RMBCA also requires T’s SH approval, but only a majority of *participating* SH.

(4) If *majority of T's SH* approve, T assets merge into A, *all of T's SH* get stock in A.

(5) Certificate of merger is filed with the secretary of state.

(6) Dissenting SH who had a right to vote have appraisal rights.

\*TA: Four protections for T's SH:

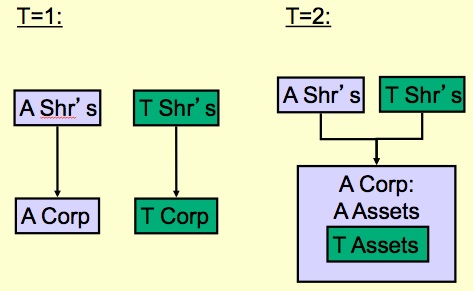
(1) BOD bound by DOC and DOL

(2) SH approval rights and, if object, appraisal remedies

(3) If merger is with a CSH or otherwise involves a conflict of interest, then subject to Entire Fairness

(4) Issuance of stock in a merger is a sale under fed securities law (so entitled to 14a-9 fraud protection)

\*DGCL: Statutory Merger (*must be in print view to see image*)



### Asset Acquisition

\*high transaction cost, low liability cost

\*Asset Acquisition Process under DGCL § 271

(1) A and T boards negotiate the deal.

(2) If sale is of "substantially all" assets (§271, *Bregman*), T’s SH get voting and appraisal rights (b/c only T is being "bought").

(3) Transaction costs are generally higher b/c title to the physical assets of T must be transferred to A.

(4) After transfer, T usually liquidates the consideration received (e.g., cash) to its SH.

(5) The result is basically the same – A has the assets of T, T is liquidated; T’s SH get shares in A.

\*Katz v. Bregman (Del. Ch. 1981 p. 453) (when sale of assets is "substantially all" assets and T's SH must approve)

\*HIST: Plant industries sells its Canadian subsidiary, which is 51% of its assets and most of its profits

\*H: the sale "constituted a sale of substantially all of Plant's assets," ∴ should have consulted SH, sale enjoined until SH vote

\*TA: This is a stretch – usually 70%-80% of all assets is required to be considered "substantially all."

\*RATI: Big departure from firm’s line of business; concerns of self-dealing 🡪 situations where we want SH approval.

\*Note: This case is pre-*Revlon*.

\*Thorpe v. CERBCO (Del. 1996 p. 456)

\*RULE: qualitative test: is the transaction "out of the ordinary course" and would it affect the corp's "existence & purpose"?

\*H: sale of 68% of shares is subject to SH vote

\*Hollinger v. Hollinger (Decl. Ch. 2004 p. 456)

\*HIST: Hollinger Int'l sells its Telegraph newspapers; Conrad Black is controlling SH, demands SH vote

\*H: Telegraph newspapers are 57% and ∴ *not* "substantially all" of Hollinger's assets

### Stock Acquisition

\*buy ~100% of stock (technically t.o. are not stock acquisitions unless complete)

\*Delaware two step merger: (1) tender offer for most/all of target's shares, target board promises to recommend to SH; (2) merger between target and subsidiary of acquirer (clears out minority SH who refused to tender)

🡪once offeror is majority SH of T, easier to get SH approval!

### Triangular Mergers

\*since surviving corp assumes T's liabilities 🡪 A absorbs T as a subsidiary to preserve "the shield of separate incorpation"

🡪creditors cannot get A’s assets if A is parent and T is sub.

\*Different approaches

\*result of both: resulting corp is subsidiary of the acquirer.

\*merger consideration: usually cash or shares of A

\*SH Voting Requirements

\*Majority of T’s SH.

\*Majority of A’s SH if you increase the # of outstanding shares by >20%.

\*DGCL: "Triangular Merger": Creation of a subsidiary and then a merger between the target & subsidiary

🡪Forward: if subsidiary is surviving corp (see chart)

🡪Reverse: if target is surviving corp 🡪 easiest and cheapest method of transfer

A Shr’s

A Corp

T Shr’s

T Corp

T=1:

A Sub

T=2:

A Shr’s

A Corp

T Shr’s

A Sub

100%

**2. T merges**

**Into A Sub**

**1. Merger consideration for A Sub stock**

T Assets

\*RMBCA: "Compulsory Share Exchange": occurs with transfers of shares

A Shr’s

A Corp

T Shr’s

T Corp

T=1:

T=2:

A Shr’s

T Shares

A Shares

A Corp

T Shr’s

T Corp

100%

\*Timberjack case study: t.o. for $25/share (from the parent company's treasury); want to acquire 70-90% (p.466)

\*reverse triangular merger: Parent sets up a subsidiary ("purchaser") solely for the purpose of the acquisition, then folds it into the target ("company"); parent company gets shares of Timberjack

\*Purchaser offers $0.01 per share for the company

### The Short-Form Merger

\*Allows corps that hold 90% of subsidiary to merge w/ subsidiary w/o approval of subsidiary SH *or* board approval. (DGCL § 253)

\*minority do have right to appraisal but don't have right to vote

# The Appraisal Remedy

(p.474)

\*DE law, appraisal is: required for merger, not required for asset acquisition (unless added to the charter)

### The Mechanics of Appraisal

(DGCL §262)

(1) SH get notice of their appraisal rights.

(2) SH have an opportunity to submit demand for appraisal before the vote.

(3) SH have to vote against the merger; otherwise appraisal right is forfeited.

(4) SH must then file a petition with the Chancellery Court.

(5) The court then holds valuation proceedings to determine the fair value of the shares.

### The Market-Out Rule

(p.478)

\*DGCL §262(b)(2): appraisal remedy is available in a statutory merger

\**Don't* get appraisal rights if shares are market traded (RATI: have a way out); >2000 SH; or SH not req'd to vote on merger

\**Do* get appraisal rights, even if shares are market traded, if merger consideration is anything other than shares in surviving corp or other publicly traded corp (i.e. cash)

\*TA: somewhat inconsistent: your exit opportunity could exist under either or maybe not under either

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Statutory Merger**  **(DGCL §251, RMBCA §11.02)** | **Asset Acquisition (DGCL §271, RMBCA §12.01-.02)** | **Share Exchange (RMBCA §11.03)** |
| **T Voting Rights** | **Yes** – need majority of shares outstanding (DGCL §251(c)), or majority of shares voted (RMBCA §11.04(e)) | **Yes**, if "all or substantially all" assets are being sold (DGCL §271(a)) or no "significant continuing business activity" (RMBCA §12.02(a)) | **Yes** – need majority of shares voted (RMBCA §11.04(e)) |
| **A Voting Rights** | **Yes**, **unless** <20% shares being issued (DGCL §251(f), RMBCA §11.04(g)) | **No** (though stock exchange rules might require vote to issue new shares) | **Yes**, **unless** <20% shares being issued (RMBCA §11.04(g)) |
| **Appraisal Rights** | **Yes** if T's SH demand appraisal and vote against merger, but **market out** (DGCL §262, RMBCA §13.02) | **No** in Delaware**, unless** provided in charter (DGCL §262(c)); **Yes** under RMBCA if T shareholders vote, **unless** stock market exception (RMBCA §13.02(a)(3)) | **Yes**, **unless** stock market exception (RMBCA §13.02(a)) |

### Fair Value: How to conduct an appraisal

\*moving from (1) to (3), increasingly good for dissenting SH (p. 478)

(1) Apply minority discount (b/c minority shares worth less than control shares)

\*Weird: DE courts reject minority discount but apply the Market Out rule

1. The market price reflects the minority discount. Appraisal rights do not. ∴ Appraisal value will be > market value.

2. Market out rule presumes that minority SH can get full value for their shares on the market.

3. But DE courts say minority discount is not enough in appraisal: ∴ they know that the market out is a fiction.

(2) Block Method: Value as a pro rata claim on the going concern value.

\*consider market value, earnings, & asset value

🡪Market Value of Shares: share price, if shares are traded.

🡪Earnings Value: last three years of earnings, capitalized using a price-to-earnings ratio.

🡪Asset Value: net assets, valued at liquidation value.

\*No minority discount, but no claim on the benefits of the deal.

(3) Value as a pro rata claim on the going concern value, including the benefits from the deal.

\*DGCL § 262(h) explicitly rejects this: not supposed to include merger-related benefits.

\*only include merger-related benefits that are *non-speculative*

(4) Discounted cash flow valuation (p. 128; *Weinberger*) 🡪 this is what courts use

\*consider corp's future projects, discounted for risk and time (NPV)

(a) estimate all future cash flows generated by the asset (terminal value often 60%)

(b) Calculate discount rate: weighted-avg cost of capital (WACC) = wghtd avg of

\*estimate all future cash flows generated by the asset (127)

\*def *terminal value*: e.g. cash flow for year 10 = year 10 and everything beyond; can be 60-70% of total

\*calculate an appropriate discount rate

\**weighted-average cost of capital* (WACC): avg of cost of debt + equity (by proportion in capital structure) + beta

\**cost of debt*: interest rate if company needed new debt financing today (pre-tax)

\**cost of equity*: investors expect a certain return

🡪*capital asset pricing model* (CAPM): assumes that markets efficiently price risk and return

🡪measure stock price movement relative to market as whole = the equity *beta*

🡪*historical average equity risk premia*: usually cost of equity is 8% higher than pre-tax cost of debt

\**beta*: estimate of systemic nondiversifiable risk

## De Facto Merger Doctrine

\*I: DE and most states recognize only *formal* mergers

\*Hariton v. Arco Electronics (Del. Ch. 1962 p. 481)

\*HIST: A is buying T; P arg: transaction is formally a sale of assets but is a de facto merger, ∴ he is owed appraisal

\*H: no right of appraisal, defer to legis (TA: trying to circumvent appraisal by doing it via assets; not a merger but result is very similar)

# Hostile Takeovers: Contests for Corporate Control

Introduction (p.510)

\*Typical situation: a bidder wants to take over a firm, mgmt afraid of losing jobs

🡪hostile takeovers usually only occur when bidder thinks that corp is undervalued and can implement better mgmt

🡪Hostile takeovers are small % of M&A (3% in 1990s).

🡪But possibly creates a strong *disciplinary effect* on managers (as long as mgmt can't completely block takeovers)

\*Method: simultaneously initiate a proxy fight and issue a t.o. to signal seriousness of the t.o.

***\*Tension***:

\*Mgmt arg: legitimate business purpose to defend against a hostile takeover (protect SH; implement long-term business plan; concerned that buyer will hurt the corp/employees/customers)

\*Acquirer arg: inherent COI (mgmt just entrenching)

## Unocal: Defending Against Hostile Tender Offers

\*Unocal v. Mesa Petroleum (Del. 1985 p. 515) (proportionality)

\*HIST: Mesa wants to buy w/ 2d half in junk. Unocals' defensive tactics ("defensive recapitalization"): self-tender at offer price for 30% of shares; if Mesa gains 50%, tender for remaining 20% at offer price, paid in debt securities (Mesa excluded). Goal: incentive for SH to (1) wait until stage two and (2) tender to the corp (and Mesa will be forced to offer full price to 2d half so they tender to him and not back to Unocal)

\*RULE: enhanced BJR if (1) there is a threat and (2) defensive tactic has a "reasonable relation to threat posed"

\*H: Yes there was a threat, yes the response was proportional (if threat is coercive, ok for tactic to be intense)

\*H: Mesa offer is *structurally coercive*: SH may feel compelled to accept in Stage 1

\*Aftermath: don't see back-end mergers anymore, will give too much power to board to resist

🡪but can cap t.o. at 51% and that's not coercive, bizarre! Always good for mgmt to argue that threat is coercive

\*Unitrin v. Am. Gen. Corp. (Del. 1995 p.521) (defines Unocal req'ts of threat and proportionality)

\*HIST: Hostile takeover; corp defends with (1) a poison pill, (2) an advance-notice bylaw, and (3) a repurchase offer.

\*RULE: threat: inadequate price is sufficient; proportionality: defense is not draconian (preclusive/coercive) + w/i "range of reasonableness"

\*TA: burden on target’s directors to show defensive action was proportional to the threat.

## The Poison Pill

\*mgmt can adopt quickly ***w/o SH approval***. (p.522)

\*market factors in to all values

\*rights given to SH in company documents

\*if redeemed (cancelled), no need to give consideration to SH

\*Flip-Over Pill: right to buy shares in A (legality uncertain)

\*Flip-In Pill: right to buy shares in T – this is what everyone uses.

(1) Rights plan adopted by board vote.

\*SH vote not necessary as long as BOD has provision in charter allowing issue of blank check preferred stock.

\*Mgmt keep the option to redeem (cancel) the poison pill (in case of a friendly bidder).

(2) Rights are distributed by dividend and remain "embedded" in the shares.

(3) Triggering event: e.g. prospective acquirer buys >10% of outstanding shares.

\*Rights are no longer redeemable by the company and soon become exercisable.

\*As a result, no bidder has incentives to start a fight at all because it will never succeed.

(4) Rights are exercised: SH have right to buy shares at a discounted price (acquirer excluded).

\*50% is the typical dilution factor.

🡪if tender offer, pill would be triggered after tender is complete

🡪almost never triggered b/c no buyer wants to be in that position

\*Moran v. Household Int'l (Del. 1985 p. 525) (threat can be putative; pill is not preclusive b/c proxy outlet)

\*HIST: putative threat; Moran is largest SH in Household; flip-over pill w/ two triggers: (1) announce a 30% t.o. and (2) acquire 20% of shares

\*H: BOD has the right to adopt the pill (DGCL §141 = BOD power to manage the company)

\*H: flip-over pill is valid exercise of BJ (DGCL §157 = BOD power to issue rights/options, including the pill – a SH right)

\*H: pill doesn't deprive SH of ability to accept tender offers b/c §§141, 157 powers can be limited in the charter (reality: no one does)

\*RULE: BJR adoption of the pill (maybe would be different for use of the pill)

\*H: Under *Unocal*:

\*Threat: yes, even though no definite threat

\*Proportional: Yes, pill does not completely block a hostile takeover.

\*Aftermath:

\**Interco* (Del. Ch. 1988): target board obligated to redeem poison pill (rejected in *Paramount*)

\**Pillsbury* (Del. Ch. 1988): target board obligated to redeem poison pill

\*TA: Court can examine mgmt assertion they have a better plan for SH

\*e.g. shares traded at 30, bid at 50, mgmt says plan will lift value to 60; must explain

## Revlon: Choosing a Merger or Buyout Partner

\*Smith v. Van Gorkom (Del. 1985 p. 533)

\*HIST: Trans Union CEO (Van Gorkom) gets w/ Pritzker to merge at $55/share (unclear where that number came from)

\*H: BOD was grossly negligent (breached duty of care), inadequate discussion/consideration (court focused on process) (539)

\*def Leveraged buyout (LBO): A borrows $$ to buy T; sells T's assets (or borrows $$ secured by T's assets) to pay back borrowed $$

\*Revlon v. Macandrews and Forbes Holdings, Inc. (Del. 1986 p. 541) (duty to act as auctioneer; reasonableness std)

\*HIST: Perl makes hostile bid; Revlon defenses/deal protection: adopts pill; self-tenders for 20% of own shares w/ notes; offers friendly bidder (F) "lock-up option" (if Perl buys 40%, F can buy top assets at a bargain price); no-shop provision; breakup fee.

🡪notes: increase debt and make Perl's takeover more difficult

\*H: Revlon breached duty of loyalty; can't "rig" the bidding

\*RULE: once sale of company is "*inevitable*," BOD must act as auctioneers, "the directors' role remains an active one"

\*H: Revlon was looking out for noteholders over SH: violation of fid duty, since noteholders already protected by K (541)

\*H: strikes down all defensive measures as invalid: fails Unocal proportionality (542)

\*DICTA: court can consider other constituencies but only if their interests align with SH

\*SUB RULE: lock ups depend on two factors: timing and size

🡪*timing*: beginning of process to attract a bidder, and a fiduciary out: OK (will survive Unocal)

🡪RATI: lockups can allow initial bidders to recoup search costs

🡪*timing*: if late in process to stop an auction rather than start an auction: not OK (less likely to survive Unocal)

🡪*size*: if too big can prevent auctions (less likely to survive Unocal).

\*Barkan v. Amsted Industries (Del. 1989 p. 545) (market check requirement)

\*H: if two bidders going at it, target can't use defense. If only one bidder, target board must "market check" to see if a higher bid is available.

\*In re Pennaco (Del. 2001 p. 545) (*not discussed*): only one bidder but breakup fee is modest, so it's ok

\*Paramount Communications v. Time Inc. (Del. 1989 p. 547) (*the "just say no" case;* when Revlon does not apply)

\*HIST: Time and Warner are set to merge. Deal protection: either T or W can trigger share exchange so one gets 10% of the other. Paramount bids for Time at $175/share. Time fears SH vote on TW merger, and so instead makes t.o. (doesn't require SH approval) for Warner that requires borrowing $10 billion. Time SH and Paramount sue.

\*P arg (Time SH): merger agreement means Time was up for sale, triggers Revlon; share exchange provision was illegal defense (549)

\*P arg (Paramount): fails Unocal test part 1 (Paramount not a threat) and part 2 (response was not reasonable)

\*H overall: TW merger is fine, Revlon is *not* triggered: neither dissolution nor sale is inevitable. Thus not obligated to act as auctioneer.

\*H: TW merger gets BJR review (SH could have voted), but Time purchase of Warner gets *Unocal* review b/c it was "*defense-motivated*"

\*H: Unocal 1: yes, Paramount offer posed numerous threats: threat to culture (551-52)

\*H: Unocal 2: yes, response was proportionate (552); TW was entitled to protect its long-term business plan against short-term SH interest; not preclusive (does not completely block the offer)

\*TA: managers can "*just say no*": can argue price is too low, must defend the SH (crit: mgmt can always say this!)

\*TA: courts will never require mgmt to redeem the pill, even if BOD has "arbitrarily rejected the offer," "unless there is no basis to sustain the corp strategy"

\*Paramount Communications v. QVC (Del. 1994 p. 554) (sale of control triggers Revlon duties; defensive tactics prob need fid out)

\*HIST: Viacom going to buy P. Deal protection: "no shop"; $100 million breakup fee; and 19.9% stock lockup. QVC (Diller) "jumps the deal," QVC becomes hostile. V and QVC offers back and forth, QVC brings suit: P is in Revlon-land.

\*H: Revlon duties DO apply.

\*RATI: Acquiror (Viacom) has a controlling SH (Redstone)

(1) control premium: Paramt has no CSH, so sale to Viacom is dispersed SHs' only chance to demand a premium

(2) control SH may break up the company, freeze out minority, etc.: BOD must protect minority SH

\*RATI: despite P-V's long term plan, SH will not reap the benefits of that plan so it's irrelevant.

\*RULE: *Revlon* trigger: inevitable breakup is not required, sale of control is sufficient

\*TA: This raises the fiduciary duties of directors, can't K around their fiduciary duties.

🡪Para can't hide behind no-shop: still has *Revlon* duties to get best price for SH (fid out)

\*RULE: reasonableness

\*Factors: BODs must (1) evaluate both offers seriously; (2) act in good faith; (3) obtain, and act with due care on, all material info; (4) negotiate actively and in good faith w/ both suitors; and (5) determine whether the deal protection measures should remain in place.

🡪#5 is especially important after receiving a 3d party offer

🡪H: lockups were not reasonable

🡪counter: Deal protections were offered at outset to attract a bidder, which *Revlon* suggests is OK

🡪concern: now lockups will not be respected

Hypo: Whale Minnow

\*Problem p. 566: Q: Xenor (whale) wants to buy T (minnow). T is selling at $12/share. X offer at $14/share (33% cash; 33% common stock; 33% nonvoting stock), plus nice offer to T's CEO. Xenor has dispersed SH. T's board assumes Revlon will not apply and adds large lockup. Then, S offers $15/share; T board rejects.

\*MYA: intermediate Revlon will apply

Lyondell Chemical Co. v. Ryan (Del. 2009 p. 568) (gross negligence ≠ bad faith, but conscious disregard is non-indemnifiable)

\*HIST: Access bids for Lyondell. Offers $48/share but requires $400M breakup fee (later, $385M); fiduciary out. Board wants higher share price, go-shop provision, and reduced breakup fee. Pressure to complete the deal w/i a couple of days.

\*P arg: directors violated DOL b/c did not maximize value: didn't shop around enough

\*H: no, directors win: *when* Revlon *duties are triggered, directors' decisions must be reasonable, not perfect*

\*H: No, filing of 13D does not automatically impose a duty to act

\*TA: unlike *QVC*, only one bidder so different standard applies

## Lockups: Asset Lockups, Stock Lockups, Breakup Fees

(1) Asset Lockup (uncommon) – gives A the right to buy specified assets of T at a specified price

(2) Stock Option Lockup (common) – gives A the right to buy a specified number of shares of T (typically 19.9%) at a specified price

(3) Breakup Fee (most common) – gives A a cash payment in the event of non-consummation

🡪For a subsequent bidder to be successful, must overcome the breakup fee.

🡪Breakup fees have increased over time – currently ~3% (> 5% probably illegal).

🡪Bankers want large lockups (this increases certainty and bankers like certainty).

🡪Lawyers want smaller lockups (because they are afraid they will not pass court scrutiny).

\*TA: only thing left is breakup fees

\*Courts more likely to allow deal protection measures granted after an auction (577)

### Related Issues

\*No-Shops: covenants that T will not shop for alternative transactions or supply confidential info to alternative buyers

🡪But cannot contract around their fiduciary duties (*QVC*), which may require them to shop/talk

🡪The opposing party could sue for contractual damages, but this is not legally certain.

\*Fiduciary Outs: def: if a better deal shows up, directors can breach a K and favor their fiduciary duties over the K (578)

🡪probably moot b/c DESC will refuse to enforce a K that requires violation of fiduciary duties anyway (579)

🡪can create difficulties during negotiation b/c they render lockups meaningless.

### Shareholder Lockups

Omnicare v. NCS Healthcare (Del. 2003 (p. 579) (SH lockup & fiduciary outs)

\*HIST: Genesis deal protection: exclusive negotiating period; breakup fee ($10M🡪$6M); "force the vote" provision: board must let SH vote even if they no longer recommend the deal; "shareholder lockup": two NSC directors hold majority of NCS stock and agree to sell. Omnicare offers double what Genesis is offering but NCS can't respond b/c of exclusive negotiating period. NCS BOD recommends Omnicare offer but Genesis forces the vote and majority were locked up so deal goes through.

\*STAT: §146 allows buyer to force a vote: can submit to SH vote even if BOD does not recommend it.

\*H: Fails *Unocal*. NCS board did not have authority to grant Genesis an absolute lockup.

(1) Threat: losing the Genesis offer (legit?)

(2) Proport: Fails—protection devices were preclusive/coercive: once agreement was signed there was no way to stop it

\*DICTA: could have passed *Unocal* via a fiduciary out

\*Counter: Genesis might not have been interested if there were a fiduciary out

\*DISC: *Orman v. Cullman*: ~Omnicare but control SH promises to vote in favor; if deal fails, won't vote in favor of another for 18 mos; H: OK b/c acting as SH, not as director

## State Antitakeover Statutes

\*TA: help keep their corps from fleeing to DE, but maybe not extreme statutes (p. 589)

\*MB: but all of these statutes are waivable w/ board approval 🡪 so *probably don't matter that much* b/c w/ pill, need board approval anyway

### Acquiring a Control Block

\*Control share statute (27 states): requires SH vote if a SH crosses an ownership threshold (20%, 33%, 50%, etc.)

\*result: can limit his voting rights (but can't limit amount he buys)

\*CTS Corp. v. Dynamics Corp of America (SCOTUS 1987 p. 589): H: IN's statute is constit'l, no conflict w/ Williams Act

\*Other constituency statutes (31 states): allow the board to consider non-SH constituencies.

\*Pill validation statutes (25 states): endorse the use of a poison pill against a hostile bidder.

### Second Step Freeze Out

\*Business combination (freeze-out) statutes (33 states): prevent bidder from merging with T for 3/5 years after gaining control, unless waived by T's board. (i.e. new SH can not take control and immediately liquidate the corp)

🡪only antitakeover statute in DE (DGCL §203): triggered upon acquisition of 15% of shares

\*Fair price statutes (27 states): set procedural criteria to determine a fair price in freeze-outs.

### Extreme Antitakeover Statutes

\*Disgorgement statutes (PA and OH): require bidders to disgorge short-term profits from failed bid attempts 🡪 prevents bidders from recouping bid costs through toeholds (e.g. greenmail)

🡪e.g. PA: if you takeover, any profits from sale w/i 18 months must be disgorged

\*Classified board statute (MA and MD): provides classified boards for all companies incorporated in the state (w/ opt-out)

## Blasius: The Importance of the Proxy Contest Safety Valve

\*Before the pill (1970s-1985): board control is a *consequence* to buying a majority of the shares: (597)

🡪Board will probably resign b/c independence is doomed, or will be voted out over one (no SB) or two (SB) annual elections.

\*After the pill (1985-present): board control is a *prerequisite* to buying a majority of the shares:

1. Bidder launches a proxy contest to replace the target’s board over one (no SB) or two (SB) annual elections.

2. Once in office, the new directors redeem the pill, clearing the way for the hostile bidder to proceed with its bid.

\*TA: Managers can interfere with outside effort to acquire the corp (b/c DE courts worried about tender pressure) but managers can not interefere with right of SH to vote for outsider (b/c DE courts worried about mgmt pressure)

\*Schnell v. Chris-Craft Inudstries, Inc. (Del. 1971 p. 598) (BODs may not move up the date of an annual meeting just to make proxy fight harder)

\*HIST: BOD knows SH are considering proxy fight; amends by-laws to make annual meeting inconvenient.

\*H: BODs may not move up the date of an annual meeting just to make proxy fight harder

\*RULE: though date change is legally permissible, BOD still has fid duties: can't inhibit SH voting franchise

\*TA: Courts eager to protect SH voting rights.

\*Blasius Industries Inc. v. Atlas Corp. (Del. Ch. 1988 p. 599) (if tampering with SH voting, compelling justification std)

\*HIST: B proposes to ask A's SH to increase the size of the board from 7 to 15 and fill new board w/ B nominees. Board is staggered. A amends bylaw and adds 2 of its own to block B's takeover of BOD ("board packing"). B sues.

\*RULE: *not Unocal*, but *compelling justification*

🡪if main goal of defensive tactic is interfere with SH voting, mgmt must show compelling justification.

\*H: The maneuver fails, b/c (1) has an entrenchment effect and (2) had the purpose of altering voting rights.

\*RATI: Primarily b/c of (2), Allen thinks that a higher standard should apply. Not about business judgment but about balance of power in the corp: mgmt can't just change the balance.

\*MM v. Liquid Audio (Del. 2003 p. 603) (not just tampering w/ voting but even making it tougher triggers Blasius)

\*HIST: LA adds two board seats; MM wins those two seats but SH reject MM proposal to add four more seats (i.e. now has 2 out of 7, rather than 6 out of 11); MM sues: this violates *Blasius*

\*Del Ch H: OK: distinguishes *Blasius*: didn't completely block MM, since SH had option to approve their proposal for 4 more

\*DESC H: Not OK: primary purpose of increase from 5 to 7 was to reduce MM's ability to influence, so that triggers *Blasius*, and there's no compelling justification

\*TA: Blasius now extends not only to total blockage but even increase in difficulty

\*Hilton v. ITT Corp. (D. Nev. 1997 p. 604)

\*HIST: Hilton makes offer for ITT; ITT does not have a staggered board and can't implement one w/o SH vote; ITT delays SH meeting and plans a reorg: puts 93% of assets and 87% of revenues in ITT Destinations, which has a staggered board

\*H: no: creation of ITT destinations is preclusive and coercive (*Unitrin*)

\*H: Blasius:

(1) yes was effort to interfere with SH voting rights

(2) no was no compelling justification

\*Aftermath: NV applies *Blasius* but not *Revlon* or *Unocal*: BJR for poison pill, defensive tactics, and company for sale

## The Takeover Arms Race: Mgmt Defenses

### Structural defenses (slide; aka "Shark Repellants"; listed in increasing potency)

\*Golden Parachutes: Large payments to mgmt and sometimes employees (silver parachutes) in the event of a takeover.

\*Pro: discourage takeovers by increasing the price

\*Con: Mgmt may have incentive to seek hostile takeover

\*Anti-Greenmail provision: Prohibits the board from buying back a stake from a large-blockholder at a premium price.

\*Supermajority Voting Provisions: Requires super-majority vote (e.g., 80%) to approve certain business combinations, e.g., sale of assets, liquidation, freeze-out, often with a "fair price" out.

\*Poison Pill: Dilutes the acquirer’s stake after hitting a certain trigger threshold of ownership (typically 10-25%).

\*Staggered Board: Allows only a fraction of directors (typically 1/3) to stand for election each year.

\*Dual Class Stock: Two classes of stock, with different voting rights, e.g., voting and non-voting stock.

### Tactical Defenses

\*Greenmail (+ standstill agreement): Agreeing to purchase a bidder’s shares at an attractive price.

\*Leveraged Recapitalization: Issuing new debt to buy back shares or issue a cash dividend.

\*Pac Man Defense: Making a bid for the bidder

\*"Bulking Up": Buying another company to make a hostile acquisition more difficult.

\*"Crown Jewel" Defense: Selling off key assets

\*White Knight defense: Seeking out a friendly acquirer, typically at a higher price than the hostile bid.

\*White Squire defense: Seeking out a friendly party willing to buy a substantial stake as a defense against the bidder.

### Types of Poison Pills

\*def "***redeem***" ***= withdraw,*** "***implement***" ***= use***

\*"Flip Over" Pill: T's SH can buy *shares of the bidder* at a substantially discounted price. (bidder excluded)

🡪probably illegal

\*"Flip In" Pill: T's SH can buy *shares of the target* at a substantially discounted price. (bidder excluded)

🡪might be illegal in CA

\*"Chewable" Pill: Pill disappears if fair price criteria are met (e.g., fully-financed, 100% offer w/ a 50% premium).

\*"Slow Hand" Pill**°**: Pill that may not be redeemed (i.e. canceled) for a specified period of time after a change in board composition.

\*"Dead Hand" Pill**°**: Pill that may only be redeemed (i.e. canceled) by the "continuing directors."

\*"No Hand" Pill**°**: Pill that may not be redeemed (i.e. canceled) by current or future boards for the life of the pill (usually ten years).

**°**Slow/Dead/No Hand: Illegal in DE (though legal in MD/VA/PA/GA): RATI: they make the proxy fight ineffective: only the old board can get rid of the pill, not the new board, so the pill will still explode automatically as soon as buyer hits 15%

### Dead Hand Pills

\*Carmody v. Toll Brothers (Del. Ch. 1998 p. 606) (dead hand pill invalid)

\*H: creates 2 classes of directors w/o auth from the charter; plus, inhibits the rights of SH to elect new directors

\*Mentor Graphics v. Quickturn (Del. Ch. 1998 p. 606) (slow hand pill invalid)

\*I: delayed redemption provision: board can't redeem (withdraw) a pill w/i 6 months of election of a new board

\*H: struck down; RATI: *Unocal*/*Unitrin*: abstract threat can't deprive the SH of a functioning board  
\*DESC affirms: *present board can't restrict authority of future boards* (Crit: lots of contracts do that!)

\*Question p. 607:

\*HIST: Oracle has hostile bid for Peoplesoft; P starts the CAP program: offers $2B to customers; about 1/3 of market value.

\*Arg valid: doesn't stop the proxy fight

\*Arg invalid: current board binds the future board (*Quickturn*); out of proportion (*Unocal*); can't consider other constituencies (as in *Ford*)

\*Also note: Aventis adopts special *bon plavix* in Sanofi takeover; Neighborcare gives customers right to exit long-term K if acquired

## The Takeover Arms Race: SH Counterattacks: Restrictions on Use of the Pill

Mandatory Pill Redemption Bylaws   
\*def: SH pass bylaw that requires BOD to redeem (i.e. cancel) an existing pill and refrain from adopting a pill w/o SH approval

\*I1: maybe infringes on board's right (under DGCL 141(a)) to exercise business discretion in managing the corp

\*counter: SH can do it under DGCL 109(b)

\*I2: maybe mgmt don't have to include such a proposal to amend the bylaws in the proxy materials

\*In Delaware, *this kind of bylaw is illegal, interferes w/ BOD's rights under 141(a)*

\*Bebchuk's alternative: pill expires w/i one year, must be renewed by SH or by unanimous board vote (609)

\*response to DE striking down earlier bylaw proposal

\*Arg will survive: *procedural, maybe more likely to survive 141(a)*

\*Arg will be effective: if bidder can get even one member on the board (e.g. staggered), can block readoption of the pill

\*I: is it preclusively difficult to take over the company through a proxy fight?

\*def preclusive: realistically unobtainable

\*DE courts: board can use the pill even if it's staggered and even if it lost one election 🡪 not per se preclusive

\*E.g.: *Barnes & Noble*/*Selectica*/*Airgas*: board's use of the pill is valid, Court won't force redemption (cancellation)

\*Unisuper v. News Corp. (Del. Ch. 2005 p. 610) (revises Quickturn: ok if in favor of SH)

\*HIST: News Corp agrees to board policy that its poison pill will expire after 1 yr w/o SH approval (not bylaw, just "board policy"); hostile bid by Liberty Media, then extends the pill in violation of "board policy"; SH sue for K breach

\*D arg: "board policy" not enforceable: can't bind future board (*Quickturn*)

\*H: distinguish *Quickturn*: prohibition on restraining a future board only applies to actions that would hurt SH, not help SH

\*RATI: "It makes no sense to argue that the News Corp board somehow disabled its fiduciary duties to SH by agreeing to let the SH vote on whether to keep a poison pill in place" (612)

\*RULE: fiduciary duties are "gap fillers" to make sure agents act on behalf of the principal; when the principal makes his desires known, those take priority over fiduciary duties (612)

# Going Private: The Duty of Loyalty in Freeze Outs (Controlled Mergers) (Weinberger/CNX)

\*def freeze out: controlling SH is buying out the minority (p.483)

\*types of freeze outs: mergers, asset sales, reverse stock splits (i.e. 100 shares = 1 share: sometimes only control SH has one whole share, everyone else has a fractional share and cashed out)

\*remedies: injunction to stop the merger; appraisal; recissory damages if freeze-out merger was unfair

## Going Private: Freeze-out Mergers

\*def freeze-out merger: control SH of A creates B, a dummy corp, and B merges with A: only require majority vote, CSH has majority (p.484)

\*Singer v. Magnavox (Del. 1977) (old rule: *increased scrutiny on freeze-outs*)

\*RULE: SH can bring class actions not just for appraisal but also for breach of fid duty

\*RULE: per se rule: freezeout w/o *business purpose* breaches entire fairness (getting rid of minority SH is not a valid purpose)

\*Weinberger v. UOP (Del. 1983 p. 486) (broadens appraisal recovery but pushes SH to seek appraisal as the proper remedy)

\*HIST: Parent-sub freezeout; Two Sub directors are also Parent employees, prepare report that Parent will pay up to $24/share. Parent offers sub SH $21/share. Sub's minority SH vote in favor. Lehman quickie opinion. Other directors of sub not aware of the report.

\*H: fairness fails: SH were not fully informed, failure of fiduciary duty to minority SH (490)

\*though buyer doesn't have an obligation to broadcast the highest price he's willing to pay, both sides triggers EF

\*H: self-interest concern: looks like they used inside knowledge of sub to hurt sub 🡪 ∴ rule is EF

\*RULE: entire fairness (fair dealing + fair price): When directors on both sides of a transaction, burden on D to demonstrate "*utmost good faith and the most scrupulous inherent fairness* of the bargain" (490)

\*RULE: fair price = "all relevant factors" (DGCL §262(h))

\*Remedy: dissenting SH is entitled to "synergy gains" created by the merger (arg: this goes beyond §262(h))

\*TA: makes appraisal more generous but suggests may be only proper remedy, fid duty action only appropriate for fraud etc. (but see *Rabkin, Cede*) [also narrows *Magnovox*: business purpose req't goes from per se to discretionary factor]

\*Rabkin v. Hunt Chemical (Del. 1985 p. 494): appraisal is *not* the exclusive remedy, minority *always* has the option of suing for breach of fid duty.

\*Cede v. Technicolor (Del. 1996 p. 495) (*not discussed in class*)

\*I: does Perelman owe fid duty to pay fair price to minority SH in second step of merger?

\*TA: Parent-sub merger: complaints about price can go to appraisal or fid duty (b/c control SH owes fid duty to minority SH).

\*TA: Arm's length merger: only complaints about price can go to appraisal.

\*Kahn v. Lynch Communication Systems (Del. 1994 p. 497) (merger freeze out; indy committee doesn't shift burden if coercion)

\*HIST: Parent offers $14/share for sub; sub rejects; offer goes up to $15.50; indy committee finds offer inadequate but accepts b/c parent threatened to get hostile

\*H: Yes, parent is control SH and exerted coercion: therefore existence of indy committee does *not* shift burden to P

\*DISC: But see *Western National* (Del. Ch. 2000 p. 503): court finds that 43% owner is not control SH

\*Siliconix (slide 33)

\*RULE: BJR, not entire fairness: no duty to offer a fair price unless coercion or disclosure violation is shown

\*RATI: tender offer (or hostile takeover) is a voluntary process under which minority SH can decide whether to tender.

\*TA: threat of a hostile takeover was enough to keep the burden on D.

\*Aftermath: more tender offers than mergers.

\**Glassman v. Unocal*, infra: short form merger does not trigger fid duty

## CNX One-Pager: How to construct a Parent-sub Freeze-Out (as t.o. or merger) and get BJR

(1) Parent notifies Target of proposal

(2) Target sets up special committee of independent directors (spec com hires the bankers, not parent)

(3) Parent negotiates w/ special committee and hopefully agree on a price; real negotiations! (*CNX*)

(a) Must be outside advice to the committee

(b) Details of that outisde advice (fairness opinion) must be disclosed

(4) Make a non-coercive offer

(a) Have a majority of the minority vote on the transaction (*Pure, CNX*)

(b) Tender offer for 90% of the shares; then short form merger at same price (*Pure*).

(c) Don't make retributive threats (*Pure*, *Lynch*)

\*TA: If special committee and offer not coercive, standard is BJR (*CNX*)

🡪If one safeguard is in place, standard is EF w/ burden on P, maybe (*CNX*)

🡪If neither safeguard in place, standard is EF w/ burden on D (*Weinberger*)

\*TA: buyer has discretion to employ fewer protections at risk of fairness review

\*In re Pure Resources Inc. SH Litigation (Del. Ch. 2002 p. 504) (t.o. freeze outs; conditions when t.o. is non-coercive)

\*HIST: Parent makes offer for sub (Pure); sub starts a special committee with limited powers (can't veto transaction / poison pill); committee recommends that minority SH not accept; parent launches its offer anyway; SH sue for an injunction to block offer

\*I: It's a tender offer freeze-out w/ a limited-power indy committee

\*RULE: BJR if tender offer is non-coercive and special committee can make an informed rec

\*H: offer is coercive; minority SH are entitled to more disclosure

\*In re CNX Gas Corp SH Lit (Del. Ch. 2010, supp) (rule: how a buyer can get BJR for a tender offer)

\*HIST: Parent (Consol) is majority owner in sub (CNX). T. Rowe Price has 37% of minority. Majority of the minority condition but T. Rowe has agreed and that's 37%, so only 12% more. Sub has Special Committee w/ ltd powers; later gives Committee authority to negotiate. Parent refuses to raise the price.

\*RULE: BJR if (1) majority of the minority and (2) special committee: thus it's like control SH is only on one side of the transaction

\*H: t.o. does not pass muster (committee had ltd power; T. Rowe had COI so "majority of the minority" factor was ineffective)

# Insider Trading

## Exchange Act §16(b) and Rule 16

\*§16a: insiders must report any transactions in the corp's securities (SOX §403: within 2 days) (p. 626)

\*§16b: insiders must disgorge any profits made on short-term turnovers in shares (6 mos)

🡪strict liability rule

🡪underinclusive: insider trading can occur over a period longer than 6 mos

🡪overinclusive: applies to all trades made w/i 6 mos even if not based on inside info

\*Calculation of profits for 16b: match sales and purchases over the six month period (*Gratz v. Claughton*)

🡪don't counterbalance with losses: i.e. if you break even over the period, still disgorge profits

🡪Problem p. 629

\*T1, R pays 10 @ $5; T2, appointed as an officer; T3, buys 5K @ $5.50; T4, buys 3K @ $5.30; T5, sells 2K @ $5.10; T6, resigns as treasurer; T7, sells 16K @ $5.70

\*TA: what he did before he was an insider doesn't matter

\*Makes $0.20/share on 5K shares; $0.40 on 3K shares; ∴ must disgorge $2200

\*measure w/i six months of purchase

\*Statutory insiders/"covered persons" (627)

\*10% SH; officers; directors

\*def: "officer": any person who has recurring access to nonpublic information

\*def: "Purchase" or "sale" (628)

\*stock offered up as collateral: maybe?

\*merger: no

\*derivatives: yes, all Ks or instruments that derive current value from the value of a covered security are a security (629)

\*Kern County Land Co. v. Occidental Petroleum Corp (SCOTUS 1973 p. 628)

\*HIST: O and T both want to buy K. Within a 6month period, O acquires 20% of K; O backs off, T merges w/ K; O's shares in K become shares in T; O sells to T an option to buy its shares for $9M; >6mos after O bought 20% of K shares, T exercises option, O gets a $19M profit. K sues O for violating §16b.

\*P arg 1: conversion of K shares into T shares constitued a sale, giving O §16 duties (b/c it was a 20% SH)

🡪H1: no, merger is not a sale of K stock

\*P arg 2: granting the option was a §16b transaction either b/c (1) K shares becoming T shares is a "recent purchase" *or* (2) it was a sale w/i 6 mos of K shares (which are now T shares)  
🡪H: no, option grant is not a sale of stock

\*RATI: K was always hostile to O so O cannot really be an "insider" as §16 was intended to police

## Exchange Act §10b and Rule 10b-5

\*def *RETAC: Relationship of Trust & Confidence*

\*SEC Rule 10b-5-2: presumption that immediate family are in a RETAC

\*Three Theories of Liability under 10b-5

🡪Equal Access / "disclose-or-abstain" Theory: all traders owe a duty to the market to disclose non-public corporate information or refrain from trading on it. (*Cady Roberts, Texas Gulf Sulphur*).

🡪Fiduciary Duty Theory: If trader gained benefit by violating a fiduciary duty b/c employed by the owner of the shares in which he's trading, violation. (*Chiarella, Dirks*)

­🡪Misappropriation Theory: If deceitful misuse of market-sensitive info (duty either to other trader or source of info), violation (see also Burger dissent in *Chiarella*)

\*Rule 10b-5 (p.630): unlawful to….

(1) defraud

(2) make any untrue statement of a material fact *or* omit to state a material fact in order to make a statement not misleading

(3) any fraud related to purchase or sale of any security

\*Kardon v. National Gypsum Co, EDPA 1946 p. 631 (private ROX for insider trading)

\*elements: CL fraud, + (1) requisite reliance must be by a buyer or seller of stock; (2) the harm must be to a trader in stock, and (3) misleading statement must be made in connection with a purchase or sale of stock (p. 631)

\*Crit: duty issue in omission cases: does it affect *everyone* who has material nonpublic info, including diligent researchers? (632)

\*Crit: reasonable reliance on a misrepresentation 🡪 fraud on the market doctrine

## Equal Access Theory

\*aka "dislcose-or-abstain*"* (p.646)

\*RULE: Must either disclose that info or abstain from trading on it if:

(1) existence of a relationship giving access, directly or indirectly to info intended to be available only for a corp purpose *and*

(2) party takes advantage of such info knowing it is unavailable to other trader (Cady, Roberts)

## Fiduciary Duty Theory

(1) Start with the trader.

(a) Is the trader an insider (e.g. CEO, or "temporary insider" like a lawyer)? If so, then fiduciary duty to the SH. If no:

(b) Is the trader employed by the owner of the shares in which he's trading? If so, duty. If not, no duty. (Chiarella)

(c) Is the trader a tippee? If so, then…

(2) Tipper-tippee liability (Dirks)

(a) Did the tipper breach a RETAC?

(b) Did the tipper receive a personal benefit? (broad definition)

(c) If yes to both, then did the tippee know or should he have known the tipper was violating a RETAC?

\*Chiarella v. U.S. (SCOTUS 1980 p. 649) (fiduciary duty rule: must have RETAC w/ owner of shares in which you're trading)

\*HIST: financial printer sees that A will buy T, buys and sells *shares in T* for $30K profit

\*H: conviction overturned

\*RULE: To be liable, you have to have owed a fiduciary duty to the counterparty (the other trader, the SH you sold to)

\*RATI: printer was employed by A, not T, so no fid duty to the T (648)

\*DISS: plain language of 10b prohibits any misuse of information; plus he breached a duty to A. (misappropriation rule)

\*Dirks v. SEC ( p.648) (tipper-tippee liability)

\*HIST: whistleblower (Secrist) tells analyst about his company's fraud; analyst (Dirks) tells clients; analyst tries to get WSJ to cover it, but WSJ refuses; SEC censures Dirks for informing his clients but avoids harsher punishment b/c was valuable in bringing fraud to light

\*H: tipper did not benefit: tipper did not violate, therefore tippee *could not* violate 10b-5

\*RULE: Liability for tipper only if

(1) there was a breached RETAC &

(2) he received a personal benefit. (NB: SEC uses a very broad definition of "benefit"; Cf. Paul Thayer: tipped a girlfriend)

\*RULE: Liability for tippee only if

(1) tipper is liable (i.e., tippee's liability is derivative of the tipper's liability) &

(2) tippee knew or should have known that the tipper was violating a RETAC.

\*RATI: tippees assumes an insider's fid duty to SH

\*HYPO: Milken is hosting a BBQ; mentions to guests he is about to finance Perelman's takeover of Revlon; guests go buy Revlon.

\*Did Milken have a fid duty?

\*10b-5: Fiduciary duty theory: no liability (If he had a duty it's to A, not T. Trade is in shares of T.)

\*10b-5: Misappropriation theory: maybe liabillity

\*14e-3: yes liability (if tipper knew tippee reasonably likely to trade on that info)

## Misappropriation Theory

(1) Trader: did you misappropriate information from someone w/ whom you had a RETAC?

(2) Tippee: should you have known that the tipper misused info (by violating a RETAC)?

(3) Did you disclose? If so, free of liability.

\*TA: Now, two potential sources for breach of fiduciary duty: duty to SH, duty to source of information

\*U.S. v. Chestman (2d Cir. 1991 p. 662) (misappropriation theory in action)

\*HIST: Waldbaum is going to be bought by A&P; Loeb's wife is part of the Waldbaum family; Loeb tells his stockbroker, Chestman; Chestman buys stock in Waldbaum for himself, for Loeb, and for other clients

\*Gov't arg: Loeb is liable as a "tipper" when he told Chestman and violated fid duty to Waldbaum family; Chestman aided and abbeted Loeb's misappropriation, and also is liable as a "tippee" b/c he knew Loeb was violating a fid duty

\*H: 10b-5: no liability; RATI: remote tipper: Loeb had no fid duty to Waldbaum or his wife, so Chestman can't violate fid duty

\*RULE: accepting a duty of confidentiality can be implied but must be based on pre-existing fiduciary-like relationship (666)

\*H: 14e-3(a): liability

\*DISC: SEC adopts R10b5-2, which suggests that all family relations have fiduciary duties

\*TA: tippee is under no duty to inquire about tipper's relationship to source; but maybe, still, "should have known"

\*U.S. v. O'Hagan (SCOTUS 1997 p. 667) (SCOTUS adopts misappropriation theory)

\*HIST: Law firm X is representing Grand Met which is going to purchase Pillsbury. Partner at X (O'Hagan) is not working on the deal but buys a bunch of stock and options in Pillsbury. Makes $4.3M.

\*RULE: misappropriation theory is about deceiving people who trusted you w/ confidential info (668)

\*RULE: full disclosure to everyone owed a duty of loyalty and confidentiality clears liability under the misapp theory

🡪but still potential liability for duty of loyalty violation (668-69)

\*RULE: applies equally to inside info from A or T

\*RULE: What constitutes a fiduciary duty under misapp theory? *A relationship w/ an implied agreement of confidentiality*

\*Martha Stewart case

\*CEO of Imclone sells lots of shares based on inside information; broker finds out, tells client (Martha)

\*broker is tipper, Stewart is tippee

\*Q1: did broker breach fid duty? (yes)

\*Q2: did broker benefit? (yes, he helped his client)

\*Q3: did Stewart know / should have known broker was breaching a fid duty? (yes, she used to be a stock broker)

\*Hypos

\*A finds info on the street, A's wife (B) uses that info: B can be liable unless A approved of B's use

\*if A and B *not married*, A may still be a tippee of a tipper who did breach a fiduciary duty

## Rule 14E-3 and Regulation FD

\*SEC Rule 14e-3: any person who obtains inside info about a t.o. (either from the offeror or the T) must *disclose or abstain* (p. 659)

\*TA: *only applies to tender offers* but SEC has reintroduced the equal access rule 🡪 broader sanction than 10b-5

\*Regulation FD ("Fair Disclosure"): if intentional disclosure of "material nonpublic info", must simultaneously disclose to everyone; if unintentional, must remedy it "promptly" (660)

\*TA: analyst earnings estimates are now less accurate b/c can't talk to insiders to explain reports