Corporations (Helen Scott, Spring 2010)

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# Corporations in General

1. **What is a Corporation**?
   1. A legal construct
      1. An organizational form that is created and permitted by the legislature
   2. A manner of doing business
   3. Internal Affairs Doctrine
      1. State law governs the internal affairs of a corp
      2. They are enabling statutes – tell you how to structure it, contain default rules if you don’t change them, and some mandatory rules.
      3. Fed regulations only address internal affairs to a limited degree.
   4. Very few limits on the conduct of corp (corp activities) or the type of business that can be carried out in corp form, the purposes of a corp, or the size that a corp can reach
      1. Corp Social Responsibility
         1. Obligation to use it in a socially responsible fashion?
         2. Does this conflict with the corp purpose of SH gain/profit
      2. Can’t break the law, even if enhancing business.
         1. But whose laws?
      3. Google leaving China
         1. Exercising duty to SH, or does the potential loss of that market harm the SH?
   5. Separation of ownership from control.
2. **Motivations for having a corporation**
   1. Limited liability of SH.
      1. Only risk is the value of the share, not their other assets
      2. Whenever there is a limitation on liability to the investors or the operators, it must be sanctioned by the legislature.
         1. Such limitations don’t exist in natural law.
      3. Exception for when the corp veil is pierced and SH is personally liable
   2. Perpetual Existence
      1. Legal stability, doesn’t disappear on the death/withdrawal of a SH
   3. Easy transferability of ownership interests
   4. Centralized management
   5. Tax considerations
      1. But double tax on profits (to Corp and to SH)
3. **Why we limit liability** 
   1. Encourage investment
      1. Lowers cost of investing which increases # of people investing, allows diversification
   2. SH are somewhat innocent
   3. Reduce transaction cost for corp – don’t have to keep everyone informed.
   4. Lowers individual transaction cost
   5. Standardizes risks – most people have the same info.
4. When do we pierce liability? (see Corp structure)
   1. Fraud
      1. Inadquate capitalization (at the time of inception)
   2. Intermingling – treat corp as your own private property
   3. NYBCL § 630 – legislative piercing of the corp veil
      1. Doesn’t happen often.

## Other forms

* 1. Sole proprietorship – don’t have to do anything to be one.
  2. General Partnership
     1. Default form for activities conducted by more than one owner
     2. Share ownership/profits with another person
     3. No limited liability.
     4. Centralized management
     5. Flow through tax
     6. Interests not transferable.
  3. **Limited Partnership**
     1. Some aspects of a corp.
     2. Most hedge funds, venture capital, and private equity firms that are professionally managed are organized this way.
     3. Limited life by K
  4. **Limited Liability Companies**
     1. Most recent form adopted by the legislature.
     2. Limited liability.
     3. No centralized management.
     4. Flow through tax
     5. Interests not transferable.

1. Public Markets
   1. NYSE – New York Stock Exchange
   2. Nasdaq – Electronic securities exchange
   3. American Stock Exchange
   4. Only about 6500 corps on these, while about 6mm in the US
      1. Very few qualify as “large publicly held corps”
   5. To be eligible, must have public market capitalization (value of shares) over $15mm.
      1. But not really feasible until you have about $60mm
         1. NYSE’s floor for an IPO

## Sarbanes-Oxley Act (Sox)

* 1. Passed in response to Enron and WorldCom.
  2. Deals with the composition and obligation of the board of directors. Must have 3 ind. standing committees.
     1. Audit
     2. Nominating
     3. Compensation
  3. Maj of BD and audit have to be composed of ind. directors (IDs)
  4. Changed the amount of information flowing
     1. Was NOT supposed to change the basic liability rules of directors or their duties.

1. **Oversight Mechanisms**
   1. Disclosure Requirements
   2. Incentive compensation (bonuses)
      1. Bonding – tie salary to performance
         1. Have to be sure to focus on the right incentives
      2. How to measure?
   3. Auditors
      1. Every public co must be audited annually by an ind. auditor.
   4. Legal Liability exposure
      1. A breach of fid duty is a personal liability claim
      2. Assures SH that there are limits to the extent to which management/BD can deviate from the accepted norms of behavior.
   5. The Law/Regulatory Agencies
      1. Fed authorities
      2. SEC – regulatory authority
      3. State AG
      4. Listing agreements with the marketplaces (these are private companies)
   6. Market forces
      1. Economic entities respond fast to market forces
      2. Market for corp control
         1. Not performing well, stock goes down, subject to takeover and new management
   7. Capital Structure of the Co.
      1. The Metrics
         1. Sources of funds
         2. People buying stock
         3. Lenders
         4. The operations of the company
         5. Debt – controlled by K

## How to Acquire a Corporation

* 1. A stock purchase
     1. Get 100% of the stock, you own it. Tough to do
     2. (1) Tender Offer
        1. Bidder makes an offer directly to SH
        2. Often followed by a second step merger.
     3. (2) Merger
        1. Agreement/K between the BDs of two corps.
           1. 2 corps, by operation of law, become one.
           2. K sets forth the terms
        2. Fundamental change in the structure of the corp, requires a SH vote.
        3. If more than 2 companies, technically consolidation
  2. Asset acquisition
     1. Get parts, but leave the corp otherwise intact.
     2. Does the liability go with the assets, or stay with the old corp?

1. Getting Your $$ Out of a Corp
   1. Sell the company/stock
   2. IPO
      1. Creates a kind of currency
      2. Public market prices it higher
         1. Diversifies risk, more liquid, one person doesn’t have to raise all the money to pay.

# Managers, Directors and Shareholders

1. General
   1. Need all three
      1. But one person could be all three.
      2. But, would have to determine in what capacity they’re acting
2. ID
   1. Someone without a significant financial stake in the co.
   2. Outside directors are not considered independent
   3. Idea is to get people with an unbiased view and no disabling conflicts

## Board of Directors

* 1. **DE § 141: The business and affairs of every corp organized under this chapter shall be managed by or under the direction of a board of directors, except as otherwise provided in chapter or in certification of incorporation**.
     1. **Mandatory** provision.
     2. MBCA 8.01
     3. (b) number of directors fixed in bylaws unless otherwise provided in cert of incorp
  2. Responsibilities
     1. Regular business affairs
     2. Hire, fire and supervise the CEO
     3. Risk management
     4. Overall direction of the company – set policy.
     5. Oversight of managers
        1. This is more recent, due to compliance and regulations
        2. Advisors also.
     6. Current shif it too much toward the monetary role and compliance obligations, makes them unduly risk averse.
  3. **§ 142** Officers
     1. Also MBCA **8.40**
     2. **DE § 158** – need 2 officers to issue stock
        1. Also need 2 when you do legal diligence.
        2. (So practically, BD of 1 is problematic)
     3. Officers are the primary agents through which a corp acts
        1. SH and directors can only act as a body.
  4. Types
     1. Inside – full time employees of Corp (including CEO)
     2. Outside – Not employed full time (may still have some relation)
     3. Independent – outside plus no previous association to Corp so no conflict.
  5. See SOX above also
     1. B/c of Sox, can’t have a BD of 1 (need three members of each comm., could technically have a BD of 3)
  6. **Meetings** 
     1. Generally have to have regular meetings
        1. Very limited ways they can act w/o a meeting.
           1. **Unanimous** written consent.

**DE § 141(f)**

**MBCA 8.21**

* + - 1. Conference call can be a mtg.
         1. § **141(i)**
    1. Acts with a majority vote of the quorum at a mtg.
       1. Quorum
          1. Statutory default is majority, can change

**§ 141(b)**

MBCA **8.24**

* + - * 1. Can change w/bylaws.
        2. Min is 1/3
  1. **Committees**
     1. BD entitled to designate committees w/1 or more directors by resolution of maj of BD
     2. Comm’s may have and exercise all powers of BD to extent authorized by BD resolution or bylaws
        1. DE § **141(c)(1)**
        2. LIMITS
           1. May not enter merger agreement
           2. May not recommend sale or lease of all SH property
           3. Many not amend bylaws unless bylaws/certif. provides
           4. May not declare dividends unless specifically allowed by certif., bylaws, or BD resolution
        3. **MBCA 8.25** similar
  2. Elections
     1. BD may be divided into up to 3 classes, staggering elections
        1. DE § **141(d**)
        2. Can be a defense to hostile takeover – takes longer.

## Shareholders

* 1. Residual claimants of corp’s equity.
  2. Elect the BD
     1. Can also remove a member (unless voted in by cumul.) **141(k)**
  3. SH proposals
     1. Usually not binding, just advisory.
     2. But, BD has to make an opinion on the proposal – can’t just ignore.
  4. Institutional SH
     1. Pension funds, insurance cos, mutual funds, etc.
     2. Hold a lot of stock of large public cos.
     3. **Control-liquidity tradeoff**
        1. Once you hold a certain amount of a co, subject to restrictions on when/how you can trade
        2. Inst SH may not want to be constrained from trading, have a fid obligation to *their* SH.
     4. These investors may not want be on the BD then, or be that involved.
        1. Not a great monitoring mechanism.

1. Officers/Managers
   1. Manage corp’s operations.
   2. Hired, supervised and fired by BD at senior level
   3. Titles/Duties set by bylaws or BD resolution
      1. DE 142(a)
      2. MBCA 8.40
   4. Pres/CEO, Treasurer, Secretary

# Agency

1. Agency Relationship
   1. Duty of Care, Good Faith, and Loyalty are all about agency
   2. **Agent** is a person who through mutual assent acts on behalf of another and subject to the other’s control
      1. **Principal** – person for whom the agent acts
      2. Agent is reliable to the principal for the faithful performance of its duties
      3. Principal is liable to the agent for expenses and indemnification against liabilities for poor performance.
      4. 3rd parties in transactions can sue an agent and/or principal.
   3. A corp acts through its agents
      1. BD are agents of the SH.
   4. Corp official are often not liable for actions of the corp
      1. If the agent had the authority to perform the act committed, it isen’t liable to the third party.

## Three types of Authority

* 1. **(1) Actual**
     1. Express and implied.
        1. Implied- authority necessary to execute expressly authorized roles.
     2. View through eyes of the agent - If a reasonable agent would read principal’s words or conduct to believe that principal authorized the act, then actual authority
        1. Can tell from position, power of office, and specific delegation of authority, sometimes bylaws.
     3. Doesn’t matter if 3rd party knew about the actual authority – can still sue.
  2. **(2) Apparent**
     1. Viewed through the eyes of the 3rd party.
        1. If the words and actions of the agent give the appearance of authority
     2. Can also arise from the failure of the principal to stop the agent – continued use of power can create authority.
     3. ***Anaconda*** (1982) pg 63
        1. Question of whether the treasurer had authority or not for a debt guarantee- if so, could sue corp.
           1. Evidence would have been enough in another situation, but the guarantee was so unusual, that GOF should have enquired further as to the legitimacy.

The unusualness of the transaction makes GOF’s belief in it’s legitimacy unbelievable.

* + - * 1. No evidence of the actual corp, Anaconda, being involved at all.
      1. One who deals with an agent does so at their own peril and must make necessary efforts to discover the actual scope of his authority.
    1. ***American Union Fin. Corp v. Uni Nat’l Bank*** (1976) pg 64
       1. Secretary lied, court held corp bound.
       2. *In Re Drive-Development Corp*
          1. **Representations made by a corp agent in the course of a transaction which are within the scope of his authority are binding on the corp**.
       3. Secretary certificate – certifies that a resolution was passed at a board meeting
          1. Can rely on this
          2. Would be bad policy to require companies to always double check.
    2. Incumbency certificate
       1. Authenticates the identify of officers.
       2. Secretary signs
          1. Another officer has to certify the secretary.
  1. **(3) Inherent**
     1. Least defined
        1. Additional penumbra around apparent and actual
     2. Viewed through the eyes of the principal
        1. Exists when no actual or maybe even apparent
        2. For unanticipated events where you have to act quickly
     3. Public policy component
        1. The incentive structure that would be created if we didn’t find authority in these circumstances – if a 3rd party were harmed by an agent, who would suffer if don’t say inherent authority.

1. **Range of obligation**
   1. Pure contractual
      1. Parties have hardly any obligation to each other
         1. Don’t lie. Good faith.
   2. Employer/Employee
      1. Close to a K, but some obligations
         1. Employer indemnifies, ee doesn’t steal, etc.
   3. Corporate Directors
      1. In a fid relationship, but not as restricted as lawyers or trustees.
   4. Lawyers
      1. Supposed to act in the best interests of their clients, clients are supposed to come first, but not as strict as trustee
         1. Client can consent to something after disclosure
   5. Trustees
      1. Have the highest level of fid obligation we have in law
      2. Have to act *solely* for the benefit if beneficiary even if at cost to themselves.

# Duty of Care

1. Directors have two main duties
   1. Duty to act in an informed manner (Care)
   2. Duty of Loyalty.
   3. They’re interwoven
      1. Duty of good faith is also now considered
2. Grounded in negligence theory
   1. Have to show a duty, a breach of duty, and proximate cause to the injury
      1. Duty to the π
         1. Generally to creditors, SH, or the corporation itself
      2. Breach – conduct has fallen below standard of reasonableness
   2. Question normally turns on whether there was a breach and whether the breach was the proximate cause
3. Structure of the duty
   1. Π has to prove breach of duty
      1. Burden shifts to D to show either
         1. The breach was cured, or
         2. That the decision made was FAIR (not just rationale or reasonable)
4. ***Shlensky v. Wrigley*** (1968) pg 75
   1. Mr. Wrigley owns 80% of corp owning baseball team, refuses to have night games. SH sues on behalf of corp saying they’re losing money because of it.
   2. Question of if there is a cause of action.
      1. Court holds for ∆.
   3. Court hesitant to step in and interfere with honest business judgment w/o evidence of fraud, illegality, or conflicts of interest.
      1. Π also failed to connect the breach to damages

## Business Judgment Rule pg 76

* 1. “the judgment of the directors of corporations enjoys the benefit of a presumption that it was formed in good faith and was designed to promote the best interests of the corporation they serve.”
  2. Why?
     1. Institutional competence
     2. Environment in which the decision was made
     3. SH could elect a diff board
     4. Statute (DE 141) explicitly delegates this authority to the BD
        1. SH agree to this implicitly when they buy shares
     5. Want to encourage boards to be risk taking.
  3. The presumption of BJR in the decision is very strong, can be REMOVED in limited circumstances by
     1. Fraud/illegality (*Miller v. ATT*)
     2. Failure to acquire info to make informed judgment (*Van Gorkom*)
     3. Breach of Good Faith (*Disney*)
     4. Conflict of Interest (*Cookies*)
     5. Corporate Waste (hardly ever successful)
        1. Use of corp assets for non corp purposes.
        2. Overcompensation – not corp waste. Purpose is legit.
     6. Hard to get rid of the BJR – high burden of proof on π
     7. Gross negligence can possibly get rid of it.
  4. Steps
     1. **Determine if BJR applies**
        1. Did BD act in GF on an informed basis w/o conflict?
           1. If yes, BJR.
           2. If conflict, was conflict cured?

If yes, still BJR

* + 1. **If no, BJR is removed and the decision itself becomes subject to review**
       1. Evaluated for fairness – has to be the better decision
          1. Higher than mere rationality.
       2. Some cures – informed SH vote approving the action
    2. Once removed, prob will say a bad decision
       1. Proof is circular – same evidence to see if the rule applies as to judge the decision.

## *Miller v. AT&T* (1974) pg 78

* 1. ATT didn’t collect on a $1.5mm debt from DNC.
     1. SH sued, not for fraud, illegality or conflict of interest – saying it was a political contribution, which is illegal.
  2. Roth v. Robertson
     1. Illegal acts may amount to breach of fid duty in NY.
  3. Held:
     1. **The illegal act could be enough to breach the fid duty**
        1. Π would have to prove
           1. They made a contribution
           2. It was connected with a fed election
           3. And it was done for the purpose of influencing the outcome of the election.
        2. Proof of non-collection is not enough
           1. Could be other business rationales
           2. Decision to not pursue a debt is within the BJR.
  4. Why is breaking the law a breach of duty if the director gets no benefit to themselves?
     1. ALI – corp bound to act within the law
     2. Can’t have efficient breach – can’t price out compliance with the law
     3. Corp breaking the law is different than an individual
        1. Corp – not their money, not as accountable
        2. Directors might rationalize away their morals in a way they wouldn’t otherwise as an individ.
     4. Individs can go to jail, corp can’t.
     5. Risk calculus is different
     6. De minimis exception though.

## *Francis v. United Jersey Bank* (1981) pg 82

* 1. **“Directors may not shut their eyes to corp misconduct and then claim that because they did not see the misconduct, they did not have a duty to look.”**
     1. Mother was extremely uninvolved, her sons stole over $12mm from the corp, the court found her liable also.
     2. Kind of a proximate cause idea
        1. Court kind of glosses over this.
        2. Causation in FACT test
           1. **Π has to show that ∆’s omission was a necessary antecedent to the loss, but for the omission/breach the loss would not have occurred**.
  2. Question was if Lillian Pritchard had breached her duty of care in such a way that her estate is now liable for the damages caused by the threat.
     1. No fraud, conflict of interest, etc.
     2. Just non-feasance
        1. Use it to remove the BJR
  3. Minimum action a director has to due to meet their duty of care
     1. Be familiar with what the corp is doing
     2. Regular review of financial statements
     3. Attend some board meetings
     4. A rudimentary understanding of the business of the corp
     5. (nothing too exacting)
  4. DE § 141e
     1. Directors are allowed to rely on directors or other experts who have the competence.
        1. As long as you reasonably believe the other knows what they’re doing.

## *Smith v. Van Gorkom* (1985) pg 84

* 1. Landmark case
     1. Dramatically changed the way BDs of public companies do business
  2. Really rushed merger between Pritzker and TransUnion
     1. BD didn’t see any documents, only had the word of the chairman/CEO that they’d get $55/share (selling at $30-38 at the time)
        + 1. VG gave a 20 min presentation, BD met for 2 hours, and approved
          2. VG signed the merger agreement while at the opera

No one read the agreement.

* + - 1. $700mm purchase price total
         1. Price was a huge premium over the current value.

But only if you add the cost of individ. shares. When you think about how much it is to buy the company, may be more. Stock is undervalued.

* + - * 1. Not a reason why they lost.
      1. Stock option triggered if P found financing
         1. Too easy of a trigger?
    1. CEO (Van Gorkom) wanted to remain open to other offers
       1. P refused.
          1. **No Shop Clause** – company could receive but not actively solicit other offers.

Hard to justify these. Depends on fid structure at the time.

* + - 1. P wanted a stock lock up at $38
         1. Stock lock up

An option, exercisable under certain circumstances, to buy stock at a set price.

Are more rare now b/c of fid effects.

* + - * 1. Once the offer is made, the stock will go up. If another bidder comes in, P can make money anyway.

Option holder becomes just another SH that can tender their shares.

* + - * 1. Stock lock up increases the cost to other potential buyers (have that much more stock to buy)
  1. Held
     1. **BD did not reach an informed business judgment**
        1. Standard is “gross negligence”
           1. If an ordinarily prudent person would have done the same thing in like circumstances.
        2. BD had lots of experience and knew a lot about the company, but judgment has to be exercised on facts. Knew nothing about the deal.
     2. BD here would have met Wrigley standard (no fraud, illegality, or self dealing) and the Francis (director needs general awareness)
     3. Legal fid duty is also about process, not a duty to get the best price.
     4. Case is really about burdens of proof
        1. **We use these rules precisely because we cannot dictate outcomes. Don’t want the court in most circumstances reviewing the substance – can only police the process**.
  2. Was no cure for the breach
     1. SH vote is an effective cure mechanism for breach of the duty of care (or others)
        1. BUT only if SH decision is informed.
        2. Here, info given was inadequate 🡪 cure was ineffective.

1. DE § **102(b)(7)**
   1. Corp can eliminate, in its charter, the personal liability of a director for *money* damages for breach of fid duty (care?).
      1. Can’t eliminate for breach of duty of loyalty, acts or omissions.

## *In re Caremark* (Del. Ch. 1996) pg 97 (in Disney)

* 1. “compliance with a director’s duty of care can never appropriately be judicially determined by reference to the *content* of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed”
  2. Case is about a settlement of a SH derivative suit – DE court has to approve of a settlement.
     1. No Duty of Care holdings, but the thinking has become the model.
  3. **BD violated their duty to be active monitors of corp performance**
     1. One time oversight isn’t enough, but only a systemic/sustained oversight failure will establish lack of GF
     2. Where does this duty come from?
        1. DE § 141 – importance of BD role the legislative scheme
        2. The need for relative and timely info to fill that role
        3. The Fed Sentencing Guidelines
           1. Where a corp is a potential ∆, effective compliance programs are mitigating factors – but not having the programs is a really bad thing.
     3. Also have to show that the compliance program is adequate to ensure that info can make it to directors in a timely fashion
        1. BD needs to make sure the programs are good and implemented and that info is flowing
           1. Don’t have to oversee day to day operations or perform an audit.

## *In re Disney* (A2d 2006) pg 88 [good faith]

* 1. Eisner was CEO, brought Ovitz in as COO, didn’t work out, kicked O out.
     1. O got $140mm for leaving after 14 months
  2. Not a loyalty case, not duty of care (Disney had a 102b7 – wouldn’t get $)
     1. Say it’s the duty of good faith.
        1. Not sure what that is though.
        2. Π argued gross negligence.
  3. Only the compensation comm. and chair knew anything, made a brief, inadequate presentation to the BD that not everyone saw.
     1. Differs from VG in that comm. HAS a basis of knowledge for this, has done this in the past.
        1. Also, the $140mm decision is more like an ordinary decision, not a one time sale of the company, and doesn’t involve the right of SH as to the company.
     2. As long as the issue was properly delegated to the comp comm., then the BD can rely on the comp comm..
  4. **Held for Disney**
     1. No gross negligence
     2. Didn’t say here if gn could be the reason for breach of GF though.
        1. Class: **GN can only be a violation of the duty of Care. If also violated GF, then GF would consume Care.**
           1. Would allow you to easily get around 102b7 also.
        2. DE statute separates duty of Care and obligation to act in GF.
  5. Three types of conduct talked about
     1. **Subjective bad faith**
        1. Director makes a decision with a bad motive and an actual intent to do harm.
        2. Breach of duty of good faith
     2. **Intentional dereliction or conscious disregard of duty**
        1. No conflicting self interest, but more culpable than failure to be informed or gross neg.
        2. **B/c duty of care and GF are different, to breach the duty of GF you must be more culpable than what would breach duty of Care**.
     3. **Lack of due care**
        1. Fid inaction taken solely by reason of GN and w/o malevolent intent.
           1. **GN, w/o more, is not bad faith**.
        2. Due care refers more to process, while irrationality is the outer limit of the BJR

1. ***Stone v. Ritter*** (2006) pg 99
   1. Addresses the Duty of Care issues discussed in Caremark.
   2. AmSouth Bank allowed a Ponzi scheme in w/o much questioning, failed to meet some regulations.
      1. Fined.
      2. Π says the fines were proximately caused by the BD’s failure to meet their Caremark duties (failed to monitor)
   3. Board had implemented a program for oversight and info to come up.
   4. Held for BD
      1. Though the system failed (things weren’t reported that should have been), but the ee’s failure to report isn’t sufficient to hold directors personally liable.
      2. **Court said that an utter failure, or a sustained and systematic failure, is the qualitatively more culpable conduct that Disney spoke of 🡪 is a Disney breach of good faith, actionable as a breach of loyalty, but NOT as a breach of care (means you can get money damages)**
         1. **Only when shown that directors knew they had a duty to act and did not**.
         2. Means that breach of loyalty can arise from other than personal pecuniary conflicts.
         3. Shows how sometimes they overlap

# Duty of Loyalty

1. Is about Conflicts of Interest
   1. Why is it bad?
      1. Worry that the agent will further their own interests rather than or to the exclusion of the principal’s interests.
      2. Agent has more sophisticated info than the SH
      3. More potential for abuse the greater the delegation of power (BD has a ton)
      4. Even if no harm to principal
         1. Risk of it is incorporated into the market
         2. People more reluctant to participate in transactions
         3. Cost in figuring out if there was a harm.
            1. Also often can’t tell.
   2. Burden of proof is placed on the agent to prove there wasn’t a conflict or that it was cured in a fid relationship.
      1. “the punctilio of an honor the most sensitive, is then the standard of behavior”
   3. Could ban all CI transactions
      1. But you’d miss out on some really beneficial transactions
      2. Cost of deterring the bad transactions is far outweighed by the cost to the good ones
         1. Might also limit who you have as directors
   4. Could say CI is part of the BJR
      1. So few disabling conflicts that we don’t need rules, leave it to BD
         1. But if BD has conflict, may make wrong decision.

## *Cookies v. Lakes Warehouse Distrib* (1988) pg 112

* 1. Cookies makes BBQ sauce then taco sauce. Herrig was a SH, then over time became maj SH and a director, took control of BD. Herrig had a distribution company that distributed and housed the BBQ sauce. Also created the taco sauce recipe.
     1. No conflict of interest when he was just a SH
     2. But then a director, series of transactions that are suspect
        1. Extend exclusive distributor K, enter K with warehouse to use facilities at going rate, royalty payments for taco sauce, increase H’s compensation.
  2. Π challenges the transactions saying H was overcompensated and breached his fid duties as a director to Cookies.
  3. Held for Herrig (∆)
  4. **DE § 144** – Interested Director/Conflicts
     1. Conflicts can exist, but can be cured – mechanisms set out by statute.
        1. Basically, **disclosure and fairness**.
           1. Transaction as a whole must have been fair.
        2. Can also **ratify by disinterested directors or SH vote**.
           1. Usually excludes interested SH – varies by statute.
     2. Also MBCA **8.60(1)(i)** – Dir. has a pecuniary interest, may cure (**8.61**) by:
        1. Approval by qualified directors after disclosure (**8.62**) or
           1. (qualified director – MBCA **1.43**)
        2. SH approval after notice, info (**8.63**)
        3. Note - A majority (but no fewer than 2) of the qualified Dirs constitute a quorum (**8.62(c)).**
     3. NY – same mechanisms for cure, interested directors count for quorum
     4. CA – same mechanisms for cure but for BD approval, must also show fairness/reasonableness to the Corp.
  5. If **NO CURE**, evaluate for **SUBSTANTIVE FAIRNESS**.

## *Sinclair Oil Corp. v. Levien* (1971) pg 131

* 1. SO is parent of Sinven, owns 97%. Sinven dividend-ed all the money out, it can’t grow.
     1. Π tries to argue that b/c SO owns so much, it owes Sinven a fid duty. Must meet a test of intrinsic fairness (no disinterested directors of SH).
        1. Show transactions btwn SO and Sinven were fair. SO tried to argue BJR.
        2. **But, in situations where there isn’t a benefit to the parent and a harm to the subsidiary, then don’t shift burden of proof.** 
           1. BENEFIT/DETRIMENT test.
  2. No self-dealing here – issuing dividends – SO just had so much more stock.
     1. **No disproportionate access to corporate assets**.
        1. Assets can include information
     2. Court DOES NOT shift burden.
     3. Would have been self-dealing if there were 2 classes of stock and they only declared a dividend for their stock.
  3. Breach of K claim
     1. Int’l had a K w/Sinven. SO owned Int’l . Int’l breached K w/Sinven, Sinven didn’t go after them. This benefitted SO to the detriment of Sinven.
  4. Fid duty in these cases may have required the board to make different decisions, not because they were illegal, but because they didn’t rise to the duty that the BD owes to the corp

## Corporate Opportunity

* 1. Claim that there was a transaction that should have been done by the corp, but instead was taken by the director and used for own personal benefit
     1. Statutes don’t apply b/c transaction didn’t involve corp
  2. **A corp’s fiduciary will NOT be permitted to usurp a biz opp which was developed through the use of corp assets**.
  3. **ALI 5.05(b**): Def of Corp Opp
     1. Opp which Dir becomes aware of in connection w/corp role that would reasonably lead person to believe opp being offered to corp, or
     2. Dir becomes aware through use of corp assets, or
     3. Any opp Dir knows is closely related to business
        1. Can’t separate here their identification with corp.
  4. Seminal case is *Guth v. Loft*.
  5. **STEPS for Court**
     1. Determine if the opp was presented to the person in their individ or representative capacity
     2. Determine the nature of the opp
     3. Analyze nature differently, depending on the capacity in which it was presented.
  6. Regardless of capacity you received opp, you CANNOT use corp assets.
     1. Assets include goodwill, co time, corp ino
  7. Circles of Duty
     1. Narrowest around senior execs
        1. Theory that these opps don’t come to them except BECAUSE of their positions – identity tied to the company
     2. More leeway for directors to take related biz opps.
  8. **Cleansing Procedures**
     1. Offer opp to company
        1. Full disclosure of all info, BD decides to take it or not, if not, director can take it.
     2. May be other fid problems
        1. Duty not to compete for example.
  9. **If you can’t cure, you DON’T go with the opp**. Fairness is too uncertain.

### Guth Rule (Line of Business test)

* 1. If there is presented to a corporate officer or a director a biz opportunity which the corp is financially able to undertake, is, from its nature, in the line of the corps biz and is of practical advantage to it, is one in which the corp has an interest or a reasonable expectancy, and by embracing the opportunity, the self-interest of the officer or director will be brought into the conflict with that of his corp, the law will not permit him to seize the opportunity for himself.
  2. About the line of business, how the corp could expand.

### Guth Corollary

* + It is true that when a biz opportunity comes to a corp officer or director in his individual capacity rather than in his official capacity, and the opportunity is one which, because of the nature of the enterprise, is not essential to his corp, and is one in which it has no interest or expectancy, the officer or director is entitled to treat the opp as his own, and the corp has no interest in it if, of course, the officer or director has not wrongfully embarked the corp’s resources therein.
  1. *Rapistan*
     1. Corollary contains no requirement that the trial court examine the desirability of the opportunity.
  2. **Court won’t shift the burden to the ∆ to prove it would not have benefitted the corp until it is proved that the info came to the ∆ in their officer capacity**.
  3. Move from the Rule to the Corollary
     1. Encourage entrepreneurism, innovation, moving people, etc.

1. ***Rapistan*** (1994) pg 167 [Corp Opp]
   1. Three R execs left R and next day join Alvey Holdings, which acquired Alvey. A and R do essentially the same thing. Sued for misappropriation of confid info and biz opp.
   2. Court applies Guth Rule and Corollary
      1. Corollary and the directors received the opp in their individ capacity is determinative.
      2. Not enough for R to say that had they known of the opp, they would have seized it.
   3. Held for execs
      1. Though they used corp assets, was de minimis, not enough
      2. Had they JUST applied the Guth Rule, would have been theft of assets and breach.
2. ***Burg v. Horn*** (1967) pg 170
   1. Burgs and Horns formed Darand to buy low rent buildings. H bought additional properties on their own – used money from D loan accounts and loans from B.
      1. B was aware of the purpose of the loans and the H’s acquisitions
   2. **Not all opps in the line of business are inherently corp opps**
      1. Court has to determine if a duty to offer the corp (Darand) all opps within its line of biz was implied between B and H. No evidence.
   3. Held for Horns.

## *In re eBay* (DE Ch 2004) pdf

* 1. Spinning – getting access to shares in IPOs. Underwriters (here, Goldman) sell the at the set price, w/popular companies, guaranteed profit to the buyer b/c they know the price will go up.
  2. Sr Execs at eBay received allocations of shares in other companies that were about to go public
  3. Allegation that these opps for shares should have gone to eBay itself, not the execs
     1. Corp opp for eBay that was misappropriated in breach of fid duty by officers/directors.
  4. Corp opp defined: a line of business they were already in and they were in the position to take.
     1. Cash management (investing in securities) is a line of business.
  5. Court – received in their official capacity, not their capacity as “rich person” – was an incentive to use Goldman in the future.
     1. The breach of loyalty is the bribe
        1. Creates a direct conflict between the individ’s personal pecuniary interest and the interest of the corp.
     2. EBay never given the opp to turn down the stock.
        1. Even if they had turned down, would only cure the corp opp claim – would still have a conflict of interest claim.
     3. Remedy? Profit made goes back to eBay. But who decides which financial firm to go with? Disinterested directors.

# Capital Structures

1. Overview
   1. Three primary types of fin assets
      1. **Common stock** 
         1. Only financial asset that all corps must issue
            1. MBCA **6.01(b)(1)** – at least one class must have unlimited voting rights.
            2. MBCA **(b)(2)** – at least one class must have residual ownership
         2. Residual w/respect to the right to receive income from the corp
         3. Residual in respect to right to receive assets upon corp’s liquidation.
         4. First in line with respect to control
            1. Know you’re paid last, so can’t make self-interested decision – incentive to maximize value of corp.
      2. **Preferred stock**
         1. Paid after debt but before common stock.
         2. Typically nonvoting except with respect to structural changes (merger or charter amendments)
         3. Can have a stated dividend, but unlike debt, nonpayment doesn’t go into default – goes into arrears.
            1. **Arrears** - If PS dividends aren’t paid for a specific period of time, goes into arrears and the PS SH get to elect some portion of the board – right terminates upon payment.

Like a residual voting right.

* + - * 1. **Cumulative Preferred** – stated dividend accrues yearly. If not cumul, evaporates at end of the year.
      1. PS dividend must be paid b4 dividends to common stock.
    1. **Debt**
       1. First in line with respect to income and assets, last in line for control.
          1. Can set liquidation preferences too
       2. Bond- long term obligation secured by property
       3. Debenture – long term obligation not secured by property
       4. Note – short term obligation
       5. Call option – can repay the debt before maturity.
  1. Cap structure = Net of debt and assets
  2. Stock has
     1. Control – exercised through votes
     2. Right to receive dividends
     3. Transferable
     4. Must be issued for some **consideration**
        1. **§ 152, MBCA 6.21(b)**
        2. Benefit must be currently existing – can’t be future services.
     5. Par Value – lowest amount for which stock may be issued
        1. **§ 153(a)**
        2. Not included in MBCA – doesn’t track market value
        3. Pretty anachronistic today
  3. Hybrid fin assets – features can be changed
     1. Voting rights, residual character
     2. Basic character through a convertibility feature – convert PS or debt into common stock

## Corporate Formation

* 1. **DE § 106**
     1. File with the Sec of State, who has to accept.
     2. **Need § 102 and MBCA 2.03**
        1. A name. Must have assoc, corp, club, found., inc., etc.
           1. Has to be distinguished from names of other corps.
        2. A place to be located within the state – a registered address.
        3. General purpose clause
           1. MBCA doesn’t require. Can use **3.01** though.
           2. DE, required.

**§ 121** – general

**§ 122** – specific, list powers of corp.

Limits what the corp can do.

* + - 1. Share value – total number of shares Corp has authority to issue as well as total number of classes of stock.
      2. Name mailing/addy of incorporator.
    1. **Permitted in Charter** – **DE § 102(b)**
       1. Supermajority voting –b4
          1. MBCA 7.27 – must be in COI
       2. Limiting duration of existence – b5
       3. Imposition of personal liability of SH – b6
       4. Provision eliminating personal liability of directors for breach of duty of care (not loyalty) claims – b7
          1. MBCA 2.02(b)(4)
          2. § 145 – Corp can indemnify

MBCA 2.02(b)(5)b

* + - 1. Limits on power of Corp, BD or SH
      2. Par Value
  1. **Charter/Certificate of Incorporation**
     1. **DE § 102 and MBCA 2.02**
     2. Principle governing docs of the corp, along w bylaws.
     3. DE statues trump charter, but charter prevails over bylaws
     4. Difficult to amend
     5. Usually only contains provisions required by statute or things so integral to the business that you don’t want them changed easily.
     6. Public.
  2. **Bylaws**
     1. Cover day to day operations, easier to change.
     2. Not public.
     3. DE **§ 109** and MBCA **2.06**
     4. When a company does an IPO, required to file bylaws as an exhibit w SEC – NOT required to file amendments.
     5. Amending – MBCA **10.20, 10.21**

1. **Amending Charter**
   1. Must amend to **(§ 242(a)):**
      1. Increase/decrease authorized capital stock
      2. Cancel/otherwise affect rights of SHs of any class to receive dividends accrued but undeclared
      3. Create new classes of stock.
   2. **Procedure § 242(b**)
      1. BD adopts resolution/makes recommendation
      2. SH vote at annual mtg or special mtg
         1. Must have maj of outstanding stock and maj of each class entitled to vote.
      3. **§ 242(b)(2):** Even if class of SH is not otherwise entitled to vote, must be allowed (and must approve by maj) if amendment is proposing to increase or decrease shares of class or affect any rights of the class.
   3. MBCA 10.01 and 10.03

# Disregarding the Corp Form – Piercing the Corp Veil

1. Can pierce for fraud, inadequate capitalization (a specific fraud), intermingling (treat corp as your private property instead of a separate entity)
   1. Random – can’t have two corps that own 100% of each other.
2. ***Kinney Shoe Corp v. Polan*** (4th Cir. 1991) pg 256
   1. Polan is the sole SH of both Polan Ind. and Ind. R. π had a sublease to IR, IR sub-subleased to PI for 50% rent. Π never got the money, sued, got a judgment, but IR didn’t have assets and PI declared bankruptcy.
   2. Court pierced the corp veil
      1. **Separate personalities of the corp and the SH no longer existed**. SH had complete dominion over the corp, same assets – couldn’t tell the difference between corp and SH.
      2. Wouldn’t be equitable otherwise.
   3. Court rejects due diligence defense – π shouldn’t have to investigate if the corp had assets
   4. Easy case because total sham corporation (no shares, no directors)
3. ***Walkovsky v. Carlton*** (1966) pg 261
   1. Π hit by cab, corp has two cabs, each with insurance at statutory min. of $10k. Carlton (∆) is a substantial SH in 10 such coprs.
      1. Π sues cab corp, gets judgment and money from insurance, but then sues Carlton for rest of judgment – wants ∆’s assets
         1. Claims that the 10 corps are acting as one company and that they are committing a fraud by acting as 10 to limit liability.
            1. But no claim that the corps didn’t observe the differences/boundaries between them.
   2. Held for ∆, won’t pierce the veil
      1. The real issue here is the statutory min for insurance is too low!
         1. If you couldn’t rely on the statute, would be substituting a ‘reasonableness’ requirement, which makes it a neg. claim.
      2. **Corp will be treated as a separate entity unless sufficient reason to overcome policies and values underlying limited liability**.
         1. Differentiates between horizontal intermingling (here), which doesn’t claim that the actual corp structure is wrong, and vertical intermingling (where the larger corp has access to all the assets of the other)
            1. **Intermingling** – ignoring corp formalities, using corp assets for personal biz, etc. Would remove LL.

Grounded in notion of misrep/fraud

* + - * 1. Incorporating for the purpose of limiting liability is not fraud – legislature allows us to incorp in order to limit.
      1. May be overcome by existence of competing values – policies so strong they overcome LL values.

1. ***Fletcher v. Atex, Inc***. (2d Cir 1995) pg 266
   1. Π suing Kodak, which owned all of Atex’s shares, on the alter ego theory.
   2. **ALTER EGO Theory** –
      1. Must show
         1. (1) That the parent and subsidiary operated as a single economic entity
            1. Factors – is corp adequately capitalized, solvent, paying dividends, formalities met, records kept (same as intermingling factors)
         2. (2) that an overall element of injustice or unfairness is present
      2. In DE, you can pierce the veil for alter ego and fraud.
   3. Found for Kodak – the formal structural distinction between the corps overcame π’s allegations, also no unfairness or injustice found
      1. Π showed that Atex was part of Kodak’s cash management system, K had to approve all significant transactions, members on both boards, Atex had assigned the mortgage of the CEO’s house to Kodak (common at the time for corps to lend execs money for homes though)
         1. BUT – had separate meetings, minutes, fin records, etc.
      2. 100% ownership also not enough to pierce.
2. ***Bartle v. Homeowners Coop*** (1955) pg 275
   1. Subsidiary operating so it could NOT make a profit – sell houses at cost to member of the co-op – but this was its mission.
      1. No veil piercing since separate existence always maintained
      2. If it’s the mission, can’t make not making a profit a crime.

# Corporate Disclosure

1. Two systems at the time that dealt with securities
   1. (1) Self regulation of the markets – public exchanges
   2. (2) State securities statutes – still exist, so called Blue Sky Laws.
   3. The Acts preserved both of these systems and built off of them.
      1. Both Acts were passed to respond to flaws in the cap market that were thought to have contributed to the Depression.
   4. Now also fed securities laws, and listing standards by private exchanges.

## [Securities Act] of 1933

* 1. Regulates the process by which the issuer of a security sells or distributes its securities (stock and debt) to the public.
  2. Principal parties are Issuers, Distributors (Underwriter or Dealer) and the Public.
  3. PROSPECTUS
     1. Disclosure statement
        1. All public offerings of securities must be registered and comply with disclosure requirements
     2. Principal mechanism used to regulate the process
  4. Company is strictly liable for mistakes in the Prsopectus
     1. Secondary participants, like BD, have a negligence standard – must show due diligence.

## Securities [Exchange Act] of 1934

* 1. The bigger one of the two.
  2. **Designed to regulate the ongoing trade of securities** (Secondary Market), did so in 3 ways
     1. (1) Created the SEC
        1. Standard admin agency, primary regulator on the fed level of the cap market system
     2. (2) Registration mechanism, requires all markets to register
     3. (3) Requires all market professionals to register and be members of FinRA – fin regulatory association.
  3. **Corp subject to Act based on size/dispersion of stock ownership if**
     1. Lists securities on national securities exchange (12b)
     2. Equity shares held by over 500 people and gross assets over $10mm
     3. Corp files ’33 registration that becomes effective (15d)
  4. Once under ’34, subject to **standard requirements**
     1. Annual report (Form 10-K)
     2. Quarterly Report
     3. Form 8-K – report for certain major things
     4. Proxy statement – Schedule 14-A
        1. Goes out in connection with any vote of the SH.
     5. These docs are publicly available, reviewed/analyzed by market professionals – this intermediate scrutiny is important to the informational efficiency of our markets
  5. Broad prohibitions on manipulative practices (§ 9) (wash sales to give appearance of market activity) and Fraud/Deceptive Practices (§ 10-b)
     1. Intentionally blurry contours – more detail would be an invitation for people to come right up to the line.

1. Few Amendments or changes over time. Exceptions
   1. Williams Amendments
      1. § 13 – midnight takeovers
      2. § 14 – proxies and tender offer regulations, taking a company off the public market (usually taken over)
   2. Additional penalities
      1. Insider trading
   3. Creation of a national market system, in the 1970s
      1. § 11-A
      2. Still private though, this hasn’t been possible.
2. Self-regulatory organizations (SROs)
   1. Can move faster than SEC, more aware of market development, technical trading issues, expertise.

## WHEN to disclose?

* 1. **RIPE**
     1. *McDonnell*
     2. Info has to be ripe – sufficiently verified for officers and dirs to have full confidence in their accuracy.
        1. Otherwise, risk of liability due to premature disclosure if inaccurate.
     3. Delay is permitted if valid corp purpose to NOT disclose
        1. NOT valid – Insider trading, conflict of interest, tipping – illegal stuff.
  2. **MATERIAL**
     1. *Basic v. Levinson*
     2. **TOTAL MIX Test**
        1. An omitted fact is material if there is a substantial likelihood that a reasonable SH would consider it important to an investment decision (vote/buy/sell)
        2. There must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.
     3. If not material, fed securities law doesn’t care about it.
     4. Difficult to determine in soft info – opinions, projections, speculative/contingent info. Soft isn’t as verifiable.
     5. **Probability Magnitude Test** (used?)
        1. Materiality will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.
           1. Probability – BD resolutions, instructions to ibankers, actual negotiations
           2. Magnitude – size of entities, potential premiums over market.
        2. *Basic* glosses over this.
           1. Kind of says the same thing as total mix.
           2. Evaluate under both?
     6. 5% rule
        1. Implicates 5% of assets, sales, any standardized measure of corp’s size and business, then prob material
           1. Can still be material under 5%
  3. **Omission v. Misrepresentation**
     1. Omission – must be material and a duty to disclose
     2. Misrep – you voluntarily speak, no inquiry into duty.
  4. Other triggers
     1. Periodic filing as required by ’34 – proxy statement
     2. Leak
        1. From the company, have to fix it
        2. Third party rumor – not corp’s obligation to disclose.
     3. Company dealing in own shares
     4. Insider trading the corp is aware of

### *Fin Ind Fund v. McDonnell Douglas Corp* (1973) pg 308

* 1. Π bought a bunch of shares in ∆ 2 days before an earnings decline announcement, suing saying that the disclosure was improperly delayed.
     1. ∆ got the info about the decline on May 27, announced on June 24
        1. But during that time, their quarter ended on May 31, so working on that, called in auditors, formed a task force – it reported back June 20. Had 2 days of mtgs w auditors, generated new earnings numbers, prepared press release the next day, issued the next.
  2. DEBENTURES – general unsecured debt, is callable, so can pay it all off when you want (generally when interest rates go down – borrow to pay off higher interest debt)
  3. Held for ∆, lack of ripeness
     1. **Burden is on π to show that ∆ had a DUTY to disclose**
        1. Who does the duty run to? (at time of lack of disclosure, π wasn’t a SH)
     2. **Decision and timing (other than legally mandated times) is a BJR decision**. (AWK outline-correct?)
  4. No obligation until info is ripe

### *Basic v. Levinson* (1988) pg 312

* 1. B and C were in ongoing negotiations over 2 years about a merger. B made 3 announcements
     1. 1 – no merger negotiations happening
     2. 2 – We know of no corp developments that would cause the changes in the market
        1. B/c of this case, corps DO NOT makes these statements anymore.
  2. Π brings suit for misrep. Class- those who bought stock between first misrep and the merger announcement (corrective disclosure)
  3. SC held
     1. Misrep was material
     2. **PRICE and STRUCTURE**
        1. Becomes material when you agree on both.
     3. Assuming that the reasonable investor has some level of sophistication.
  4. Rejected theories
     1. 6th – that when you lie about it, it becomes material.
     2. 3rd – prelim merger negotiations became material only when an agreement in principle had been made.
  5. Holding makes secrecy easier for prelim merger negotiations, which is important.
  6. **Does not tell us when the DUTY to disclose arises**
     1. Not enough to just be material. Must also be a duty (for omission)

## Duty to UPDATE

* 1. To **Correct**
     1. **Arises when there is an affirmative misrep or materially misleading statement which is wrong when made**
     2. Easier to show than duty to update – don’t have to show a duty for misreps
  2. To **Update**
     1. But, what about a statement that is true when made, and then circumstances change?
        1. **Look for FORWARD INTENT**
           1. Did the statement intend to cover something happening in the future, which a SH could be expected to rely on?
           2. Is disclosure still ‘live’ b/c disclosure implies continuing state of facts?
        2. **If alive, then court looks at the undisclosed facts for their materiality – may trigger duty if it negates the prior statement or makes it materially misleading**.
     2. Courts treat this as an omission claim
  3. ***Backman v. Polaroid Corp***
     1. Polaroid introduced Polavision, projected high sales, sales were actually way low. Made a short statement hinting that things weren’t going so well, finally later a press release saying costs exceeded revenues.
     2. Π – class formed from when they claim P had ripe info and the press release.
     3. Held, statement about expenses was not forward looking but of “historical fact”
        1. No duty to update.
  4. ***Wiener v. Quaker Oats*** (3d 1997) pg 319
     1. Statement “for the future, our guideline will be in upper-60 percent range” (referring to debt to equity ratio)
        1. Wanted to acquire Snapple, which would add a lot more debt
     2. Held that there was a duty to update as soon as the possibility of acquiring Snapple materialized
        1. Was forward looking, still alive
        2. The development itself may be material.
           1. **Made a previous statement misleading, becomes a disclosure trigger**.

### *In re Trump Casino Securities* (3d 1993) pg 378

* 1. **BESPEAKS CAUTION** doctrine – the inclusion of sufficient cautionary statements in a disclosure document may render misreps and omissions non-actionable.
     1. **SAFE HARBOR RULE** (rule 175, pg 381)
        1. If you make disclosures in accord with the rule, you CANNOT be held liable for violation of disclosure requirements.
        2. Allows forward looking statements with tons of caveats
        3. Have to say, “This is a forward looking statement”
  2. Held – the prospectus was sufficiently cautionary, no liability.

### *In re Time Warner Securities Litigation* (2d Cir 1993) pg 322

* 1. Π claims that at some point after TW was seeking strategic partners, their plans changed enough that there was a duty to update.
     1. These were 3rd party rumors, not an obligation to the company.
        1. Market info, not inside info
     2. B/c omission issue, π has to show a duty, which it can’t.
  2. TW’s statements were not misreps
     1. For π to win, would have to show that ∆ either did not have the favorable opinions on future prospects when they made the statements or that the favorable opinions were without basis in fact.
        1. You can have a misrep of fact in an opinion.
  3. The info they didn’t disclose was material, but don’t have to disclose just b/c people want to know.
     1. Duty to disclose is separate from the materiality of the information.
     2. **BUT, once the corp says something, it does have to update when another material event develops that changes the statement already made**.

### *SEC v. Texas Gulf Sulphur Co* (2d 1968) pg 369

* 1. Mining company, drilled a really positive test core, kept it secret so they could buy up the land around it. Market was not affected with the knowledge.
     1. **Valid corp purpose to withhold**.
        1. (though, holding later overturned for insider trading, the valid corp purpose rule still stands).

1. If you advise a company that has no obligation to disclose, but no valid purpose not to disclose, what should they do?
   1. Prob not disclose. Risk of liability exposure – the less you say, the harder it is for πs.

# Implied Civil Liability

## Rule 10b-5

* 1. Private cause of action – intended to provide a catch all remedy for fraudulent, manipulative, or deceptive acts/practices.
     1. Intended to be a new cause of action made by Cong in 1946, get to things that common law couldn’t get to.
  2. Can relate to ANY securities transaction, private or public.
  3. Text: *“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,*
     1. *To employ any device, scheme, or artifice to defraud,*
     2. *To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, misleading, or*
     3. *To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,*
     4. *In connection with the purchase or sale of any security.*
  4. **Elements**
     1. (1) **Standing**
        1. Buyer or seller (*Blue Chip Stamps*)
        2. Only applies to private parties, not criminal prosecutions as in misapp insider trading cases (*O’Hagan*)
     2. (2) **Materiality**
        1. Same as *TSC Indus/Basic/Texas Gulf Sulphur*
        2. Always required element of proof and π’s case
           1. Almost always economic – **5% rule**

If 5% of revenues, assets, or sales would be affected.

* + - 1. Management integrity almost always material
         1. Doesn’t include personal behavior (divorce)
      2. Can be material because of public reaction – affect climate change or censorship.
    1. (3) **Causation**
       1. Includes subsidiary issue of reliance
       2. Fraud on the Market Theory
    2. (4) **Scienter**
    3. (5) **Damages**

1. **Standing**

### *Blue Chip Stamps* (1975) pg 353

* + 1. Π was not a buyer or seller of stock
    2. Court said no standing – must be a buyer or seller.

1. **Causation**

### *Affiliated Ute Citizens of Utah v. US* (1972) pg 382

* + 1. Bank screwing over tribal members with their shares.
    2. Defense trying to say π didn’t prove reliance
       1. Court – Proof of causation makes proof of reliance unnecessary.
       2. Showed causation by showing omission of a material fact and a duty between the parties to disclose.
          1. Duty as the surrogate for reliance
          2. Materiality of the omission becomes a surrogate for causation.
       3. Does this only apply for non-disclosure cases? If an affirmative misrep, some cases have said π must prove actual reliance.
  1. Types
     1. **TRANSACTION** Causation
        1. Really reliance – BUT FOR the fraud, π would have acted differently.
     2. **LOSS** Causation
        1. Form of proximate cause – was the material misstatement sufficiently related to the trading price that caused the loss?
  2. **Fraud on the Market Theory**
     1. Expectation that markets are free from fraud. **Theory that the material misrep made into efficient trading market, which remains uncorrected, affects the price when the π trades. Π relied on the market price to reflect all publicly available info about the company**.
        1. Presumption of reliance.
           1. If didn’t, then market frauds would be virtually unchallengeable.
        2. Materiality establishes a REASONABLE NEXUS the loss would follow fraud.
     2. **Occurs if π makes an investment decision at a time when the price is inaccurate because of a deception**.
  3. ***Basic v. Levinson***
     1. Found misrep to be material, now question of reliance
     2. Court adopts FOMT.

1. **Scienter**
   1. ***Ernst & Ernst v. Hochfelder*** (1976) pg 396
      1. EE was an accounting firm, a client they were auditing had a big fraud going, π claimed that EE aided and abetted the fraud
      2. Was there scienter for a 10b-5 claim?
         1. Aiding and abetting claim requires there to be a primary violation, and that the aider was aware of it and there was substantial participation in the fraud.
         2. No
         3. Court – **negligence is insufficient**.
   2. **Private Securities Litigation Reform Act of 1995**
      1. Added 2 provisions for scienter – increased amount of scienter needed
         1. Liability for a false forward looking statement will only arise if the π can show that the ∆ had actual knowledge it was false.
         2. Only gov can bring aiding and abetting complaints- but can be liability for aiding and abetting.
            1. Have to knowingly provide substantial assistance
2. **Damages**
   1. Types
      1. **Out of Pocket** – difference between price paid and actual value received. Most common.
      2. **Rescission** – if ∆’s profit exceeds π’s loss, the damages award could include the profit. Also good if valuation is difficult.
      3. **Cover**
         1. Effective Dissemination Doctrine – period of time between release of info and full effective dissemination to investing public.
            1. Previously 5-7 days, now under 24 hrs
         2. Now, essentially same as out of pocket.

### *Mitchell v. Texas Gulf Sulphur* (10th 1971)

* + 1. When has cured information made it into the market? When should a π be responsible for knowing the contents of a curative press release?
       1. Once determined to be effectively disseminated, class closes.
       2. Here, court found a week. Now, matter of hours for big corps.
    2. Damages
       1. Π wants rescissionary
          1. Court rejects – corp received no benefit from the π or the fraud
       2. Adops out of pocket reliance, consistent with FOMT – difference between value they got/paid and actual value.
          1. Court picks highest price in the market once the value was disseminated – common to pick price that generates the most damages.

1. Random 6th Element – **IN CONNECTION WITH sale of security**

### *Santa Fe Industries v. Green* (1977) pg 432

* + 1. DE short form merger (if a co. owns 90% stock of another co., they can merge w/o SH vote) – have to give notice to min SH after the fact, disclosure obligations similar to a proxy statement. Target appraised at $640 a share in assets, SH got $150 a share. All this was disclosed.
       1. If dissatisfied w/price offered, remedy is **APPRAISAL** – court hearing for you to show stock was worth more. ONLY remedy under DE law.
    2. Π sues under 10b-5, trying to argue the merger had no valid biz purpose, lack of notice to min is a fraud (essentially short form merger is fraud) and price is SO low to be fraud (unconscionable)
    3. Court – you can’t bring this under 10b-5
       1. (1) Conduct must include deception, or a disclosure defect. Info was complete here.
          1. **Securities law is about DISCLOSURE**.

“**once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute**”

* + - 1. (2) State law already has a remedy – appraisal.
      2. INTERNAL AFFAIRS Doctrine – don’t turn corp law, state law into federal claims.

# Insider Trading

1. What’s wrong with it?
   1. Creates incentives for delay w/in management – beat everyone to the market
   2. Loyalty issue
      1. Agent owes fidelity to the principal, assume that accruing secret profits is damaging to the loyalty principle
   3. Damages
      1. The whole system
      2. The corp – less trust.
      3. Takes investors out of the market due to lack of confidence in the market – reduces liquidity, which is a serious issue.
   4. Disclosure – flies in the face of this.
2. What could be good?
   1. Useful system of compensation – costless to the company
   2. Price discovery
   3. Market efficiency – market reflects hidden info too.
   4. If harmful, corps could prohibit with private K.

## *Cady, Roberts & Co*. (SEC 1961) pg 446

* 1. Diff btwn broker and dealers
     1. Broker – place stock order, they make the trade, get a commission regardless of whether you make a profit
     2. Dealer – have their own stash of stock, when you order, can choose to sell from their own stock – can make profit this way. Dealers are highly regulated. Goldman – broker and dealer.
  2. **DISCLOSE OR ABSTAIN** - insiders must disclose material facts known to them, but if disclosure would be improper or unrealistic, must forego the transaction.
  3. Here, the director could def not sell his stock. What about an affiliate?
     1. **Scope of Coverage – those who have this relationship that gives them access, directly or indirectly, to information which is supposed to be used only for a corporate purpose**.
        1. Scott- “indirectly” will come back to haunt us.
  4. Even though the buyers have no relationship until *after* they buy, SEC says that’s too narrow. Obligations imposed by securities act are not coextensive with the common law fid duties.
     1. Opinion suggests that fed securities law invoked anytime there is informational asymmetry between parties to a transaction, and the asymmetry arose out of access to non-public information.

## *Chiarella v. US* (1980)

* 1. Changes the notion of DUTY – not just about having nonpublic market information – duty arises from the fid relationship.
     1. Insider trading only constitutes fraud if the non-disclosure/omission is in breach of a duty to disclose.
  2. Case came up as a crim case. C was a proofreader for a financial printer – would prep docs for disclosure, but would trade before the docs were filed.
     1. Would buy shares in the Target, not the Buyer.
  3. Court
     1. C was not the corp’s agent, a fid, or someone in whom the Target had placed their trust and confidence.
        1. **No duty to the Target. No general fed duty arising out of securities law.**
        2. **Relationship must exist separate from the trade**
           1. **The trade itself doesn’t give rise to the relationship**.
           2. Can you make someone a fid/insider by K?
     2. “A duty to disclose under § 10b does not arise from the *mere possession* of nonpublic market info.”

## *Dirks v. SEC* (1983) pg 454

* 1. D worked for a broker/dealer, learned from Seacrest that Equity Funding had tons of fraud going on. D confirms fraud. Told his clients, who got out of Equity. D did not have any stock in E.
  2. In a 10b-5 relationship, D is a “TIPPEE” – got info from an insider and knows he’s an insider.
     1. How does a tippee get Cady duty passed on to them?
     2. **PERSONAL BENEFIT TEST**: whether the insider personally will benefit, directly or indirectly, from his disclosure – then duty passes.
        1. **Tippee cannot be liable unless there is a breach by the insider.** 
           1. **Also have to show tippee knew, or should have known, of the breach**.
        2. But what is a personal benefit? Kickback, reputation, quid quo pro?
  3. Court said that Seacrest didn’t benefit from the tip, so no breach, and D isn’t liable.

1. Hypos
   1. Thief sees info on desk and trades – no liability. Not an insider, no relationship, a tippee – but no breach by an insider
   2. Scientist hired to evaluate, has a K, then trades on info he got through work.
      1. If an insider, then a breach.
      2. If a tippee, no breach b/c go info legitimately
      3. Can sue for breach of K, but not under 10b-5 (no standing)
   3. Can’t contract around to allow insider trading – can’t remove a fid duty.

## Temporary Insider

* 1. Enter into a special, confidential relationship and are given info solely for corp purposes, you are treated as a tipper/insider
     1. Corp must expect the info to be kept confidential and relationship must imply such a duty
  2. Lawyers, underwriters, accountants.
  3. ***SEC v. Lund***
     1. L is Pres of V, friend who is Pres of PF calls and invites V to invest in a joint venture PF is doing, L declines on behalf of V. L then buys PF stock.
     2. L found liable – Scott: This case is ridiculous
        1. Can’t be a tippee- no breaching insider
        2. Found liable as temp insider based on friendship
           1. How would you figure out at what point the duty arose to not trade info? When they became friends, good friends?

1. **Fair Disclosure**
   1. If a company discloses MNPI to a market professional or a SH likely to trade, then the company has to make full disclosure at the same time.
      1. If inadvertent disclosure, have 24 hrs to disclose fully
   2. Exceptions – temp/constructive insiders, people signing confidentiality requirements, credit rating agencies.

## Misappropriation

* 1. Dissent in Chiarella would have found C liable under misapp.
  2. Theory – a person commits fraud ‘in connection with’ a securities transaction when s/he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.
     1. This violates 10b and 10b5

### *U.S. v. O’Hagan* (1997) pg 470

* + 1. OH is a partner at a law firm representing a merger. Didn’t work on merger itself, but knew of it. Bought call options for the target corp’s stock.
    2. Court needs to find a duty that OH violated to find any liability
       1. Classic theories of insider, tippee of an insider, and constructive insider would not get to OH.
       2. **Duty here is a duty to the SOURCE of the info**.
          1. Breached a duty of trust and confidence to his firm, which harmed their obligation to their clients.
          2. **Abstain or Disclose rule applies to misapp**

If you disclose to the source that you’re going to trade, there is no deceptive device.

This only clears you from 10b/10b5, may still be liability under 14e

* 1. Most of the parties in misapp cases are law firms, financial printers, etc – parties who themselves are not trading and have fid relationships
     1. If there isn’t a trade, there is no standing.

### *U.S. v. Chestman* (2d 1991) pg 488

* + 1. Family owned grocery store, long line of remote tippees
    2. **To find a remote tippee liable, you have to find each preceding person liable – wherever the chain breaks, that’s the end of it.**
       1. Here, tough to show personal benefit for initial insider.
       2. Then, tough to show scienter all the way down the chain – have to show that each knew the standard should have applied to them.
    3. Couldn’t show remote tippee chain, so brough on Misapp theory.
       1. **If not a traditional fid relationship, then court looks for the essential characteristics present in a traditional** –
          1. Discretional Authority and Dependence
          2. Reliance by other party
          3. De facto control and dominance.
       2. **Mere marriage doesn’t establish it, need**
          1. Repeated disclosure of biz secrets
          2. Proof you were the inner circle of confidential biz info
          3. Proof of nature of the confidences that were shared.
       3. 10b5-2 later passed by SEC, list of “duty of trust or confidence”. Adds family relationships. Just a presumption, so *Chestman* is still good law.
  1. § 21A (1998) – places liability on publicly traded companies, accounting firms, and law firms that haven’t taken the appropriate steps to prevent insider trading.

### Rule 14e-3

* + 1. Prohibits any person in possession of material nonpublic information about a tender offer from trading in securities affected by the offer without disclosing such info and from communicating info to others who do not need to know it in order to effectuate the offers
    2. Private right of action
    3. No requirement of showing of breach of fid duty: broader than 10b-5 (Passed after *Chiarella*)
    4. Rule affirmed as w/in statutory authorization by SC in *O’Hagan*
       1. Prophylactic measure to prevent fraud.

# Shareholder Democracy/Voting

1. General
   1. Very difficult for SH to act collectively – difficult and expensive
      1. Management is very rarely successfully challenged on issue or transaction basis.
   2. 2 investors most involved in issues
      1. Public pension funds
      2. Social investors
   3. 2 ways to get your message across
      1. Wall St Rule – sell. If enough do, price will reflect.
      2. Market for Corp Control – takeover market
   4. **Annual Meetings**
      1. Required by DE § **211b** and MBCA **7.01**
         1. Have to get 10-60 days notice. DE § 222b.
         2. Election of BD happens, other proper biz. § **211b**
         3. BD may call special meetings. § **211d**.
      2. Record Date
         1. Chosen date that freezes the transfer records of the corp (does not affect trading) – whomever owns shares on this date is entitled to vote.
            1. Tough to figure out who owns, as you’re often not the record owner – the proxy you get in the mail is kind of a fake one.
      3. Must have a quorum in person/proxy to do anything – generally majority, but can change by charter or bylaw, or by issue.

## PROXY SYSTEM

* 1. Governs system of SH democracy w both state and Fed law.
  2. System by which votes are accumulated
  3. **Proxy** – legal relationship under which one party is appointed to fid to vote another’s shares. Also can refer to the nominee or the actual document.
     1. DE **§ 212b**, MBCA **7.22a**
     2. Like power of attorney.
     3. For a *particular* meeting.
     4. Are revocable, generally at any time
        1. Expire in 3 years.
     5. Latest, signed and dated proxy counts
        1. Presence at the mtg revokes all prior proxies.
  4. Solicitation period- when proxies are sought. Have to comply w fed/state law.

## Written Consent System

* 1. Unless Charter specifies otherwise, corp may take action w/o a meeting and w/o prior notice or vote through written consent if certain reqs are met**: § 228**.
  2. Some states require the consent to be unanimous – **MBCA 7.04**
     1. But DE only requires that consents represent the min number of shares that would be req’d to approve an action if the mtg was actually held (50% plus one share). **DE § 228**.
        1. Consent must be dated, must have req min w/in 60 days of receiving earliest consent. DE § **228c**.

### *Datapoint Corp v. Plaza Securities*

* + 1. AE, a takeover guy, approached D BD w/takeover proposal, was rejected. Said he was going to solicit written consents from SH, bypass the BD entirely. BD adopted new bylw to regulate the consent procedure, put in 60 day delay of anything decided by SH consent, longer if litigation over validity of the consent.
    2. Court invalidated the bylaw for being in conflict with § **228**.
       1. **228 is only concerned with validity of consent – anything else not related is unreasonable.**
       2. Court very protective of ownership rights of SH.
    3. Preserves right for BD to adopt bylaws and govern consent though.

1. § 14a of the 34 Act
   1. Core package of information that the SEC requires investors to have, includes annual report and proxy statement. Trying to increase info disclosure and SH access to the proxy machinery
   2. Schedule 14a is the proxy statement.
   3. Proxy Season
      1. Time between mid-March and early May where proxies are sent out, due to rules, which results in the meeting between mid-April and mid-June (10-60 day notice requirement)
   4. All the info (proxy, annual report, slate of nominated directors) is sent by the company – very expensive to come up with a competing slate of directors, have to pay for it on your own.
      1. Under the rules, corp has no obligation to include in their proxy materials, proposals from the opposite of something they’re advocating.
      2. PROXY ACCESS RULE – may go into effect next year, would require under certain circumstances a corp to include SH nominees for board.
2. § 14a-8: SH Proposals

## PROXY FIGHT

* 1. Company is soliciting proxies and someone else is doing so in opposition
     1. If you win, get control of the company. Even though SO expensive, still cheaper than other ways.
        1. Doesn’t happen often.
  2. Way of effectuating a hostile takeover – place bid, then wage a proxy fight, saying if you win, you’ll dismantle the defense mechanisms, takeover, and SH get their money.
  3. Proxy area becoming more active. Not just directors, also now exec compensation.
  4. Schedule 14b is anyone other than the company’s proxy solicitation.
  5. ***Rosenfeld v. Fairchild Engine*** (1955) pg 595 – NY
     1. Proxy fight by faction opposed to CEO’s employment K, they won, took over BD. Old management had spent about $134k from corp treasury, new management had spent $127k, sought reimbursement, submitted to SH – voted for them 16 to 1.
     2. **ULTRA VIRES** – illegal as beyond the control/purpose of the corp
        1. Very rare, very limited, because of general purpose and powers clauses.
        2. Illegal acts don’t fall within this
        3. **WASTE Theory** – unreasonable use of assets for a non-corp purpose with no corp benefit.
        4. A true ultra vires act can only be taken unanimously (unanimity doesn’t exist in a public company)
     3. Π claimed this was waste
        1. Court – If you win, can be reimbursed. Still good law. Still have to show they were bona fide expenses though.
           1. But you have to win.
  6. **Proxy Solicitation**
     1. **14(a):** “It shall be unlawful for any person” to **solicit** (or permit use of name to solicit) any proxy or consent or authorization in respect of any security of a registered company “in contravention of such rules and regs as the SEC may prescribe as necessary or appropriate.”
        1. Essentially every attempt to get SH to act w/respect to her shares outside of buying/selling.
     2. ***Studebaker v. Gitlin*** (pg 654) - ∆ got 42 other SH to aggregate shares to access the SH list (need 5% of stock and a proper purpose) to consider whether or not to change the BD.
        1. Corp sued him for violating proxy rules – the aggregating being the solicitation. And though the court believed he’d ultimately engage in formal proxy solicitation, this was still covered.
     3. 14a-2 **Exemptions** from coverage
        1. A2-B2- if you solicit not more than 10 people
        2. A2-B1 – solictation on behalf of any person who does not seek directly or indirectly power to act as proxy.
        3. For communications in speeches, press releases, etc., as long as it’s not a proxy solicitation.

## Shareholder Proposal (pg 940 of code)

* 1. If you can get your proposal into the proxy statement, will be distributed along with the rest (**Rule 14a-8**) – don’t have to meet all the requirements yourself.
  2. Must always be **precatory** – DE **141(a**), MBCA **8.01(b)**
  3. 14a8 – **Eligibility**
     1. Must have more than 1% or $2k of stock for at least a year
     2. A8c – can only submit one proposal
     3. A8d – can’t exceed 500 words, total.
     4. A8e – must be submitted 120 days before proxy statement released.
  4. If Corp fails to include material SH proposal w/o exclusion grounds, then proxy statement’s false/misleading on basis of material omission (**Rule 14a-9**)
  5. **Exclusion Rule 14a-8(i)**
     1. If wants to exclude, must file proposal w/SEC and explain grounds for exclusion.
        1. Division of Corp Finance issues a “no-action letter”
     2. Reasons –
        1. (i)(1) Not proper subject (contrary to delegation of power),
        2. (i)(4) Personal grievance or special interest (political rather than about SH interests),
        3. (i)(5) Relevance – materiality. 5% rule. Management integrity issues, rights of SHs, disclosures typically treated as material.
           1. Non-economic materiality changes as issues change/move.
        4. (i)(6) Corp lacks power or authority to implement
        5. (i)(7) Concerns a matter pertaining to the **ordinary business operation**s of the corp.
           1. How to tell: distinguish between matters of fundamental biz strategies or long term goals on the one hand, and matters of implementation (ord biz)
        6. (i)(8) Relates to an election for BD
           1. An actual election contest, not just elections
        7. (i)(9) Conflicts w/Corp proposal
        8. (i)(10-12) Moot; Duplicative; “Recidivist” – proposal that failed w/in last 5 years
        9. (i)(13) Specification of dividends
  6. ***Medical Comm for Human Rights v. SEC***
     1. SH proposal asking BD to consider a charter amendment to ban the manufacture of napalm – argued concern for human life and bad for business.
        1. Corp tries to exclude, at time, moral/political concerns were excludable (now (i)(4)), also (i)(6) lacking power to implement, though not true here.
     2. Court says can be a proper subject. Notes that BD didn’t justify napalm production on basis of biz considerations but in spite of them based on own moral/political. **BD’s moral judgment can’t be shielded from contrary views of beneficial owners**.
  7. ***Lovenheim v. Iroquois Brand*** pg 675
     1. About foie gras, force feeding geese. Way less than 5%. **But court refused to let it be excluded based on the ethical and social significance of the issue**.
  8. **Ordinary Business Exclusion** is tough to apply (pg 676)
     1. *Wal-Mart* – about employment, SEC trying to say all employment questions are ordinary business (rather than just day to day affairs – now would include significant policy considerations), court says no to SEC change.
     2. *Roosevelt* – proposal for phaseout of CFCs was excluded as ord biz. SH weren’t satisfied with the *pace* of the phaseout- corp already committed to phasing out.
     3. *Cracker Barrel* – SEC tried to adopt blanket policy excluding all employment issues in allowing corp to exclude proposal to prohibit sex orientation discrim. Later changed policy, ee issues are decided on a case by case basis
        1. Key distinction: whether policy implicates important issues for corp’s long term biz strategy and fundamental policy over which SH should have input VS. short term operations concerns.
  9. Per Se Includable?
     1. Executive compensation – per se material to SH
     2. BD composition/practices
     3. *American Federation* – wanted bylaw to include SH nominated candidates in proxy statements. Corp tried to exclude because it relates to an election. But what does that mean? A specific election contest, or all election stuff? Court says election contest, favors SH.

1. Conflict Rule in Proxy Provisions

## Rule 14a-9: False of Misleading Statement

* + 1. Private right of action
    2. 5 elements below (similar to 10b-5, but modified)
  1. If Proxy is misleading – send out an amended one, or pull the old one and start over.
  2. (1) **Standing**
     1. Subject of the proxy statement – owner of record or beneficial owner, person to whom it was directed.
  3. (2) **Materiality**
     1. Same legal standard as securities laws (total mix or prob/magnitude based on what a reasonable investor would find important)
        1. But what is material for an investment decision isn’t necessarily the same for a voting decision.
        2. Also, no real timing issues b/c connected to the proxy’s mandatory disclosure.
     2. **Failure to include a provision mandated by proxy reqs is per se material**, but may have problems proving reliance/causation.
     3. ***U.S. v. Matthews*** pg 691
        1. Running for director, object of grand jury proceeding, didn’t disclose.
           1. Line items require disclosure of convictions and pending criminal proceedings – not proceedings prior to indictment, which may never result in a charge.
        2. Hang yourself doctrine – to require disclosure when nothing had yet happened places person in additional jeopardy.
           1. Similar to a ripeness evaluation.
     4. ***GAF v. Heyman***
        1. Insurgent trying to take over GAF, didn’t disclose he was being civilly sued by sister over family trust, GAF sued him for violating proxy rules.
        2. 2nd Cir refused to require disclosure of unproven civil litigation – really easy to bring suit.
  4. (3) **Scienter**
     1. Rule 14a-9 doesn’t have “manipulative or deceptive” language.
        1. This language is major for courts in 10b5
     2. Usually just negligence, with a few courts requiring more.
        1. Less than 10b5
  5. (4) **Causation**
     1. Essential link test – if the problem is material, and the proxy was an essential link to the transaction, there is causation.
     2. ***Mills v. Electric Auto*** (1970) pg 694
        1. E was merged into M, M already owned 54% in E. Proxy statement emphasized that the target board had approved the merger, but w/o disclosing that all of E’s BD were M employees.
        2. SC test
           1. When there’s been a finding of materiality, a SH has made a showing of a causal relationship between the violation and the injury if they prove the proxy solicitation itself, rather than the particular defect in the materials, was an essential link in the accomplishment of the transaction.
           2. Otherwise, court would be determining fairness – they just care about disclosure.
        3. Here, essential link was that though M had 54% shares in E, a 2/3 vote was required, so they couldn’t have done it themselves.
           1. Does that make the need to solicit proxies in and of itself the essential link? Yes 🡪 *VA Bank Shares*.
     3. ***Virginia Bank Shares*** (1991) pg 697
        1. Scott- terrible case
        2. SC – π failed to establish that the proxy was an essential link – their votes weren’t needed
           1. This basically denies standing to those SH whose votes aren’t required

(Is the Essential Link the only way to show causation?)

* 1. (5) **Remedy**
     1. Varies. Can be damages, or invalidating proxies, resolicitation and re-vote.

# Close Corporations

1. **Traits** of a CC
   1. Small number of SH
   2. Owner-managers – almost all owners are managers
   3. Desirable to customize the management structure and corp governance rules (due to corp size or owner/manager overlap) – standard structure not as appropriate.
   4. Lack of liquidity – no public market for shares
      1. Results in difficult valuation.
   5. Restrictions on transferability
      1. Whereas public corps are generally freely trade-able.
      2. Care very much who other SH are.
2. Why do we treat CC differently?
   1. Our system is one where SH’s major concern is to effectively monitor management and its treatment of SH money – ownership is separated from control.
      1. CC, problems are different.
      2. Control/ownership overlap – less of a need for costly oversight mechanisms.
   2. Compliance statutes can be traps for CC – don’t have the resources to be as informed.
   3. Very much resemble partnerships, and may be run like one.
3. **When are you a CC**?
   1. NY – any corp other than a public corp
   2. **DE** – § **342** three elements
      1. (1) All shares not held by more than 30 people
      2. (2) all shares must have at least one restriction on transfer pursuant to DE § **202**
      3. (3) Can’t make a public offering of the shares.
      4. If meet these reqs, can become a CC by amending the certif. of incorp. by a 2/3 vote of SH (§ **344**)
         1. Can also incorp as one § **343**.
      5. No longer a CC if cease to meet one of the three elements (§ **345**) or voluntary termination by 2/3 vote (§ **346**) – COI may require more than 2/3.
   3. CA – Only corps whose articles permit no more than 35 SH and void any voluntary inter vivos transfers of shares violating this req.
   4. MD – Only those corps having statutorily detailed stock transfer restrictions that effectively eliminate general trading of shares.
   5. **MBCA** – **SH agreement to, must be unanimous**.

## Shareholder Agreements

### *Ringling* (DE 1947) pg 737

* + 1. R and H agree to vote together, and if they can’t agree, to go to an arbitrator whose decision binds them. H breaches.
    2. Court says the K is valid, remedy is that H’s votes don’t count.
       1. K did not have an **enforcement mechanism**.
          1. Specific performance
          2. Irrevocable proxy.
    3. **CANNOT be an agreement/device which irrevocably separates voting power of stock in a DE corp from the ownership of the stock**.
       1. But that’s not what this is.
    4. These agreements are **only valid at the SH level** – can’t be about BD decisions that may later be made or dividends.
       1. Just about pooling in the election of directors – something in the SH role.
  1. DE § **218c** – **Voting agreement**
     1. 2 or more SH
     2. No durational limit
     3. Upheld as valid in every jurisdiction
     4. Pure Pooling agreements – about how to vote
     5. Not self enforcing, need a § **212e** **Irrevocable Proxy**.
     6. Private- no disclosure requirement (is for VT)
  2. MBCA **7.31 – authorizes SH agreements** (like 218c)
     1. For the election of directors
        1. Doesn’t have to be unanimous
        2. Ringling type pooling agreement
        3. No durational limit
     2. Specifically enforceable by statute (**7.31b**)
     3. Provision for IP under **7.22d**.
        1. Doesn’t mention coupling with an interest, but specifies what qualifies – pledgee (holds the shares as security), person who agreed to purchase the shares, creditory, employee whose ee K requires the appt, a party to a voting agreement.
     4. Can’t move appt of officers to the SH level.
        1. Need an Extraordinary SH Agreement
  3. MBCA **7.32 Extraordinary SH Agreement**
     1. Can
        1. Determine identity of officers or directors
        2. Eliminate BD or restrict its discretion
        3. Govern authorization of making of distributions
     2. Must be in charter or bylaws
        1. Stock must be legended.
     3. Must be unanimous.
        1. Still need an IP to enforce – still a K
     4. Only valid for 10 years.
        1. (Unless you provide otherwise?)
     5. Company can’t be public.
  4. DE § **350** – **SH Agreement**
     1. Maj enter into agreement which can restrict/intrude upon traditionally BD functions (elect ee’s, declare dividends, etc.)
  5. DE § **351**
     1. Eliminate the BD entirely.
        1. Liability also transferred to SH level.
     2. Requires unanimity.

## Voting Trusts

* 1. DE § **218**
  2. MBCA **7.30**
     1. Limited to 10 yrs, but extendable.
  3. Device established by the formal transfer of voting rights of shares, usually for a designated period, from their owners to a trustee.
     1. Trustee has legal title and the right to vote in the manner agreed upon.
        1. Old shares given to corp, they record, give new shares to trustee that are legended – indicate VT agreement.
     2. Might want one if sr. security holders in a rocky corp, want to maintain control, or maybe new lenders – want to have a say in the new BD, family run companies, politicians (use blind trusts, avoid conflicts), if you aren’t a U.S. citizen and have a company w/Defense contracts – use a VT to get around Alien Ownership Rules.
     3. Self-enforcing.
     4. Cannot be secret.

### *Abercrombie v. Davies* (DE 1957) pg 745

* + 1. 54% of SH agreed to give voting rights to Agents for 10yrs, sued to say it was invalid.
       1. SH had transferred their share certificates, endorsed in blank, into an escrow account (segregated assets that can only be accessed by certain people upon certain events) – HUGE step.
          1. A non complying party had no way out
    2. Court – this is essentially like a voting trust, but not set up according to VT rules
       1. **Key elements of VT – a device where 2 or more persons divorce voting rights of stock from ownership and assign the voting rights to a trustee – in whom all the voting rights of the depositors are pooled**.
       2. DE statute requires that the shares be transferred on the books and a copy of the agreement be filed.
    3. Court so hostile because of the lack of notice
       1. Concerned about secret shifts in control
  1. Hypo
     1. If in Abercrombie, instead they’d formed company Y whose sole assets are shares of company X (Abercrombie). BD of Y decides how assets of Y (shares of X) are used. SH of Y enter a unanimous voting agreement in the election of Y directors and a unanimity requirement for BD.
        1. Have created a majority, but not a VT.
        2. Have sold your shares (at whatever price you want – can be stupidly low) to Y – no separation of voting and ownership.
        3. But notice problem is gone somewhat – have to record the transfer.
     2. Quite Common.
     3. Would accomplish what SH in Abercrombie were trying to do, just legally.

### *Lehrman v. Cohen* (in class)

* + 1. Long complicated case of 2 families owning Giant Food. Created a 3rd class of SH by unanimously amending the COI – class could elect 1 director (intended to be a deadlock breaker) – no dividends, no liquidation rights, was callable at $10 upon vote of other directors. 14 yrs later, 5th director became Pres, counsel, all this stuff.
    2. Suit arguing illegal VT
       1. Says stock was created with the sole purpose of removing control of the power of the votes from other shares
          1. **But dilution of voting power that results from issuing more stock is NOT the same as separating voting rights from particular shares**
          2. As long as you can vote your shares and there isn’t separation, the concerns of the VT statute aren’t implicated.

Just because it ended up affecting a transfer of control, not inherently bad.

* + - 1. This is open and notorious.
    1. Court – stock can have a lot of motives behind its issuance, tough for a court to evaluate. They did everything properly here
       1. Corp’s failure was that they didn’t talk enough about what the stock could or could not do – to avoid this, should have put in more limitations.

## Agreements Regarding Directors

### *Clark v. Dodge* (NY 1936) pg 756

* + 1. K saying that upon D’s death a trustee would vote so C could continue to be director and gen manager as long as faithful/competent, C would get 25% net incom (C had 25% shares), and on one else would get ridiculous salaries. C would also give D’s son the secret formula.
       1. D breached.
       2. Is the K enforceable?
          1. Yes.
    2. **K doesn’t harm § 27** – “the biz of a corp shall be managed by its BD)
       1. K didn’t put C in control of the whole corp.
       2. Unanimity in the K mattered to the court.
       3. No real harm – no min SH, no damage to creditors, no damage to public interest.
  1. ***Long Park*** (NY 1948) pg 757
     1. K giving 3 SH full authority to manage the corp’s biz for 19 yrs was invalidated
        1. **Can’t sterilize the power of the directors over management**.
  2. Rule
     1. **Less than 100% of SH agree – no agreements to control directors**
     2. **When 100%, some impingement is ok**.
        1. Control of officers and salaries ok.
     3. Codified in ability to move appointment of officers to SH level, unanimous superagreements, unanimous abolishing of BD

## Restrictions on Transferability

* 1. DE § **202** – List of restrictions
     1. MBCA **6.27** – very similar.
     2. **Requires**
        1. **Notice**
           1. Must **LEGEND** the stock. Invalid otherwise, unless you can prove actual knowledge of the restriction.
        2. **Imposition**
           1. Bylaws or agreement among SH

Doesn’t apply retro-actively unless the owner agrees

* + - 1. **Presumptively reasonable purpose for the restriction**
         1. Tax advantage, maintain a regulatory or statutory advantage.
    1. § **349** – even if invalid under § 202, can still have an option for 30 days after the judgment, to buy at an agreed upon price by parties or court.
  1. Shares are considered personal property, concepts of restrictions derive from this notion. Unreasonable restraints on alienation are against public policy – must always retain *some* right to dispose of your property.

### *Allen v. Biltmore Tissue* (NY 1957) pg 727

* + 1. Shares with a first option to corp and SH upon death of holder at purchase price. Bylaw restriction was on the face of the shares. Kap dies, corp exercised right, bought for $20 a share (double purchase price)
       1. Kap’s executor’s didn’t want to sell, argue bylaw should be void as an unreasonable constraint (didn’t like the price)
    2. Held – not an unreasonable constraint
       1. **Validity of restriction doesn’t rest on intrinsic fairness of price**.
          1. Reasonableness of price is assessed at the time of IMPOSITION.
       2. As long as the price formula is agreed to and there is notice, the formula is valid.

### *Rafe v. Hindin* (NY 1968) pg 730

* + 1. Two SH, restriction that you couldn’t sell if other approved. But, more than first refusal – if they didn’t approve, you were stuck
    2. Held: Unreasonable restraint on alienation
       1. **Arbitrary consent restrictions are unreasonable**.
          1. Here, nothing as to how consent would be structured, no obligation to buy.
    3. (Change from completely arbitrary to a formula/number buyback price that both parties have notice of is enough to make it ok)
  1. **Right of First Refusal**
     1. Right to match an offer made
        1. Triggered by another offer for the shares.
           1. Rightholder has no control over timing or price.
           2. Has to be a bona fide offer.
     2. Drawbacks
        1. Could require a lot of capital at an unpredictable time.
        2. If you don’t exercise the right, stock could go to anybody.
  2. **Option**
     1. Right to buy back on the occurrence of certain events at a strike price.
        1. Need to determine who the has the option right
  3. **Buyback/Redemption Agreement** l
     1. Use this upon the death of a SH, maybe if the company goes public, if somebody leaves the employ of the company, disability, personal bankruptcy
        1. Lay out what will be the trigger(s).
     2. About trying to keep the stock out of the hands of others
     3. NOT OPTIONAL
        1. Once triggered, it goes.
  4. **Consent** Restraint
     1. Can be legal.
        1. Need a reasonableness requirement – can’t unreasonably withhold consent.
           1. Even stronger with some kind of buyout, but not necessary.
        2. Can control who and how many
     2. Can add to a RFR
  5. **Tag Along Rights**
     1. When SH sells shares, other have option of selling shares to purchaser at same price
     2. Important protection for min SH
  6. **Drag Along Rights**
     1. Ability to require other SH to sell to 3rd party when one SH does so.
  7. **Necessary provisions**
     1. Price/formula for price – fair at time of agreement
     2. Triggering event – disposition is ambiguous
     3. Duration of option
     4. Securities covered – only if you sell all, or some?
     5. Who has the right? Corp? SH? Who first? How much do they have/get to buy?

## Fiduciary Duties of SH in CC

* 1. ***Donahue***
     1. Read solely as a stock repurchase case
     2. Π’s husband dies, gets his 20% in corp. Other SH of CC wants out, corp repurchased many of his shares at book value, gave rest to his sons. Transaction reasonable and appropriate in itself. But widow sues, says she should have had option to sell at same price, and to not offer is a breach of the duty of loyalty.
        1. ∆ argues within power of corp to buy back stock, was taken in good faith and met standard of fairness.
     3. Court holds for π
        1. In a CC, SH have to have a very substantial relationship of trust, confidence, and absolute loyalty.
        2. Π must be given same opp to participate in the buyout, b/c the buyout itself conferred benefits on the SH selling disproportionate to other SH (corp using corp assets to benefit only one SH)
           1. Repurchase created a market for shares where none existed before.
     4. Had other SH sold to a 3rd party, would have been different – no participation of the corp or the corp funds.
        1. See Tag Along and Drag Along Rights above.
     5. Had there been *any* market for shares, π may not have got relief.
        1. Illiquidity is a huge factor here.
           1. Enough to create a fid duty?
  2. ***Wilkes v. Springside Nursing Home*** (Mass 1976) pg 761
     1. W, original SH in CC, also source of his full time employment.
        1. Froze him out – fired, min SH, they offered to buy his shares at a shameful price.
     2. W sues for violation of fid duty to him as a min SH.
     3. Cour holds for W
        1. But doesn’t want to take GF standard too far, don’t want to hamper management
        2. Modify Donahue – **Ask if there is a legitimate business purpose for the action.**
           1. Here, no.
  3. **TEST**
     1. (1) Ask if the group in control has a legit biz purpose for the actions it took.
     2. (2) After a legit biz purpose is shown, burden shifts to π to show that the same objective could have been achieved through an alternative course of action less harmful to the min SH interest.
  4. ***Zidell v. Zidell Inc*** (OR 1977) pg 768
     1. AZ and JZ own 37.5% of corp, R owns 25%. JZ bought R’s shares, making him a maj.
        1. AZ sues for breach of fid duty in that JZ bought shares rather than allow corp to buy.
     2. **General rule that a director violates no duty to the corp by dealing in its stock on his own account**.
        1. Insider trading aside that is.
     3. Court: No duty violation, held for ∆
        1. Sucks, but not illegal or a breach.
        2. Could have put in some sort of agreement to avoid/limit this.
           1. Court won’t imply duty that could have been contracted for.

# Takeovers

1. **General**
   1. BJR presumption can be removed via two routes (π’s plead both!)
      1. Duty of Care
         1. *Van Gorkom* (a takeover case!)
            1. Show decision was made negligently, then decision reviewed under fairness standard.
      2. Duty of Loyalty.
         1. Not all conflicts are disabling – has to rise to a certain level likely to affect the objectivity of the decision making
            1. Directors are **paid** for their jobs, which is fine, but if your motivation is **keeping** your job, we have a problem.

Can’t make decisions in order to **entrench** yourself as a director.

* + - 1. Loyalty analysis starts with
         1. Show a disabling conflict
         2. Then that it went uncured.
         3. If cured, then BJR back

Cures can be vote by disinterested directors, vote by SH, or intrinsic/inherent fairness.

* 1. **Parent/Subsidiary**
     1. Structural conflict of interest
        1. Always a potential conflicting loyalty
        2. But not always a problem – mere conflict is not enough.
           1. **Have to show probability of, if not actual fact of harm.**
           2. **Benefit/Detriment** test of *Sinclair*.
     2. Usual avenues of **cure** are unavailable
        1. No disinterested directors, parent is the controlling SH
        2. **VERY difficult to show cure once benefit/detriment is shown**.
           1. Same evidence used to overcome presumption prevents board from showing fairness/cure
     3. One P/S transaction you don’t have to show B/D for is a **Squeeze Out**.
        1. Where parent is trying to get rid of another SH
           1. Structural conflict is also real.
        2. **Courts skip B/D and go straight to fairness**.

1. **State Corp Law regulates TARGET corp’s BD**
   1. **Does not regulate bidder/acquirer’s BD**
      1. For them, is an **ordinary management decision** – like whether to expand a product line or to buy/build.
      2. Relationship between B/A and their SH is not affected.
         1. If buying w/stock, SH already authorized that stock
         2. If using cash/debt, this choice is delegated to BD (§ **141a**).
   2. **To the extent the B/A regulated, it’s by Fed Securities Law**, not state corp.
   3. How do we view Target BD?
      1. Always conflicted, like a P/S squeezeout?
      2. Or presumptively NOT conflicted, ordinary BJR.
      3. Debate continues
2. Note on Directors
   1. Outside director and independent director are not the same thing.
      1. **Outside** – not employed by the company
      2. **Independent** – not employed and no significant financial ties.

# Hostile Takeovers

## *Cheff v. Mathis* (DE 1964) pg 945

* 1. Old takeover case predating hostile takeovers being common. M proposed a biz merger, was turned down, implied he was leaving forever. Then bought 3.5% of the company. Corp continued to rebuff him. Corp bought M out.
     1. **Greenmail**: Potential acquirer offers to go away if you but them out a premium. No longer legal.
  2. Π saying that the corp had an illegit purpose in the greenmail – not about protecting the corp, was about keeping their positions (buying back your stock is facially legal).
     1. Court found ∆’s purpose legit, but said had it been illegit, it would have been improper.
  3. Court still going to **require evidence of a real conflict**, not just potential (like the P/S context), but were going to **shift the burden to the Board to explain why the conflict was not disabling**.
     1. **BD has to show reasonable grounds to believe a danger to corp policy and effectiveness existed**.
        1. Good Faith and reasonable investigation.
        2. Then BJR is restored.
     2. Again, this is a procedural remedy – can’t know what’s in the mind of the directors.
        1. Courts wouldn’t look to the price paid (as long as didn’t render corp insolvent).

1. Types of defenses to unsolicited offers
   1. Blank check preferred – authorized stock with terms to be defined by BD later – at the heart of most poison pill plans
   2. Fees – not all justified, could be a fid duty breach
      1. Bust up – paid to an unsuccessful suitor
      2. Goodbye – if someone else prevails, bidder gets this fee
      3. Hello – to bring bidders in
   3. Creeping tender offer [offense]
      1. Not used anymore – once you get 5% of a corp, have to file and disclose
      2. Prevents midnight raids
   4. (ESOP) Employee Stock Option Plans
      1. Used to be used more defensively. EE ownership is increased, bunch of stock in an ee trust, ee’s own it, but voted by a trustee.
   5. Fiduciary Out
      1. Always a part of merger agreements now
      2. Where it is necessary for the BD of the target, in order to fulfill its fid duty, to break the terms of the K, they can.
   6. Golden Parachutes
      1. EE K’s providing for bonus payments in salary if a change in management occurs – so that ee’s to leave the moment a takeover possibility emerges.
         1. Tax law has scaled them back recently – used to be obscene.
   7. Just Say No (Time Warner)
   8. No Shop Clause – prevents corp from actively seeking competing bids – limited now.
   9. **Poison Pill**
      1. BD issues rights (stock, preferred stock, warrants) to SH as a dividend on existing stock, but it’s not exercisable at the time of issuance.
         1. Has no value at issuance (tax purposes)
         2. Becomes exercisable upon triggering event
      2. Trigger usually acquisition of a certain amount of stock by someone WITHOUT prior approval of the BD
         1. Generally 15% trigger.
      3. **Purpose: to bring the bidder to the bargaining table**
         1. Negotiate, avoid triggering.
         2. Also gives BD more time – find another bidder, figure out what to do.
      4. Board can redeem the pill before it becomes exercisable for a very small amount.
      5. **Flip IN Pill** – SH exchange shares for high yielding short term debt with high face amount – leaves bidder with no equity and a short time to pay back the debt.
      6. **Flip OVER Pill** – target SH can exchange their stock in the corp into stock in the bidder at half price upon the trigger.
         1. Has never happened – not even sure it’s legal.

## *Unocal Corp v. Mesa Petroleum* (DE 1985) pg 955

* 1. M makes tender offer to U’s SH for $54 a share. U responds with an exclusionary self-tender: offers $74 a share to everyone but M. M sues.
     1. Threat 1: Coercive element in offer – if you tender in, get $54 a share, but if you cash out later, get severely subordinated securities. Pressures you to tender at the beginning, whether you like it or not.
        1. These front loaded two tier junk bonds are now rare- market doesn’t like them.
     2. Threat 2: Price was inadequate.
  2. Court holds for U – Corp has the ability to discriminate against SH for a valid corp purpose.
     1. BD has an affirmative duty to respond to a threat, even if it comes from a SH
        1. Justified in protecting other SH from a SH that the BD sees as acting contrary to the best interests of the SH as a whole.
     2. The coercive offer was a threat.
  3. **Enhanced Duty of Unocal** (only attaches after a bid)
     1. Board shows **(1) good faith reasonable investigation on the basis of which the BD shows they had reasonable grounds of believing a threat existed.** 
        1. Proof is materially enhanced by approval of a BD comprised of a maj of outside ind. directors – especially after SOX
        2. Real threat means BD wasn’t (only) acting in self-interest.
     2. **(2) Proportionality Test – show their defensive measure is reasonable in relation to the threat posed.** 
        1. Limits Cheff, which didn’t have a component to logically limit what a board could do. Responding to scorched earth defenses.
     3. **Meet these, you get BJR again**.
  4. Factors BD might consider
     1. Inadequacy of price
     2. Nature/timing of offer
     3. Illegality
     4. Lack consummation
     5. Quality of securities offered in exchange (junk bonds?)
     6. Interests other than SH
  5. What BD did right
     1. Lots of meetings, detailed presentations from outside/inside counsel and fin advisors, outside directors met separately with fin advisors and lawyers.
  6. Final Question
     1. After Unocal, can a BD just say NO, regardless of whether there’s a threat or not and how high the bid goes?
        1. Some say Paramount validates “Just Say No”, but Scott said the facts aren’t as broad as that.

1. Threats
   1. Price too low
   2. Coercive
   3. Corp busted up to pay for it
2. ***Moran v. Household Int’l*** (960)
   1. **Upholds** BD’s precautionary implementation of a **poison-pill plan** (there wasn’t a bidder or offer, or expectation of one)
   2. Key – that the BD could choose to “redeem” the pill if an attractive offer came in – pill might never go into affect.
      1. **Defers the application of Unocal proportionality until the time that the BD chooses NOT to redeem the pill in the face of an offer/takeover**.
   3. This is defensive, not preclusive.

## *Paramount v. Time Inc* (Del. Ch. 1989) pg 964

* 1. Time has been in merger negotiations with Warner, Paramount makes an offer for time. *Unocal* still applies – T took defensive steps. Time arguing their corp culture and corp identity were threatened – very concerned about journalistic integrity, had made sacrifices in the merger agreement to preserve it and culture.
  2. Question – does the P offer represent a threat to an interest the board has an obligation or right to protect by defensive action.
     1. P argues that an all cash/all shares offer followed by a second step merger for cash can only pose a *price* threat.
        1. But here, Time wasn’t looking to bust up their corp – Revlon price maximization doesn’t apply?
        2. **Court rejects that it can *only* be a price threat**. No obligation to maximize in the short term, and price isn’t as simple as P makes it sound.
     2. **Conditions of the deal could also be a threat.**
     3. *Unocal* only attaches after P made bid – original TW transaction is just normal BJR, **but after bid, Unocal attaches to everything**.
  3. Court finds threat, then evaluates reasonableness of response.
     1. Evaluate the importance of the corp objective threatened, alt methods for protecting that objective, impacts of the ‘defensive’ action, other relevant factors.
     2. Here, response was the restructuring of the TW deal from a merger to an acquisition, removing the decision from the SH.
        1. This is **defensive**, not **preclusive** – T isn’t cramming a transaction down SH throats that’s essentially same as bidder’s.
           1. TW transaction makes P go away because P only wants T, not TW.
  4. Held for directors
     1. DE **141(a)** has the subsidiary obligation to assess the appropriate time frame in which profitability may be enhanced – no obligation to maximize in the short term.
        1. It’s the BD’s non-delegable obligation.
     2. If the court had decided otherwise, would be allowing the BIDDER to determine when, which companies, and at what price, are taken over.

# Friendly Transactions

## *Revlon v. MacAndrews & Forbes* (DE 1986) pg 993

* 1. Pantry Pride made the bid for Revlon for about $43 a share. PP essentially an acquisition vehicle. R said it was grossly inadequate and would be a junk bond bust up.
     1. R’s BD responds with
        1. Discrim flip-in poison pill, notes purchase plan (increases debt to buyer). Pill also sets a price they think is reasonable.
           1. B/c of debt, makes it harder for bidder to use junk bonds.
           2. Can be legal on its face, but is it a breach of BD’s fid duty?
        2. Exchange Offer notes with limits (waivable by BD) – R gives about 1/3 shares for these notes – goal: get money to SH, use up borrowing capacity, force PP to deal with BD
     2. These responses are ok with the court.
        1. BD is consistent, legit, GF reasonable belief that the offer is too low.
  2. PP comes back with a $53 bid if BD would agree to participate in a negotiated merger (what court wants to happen with poison pills)
     1. In response, BD authorized itself to negotiate with other bidders, with no limitation on the types of bidders
        1. This is the **MOMENT** when BD gets in trouble.
           1. **Essentially saying that the corp is for sale**

The bust-up is no longer a threat.

Only price is the threat now.

* + - 1. At this moment, BD’s role changed from “defenders of the corp bastion to auctioneers charged with getting the best price for the SH at a sale of the company.”
         1. No longer looking at a BD acting defensively under Unocal standards, but sellers looking to get the best value for SH in the shorter term.
  1. **Once in Revlon territory, BD has to satisfy a reasonable belief based on GF reasonable investigation that one bid is preferable to another in order to favor a bid**.
     1. R’s **BD failed to do this**. Favored FL w/o GF reasonable investigation.
        1. **So court analyzes for fairness**.
           1. Crown Jewel Lockup here was not to the benefit of SH – assets to be sold way below market value.

Was not about bringing in other bidders, but locking out PP.

* 1. **Crown Jewel Lockup** 
     1. Option to let the bidder purchase certain corp assets if their bid doesn’t succeed
     2. Can be a good way to bring in bidders, or can be used to cut off bidding in a bad way.
     3. Can be legal, but has to benefit SH and be in furtherance of the BD’s Revlon imposed fid duty.
  2. **Major problem here was that the BD favored FL in order to protect themselves from liability from the noteholders** (value of the notes were plummeting, as the BD would waive the protective covenants for the winning bidder. FL was going to pay the noteholders)
     1. **Conflict of interest! Directors protecting themselves at expense of SH when they’re ONLY supposed to be considering the SH**.
        1. **Loyalty problem. BD does not get BJR back**.
     2. Noteholders’ protections were in the K, knew this could happen from the beginning.
  3. This is a **Care** (didn’t have sufficient info to compare bids – Van Gorkom) and **Loyalty** (put noteholders before SH, never got BJR back).
     1. Don’t play favorites! Once in Revlon Mode, have to consider the bids fairly.
        1. Does NOT mean you need to essentially have an auction.
  4. **Once a corp makes the decision to sell, they relinquish the bust up threat defense and the obligations shift**
     1. The entire situation is revisited with eye to **new duties**.
        1. Poison pill essentially is a BD substituting their judgment for the market’s
        2. Have to be scrupulously fair in deciding between bids.
     2. **“For sale” can be an active auction, a management buyout, restructuring**.

## *Mills Acquisition Co. v. MacMillan* (Del Ch 1989) pg 1000

* 1. Management had clearly dominated the BD’s decisionmaking process – BD was conflicted and not independent – **independence is crucial to this process**, enhances reasonableness.
     1. B/c management dominated, BD loses good faith and BJR protection.
     2. Normally, court focuses on the actions of outside directors, but here focused on interested directors
        1. CEO and Riley clearly violated their duties of loyalty – favored one group, fed them info, de facto became part of one of the factions.
           1. This raises the stakes for the rest of the BD (to oversee?) Conflict of managers was so obvious that BD should have known

Even if not obvious, BD required to make sure management is proceeding fairly and isn’t conflicted. Be sure to get unbiased information.

**Essentially, if you know/suspect conflict, you can no longer reply on the reports of management**.

* 1. Mac CEO foresaw a takeover in the future, proposed a leveraged buyout to consolidate control in management, went through, and adopted a poison pill.
     1. Bass was trying to buy the company, some back and forth, Mac negotiating a restructuring with KKR. Wasserstein hired to shop the company, see what’s out there. Maxwell emerges with a high bid. KKR gets all this confidential info. KKR favored, back and forth bids, Maxwell willing to pay whatever.
     2. Corp holds an auction, will waive the pill for the winner. M offers $94, KKR finally came up to $90 and some junk bonds. CEO had told KKR about M’s bid. Corp went with KKR and gave them a lock up. M offered more conditioned on invalidation of the lock up.
        1. Lock ups to end an auction are touchy – really in the best interest of SH? Must be a **substantial** benefit.
           1. Must withstand **exacting scrutiny**.
           2. Here, KKR was already enticed, increased value was minimal.
  2. Because BD had been deceived by self interested officers, court looks at transaction.
     1. **BD failed to exercise oversight of bidding process**.
     2. After this case, still true though that BD doesn’t have to auction.

## *Paramount v. Time II* (Del Ch. 1989) pg 1003

* 1. Π’s other claim was that T was for sale and that Revlon duties were triggered.
     1. (1) **Trying to say a stock for stock merger was the equivalent of a sale b/c control would go from T SH to W SH**
        1. Court – control, before and after, would be in the market.
     2. (2) Merger would prevent W SH from ever getting a control premium on their stock, as required by *Revlon* (a transaction that cuts off the possibility of the high premium is preclusive and not proportionate under *Unocal*)
        1. Nothing preclusive. Just b/c P doesn’t want to buy after the merger doesn’t mean that another bidder can’t bid.
  2. **Difficult for Revlon to attach inadvertently**
     1. **Has to be the result of *intentional* transactions**. Must be **action** taken by the BD.
     2. In play does equal for sale
        1. Being an attractive target isn’t enough.
  3. Revlon not applicable here, only Unocal.

1. Paramount v. QVC (1994) pg 1009
   1. P wanted to merge with Viacom. Viacom 84% owned by a single SH (Redstone). After the merger, Redstone would be the controlling SH of the new corp. QVC wants a merger with P, P takes defensive actions (No Shop Provision, Termination Fee, Stock Option/Lock Up Agreement)
      1. Fee was $100mm – essentially a lock up, need good reason to justify.
      2. Lock Up- court hated it. Was ridiculously favorable to Viacom and bad for P.
   2. The P/Viacom transaction would result in a **CHANGE OF CONTROL.**
      1. **Both Unocal and Revlon attach to the defensive actions as a result**.
         1. **A new controlling SH will preclude a controlling premium of the other SH**.
         2. Future of the company and any other takeovers now up to that one person, will depress price.
      2. **The Unocal rationale for the deal of implementing a long term strategic vision is eviscerated with a controlling SH** – controlling SH can just change vision and BD.
   3. **CARE** case – BD failed to consider both offers considerably and critically, was under Unocal and failed to meet burden to get BJR.
      1. A BD has to be especially diligent in Revlon land
         1. Adequate info, outside directors, concerns over management’s impartiality.
      2. BD here didn’t get all info or have a reasonable basis for choosing one over the other.
   4. Viacom tries to argue for a vested K right to have the Fee and Lock Up enforced and damages for the No Shop. Court rejects
      1. “To the extent that a K, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fid duties, it is invalid and unenforceable…The P directors could not contract away their fid obligations.”
         1. No remedy.
         2. Does the court only mean this in takeover situations?

## *Omnicare v. NCS* (DE 2003) pg 1034

* 1. Scott- troubling case.
  2. NCS was insolvent, seeking anything to keep the company alive and avoid bankruptcy. Invited Omnicare, O made an offer, was low, negotiated with NCS creditors, made a bit higher offer, still not enough to pay off all NCS debt. Genesis brought in.
     1. **G offer** would take care of all the debt and leave some for SH, but required **several provisions**.
        1. Tough no shop clause
        2. Require merger vote to be submitted to SH, regardless of whether BD favored or not.
        3. Goodbye Fee
        4. Agreement from 2 SH that controlled 65% of the voting power (was an A/B stock classification) to vote for the G merger.
     2. BD agreed to G’s offer.
     3. **The combined effect to the provisions GUARANTEED the G deal to go through** – SH get to vote regardless of what BD thinks, and controlling SH have to vote for it regardless.
        1. **No fiduciary out**.
        2. **BD abdicating any control and their fid duty**.
           1. Even though elements may be legal in the abstract, as applied here, unacceptable.
  3. O, after bowing out, comes back with an 11th hour conditional bid.
     1. NCS rejected – G agreement, O had been unreliable in the past. Still used O’s bid to negotiate better terms with G.
  4. After announcing the G takeover, O makes a tender offer and sues.
     1. NCS wanted O’s final offer (much better), but couldn’t.
  5. Court - **The G conditions constitute defensive tactics – *Unocal* applies in analyzing** (*Unocal* applies when more than one bidder) (didn’t apply *Revlon* because structure of deal didn’t involve a change in control…?)
     1. **Court says, w/o fid out clause, the tactics are preclusive and coercive, and therefore unenforceable**.
        1. BD abdicated ability to protect min SH
     2. But, how much control does the BD have over a SH voting agreement? Is that really their fault? Involved here, but what if not?
  6. **Dissent – this should be pure BJR**
     1. **BD not seeking to fend off anybody, just the best transaction: NO CONFLICT, potential or actual**.
        1. BD not acting defensively.
        2. Only way to secure a viable offer was to use these devices, and at the time of G’s bid, they were the only bidder.
  7. After this, how do you ever stop an auction? Bidding is costly, and there will always be a fear that if someone bids more, however late in the game, they have to be considered if you can’t use lock ups
     1. Lock ups with fid out – is it always the BD’s fid duty to use the out if they get a better price?