**Corporations Arlen - Fall 2011**

**When I pasted the index lists, the numbering got messed up and I can’t figure out how to fix it. It’s all in the same order so it shouldn’t be too confusing.**

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1. Agency Law-----------------------------------------------------------------
2. Who is an Agent and Principal’s Liability in Contract--------------------

**P is liable for A’s Ks when: Agency relationship;** **Rest. 1.01**: Relationship resulting from a “***manifestation* of consent**” by one person (the principal) that another person (the agent) shall act: 1) **on P’s behalf** **AND** 2) **subject to P’s *right* of control**.

Types of Agency Authority:

**1) Actual Authority**:

* Either express or implied, binds the principal to the 3rd party K, and NOT the A (unless undisclosed or unidentified principal), with **no right of indemnification**.
* **Factors that tend to indicate no agency relationship in intermediary transaction**: 1) A to receive fixed price from alleged P for good, 2) A acts in own name receives title in own name, 3) A has an independent business of buying and selling property (buyers other than alleged P).

1. **Express** Actual **Authority**: Explicit legal duties by which P agrees to be bound by A’s actions in agency capacity, which terms **evidence a finding of agency relationship** only to the extent they **tend to show consent to structure of agency relationship**.
2. **Implied** Actual **Authority**: No explicit terms, but agency relationship implicit in actions/manifestations of A and P.

Mill Street: Painter (A) had BOP to establish “**reasonable belief**” that Church (P) had granted authority to hire brother on job and **court found implied authority** because of **past practices** to that effect, **industry standards**, manifestation of church to hire *some* help and practical necessity of completing job (last point also informs inherent authority analysis).

Cargill:

* + Cargill maintained certain rights of control not uncommon of non-agency creditor relationship, including **veto rights on certain transactions**, BUT…
  + The **level of specificity** with which Cargill influenced Warren’s **daily managemen**t established “de facto control” of an agency relationship, AND
  + Warren’s **distressed financial state** meant that all profits would go directly toward fixed liabilities such as credit, **effectively rendering Cargill a residual claimant**, adding **an incentive to control Warren** that informed the court’s view of events, compelling court to find **implied authority**.

Lind: **VP would have known** that **company policy** allowed only prez to set salaries, so at least at this intervention **breaks any chain of actual authority**, leaving the plaintiff with apparent authority.

* **Undisclosed Principal**: When 3rd party does not know A works on behalf of any P, **both P and A are parties to the K, with A liable to the extent P cannot pay**.
* **Unidentified Principal**: Even when 3rd party knows A works on behalf of some P, but not who, court will generally hold A liable to the extent P cannot pay.
* **Ratification Rest. 4.01-04**: One can establish **actual authority** (protecting A from indemnification by P, unlike apparent authority) if:

1) A purported to work on P’s behalf,

2) A did not have actual authority, **and**

3) P subsequently and **with** **knowledge of all material facts** **either**

a) **expressly affirms A’s actions** by manifesting an intent to treat A’s actions as ratified **or**

b) engages in **conduct that is only justifiable if** P had such an intention (**implied ratification**).

In Lind (full case below), P may have had **alternative claim to actual authority** under **implied ratification** because his superiors continued to employ him with knowledge of his compensation expectations, which they only later rejected.

**2) Inherent Agency Power**:

- Authority the A reasonably concluded that the P actually intended the Agent to possess, which includes the powers **practically necessary to carry out delegated duties.**

Mill Street: hiring help was **practical necessity** of carrying out **delegated painting duties**, resulting in **incidental implied authority**, as well as informing implied authority analysis.

**3) Apparent Authority**:

* **P’s manifestations** (not A’s) are such that a “**reasonably prudent person**” (RPP) in position of 3rd party would believe A was acting on P’s behalf and subject to P’s control **and in some jurisdictions, detrimental reliance** on such manifestations.
* Cargill: Some of the plaintiffs could have sued under apparent authority, but because the claim assesses the reasonableness of the **3rd party-plaintiff’s position**, a class action **would have required separate examinations** of the conditions of each plaintiff’s K, so the implied authority claim was better for a plaintiff class.
* Dweck: Settlement negotiation. Apparent authority claim rejected because alleged P never made any direct manifestations to 3rd party, only through agent. There **must be some direct manifestation of P’s to establish reasonableness of 3rd party’s belief** in agency relationship.
* Lind: Because the **reasonableness of L’s belief in Kauf’s auth** to ultimately set the compensation **implies reasonable belief that authority have been validly delegated**, we must conduct an apparent authority analysis on the VP’s representations of his authority to delegate, as well as Kauf’s.

1. **VP auth. to delegate**: Although there was **no affirmative manifestation** **from** the president, **the principal**, that VP had the authority to set salaries, VP’s **job title (“dignitary mechanism”) constitutes a sufficiently affirmative manifestation by the principal** (reflecting flexibility of requirement to encompass past actions) to the extent that L is reasonable to believe this indicates salary-setting authority, which he is because it is **standard industry practice**, distinguished from Gumper, in which employee’s belief board member had hired him was unreasonable because contrary to standard industry practice.
2. **Kauf’s auth. to set such a high salary**: arguably unreasonable for L to believe such a dramatic raise was within the scope of the delegated authority because it increased L’s compensation beyond that of even the VP, **altering the corporate hierarchy**, but jury has already spoken on this question.

* 3-70 Leasing: Severing K claim from App. Auth. Q completely (not allowing dubious K to affect reasonableness of belief in A’s Auth.), court finds App. Auth. because:

1. Credit check was only condition to sale of which they were made aware, and they subsequently passed credit check.
2. **Received effective confirmation from a salesman** (Kays): the fact that a letter to Joyce named Kays as the **point person for all communications** regarding the deal suggests that, **even had Joyce been aware supervisory permission was necessary, such permission would only have been communicated to them through Kays anyways.**
3. Ampex **could very easily have included a term in K** specifying the need for supervisory approval.
4. Liability in Tort/Vicarious Liability/Respondeat Superior----------------

**Analysis**:

1) is there an agency relationship?

2) If so, is it a master-servant relationship? (greater right of control over **details of how the A completes their tasks; their “physical conduct,”**  as opposed to an **independent contractor**) 3) If so, was the tort committed within the **scope of employment**? If yes, then vicarious liability (Rest. 204).

**Indicia of m/s control**:

* Look to 1) **direct evidence of actual day-to-day control**, 2) **indirect evidence** such as **right to control specified in K** (like termination clauses, but as in agency context, K nominally eschewing m/s relationship not dispositive, such as IC K in Humble), and 3) **incentives** such as **who bears the residual risk** of the business venture. Rest. 220 (in outline) has more.
* **Franchises generally**: There are competing interests for a franchisor to maintain control, or not, of the franchise.

**Less control**: better investment opportunity for franchisee if they have control over own fate, **local knowledge/connections** may be required, **potentially more limited tort liability,** **in this case there is also a risk of antitrust violation for vertical integration**.

**Greater control: avoid brand dilution, potentially greater profits if residual claimant**.

Humble and Hoover v. Sun Oil Comparison:

|  |  |  |
| --- | --- | --- |
| Element | Humble (liability) | Sun Oil (no liability) |
| Products | Retained title; Exclusive sale of P’s product. | Title retained by A, **Non-exclusive sales** suggestive of distinct business operation. |
| Duration | P could **terminate at will**. | 30-day notice |
| Reports/required performance | Yes reports and **had right to require additional duties** | None; only occasional visits |
| Hours of operation | Set by Humble | No requirement |
| Appearance | Signs/Uniforms Mandated | Signs/uniforms |
| Employees | No control by P | No control by P |
| Risk/return | Most risk borne by P, **establishing a residual claimant incentive** | Most risk borne by A, though some downside market risk borne by P via rebates. |

Murphy: Hotel franchisor **not vicariously liable** because **despite brand preservation efforts** (architecture, signs, **hours**, training, **inspections**, reports), **franchisee bore risk of losses**, creating powerful **residual claimant incentive**, and significant **on-site discretion** is practically necessary to run a hotel.

**Scope of Employment**

* **Rest. 228:** Conduct of servant within scope of employment if:
  1. it is **of the kind he is employed to perform (not “frolic and detour”)**,
  2. it occurs substantially **within the authorized time and space limits (not F & D)**,
  3. it is actuated, at least in part, by a **purpose to serve the master** and
  4. if force is intentionally used by the servant against another, the use of force is not unexpectable by the master (security guard).
* **Criminal Liability:** Same rules apply; **intent to benefit the master**, such as saving money through environmental violations, firm will be liable.

Vandemark: P injured in MCD robbery. No vicarious liability because franchisor did **not control specific aspect of business that led to injury** (security measures); **minority view**.

**Ostensible Authority** – **apparent MS relationship** can found **separate tort theory**.

* If **P holds himself out** in a way that would cause a **3rd party to reasonably believe** that master/servant relationship exists, P may be liable in tort.
* Most states require the π to show **reliance**: **Convenience ≠ reliance** – Emergency rooms are often separate entities from the hospital; requesting that emergency room v. it being the closest one. Someone using the hotel b/c it says Holiday Inn and there is reliance on the hotel name.
* The minute you go to **reliance** you go out of the Master/Servant theory & into Ostensible Theory.
* Sun court includes potential ostensible authority in its analysis.

Miller v. Mcdonalds: Stone in burger. No m/s but ostensible auth. based on MCD’s representations (holding themselves out as Master).

**Policy Arguments for making P liable: Incentive to:** i. hire responsible As, ii. set right balance b/w productivity & care, iii. provide good equipment, iv. regulate risk through power to control.

1. Agent Liability to Principal: Fiduciary Duties------------------------------

**Cutting agency costs**: in addition to **incentives** that cut down on **monitoring** (costly), fiduciary duties provide **common law default rules for enforcing agency relationships** that help parties to avoid the counterproductively burdensome **transaction costs of “complete contracts”** that attempt to anticipate every possible contingency with specificity (the problem of **bounded rationality**).

**Duty of Care**: Subject to any Agency agreement, A has a duty to P to act with **care, competence and diligence** normally exercised by agents in **similar circumstances**. **Special skills or knowledge** possessed by A are included in the circumstances considered in evaluating due care

**Duty of Loyalty**: Unless the parties otherwise agree (see waiver), an A is subject to a duty to his P to act **exclusively for the benefit of the P** in **all matters connected with his agency**.

**Umbrella duty** for the following specifics:

1. Use of P’s property for A’s benefit or the benefit of a 3rd party. (Reading) (8.05)
2. Use of P’s property so it appears to be A’s property (Reading) (8.12)
3. Usurpation of business opp. belonging to P. (Gen Auto and Rash)
4. Use/disclosure of confidential information for A’s benefit or the benefit of a 3rd party. (8.05)
5. Acting with conflicting interests (Gen Auto) (394)
6. Competition: Throughout the **course of the agency relationship**, A has duty not to compete with, or assist the competitors of, the P. (**2d Rest. limits this** to opps within the **subject matter** of the agency as seen in Rach, but 3d does not).

Note: A can take action **in preparation for competition** at the termination of employment, providing such action is not otherwise wrongful.

1. Act as or on behalf of adverse party in transaction connected with agency relationship (self-dealing steps outlined in Rash case).
2. **Material benefit arising out of position**: duty not to acquire any material financial benefit arising out of actions taken in agency capacity, **including after agency relationship has ceased**. Although ancillary benefits to the A may seem innocuous, they almost always indicate some other breach of loyalty (bribe from adverse party for ex.) so rather than allow evidentiary frustrations stand in the way of proving the underlying breach, courts have made **policy judgment to ban the suspect practice entirely**. (8.02)

**Note**: under 2d rest. this was “**failure to acct for profits**,” which was limited to the actual usurpation of the P’s profits, requiring causation and harm, rather than the unjust enrichment approach taken in the 3d Rest.

1. Duty of **candor**: A has duty to use reasonable effort to provide P with the facts that the A knows or has reason to know when 1) P would wish to know the info or it is material to A’s duties to P **and** 2) the info can be disclose without violating a superior duty owed by A to another party. (8.11)

Reading:

* **Use of P’s property for personal benefit**: If the uniform is owned by the P, then this is a clear violation because the uniform is essential to the profit.
* **Material benefit arising out of agency relationship (under 3d rest.):** Although the profit derives from actions taken while off-duty and with unrelated parties (arguably outside the scope of employment), the **status conferred on A by P (via uniform)** by virtue of agency relationship is **essential to the profit**, so it still “**arises out of” agency relationship** in a DoL sense.
* **Failure to acct. for profits: under 2d rest**, A might be off the hook here because P would not have gotten this money anyways, and 2d rest limits “profits” to those P would have had some claim to.

General Automotive: The industry consultant. **Usurpation of Corp. Opp.** (also conflicting interests, duty to disclose profits arising out of agency rel.)

**Usurpation**:

1. Reasonably related to line of business? Here yes, just another potential customer.
2. If yes, establishes **presumption that P is capable of taking Opp**., overcome only by **objective evidence** to the contrary.

* **Disclosure**: **Even if P was incapable** of taking on Opp., **conflict of interest** on commission **requires that A disclose and seek waiver**.
* **Entire time clause**: A has clause in K mandating that he work exclusively for P, which serves to obviate any potential ambiguities about the scope of competition for DoL purposes.

Rash:

1. **Duty not to compete**: Under the 3rd Rest. the duty not to compete would arise as soon as P started its own scaffolding business. **But the 2d Rest**. **limits the scope** of the duty not to compete to the **subject matter of the agency relationship**, which encompassed only the work of the division which A was hired to run. Court chooses not to address issue because they found liability on self-dealing claim.
2. **Steps to Self-dealing transaction claim**: 1) Is there an Agency relationship? Yes, employee. 2) Is there a self-dealing K? Yes, A has material interest in scaffolding co., 3) Was there informed consent? No. So there is liability for SD.

**Consent by custom**: Certain **technical violations** of DoL within the **zone of reasonableness** may be allowed by **customary consent**, such as tips for a waiter.

**Waiver** (8.06): **The final question in establishing any breach of FD claim is whether there was informed consent;** P can waive fiduciary duty providing:

1. A acts in **good faith** in seeking consent,
2. A **discloses all material facts** he knows or reasonably should know would affect P’s decision **and**
3. consent concerns either a **specific act or transactions** that could reasonably be expected to occur in course of agency relationship; **P cannot simply waive the entire duty of loyalty, but can waive individual violations of sub-duties on an ad hoc basis**.

**Damages:** Even when plaintiff proves **no harm resulting from DoL breach**, courts will still **disgorge A of unjust enrichment under restitutionary theory of damages**, though if plaintiff does prove causation and harm, then **compensatory damages will apply as well**.

Reading: **No harm alleged**, but court still disgorges A of profits.

1. Corporate Formation, Finance and Limited Liability------------------
2. Basis Concepts in Valuation and Corporate Finance----------------------

**Present Value**: PV \* (1 + r)^n = FV so, **PV = FV/(1+r)^n**. Where n represents number of years, PV represents present value, FV represents future value and r represents the discount rate.

**Expected Value**: Weighted average of the value of the investment, weighted by the relative probability of each possible outcome. To calculate, simply add the weighted net present values together.

**Compounding**: **Earlier liquidity on a given investment allows one to compound the interest by reinvesting the return, in addition to the principal**, rather than continuing to reap the same rate of return calculated based on the principal alone.

**Accounting for Risk Premium**: 1) Calculate ERR, 2) calculate and add risk premium (will depend on idiosyncrasies of investor, so will usually be given), 3) discount to present value using **risk-adjusted ERR**, 4) subtract principal and voila, you have your **discounted expected net present value**.

1. Corporate Securities and Capital Structure----------------------------------

**Leverage**: **Magnifies variance** in investment outcomes because higher debt-to-equity ratio leaves fewer equity holders and therefore, profit-sharing amongst fewer residual claimants, but the increase in debt increases the severity of the bad times because greater liabilities will remain. Conceived of more cleanly, **leverage confers a risk premium to the equity holders.**

1. Limited Liability and Piercing the Corporate Veil-------------------------

**Limited Liability (LL)**:

1. Benefits:

* Centralized delegated management: because SH need not monitor managers as actively since liability **exposure is limited to value of investment**.
* **Promotes transferability** of shares/liquidity of capital: limited exposure to risk means transaction costs of transfer are decreased (less investigation into firm, solvency of co-equity), which in turn **promotes diversification**.

1. Drawbacks: the **agency costs of limited liability**:

* **Misaligned risk incentives:** equity’s incentive to make investments with greater variance is distorted by their ability to capitalize on the upside risk, while limiting their downside risk, overincentivizing risk and misaligning their interests with those of creditors.
* Voluntary creditors: may charge **higher interest rate** to account for risk associated with perverse equity incentives (since equity controls direction of firm via voting), or may alternatively incur greater **investigatory and** **monitoring costs**, **increasing the transaction costs of debt**.
* Involuntary creditors: including society at large in the case of environmental harms, have **no opportunity to haggle for ex ante compensation, but instead bear the cost of a significant externality of LL when liquidated firms fail to compensate their tort victims**. The ability of firms to push this cost on society without ex ante compensation **underdeters such harms**.
* Regulatory burdens: policing such agency costs can impose additional burdens on society, such as those listed below.

1. **Legal solutions**:

* Capital regulation: such as minimum capital requirements, capital maintenance requirements and dividend distribution constraints, **generally rejected in U.S.**
* Fiduciary duties to debt: rejected in Del., except on the eve of and during insolvency, when creditors become residual claimants (lol!).
* Laws affecting pool of available assets:

1. **Fraudulent Conveyance**: Transfer of assets with intent to defraud and without receiving reasonable consideration (giving factory to kids on eve of insolvency) when debtor knows insolvency is imminent can be undone by creditors (restitutionary remedy).
2. **Equitable Subordination**: Firm makes loan to equity on eve of insolvency in attempt to elevate equity to debt at liquidation; courts can see through this and invalidate loan.
3. **Piercing the corporate Veil…**

**Piercing the Corporate Veil:** Creditor can “pierce” limited liability, allowing them **access to all equity funds** (no matter how small the pierce, tiny comingling of assets) to collect on debt. Very rarely in piercing successful, so always ere on the side of no pierce.

* **Alter Ego**: allows pierce if

1. **Unity of interests and ownership**: failure to respect corporate formalities fuses SH and corporate identities into one **and**
2. Refusing pierce/upholding fiction of corporate form would “**promote injustice or sanction fraud**” **causal “nexus” between failure to respect corporate formalities and the harm**, which usually manifests as a **failure to respect asset partition** affecting firm’s ability to pay its creditors.

Sealand v. Pepper Source: tort victim of Marchese. **Yes pierce on remand.**

* 1. Unity of interests and ownership found due to **comingling of corporate and personal funds** resulting from messy book-keeping.
  2. Promote injustice? Sealand 1 did not find pierce because **uncompensated tort victims generally do not present sufficient injustice** to justify piercing LL and **plaintiff failed to connect comingling to the use of corporate facades to avoid obligations to creditors**. However, in Sealand 2, the plaintiff plead correctly and found additional evidence of tax fraud (a variable of questionable nexus to ability to pay), so court found pierce.
* **Respondeat Superior**: allows pierce if

1. **Control test** similar to that for **vicarious liability** in the principal-agent context, that SH has **control over** **day-to-day details** of firm operations and
2. Distinguished form regular vicarious liability, there is the countervailing interest in preserving LL, so SH must manifest a **abuse of corporate structure** such as **direct benefit to SH, rather than indirect through profit-sharing**, such that **maintaining protections of LL would unjustly enrich SH**.

Note: **Thin capitalization**, while considered, is **not generally sufficient abuse of corporate form** to allow pierce, as seen in Walkovsky.

Walkovsky: cab companies. **No pierce.**

* + 1. Control test: Carlton exercised sufficient control over day-to-day details of corporate operations that court found m/s relationship.
    2. Abuse of corporate form: **Although** it appears as if Carlton set up 9 **thinly capitalized** firms, rather than one firm, precisely for the purpose of dodging tort creditors, court finds this insufficient because there’s **no evidence Carlton sought to exploit firm for his interests, to the exclusion of the firm’s interests**. (court also noted that legislation only required cabs to carry up to a certain amount of tort insurance, which they had here).
* **Instrumentality Rule**: pierce if

1. **Total domination**: control of firm so complete as to constitute “total domination” that **resembles agency relationship** in that **firm acts in SH interests, to the exclusion of firm interests**,
2. Control used to commit **injustice** and
3. Commission of injustice was **proximate cause** of injury.

Zaist: Olson owns corp & EH, and through EH, hires 3rd party to do work for corp, w/ no benefit to EH. EH turns out to be insolvent, and Plaintiff wants to pierce to corp. & to Olson. **Yes pierce.**

* + - 1. Total domination: Olsen used control over firm to effect sham transaction which benefitted his other firm, with no benefit to firm engaged in transaction.
      2. Injustice: Olsen used control to effectuate a misrepresentation of solvency.
      3. Causation: suit arises from premeditated default on the very transaction which established total domination.
* **Reverse Pierce**: once successfully pierced to SH, additional pierce back into another company owned by that SH, **assessed by same standards as regular pierce**.

Sealand II: It appeared as though Marchese anticipated pierce and hid assets in other companies. Court allows **pierce back into another company** co-owned with a 5% equity-holder, which Arlen thinks should have compelled the court not to pierce to that company because Marchese would more logically have hid money in corps that didn’t distribute to another SH as well as him.

* **Enterprise Liability**:

If plaintiff presents evidence that a **series of firms operate as a single business enterprise** (such as through **transactions with one another with no expectation of profit**/less than arms-length) than they **may be able to recover against assets of entire corp.**, though the **SH will still be protected by LL**.

1. Centralized Management and its Implications--------------------------

**Partnership default rules**: In the absence of formal documentation**, business ventures are partnerships by default:**

No legal personality (Partnership property owned by partners), Limited life (dies with death/exit partner), **Partners personally liable** for debts of Partnership (though not in LLP obviously), Partners also manage; (**decentralized mgmt**.), Profit sharing equal across partners, Partnership ownership stake not easily transferable (**illiquid equity**; can’t bring in a new partner w/o consent of all partners), Tax treatment: “flow-through,” meaning income is taxed only once, on its way to partners.

**Key attributes of the modern corporation**:

Independent legal identity, Infinite life, **Limited liability**, Required Formalities, **Centralized Management** (can significantly improve efficiency of decision-making in firms with dispersed ownership), Internal complexity, **Separation of Ownership & Control** (refers to attenuated control of SH, furthered by the delegation of officer selection to the board, as opposed to SH), High **transferability/liquidity of shares**, Tax treatment: “Double” taxation of income at corp level and at distribution to equity, but only single taxation of losses (deduction) because no distribution of losses to equity.

Why Del.?: **Internal affairs rule** choice of law and favorable/predictable/flexible default rules.

**Important provisions**:

**102:** **Contents of Cert**: includes important things such as number of shares issued (total allowed authorized via by-law), par value, 109 power of board to amend by-laws unilaterally, classified board, elimination of SH power to act by written consent.

* **102(b)(7) Indemnification**: must be specified in cert. Firm can indemnify board members from **personal liability** essentially for **violations of care** (except bad faith, including Stone/Caremark liability) and **settlements under 145** (**magnifying incentive to settle**). **Excludes violations of loyalty**, bad faith, improper personal benefits and 174 liability.

**109: By-laws**: **mandates** that **SH have unilateral right to amend by-laws**, and grants firm authority to specify in cert that board can unilaterally amend by-laws.

**141:**

1. **Board shall manage**: **Non-delegable/immutable** as remarked on in Grimes and which fact shapes the outer bounds proxy proposals (can only be precatory), and can’t be usurped by SH or officers.
2. The **number of directors shall be fixed by**, or in the manner provided in, **the bylaws**, **unless the certificate of incorporation fixes the number of directors**, in which case a change in the number of directors shall be made only by amendment of the certificate. **Each director shall hold office until such director's successor is elected and qualified or until such director's earlier resignation or removal.**
3. Board has **authority to delegate** and rely on committees.
4. Classified Board: you **can only classify the board by means which require SH action**, preventing the board from unilaterally entrenching itself.
   * **Effective Classified Board**: 1) board classified in cert. (to prevent unilateral SH amend), 2) number of board members classified in cert. (to **prevent “board packing**”) and 3) 228 power of SH to call special meetings removed.
5. **Safe Harbor for reliance on advice of 3rd party experts and reports of officers:** Board members fully protected in **relying on opinions and information generated** by committees or others competent to render opinions provided that:
6. Board relies in **good faith**,
7. reasonable belief in professional or expert competence of person furnishing report **and**
8. expert has been selected with reasonable care by or on behalf of corporation.

k) **Power to remove directors:** Directors can be removed **without cause** **by majority SH**, except in the case of a **staggered board**, in which case **cause is required**. The for-cause limitation on SH power to remove is the **true power behind the staggered board** because it allows board to remain entrenched in spite of hostile acquirer’s new majority ownership.

142: Officers; Titles, Duties, **Selection,** Term; Failure to Elect; **Vacancies**:

1. Officers shall be **elected by as stated in by-laws or by resolution of the board**. One person can hold multiple officer positions.
2. Officers hold their position for **term in by-laws** and until successor is chosen and elected or by earlier resignation or removal.

e) **Vacancy** shall be filled **as by-laws provide or if silent, by board** or other governing body.

**211: Meetings of Stockholders:**

(a) **annual meeting** must be held (anywhere, or as **designated in bylaws**);

(b) **election of directors annually at meetings** or by **written consent** (228**) if cert allows** (any other business at annual meetings as well);

(c) **special meetings** may be **called by board**, **or by SH if cert/ bylaws allows** (generally called by board under 211(d))

212: **Voting rights** of SH:

* One Share, one vote
* **Proxies:** 1) allowed by default, 2) duration of proxies limited to three years unless otherwise stated, 3) irrevocable proxies allowed providing sufficient interest at law (whatever that means).

214: **Cumulative Voting**:

* Cert. of incorp. can allows shareholders to **concentrate their votes on particular board members**, empowering minority shareholders to **prevent** control (or **unanimity or supermajority**) of the board.
* **A great defense** **to cumulative voting** when number of directors is fixed and both that provision and cumulative voting provision are protected by supermajority provisions, is to classify the board, shrinking elections from 9 to 3 and requiring minority SH to get 33% to have any effect on election.

216: **Quorum and required vote**:

* **Default quorum** for SH action is majority of shares entitled to vote. Cert or by-laws may specify decrease in quorum for general SH action not lower than 33%.
* Required Votes for action: Director election done by **plurality by default**.
* SH **can adopt by-laws requiring majority** (rather than plurality) for **director** election, which cannot be subsequently unilaterally altered by board.
* **Supermajority Voting**: 216 allows you to require supermajority to amend specified by-laws. If you want to require supermajority for amending particular by-law in anticipation of shift in majority control, you had better ensure that the by-law which specifies such requirement only itself be amendable only by supermajority.

223: **Vacancies and newly created directorships**: Vacancy on Board may be replaced by remaining members of board (case law states clarifies that inherent power rests with shareholders).

**228: Consent of shareholders in liue of meeting**: legitimate (**unless cert provides otherwise, which it usually does**) provided you have number of outstanding shares needed to authorize as if all shareholders were in attendance at meeting with “**proper purpose**” (within the normal scope of shareholder power at actual meetings; no 141(a) decisions). **“Unspeakably powerful**” provision.

**242(b) Amendment to cert**:

* The **board may adopt a resolution** setting forth the amendment and declaring its advisability.
* A **special meeting of the shareholders may be called** for consideration of the amendment or amendment **may be considered at the next annual meeting**.
* A **majority of outstanding stock and a majority of votes for each class of stock entitled to vote is required** for amendment to the certificate, **in addition to board approval**.
* If the cert requires a greater proportion of SH votes for board action, the board will not alter, amend, or repeal the provision except by such greater vote (auto-meta-supermajority protection).

251: SH and board must approve merger.

271: SH and Board must approve sale of substantially all assets.

Airgas: SH attempt to amend by-laws to change the date of the “annual” SH meeting in attempt to gain control of staggered board more quickly termed “**constructive removal**” of directors by court, which is **limited to for-cause removal under 141(k)** in the case of a **staggered board**.

**Classified stock**: another potential defense is to issue classified stock, with all voting stock retained by original owner of co. Family companies gone public will sometimes do this, but it decreases the value of the stock because control of the firm is subject to the idiosyncracies of the voting SH, creating additional risk to the investment.

1. Fiduciary Duties and Shareholder Litigation----------------------------

**Disciplining (Potential) Renegade Managers**:

**- Incentive-based pay** (“carrots”): payment of stocks or bonds does tie the managers’ interest to the firm’s, but it underincentivizes risk-taking because too much of the managers’ personal wealth is attached to the health of the corp, whereas the SH wealth is diversified, creating a mismatch in risk aversion. To acct for this, firms offer **stock options** which confer the right but not the obligation to purchase stock at the value of the date of option conferral, some time down the line, creating an incentive to succeed while mitigating the downside risk by allowing for diversification.

- But the **most important disciplinary mechanism** for our purposes is **Fiduciary Duties**…

1. Fiduciary Duties: Care and Good Faith--------------------------------------
2. Business Judgment Rule and Challenges to Substantive Decisions-

**Business Judgment Rule**: Protects against breach of fid duty suit **unless plaintiff can rebut one of the presumptions** that the board:

1. Was disinterested (no duty of loyalty conflict of interest),
2. Acted with due care (**procedural gross negligence**) and,
3. Acted with a **rational, good-faith belief** action was in **best interest of corp**. (inextricably intertwined combination of duty to act in good faith and duty not to waste).

* Generally accepted that BJR applies to all fiduciaries of firm.

Kamin v. Amex: Amex purchased significant amount of stock that decreased dramatically in value, and board quite foolishly/futily attempts to hide the loss from the markets by distributing devalued stock as dividend in-kind, rather than taking tax loss, to which SH object.

**- Breach of care**: breach of duty of care has nothing to do with the wisdom of the decision, but focuses instead on the **process** **taken in becoming “informed” about the decision** (procedural gross negligence, rather than substantive gross negligence), and there was evidence board had considered alternatives and rejected them, so they’re off the hook here.

**- Rational Good-faith belief**: this standard requires only that the board articulate a **plausible** **“firm-regarding reason”** for action because requirement that belief be rational is meant only to ferret out bad faith in a subjective duty of loyalty sense, rather than reasonable prudence. **Courts have consistently recognized attempts to fool the market as rational grounds for board action**, so the board gets off here as well.

**- Conflict of Interest Claim**: 4 of the 20 directors have **incentive-based pay** tied to the stock price, so they have a **conflicting interest in maximizing the short-term value of the company which would be sufficient to rebut the BJR**, but for the fact that the remaining 16 disinterested directors got on board with the decision as well, cleansing the conflict.

1. Limitations on the Board’s Power to Act: Waste and Ultra Vires---

- Rational good-faith belief claims link into doctrine of ultra vires, though **straight ultra vires claims are very rare**.

- Ultra vires means “**beyond the scope of one’s power as a corporation**,” which **reduces to “waste of corporate assets.”**

- **Cleansing** ultra vires transactions requires **unanimous SH approval**.

**- Ultra vires K invalidation**: Traditionally, K’s entered into on ultra vires grounds could be voided because it was beyond the scope of the firm’s consent to enter into K, resulting in a lack of mutuality. But **124 eliminates the use of ultra vires as a defense in K disputes**, but **allowing SH suits against directors for compensation damages** and**, in the case of partial performance, allows enjoinment if moral equity demands as much both for the firm and for the other party** (who perhaps should have known the K was ultra vires for ex).

Dodge:

- **Shareholder Primacy**: The prevailing view that board fiduciary duties are owed to the SH and only to the SH, which renders employees beyond the scope of fid duties here.

**- Rational firm-regarding reason claim**: **Ford refused to admit** to a reason for the action other than to help the employees, to the detriment of SH. This **violates shareholder primacy**, and led the court to find a violation of the duty to act on good faith firm-regarding beliefs.

- Case showcases how **imperfect** a **disciplinary mechanism** “**voting with one’s feet**” can be in that the firm **clearly didn’t need financing**, so markets couldn’t punish, and even if it did, **stock** would be **drastically devalued** by dividend announcement, so **SH would internalize loss, rather than directors**.

Shlensky v. Wrigley: Despite **suspect and seemingly post-hoc nature of alleged reason** for action (reputational harm to firm resulting from stadium lights harming neighborhood) **court accepts** is as rational firm-regarding reason, **demonstrating the flexibility of the BJR**.

Donations:

**- 122(9):** Corp has the **power to make donations for the public interest to the extent it furthers the interests of firm** (such as via **publicity**) which is only really difficult to articulate as a rational firm-regarding reason in the case of anonymous donations.

Barlow: NJ corp. wants to donate money to Princeton, SH institutes ultra vires claim.

* **Change in Corp Law**: NJ passed its version of 122(9) power to donate only after the incorporation of the business, which plaintiff claims exempts them. But the court rejects this, holding **that all corporations are subject to changes in corp. law, which is general principle of corp. law.**
* **Waste claim**: Board justifies its decision on publicity grounds, and on a desire to improve capitalism (rather attenuated) and the **court buys it**.

- **Policy**: To my mind, the most compelling argument against allowing corps to donate money is that they will direct it toward **charitable orgs that serve their interests**. But you also worry about **the focus on publicity leading to conspicuous donating**, which might be more likely to **exclude localized charities**, and **donating that benefits the directors/officers**.

1. Challenges to Board Actions (When Directors Disinterested): Duty of Care------------------------------------------------------------------------

Smith v. Van Gorkum:

**Duty of Care Claim**:

* Court applies **objective standard of gross negligence** (“cushion of unreasonably low care”) and notes that the sale of **control premium adds** a degree of **significance** to the **decision** that requires board to obtain “**all material information reasonably available**.”
* Here, firm board was grossly negligent in failing to uncover true nature of negotiations, devoting only 2 hours to decision on lock-up provisions (which prejudiced entire transaction), **failing to seek 3rd party fairness opinion**, and failing to investigate fair price, since comparison to LBO price was inapt due to sale of control premium.

**141(e) safe harbor**: unavailable because such heavy reliance on the clearly conflicted VG was unreasonable.

**Ratification defense**/**SH Cleansing**:

1. SH not fully informed under 144 and
2. Even had they been, SH vote does not 144 cleanse transactions that required SH approval anyways.

Gantler: **SH approves deal** and **then turns around and sues** on grounds that board could have gotten a higher price. Court allows because SH only gets to choose between yes merger or no merger, whereas the board can and has a duty to seek the highest price. **Only those decisions that do not normally require SH approval can be cleansed through such approval**.

**Entire Fairness**: substantive evaluation of transaction.

- **Rebutting BJR brings you to entire fairness**, which **usually results in settlement** because 102(b)(7) doesn’t indemnify against judgments on breach of loyalty/bad faith.

- **Factors to consider:**

1. Procedural: **Fair dealing**: requiring consideration of aggressive, **arms-length bargaining by fiduciary**, **fiduciary knowledge of business,** and **whether 3rd party expert advice was sought**. Although this appears to insert a process duty into a substantive evaluation, **courts rely heavily on the legitimacy of process** to point to the fairness, vel non, of a transaction, given the uncertainty of battles of experts on valuation.
2. Substantive: **Fair Price**; magnitude of **control premium** over price, expert opinions.

Note: **Full disclosure factor**: a finding that **SH were not fully informed** in approving transaction is **nearly dispositive evidence of unfairness**.

Cinerama: Although **BJR rebutted on care**, **transaction substantively fair**: just because board breached its duty of care doesn’t mean no one was doing their job; CEO negotiated hard, sought 3rd party opinion, and despite lock-ups, **price was substantively fair** (“**highest reasonably available**”).

**Remedies**: duty of care violations can result in both rescissory damages, and **injunction**.

1. Duty of Care/Good Faith and Executive Compensation---------------

Disney:

**Old Board**

1. **Breach of duty of care**: in that old board was not informed in approving comp comm decision because it didn’t calculate cost of no-fault termination. And comp comm not itself informed.

- **Board** at large off the hook because they **fully delegated auth. to comp comm**.

- **Comp Comm**. met for only an hour and had a report on terms of K, but it included no calculation for no-fault termination, which is arguably such an obvious “reasonably available material fact” that the board was grossly negligent in failing to pursue it. However, **board had sufficient documentation that made them aware of severity of no-fault termination provisions**; **“constructive knowledge**.”

|  |  |
| --- | --- |
| **Compare with Van Gorkam**  • **(1) Importance of Decision**  – Sale control last act of board  – Hiring one of many decisions  • **(2) Board Conflict of Interest?**  Disney board no conflict of interest  Van G court assumes Van G conflict  • **(3) Experts**  Disney: Had outside expert  Van Gorkam: No outside Expert  • **(4) Amount of information**  Van G: No information on value sale control outsider  Disney had the information if wanted to calculate  **(5) Multiple meetings** | **Why Not Breach DC if Smith Is?**  • **Court concludes had information**  – Documentation is what’s defective (at least some respect for 141(e) defense)  • **Different Magnitude of Decision**  – Expect Board to know more well selling the firm. Should  focus all their time on this decision.  – Disney: Hiring Ovitz only one of many decisions.  • **Probability Lower**  – Smith: Higher Expected cost of infor. Neglected  • Probability need to know value firm = 1  – Disney: Probability NFT << 1. Cost missing info less  • **Dir. *could* have figured it out**  – Dir. Had enough info to come in ball park of value. |

1. **Bad faith/substantive due care**

- Bad faith requires **intentional dereliction of duty**, rather than gross negligence.

- Did full board **knowingly neglect** duty? No because as we saw, **they had delegated duty to comp. comm.**

- Stone will come along to clarify that bad faith is a violation of duty of loyalty rather than violation of duty of care, but we see that one can violate bad faith without malevolence or ulterior motives, if through intentional dereliction of duty.

**New Board**:

1. **Waste**: decision to give Ovitz compensation package was waste because they didn’t even attempt for-cause termination.

- But because failed attempt FCT could have left Ovitz as president, outcome could have been worse for Disney, presenting a **countervailing consideration** sufficient to form a **rational basis** for decision.

1. Due care: Board abdicated duty to fire Ovitz because they **didn’t intervene into any of Eisner’s actions**.

- But board had **fully delegated hiring auth** to make personnel changes via **past practice** and consistent with 141(a) duty (in contrast to non-delegable duties in tender offer scenario).

- Eisner and his attorney had **made reasonable investigation** into possibility of for-cause termination sufficient to fulfill duty of care.

1. Challenges Based on Director Inaction: Failure to Supervise--------

Francis: (NJ Law, but much of it ports to Del. and endorsed in Caremark)

**- BJR does not apply because the suit addresses nonfeasance**, rather than malfeasance.

**-** Instead **standard of liability** **for nonfeasance** is: “duty **to discharge duties** in **good faith** and with **degree of diligance, care and skill which ordinarily prudent men** would exercise **under similar circumstances**.”

- “**Similar circumstances**” **does not extend to** admittedly pitiable **life circumstances** of widower saddled with crushing responsibilities, rather **it refers to the type of position within the type of corporation**. In fact here, **companies that hold money in trust have even higher duty to monitor corporate funds** due to heightened expectation of safety (and in fact, court later finds actual **fid duty to creditors because** **firm holds money in trust to depositors**).

**- “Bare Bones” Director Duties**:

– Get a rudimentary understanding of the business

– Keep informed about corporate activities

– Engage in General Monitoring of corporate affairs and activities

– Attend board meetings regularly

– Review financial statements regularly

– **Make inquiries into doubtful matters, raise objections to apparently illegal action, and take appropriate action**.

- **141(e) defense** for relying on reports of criminal sons is not available because it was not reasonable to do so and she’s got other duties as well.

Notice here: **when directors see red flags** (such as SH or exec loans)**, they have a duty to investigate**.

Bottom line of Francis **as it ports to Delaware** nonfeasance liability for dereliction of “bare bones” duties.

Caremark:

**New causes of action to monitor**: Distinguished from Francis, the board has fulfilled their “bare bones” directorial duties. Instead, Allen creates **two new causes of action for information and reporting system:**

1. **Failure to create compliance program**:

- Duty attaches **even if directors have no reason to believe there is corporate misbehavior** (no red flags necessary, essentially **overturning Graham**) because ensuring that effective reporting systems are in place is **requisite to fulfilling duty to keep informed of corporate activities,** so this is **intentional dereliction of duty constituting bad faith because information and reporting so basic as to be a bare bones duty and boards on notice about the requirement.**

- In the case of failure to institute compliance program, such nonfeasance would need to be proximate cause of harm, but court explicitly reserves question of burden of proof allocation for later date.

- **If** **the claim is that the board considered the need for a compliance program**, **but** came to the conclusion that the **current corporate reporting program was sufficient**, or if you are challenging the direct result of the boards decision, then it **is treated as an act of malfeasance** and therefore **protected by BJR**.

1. **Failure to ensure continuing effectiveness of compliance program**:

- “**P must show**:

1) that the directors knew or

2) should have known (negligence) that violations of law were occurring,

3) that the directors took **no steps in a good faith effort to prevent or remedy that situation** [“systemic,” “utter failure,” “sustained indifference,” “continued neglect”] and

4) that such failure **proximately caused** in the losses complained of, (although under *Cede & Co. v. Technicolor, Inc.,* Del.Supr., 636 A.2d 956 (1994) this last element may be thought to constitute an affirmative defense).”

- Although process claims are generally analyzed by gross negligence standard, Court elevated to **“good faith”** standard (Stone subsequently realigns things by classifying duty to monitor failures as duty of loyalty breaches), but note that **elevating the standard of liability to good faith eliminates availability of 102(b)(7) indemnification**.

Stone: Derivative suit alleging that board of directors breached fid. Dut. In failing to prevent acts that led to hefty fines.

- Court accepts the view that Caremark narrowly construes Graham and **endorses heightened standard of liability (good faith**, “sustained neglect,” “conscious disregard”).

- However, the **court departs from Caremark** in that it **derives the doctrine from the duty of loyalty**, rather than the duty of care, to **focus analysis on the intended beneficiaries of the board action** (i.e. whether or not they intended to benefit SH), removing negligence from the analysis entirely.

- **Two Claims**:

1) **Establishment of a Deficient Compliance Program**: Independent party determined that **compliance program was** “**materially deficient**,” which the plaintiff claims renders the program **unreasonable**. But the court notes that unreasonable is not enough, because this is **analyzed as an act of malfeasance and therefore protected by the BJR**.

2) **Failure to monitor**: Despite genuine anemia of compliance program, the fact that genuine efforts were made to oversee program shows that **motivation** for **“negligence” was not in bad faith**.

1. Federal Laws Governing Compliance and Compliance Programs---

**Federal Law**

– \* Sentencing Guidelines: Credit in sentencing if have an **effective compliance program** but **no duty to have one**

– \* Sarbanes Oxley: 404(a): Duty by top 2 officers to attest that have good reporting system (+ some requirements (audit comm)

1. Challenges to Board Action Revisited: Acting in Bad Faith----------

AIG: Plaintiffs avoid summary judgment on Caremark claim against **directors** who were **personally committing crimes**, serving **as automatic evidence of a bad faith failure to oversee themselves**.

Citigroup: Court rejects liability for the purchase of mortgage-backed securities before crash because Caremark claims are focused on **motivations** of directors, so **no matter how negligent, actions of calculated business risk are protected by the BJR**. And while the **board cannot knowingly allow violations of the law**, even very risky business decision will be protected by BJR as long as board articulates **rational firm-regarding reason**.

1. Fiduciary Duties: Duty of Loyalty---------------------------------
2. Self-Dealing Transactions (No Controlling Shareholder)-------------

- Plaintiff faces a **presumption that entire board is disinterested** but can **rebut by showing** that a **single director** was **interested** by virtue of 1) material **financial interest**, 2**) fiduciary duty to interested party**, or 3) “**domination**” by interested party (usually entails material control over financial health of dominated party).

**144 Cleansing/ratification**:

a) No conflicted **transaction** (transaction involving firm **requirement excludes corporate opportunity claims**, since the firm was notably excluded from THOSE transactions (lol), though an **analogous analysis applies**) shall be void/voidable **solely** due to conflict (**BJR reinstated)** if

1. Majority of **disinterested**, **fully informed** (of both details of transaction **and of nature of conflict**) **directors** approve transaction **in official capacity** and in good faith,
2. Majority of **fully informed** (of both facts of transaction and **of nature of conflict**), **disinterested (Fliegler**) **SH** vote to approve transaction in good faith (**except**: if **CS in SD transaction**, then **majority of minority SH ratification** **does not reinstate BJR**, but instead **shifts burden of proof on entire fairness** to plaintiff, as discussed in Wheelabrator), **or**
3. Entire fairness **with BoD on defendant**

b) Interested directors can count for quorum.

-Note: Gantler still holds under 144 cleansing, so SH **cleansing ratification on transaction that already required SH approval** (such as sale of substantially all assets, etc.) would **require** a **separate fully informed vote on the specific issue of cleansing**.

Benihana: Three Claims:

1. **Board can’t issue new class of stock without SH approval**: The issuance of yet-to-be-authorized stock would require cert amendment and therefore, SH approval pursuant to 242(b). **However**, Benihana’s **Cert** had **“blank check preferred” provision**, authorizing the issuance of unlimited preferred stock as a potential takeover defense.
2. Board breached duty of loyalty by issuing new stock for the purpose of diluting CS control

**- Board cannot issue stock solely for the purpose of diluting a renegade SH, even if rationalized by benefit to remaining SH.**

**- Because the board could have secured financing without diluting the CS**’s equity, they **must articulate a rational business reason why they chose to do so** (**assuming BJR**, which we do because as we see below, the conflict was cleansed). The **investor** has a **legitimate business interest in resolving a risky control situation** by a securing seat on board and ability to dilute if necessary, and **would otherwise demand higher** dividends/interest rate to compensate for the additional risk.

1. **Decision to go with director’s firm violated duty of loyalty as SD**: Under 144, cleansing requires **fully informed** disinterested director approval. Here, although conflicted director **did not explicitly inform the board** of his role as negotiator on opposing party’s behalf, the fact that he personally presented the proposal to the board gave rise to a **reasonable inference to the nature of his conflict** (**“constructive knowledge”**) **sufficient to cleanse**.

Note: Had the conflicted director actually **misappropriated confidential information to use against the board in negotiations** on the investor’s behalf, this would have been a separate violation of duty of loyalty, specifically, **duty not to use confidential information for 3rd party’s benefit**.

Fliegler: Court **denied** 144 **SH cleansing** because **only reached majority approval if counting** **interested SH**, who are excluded from majority calculation for cleansing.

**Special Rules for CS (preview):**

Wheelabrator: Acquirer with large minority stake in target, elected 4 directors, got acquisition transaction approved by board.

- **CS Cleansing Burden-shifting**: When a **CS uses 144 to cleanse** SD transaction via **majority of minority SH vote**, this **does not reinstate BJR**, but rather, **shifts burden of proof on entire fairness** analysis to plaintiff.

- However, here the **court determines that alleged CS not really CS** by examining factors such as 1) percent of board “**beholden**” to SH, 2) direct evidence of board dominance (as we see in Kahn v. Lynch) and 3) whether or not a an actual majority of shares owned by SH. So **BJR reinstated**.

1. Corporate Opportunity-----------------------------------------------------

**Modern Test**: First established in Guth v. Loft, in recognizing a **duty** not just to avoid hurting the firm, but **to affirmatively promote the firm**, court look to the following factors, with **no one factor being dispositive**:

1. **How** the fiduciary **came to the opportunity** (i.e. whether or not “**in their corporate capacity**”),
2. how far removed from the **“core economic activities”** of the firm it is; “**fundamental knowledge, practical experience and** **ability to pursue,** which, logically and naturally, **is** **adaptable to its business** having **regard for its financial position**, **and** is one that is **consonant with** **its reasonable needs and aspirations for** **expansion,**” –Guth and
3. Whether **corporate information** was used in recognizing or exploiting the corporate opp.

Note: notwithstanding the Guth court’s mention **“financial position,” courts are very hostile to the defense** that the firm could not have pursued the opportunity for lack of financing because if it’s really a good opportunity, generally someone will finance that shit (though financial incapacity is actually key to the decision in Broz because there was **objective evidence** of incapacity).

Broz:

1. Pre-Pricellular bid: run through **Guth factors**:
2. **How** did Broz **come to opportunity**? Came to opportunity through RFB capacity, rather than through corporate capacity.
3. **How far removed from core economic practices**? FCC license is very clearly within CIS line of business. **However**, it is **not “within reasonable aspirations for expansion**” because CIS was actively divesting itself of these licenses. However…
   * + **Financial incapacity**: Because good opportunities will generally attract sufficient financing inandofthemselves, **courts are generally hostile to the defense** that an opp was not within the scope of the firm’s aspirations due to financial incapacity absent a **contractual impediment** of other **objective evidence** of an inability to secure financing. In this case, the active divestment of licenses due to a **bankruptcy reorganization** served as objective evidence of true financial incapacity, and this was **key to the decision**.
4. Corporate information? Not used in getting opp.
5. Pricellular deal on horizon:
   * Although Pricellular had both the financial capacity and the expansionary plans to purchase the license (as evidenced by their bid), the court renders these facts irrelevant because at the **point in time** (timing very important) at which Broz made bid, the acquisition had yet to be consummated, and was therefore **uncertain**, and **courts draw bright line to analyze CO claims based on facts known at time of decision**.

Ebay:

1. Does opp. come to them in corporate capacity? They argue that Goldman intended to attract them as clients because they are wealthy. Court doesn’t buy that there’s no quid pro quo with respect to their corporate capacity (future issuances through Goldman).
2. Outside core economic practices? Ostensibly, but as it turns out about half of Ebay’s profits come from its investment practice, so it’s close enough.
3. “**Non-fungible unique good**?” Normally, the opportunity to purchase stock would not constitute a corporate opportunity because **taking fungible, non-unique opportunities does not deprive the firm of them**. But here, the court determines that this is **“materially different**” **from normal investment opportunities** in that it is a virtual certainty that it will make money. This probably distinguishes the case from Beam, in which Martha Stewart simply sold shares onto the open market.

Alternative claim: Failure to acct for profits arising out of agency relationship.

* **Remedy**: Can include disgorgement and **injunctive relief**, but also punitive damages. Of course, the firm will have to reimburse you for the cost of pursing the opportunity.
* **C.O. Cleansing/Rejection**: Not covered under 144 because there is no “transaction” of the firm’s, but a **parallel analysis to 144** applies: must disclose opportunity and nature of conflict and majority of disinterested board OR SH (important if entire board in conflicted out) must **vote to reject in official capacity**.

Broz: Cleansing? No because 144 parallel analysis applies, which requires **formal rejection of opportunity** by majority of interested directors. Here, there was only informal rejection.

* 122(17): **Firm can ex ante “renounce**, in its certificate of incorporation or by action of its board of directors, any **interest or expectancy of the corporation in**, or in being offered an opportunity to participate in, **specified business opportunities** **or specified classes or categories of business opportunities** (**can’t do across-the-board renunciation**).”

1. What Constitutes Self-Dealing by a Controlling Shareholder--------

Sinclair:

* When acting solely in their SH capacity, CS have no duty to minority SH. But **fiduciary duties equivalent to those of board members attach to CS to the extent and they exercise control over the board**, though **BJR protection attaches as well**.
* Three claims:

1. **Self-dealing dividends**:

- Regarding dividends, start with the premise that the board has wide discretion.

- In order to prove CS SD, plaintiff must show that **CS seeks to treat themselves more favorably than other SH**.

- Because dividends are distributed equally on a per-share basis to all SH, the only possible favorable treatment is that sub to parent dividends are tax exempt, but **courts focus exclusively on what leaves the firm**, rather than what intervening 3rd parties leave for the ultimate recipients. So this **claim fails.**

1. **Corporate opportunity**: On grounds that Sinclair allowed other subs to take oil opportunities that Sinven could have taken.

* Court rejects on the grounds that a) no opportunities came directly to Sinven (meaning **none came to CS in corporate capacity**) and b) parent company discretion to determine the division of labor amongst their subsidiaries is protected by BJR, “expansion policy one of business judgment.”

1. Breach of K: Sinven had K with other Sinclair subsidiary who breached, but had no fid. duty to Sinven. However, **Sinclair exercised control over Sinven board to prevent them from bringing litigation against other sub, violating DoL** to Sinven because Sinclair clearly had conflict of interest **while acting in board capacity**, under board-like fid. duty.
2. Shareholder Enforcement of Fiduciary Duties: Direct and Derivative Action----------------------------------------------------
3. Direct v. Derivative Suits--------------------------------------------------

Direct Action: SH sues firm directly for **harm suffered apart from harm to firm.** **Remedy goes directly to plaintiff**-SH. SH **pays own atty fees**.

**Tooley Test** for direct action:

1. Direct **harm to SH apart from the firm** (such as right to vote (Eisenberg), participation rights, dividends or governance rights (Grimes)) (doesn’t have to affect the SH as an individual apart from other SH, though this may be some indication of direct harm such as unfair treatment of particular class of SH) **and**
2. **remedy goes directly to SH**, as opposed to indirectly through firm.

* **Burden of proof on P, but court will not look to merits of the claim in assessing whether direct or derivative**, and because of disadvantages associated with derivative claims, **plaintiffs will sometimes strategically plead to utilize direct action**, as seen in Grimes and Eisenberg:

Grimes:

Court did not apply Tooley but would today:

1. **abdication of immutable 141(a) duty to manage is direct breach of K with SH** (SH agreement), whether or not firm was harmed, and
2. remedy plead is voiding the employment K, which is apparently direct.

* Court **suspends disbelief** to analyze the direct claim because courts do not allow the merits of the claim to interfere with their determination about whether it is direct or derivative.
* But **Court finds no abdication** because however bad the incentives of the K, absent direct duty of abdication, the board could have used their **fiduciary out** in K: “board retains right to manage.”

Eisenberg: Firm restructures to put parent co. between SH and assets, now held in subsidiary co. Although P is really concerned about managerial oversight issues, he **frames his claim to complain of a dilution of his voting power**, which is quite legitimate since big decisions that would normally require both board and SH approval (merger, cert amendment…) now require only approval of the sub board and the parent board, acting as the sole SH.

* Applying the **Tooley test:** 1) **dilution of voting power is a direct harm to SH** but 2) Whoops didn’t finish the case in class.

**Derivative Action:**

* SH brings suit **on behalf of firm**, for **breach of fiduciary duty to firm**, in an attempt to **compel the board** (as 141(a) managers) to bring suit on behalf of firm. **Atty fees paid by firm**.
* Atty fee-shifting policy: In derivative actions, **recovery** goes **directly to the firm** and **only indirectly to *all* of the SH** in accordance to their equity. So in that sense recovery is **non-excludable**, creating a **collective action problem** in that any given **SH is underincentivized** (and thus, the **board underdeterred from breach of FD**) to bear the cost of bringing suit because they can reap equal benefit from **free-riding** off of someone else doing so. To address this problem, courts order the **firm to pay the attys fees of plaintiffs** in **successful** derivative actions.
* “Strike suit:” Fee-shifting brings with it the **risk that** plaintiffs (or rather, **plaintiff’s attys**) will **bring frivolous suits because** 1) **reputational harm associated with pending FD suit** may incentivize boards to settle even unfounded suits simply to make them disappear (though empirical evidence only confirms this hypothesis when suit alleges facts that suggest firm defrauds the market, as opposed to environmental harm for ex.) and 2) While **145 allows the firm to indemnify directors from settlements**, **judgments** against directors **are excluded**, creating the **threat of personal liability**, which **overincentivizes directors to settle**, and as a result, **motivates plaintiffs** to bring derivative actions for their **nuisance value**.

**Procedural hurdles**: To address the risk of strike suits, courts force plaintiffs through several procedural hurdles to derivative actions:

1. Standing: In an effort to ensure derivative actions are limited to plaintiffs with a **genuine interest in the well-being of the firm**, plaintiffs must **own stock contemporaneous with the alleged wrong** (attys *can’t buy in* to the suit *for the nuisance value*), **retain it throughout the litigation** (must be along for the ride so you *continue to act with the firm’s interests* in mind) and must **fairly represent the firm** (*can’t manifest interests opposed to those of the SH*, such as being a *competitor of the firm*).
2. Bonding/Security Requirement: **DE does not have**. Some states have security requirements which require plaintiffs **who own less than a certain percentage of the shares** to put up **bond for the payment of the defense attys fees if P loses**. The incentives of large stakeholders to bring frivolous suits are mitigated by how directly they would bear the cost to the firm of such a suit, so the threshold requirement aims at small SH for whom the economics of a strike suit creates stronger incentive.
   * Cohen: Derivative suit against Del. Corp. filed in NJ, removed to Fed Court applying NJ law. The court confronts an **Erie question** in deciding whether or not to apply NJ bonding requirement, which by its letter applies to all companies “doing business” in NJ. Court determines **bonding requirement is substantive**, rather than procedural, and applies that shit. Had the issue been one of “purely internal affairs,” then Del. Law may have applied as the state of incorporation.
3. and 4) are Demand and SLCs, below.
4. Derivative Suits: Demand Requirements--------------------------------

**Demand**:

There is **no formalized mechanism for making demand**, so a plaintiff can sometimes stumble into demand by attempting to utilize intracorporate dispute resolution, as in Grimes.

**Demand Excused/demand futility**:

* In Del and NY (though subject to divergent standard as in Marx), plaintiffs can circumvent the demand requirement by alleging that it would be futile because the **board is conflicted on the decision to sue** vel non. Although it is intuitive to think that boards are inherently conflicted on a decision about whether or not to sue themselves, the Grimes court expresses their **fear that plaintiffs would systematically shirk demand simply by joining a majority of directors** to an otherwise frivolous or more limited claim. For this reason, **demand was denied** **even** in the seminal Aronson decision, in which **all** of the **directors were named as defendants**.
* **Only apply Aronson if a majority (which includes 50% of board; Ryan v. Gifford) of directors at time of complaint are joined as defendants and accusation is not nonfeasance (since board never really “spoke” on act of alleged wrongdoing at any specific juncture; Goldman Sachs Group v. Shareholder Litigation). Otherwise apply Rales.**
* **Aronson Test**:

**Plaintiff has burden** to plead facts showing **“reasonable doubt”** that majority of board making decision on demand (at filing of suit) not either conflicted in underlying transaction via prong 1 or in suit itself via prong 2:

1) Directors have “**direct and substantial financial interest** (as in most conflict analyses, the inquiry focuses on **material financial interests**, differentiated from the more flexible conflict analysis applied in the SLC context), or **other interest** (such as domination) in the [**underlying**] **transaction**” (wouldn’t want overturned by the suit).

**OR (test is disjunctive despite wording which suggests the opposite)**

2) Plaintiff can create “**reasonable doubt” that BJR would apply** to **alleged wrong** (as opposed to the decision to sue vel non, which is the focus of step one and of a wrongful refusal analysis), which in the case of alleged 144a cleansing, requires reasonable doubt that cleansing was proper.

* Consistent with the **purpose of demand futility, to ferret out conflicts on decision to sue**, the second prong is really aimed at determining whether the litigation has sufficient **teeth** to constitute a material interest in itself. Accordingly, courts have held that for **duty of care claims for which the directors would be shielded from personal liability via 102(b)(7) indemnification** (except when injunctive relief is sought because 102b7 does not block injunctive relief)**, BJR rebuttal is not sufficient to establish demand futility because the board does not have a material financial interest in the suit**. For the same reason, BJR rebuttal is not sufficient when board has turned over either, as seen in Rales.
* Rales: **No one from board at time of alleged wrong remained on board** making demand decision, nor were they dominated by anyone from old board or otherwise conflicted. Rales says plaintiff must "create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand." Aronson Prong 2 appears to suffice as well: “[I]f the directors face a “substantial likelihood” of personal liability, their ability to consider a demand impartially is compromised under *Rales*, excusing demand.” Guttman v. Huang.

**Effectively: Rales allows you to add Aronson prong one and two conflicts together.**

* Note: Del Courts have decided that prong two claims will still excuse demand even when injunctive relief is sought, despite the fact that directors are not facing personal liability.
* **NY demand futility**: Marx: Key difference is that Plaintiff must plead one of the above “with particularity,” rather than by reasonable doubt standard.

**Wrongful Refusal**:

* If/when board receives actual demand and has decided (unsurprisingly) **not** to pursue the claim, plaintiff is left with wrongful refusal:
* Once demand has been made, either of plaintiff’s volition or by force of a failed demand excused claim, plaintiff **concedes that the board as of the filing of the complaint was disinterested** because the plaintiff cannot contradict their own view of that fact (or their assigned view) in a subsequent pleading, for fear of “undue harassment” of the board.
* This **focus on consistency** is exemplified in FLI Marine below. **Plaintiff is left with breach of duty of care (failure to make fully informed decision on litigation) in making the demand decision, or other developments that allow plaintiff to find new grounds for interestedness** (though the latter is unsettled law).

FLI Marine: P made demand futility claim on grounds that 2 directors were CS, others were dominated. Claim fails, makes demand, subcommittee of arguably interested directors refuses demand, wrongful refusal fails because **in making demand plaintiff conceded that CS was disinterested**. Court left open door for **possible claim if plaintiff learned new information that tended to show interestedness after making demand**.

Grimes: Direct claim having failed, court is left with waste and excessive compensation claims. **Court never reaches Aronson analysis because actual demand was made**. Absent grounds for wrongful refusal (**violation of duty of care** in failing to make fully informed decision on litigation), the claim is dismissed.

1. Role of Special Committees-----------------------------------------------

141(c) delegation of authority to subcommittee of disinterested directors to investigate litigation and assess the costs and benefits of proceeding.

**When an SLC?**:

1. Wrongful refusal; no SLC because board has had opportunity to speak on the litigation and blew it,
2. Actual demand made: Wrongful Refusal only recourse,
3. demand excused: SLC subject to Auerbach (NY) and Zapata (Del) because it’s been **tainted with suspicion of “structural bias.”**

Zapata (Del.): Fiduciary suit against BoD in which demand was excused.

Court establishes that **SLCs can intervene in demand excused proceedings** because they retain their 141(a) authority to manage and deserve an opportunity to speak on the litigation providing they can cure board interestedness through the SLC (via 141(c)). But because court is **more wary of structural bias than NY**, the standard is more nuanced:

1. **Defendant has burden of proof** to show that
   1. SLC was **disinterested** (**heightened standard of scrutiny** established in Oracle),
   2. decision made in **good faith** **AND**
   3. “**reasonable investigation**” made into potential legal liability.

**Prong 1 similar to Auerbach standard *but* with burden of proof of defendant and Oracle standard for independence**.

1. Court must exercise its “**independent business judgment**” to determine whether, **despite technical compliance with prong 1**, the decision of the **SLC nonetheless violates the “spirit” of prong 1**, to **ferret out structural bias**, or otherwise prematurely terminates legitimate SH interests. In exercising this discretion, **courts should look to** equivalent considerations to those of a truly loyal director, including not only the likelihood and lit. costs of legal liability, but cost to corporation of bad publicity etc.

Oracle (Del.): Larry Ellison Case

* Demand is excused but the SLC dismissed the suit, eliciting this Zapata challenge.
* **Zapata prong 1 evaluation of the independence of the SLC members**:

SLC composed of prominent Stanford professors who the defendant shows (pursuant to the Zapata prong 1 burden of proof) have no material financial interest in the company and are not dominated by any conflicted persons, and therefore **would be independent under normal conflict analysis**. But the **court develops a** **more nuanced standard** in a further effort to counteract the threat of “structural bias” on SLCs.

* The court focuses on **true impartiality**, finding that **any fact which could substantially bias** the decision may establish a conflict of interest. In this case, the fact that both the SLC members and the directors **belonged to a close-knit community** of prominent silicon valley businesspeople **unavoidably influenced the decision-making** (whether this fact pushed them in favor or against, it was on their minds) of the SLC in bringing **such a serious, and embarrassing, charge as insider trading**. For these reasons, the court concluded that the SLC was not fully independent.

**Discovery**: one additionally notable point about Del SLC analysis is that limited **discovery is permitted on the issue of SLC conflicts**. This comes up in Oracle when the court notes its “shock” at revelations of connections suggesting substantial bias of the SLC, which Prof. Arlen thinks was very influential in that case.

London v. Tyrell: SLC dismissed case. Court refused to grant dismissal because the **personal relationship between SLC members and conflicted parties can create a conflict** under the more nuanced Zapata independence analysis, **even relatively attenuated ones** such as the distant familial relations at issue here (family was somewhat estranged; only saw each other at holiday dinners) and **former conflicts** (former employee) when SLC member feels “beholden” to conflicted party.

1. Corporate Governance and Shareholder Voting------------------------
2. Proxy Contests: Purposes and Reimbursement-----------------------------

Essential Provisions:

**112 Access to proxy solicitation materials**: Firm has **great freedom to specify in by-laws conditions to accessing proxy solicitation materials** including requirements that SH own a certain amount of stock, not have recently acquired a certain amount of stock (takeover defense), certain disclosure by SH, agreement to indemnify firm against harm for misrepresentations in proxy materials…

**113**: **Proxy expense reimbursement**: Great **flexibility** to set out in by-laws. **Except** that “no by-law so adopted shall apply to elections for which any record date precedes its adoption” so as to counteract conflict of interest of directors changing by-laws to reimburse themselves ad hoc.

**211 Shareholders Meetings**

(a) Annual meeting must be held; but can be held anywhere, as designated in bylaws

(b) Election of directors annually at meetings or by **written consent (§228)** if certificate allows

- Any other business at annual meetings as well

(d) **Special meetings** may be called **by board**, **or** by **SH** **if certificate/bylaws allow (though they almost never do).**

**228 Written Consent**: SH may vote by written consent, **unless certificate provides otherwise**.

**212 Voting Rights**

(a) One-share, one-vote is the default rule unless specified otherwise in **cert**.

(b) Proxy voting permitted (you assign a motherfucker the right to vote on your behalf; generally revocable at SH discretion, though they can be irrevocable if they so state)

(c) Most decisions majority vote; Board elections: plurality

**216 Quorum**: Minimum 33%, default 50% so written consent virtual necessity in dispersed capital markets.

**213: Record Date:** Board selects date that **affixes identities** of those able to vote in SH meeting (you retain right to vote even if sell shares pre-meeting so long as own shares at record date)

* **Window of opportunity** leading up to SH vote during which board can affix record date to **prevent them from using it as a takeover defense**.

Reimbursement:

Levin v. MGM: **successful incumbents** allowed to reimburse themselves for proxy contest expenses 1) differed from insurgents on issues of corp. policy and 2) **expenses reasonable** in relation to contest (**with consideration to firm’s ability to pay**).

Rosenfeld: **successful insurgents** allowed reimbursement because 1) corp. policy, 2) expenses reasonable, and 3) **disinterested SH ratification** (curing self-dealing). Waste rejected because court takes “dynamic” view of transaction, recognizing ex ante benefits of proxy contest.

1. Shareholder Inspection Rights----------------------------------------------

**219**: **Voter list access**: Ten days pre-SH meeting, a list of SH entitled to vote must be open for any SH for “any purpose germane to meet”(stock ledger is on going list of who’s a SH; stock list is who’s entitled to vote; **but** *10 days* ***useless for proxy contest***.

**220: General Inspection Rights**: SH has right to copy and inspect “for any proper purpose” (“purpose reasonably related to such person’s interest as SH” i.e. firm-regarding Pillsbury):

* **BOD**: On board if deny stock ledger, on SH for other docs, such as board minutes for a derivative suit, in which case SH much show by preponderance, credible basis for claim.

Pillsbury:

* SH buys shares upon discovering corp’s role in manufacturing weapons for Vietnam war. **Requests SH list under 220** in order to inform SH of activities with the **explicit purpose of preventing allegedly immoral conduct**.
* Court holds that admittedly political purpose is not ‘germane to his interest as SH” in that **SH interests qua SH are purely economic**.

Crane v. Anaconda: Hostile acquirer 220 request SH list to persuade SH to jump ship on firm, allowed because “welfare of SH” counts as in the “interests of the business” (NY standard; further distinctions include minimum share req. + equal treatment of all docs).

Seinfeld: SH seeks books and record relating to compensation of **three highest paid executives**. Claim **rejected as excessive and wasteful**.

1. Federal Law: Shareholder Proposals (14a-8)-------------------------------

14a-8: **Proposals of Securities Holders:** Board required to grant SH request to include proposal in **firm’s own proxy at the firm’s expense**, subject to the following:

1. **Eligibility**: (1) Resolution form; (2) **Stake/ Holding requirements** (Need at least 1% of company or $2000 for **at least one year prior to proposal of submission date** – and such ownership must **continue through date of meeting**); (3) One proposal per SH per meeting; (4) **500 word max** (while management has unlimited response); (5) Proposal must be submitted not less than 120 days before the company sends out its proxy (there are exceptions); (6) Timing requirements;
2. **Exceptions**: 1) **Not proper subject for action by SH** under state law (such as a direct order for board action in violation of board’s 141(a) auth.; in this respect it often goes with #7); **instead, SH must make precatory proposals when it relates to board action**, 2) Would require illegal act if implemented, 3) Misleading or fraudulent in the 14a-9 sense, 4) Relates to **personal grievances**, 5) Concerns a matter of “**small stakes**,” (Loveheim-type issues that **account for less than 5% of firm business** and is “**not otherwise related** to business interest.” 6) Matter beyond power of firm to effectuate, 7) relates to ordinary business operations (141(a)), 8) **Relates to [a particular] election**/nomination to board (limited in scope in AFSCME v. AIG to proposals concerning “**a particular election**,” rather than general election procedures/process, **and by amendment** limiting exclusion to **substantive** actions rather than procedural ones such as 112/113 by-law amendments, as in CA v. AFSCME), 9) **proposal directly conflicts with mgmt. proposal** (no opposition!) at same meeting, 10) proposal is moot because it has been substantially implemented, 11) proposal is substantially duplicative of another proposal at same meeting, 12) proposal submitted in the past and lost, 13) proposal relates to specific amounts of cash or **dividends** (141(a)).
3. **Process**: (1) SH submits Bd. proposal to send out in proxy solicitation; (2) Bd. then considers whether to exclude the proposal; (3) If it excludes, it must inform SH and file with the SEC ((a) a copy of proposal/ supporting statements; (b) statement of reasons for exclusion/ omission; (c) supporting opinion of counsel; (d) **burden of persuasion on board**); (4) SH can respond; (5) SEC staff issues, or declines to issue a “no-action letter” (Essentially, SEC stating it will not take action against corp if they decide to exclude SH proposal in proxy); (6) SH can seek injunction (as in **cases here**)

Strategic framing:

Loveheim: Animal cruelty representing **<5% of business**, 14A-8 request, board objects.

* + Framing: requested inclusion is **merely precatory to avoid 14A-8(1)** 141(a) violation by virtue of forced board action and **in terms economic** impact via reputational harm to **avoid 14A-8(4) personal grievance exclusion**.
  + **BOD on board**: exclude as **small stakes (<5%) under 14A-8(5)**.
  + **Court rules** that falls under **14a-8(5)**’s “**otherwise significantly related**” to business interests out in that **issues of “ethical or social significance”** can have an economic impact on the firm that exceeds their proportion of total revenue due to reputational ramifications, **establishing a sufficient “nexus” to business interests**.

**Unilateral SH Amendment**: Notice that in both AFSCME cases, the SH requests inclusion of proposal for unilateral SH by-law amendment, rather than board-initiated by-law amendment so the request avoids excludability under 14a-8(1).

SH Nomination to Board:

AFSCME v. AIG: AFSCME submitted **14a-8 request** to board to include in proxy materials a proposal to **amend by-laws** to establish **procedure** requiring company to include **SH nominees for director** in proxy materials under certain circumstances.

* **Board sought to exclude** under **14a-8(8)** “**relates to an election**,” but the court narrowly interpreted “an election” to refer to “**a particular election**,” **rather than general election process** (“**process-related proposals**”). Here, because the proposed rules would apply prospectively, the court finds it to be process-related and **denies excludability under 14a-8(8).**
* **Subsequent amendment to 14a-8(8)**: limits scope of excludability to **substantive** proposals relating to an election, rather than procedural, clearing up any ambiguity.

**Short Slate:** increasingly common (after subsequent 112/113 amendments) use of 14a-8 is to ensure reimbursement of election expenses for “short slate” of directors, meaning **less than a majority of the board is replaced, making 113 reimbursement for insurgent election expenses unlikely** since incumbent board still holds the purse strings, as in CA v. AFSCME.

CA v. AFSCME: AFSCME submits short slate reimbursement amendment 14A-8 request

* Holding: because **mandatory reimbursement would exclude the board from a decision regarding the use of corporate funds**, it **encroached on 141(a)** duty to manage, rendering the proposed by-law **inconsistent with state law** and therefore, **excludable under 14a-8(1)** and/or (7) “ordinary business operations.”
* **Fiduciary out**: court notes that had the proposed amendment included an exemption if reimbursement would cause board to violate fid duty, it would be cool, **despite the fact that it unequivocally dilutes board discretion; very low standard**.
* **Subsequent amendments to 112/133**: explicitly provide for these types of provisions **even without fiduciary out**, so they are commonly implemented today.

1. Federal Law: Antifraud Provisions Governing Proxies-------------------

14a-9 is the principal anti-fraud provision governing proxies, though 10b-5 is always lurking in a more general sense, and violation can result in SEC prosecution in court, SEC administrative action and private right of action (established in Borak).

**14a-9 elements**:

1) “False or misleading statement:” **mens rea** not scienter (as it is in 10b-5 because section 10 grant of authority limited to fraud, whereas it is wider in section 14) but only **negligence**, though this is unsettled law,

2) of material fact: **Materiality** determination uses TSC v. Northway standard that there be a “substantial likelihood” that a “reasonable SH” would consider it “important in deciding how to vote.” Or in the case of an **omission**: In view of an affirmative statement (complete silence cannot for basis of material omission), there is “a substantial likelihood” that the disclosure of the omitted fact would be viewed by a “reasonable SH” as having “significantly altered” the **“total mix of information**” upon which they base their decision.

and **in the case of private right of action**:

4) transaction causation and

5) loss causation.

**Attorneys Fees:** Successful SHs will be awarded attys fees as well.

Borak: Supreme court derived **private right of action both in direct and derivative form** on the grounds that to do otherwise would be inconsistent with the policy goal of protecting SH, even though such an action is never explicitly mentioned in reg. Very different Court in 1964.

Note: **Federal derivative actions are not subject to demand requirement**.

Mills: Merger in which board failed to disclose in proxy statement that company was majority owned and controlled by acquirer. **Class action derivative** **SH bring suit** brought under 14a-9.

**Materiality**: District court had found materiality because a reasonable SH would view a merger proposal by a conflicted board with much greater scrutiny, “significantly altering” the “**total mix**” of information available.

**Mens Rea**: the board clearly **knew** they were controlled and that they omitted this fact from proxy materials, so even if the requirement were 10b-5 scienter, we would STILL have necessary mens rea.

**Transaction Causation**: In a normal tort action, one would have to prove they relied on the misleading statement in order to prove causation. But in dispersed, liquid markets, any given investor is unlikely to have relied on any given statement, so the court takes a **more nuanced view**:

* **Requiring each Plaintiff to prove individual reliance** would **eliminate** the possibility of **14a-9 class actions** because questions of individual reliance would always predominate.
* Court recognized that especially in the tender offer context, the economic well being of one SH is directly dependent on the reliance of other SH on misleading statements, so there’s **overall transaction causation** (the vote may not have gotten over 50% had others not falsely relied, and vote bound even those who didn’t rely). And proving overall transaction causation would be extremely difficult.
* To grapple with these problems, the Court **rejects the 7th Cir. Suggestion that you go to fair price analysis** because this deprives SH of their opportunity to vote on price, whether or not it can be shown to be fair by post facto judicial determination.
* Instead, they develop **separate standard** requiring:

1. Materiality (same test as above) **and**
2. That **proxy was an “essential link” in transaction**: basically there is essential link when SH vote is needed because otherwise, the proxy cannot be said to be “essential” to the transaction.

**Loss Causation**: once you establish transaction causation, you still need loss causation in order to have something to recover damages for. So on this point a **fairness analysis creeps back into the action when pleading damages** because you must prove that your stock would have been more valuable if not for fraudulent transaction.

Virginia Bankshares: CS cashes out minority SH in self-dealing merger, which SH vote to approve on board’s subjective recommendation of “high value” in the proxy, though SH vote was not required for merger to proceed.

**Materiality:**

**Can opinions be materially misleading statements of fact?** Yes, **implicit in an opinion** are two facts, a **good faith belief** in the veracity of the opinion and that the **reasons stated** for holding that opinion are your **true motivations**. However the court recognizes the evidentiary challenges of an exclusively subjective test so they require **two elements for an opinion to constitute 14a-9 materiality**:

1. **Subjective falsity**: board did not have good faith belief in their opinion, or their stated reasons were not their true motivations **and**
2. **Objective falsity**: objective evidence of the opinion’s falsity.

**Transaction Causation:**

* Under Mills, we still need **transaction causation**, requiring both **materiality** (which we already proved above) and **essential link**, for which plaintiffs allege “**Vote Causation,**” that the merger would not have been approved if not for misleading opinion.
* But because an SH **vote was not legally required** for the merger to go forward, defense claims the **proxy was a supererogatory formality**, eliminating any essential link.
* Plaintiffs proffer two arguments in favor of **essential link via** **vote causation:**

1. **Shame facts:** A negative vote by SH would have “**shamed**” minority SH into withdrawing from deal. But court determines that **premising causation on behavioral predictions is too speculative** to found a functional rule, focusing exclusively on the more predictable legal limitations on behavior.
2. **Sue Facts**: Negative vote by SH would have removed 144 cleansing of SH ratification in state-based DoL suit against directors. But court **limits inquiry to legal barriers specific to the completion of the transaction**, independent of ancillary legal issues. Furthermore, the state claim may not be completely hopeless if plaintiffs could prove ratification was coercive/misinformed, yet this is exactly the kind of trial-within-a-trial the court intends to avoid by limiting inquiry to legal limitations on the completion of the transaction.

**Note on loss of state right**: Although the Virginia Bankshares court excludes loss of state right from consideration in the transaction causation analysis under Mill, had P claimed to have sacrificed state-based opportunity to perfect appraisal as a result of lie then there would be individual reliance alleged and Mill test would not be applicable. In this context, 2d cir. Has held that loss of a state right can form a 14a-9 cause of action.

1. Controlling Shareholders--------------------------------------------------
2. Sale of Control------------------------------------------------------------------

CS duties to fellow SH arise only in the **exercise of control in board capacity**/managerial power, rather than in SH capacity, a distinction found in Dipex:

Dipex: Underperforming parent is CS of valuable subsidiary and refuses to sell. Subsequently, parent acquires company with board waiving 203 (anti-takeover statute) defense.

* **Refusal to sell**: Here, the CS acts in its SH capacity by voting against the proposed merger, which is has the unfettered right to do, with no duties to minority SH.
* **Board waiver of 203**: Pushing the subsequent merger past 203 obstacle required the CS to exercise its control over the board to waive 203, **manifesting the exercise of control in a board capacity implicates duties to minority SH**. And to do so **for the benefit of the CS and to the exclusion of minority SH interests constitutes seld-dealing**, as seen in Sinclair.

Bottom line: CS exercising 141(a) managerial power to further its interests, to the exclusion of minority Sh interests, constitutes self-dealing.

**Usurpation of Corp Opp. in CS sale context:** SH can sue CS for usurpation of a corporate opp if CS, despite no duty to investigate, comes into knowledge of an acquirers intention to loot the firm and sells with reckless indifference to that fact, effectively profiting on the subsequent usurpation of corp. opps in bad faith.

Perlman v. Feldman: Derivative action brought by minority SH **against former CS (Feldman)**, seeking restitution for allegedly illegal gains arising out of sale of control of Newport (steel company) to Wilport (steel purchaser).

**- “Effective” Controlling Shareholder**: although only 37% of stock is owned by Feldman, and only through his family, court finds effective control because he is chairman of board and president, plus huge voting power.

- War-time steel shortage caused true price of steel to skyrocket, yet reputational risks associated with engaging in perceived “war-mongering” created an industry-web practice called “the Feldman plan,” which involved the exchange of interest-free loans from steel purchasers for the promise to sell steel to them over other purchasers, albeit at the market price, effectively increasing the price to reflect war-time demand through time value of money.

**- Anticipated Usurpation of Corp. Opp**.: Because the acquirer is a steel purchaser, they presumably will not implement the Feldman plan against themselves, and **such plot must be reflected in the price of the control premium**. So effectively, **selling CS derives unjust enrichment from the future usurpation of a corp. opp**, so court finds liability for facilitating a presumptive future usurpation and despite the possibility that minority SH could challenge those acts once committed.

**- Disgorgement**: court disgorges selling CS of bonus to control premium resulting from anticipated corp. opp. usurpation and notably, **gives damages directly to plaintiff minority SH**, as opposed to the corp., because distribution of damages via corp. would allocate 37% to Wilport, who was a party to the wrong at issue.

Bottom line: CS will be found to indirectly exercise management power is it facilitates breach of fid. duty via board power, through otherwise legal sale of control.

1. Freeze Out Mergers (and Appraisal Rights)--------------------------------

Merger Provisions:

* **General 251 Merger**: requires **approval of both board and majority of outstanding SH (including interested SH)** and if approved, all SH must turn in their shares under terms of merger agreement unless they perfect appraisal rights.
* 253 **short-form merger**: If parent owns 90% of sub then only approval of parent board required if parent is surviving co. If sub is surviving co, then you need approval of sub’s SH.
* **251(f) Statutory Merger**: **Acquirer’s board can avoid vote by acquirer SH** if 1) rights of SH acquirer corp. do not change (i.e. no change to charter and number of additional shares issues is less than 20% of outstanding shares prior to merger) **and** 2) board and SH of target corp. approve.
* **271 sale of substantially all assets**: Requires approval of acquirer board and target board+SH, unless acquirer cert/by-laws state otherwise. **Eliminates appraisal right**.

262 **Appraisal Right**: Must hold shares from date of merger proposal through effective date of merger, must file notice of dissent from merger within 20 days preceding SH vote, **must vote against merger**, must file petition to seek appraisal remedy within 120 days of effective date of merger, resulting in **judicial valuation of stock exclusive of value arising out of merger** (either in anticipation of merger or subsequent synergies) but with fair interest and **if court values appraisal lower than merger price then you’re stuck with it anyways**, so it’s something of a **gamble** given the uncertainties of valuation.

* **Market-out exception** to appraisal: No appraisal right in mergers effected **exclusively** through the exchange of publicly traded stock in surviving or 3rd party company with at least 2000 shares traded publicly (to ensure liquidity), implying of course that **appraisal IS available for cash-out mergers**.
* Imperfections of perfected appraisal: it’s not a derivative action so attys fees for individual action can be expensive and court will not always shift fees, plus it’s not available for all mergers (via market-out exception and via 271 sale of substantially all assets).
* Andra v. Blount: Plaintiff to **derivative action for breach of fid duty** explicitly admits that **appraisal damages** would have been perfectly **sufficient to remedy wrong**, so from a compensatory perspective there’s no reason to allow derivative action. But **court allows derivative action anyways** because 1) the “**substantial procedural advantages**” of “equitable actions” and 2) to the extent **fiduciaries believe that can avoid responsibility to the entire class** and require a **relatively small group of SH** to bear the significant costs of proving an unfair price **via appraisal action**, they are “**not adequately deterred from engaging in faithless** (i.e. breach of fid duty) **behavior**.”

**Recourse for Dissenting SHs** (SHs against the merger):

• **Vote against it**: If other SHs do the same the consolidation may proceed; (2) As a first step in perfecting appraisal rights

• **Enjoin Merger on fiduciary basis (Weinberger)**: (1) May also get damages if too late to enjoin; (2) May file before merger has gone through.

• **Claim that merger violated express K rights (Rabkin; RCA)**

• **Some jurisdictions (not del.) allow for enjoining merger for “no proper business purpose” (Coggins)**

**Benefits of Filing a Class Action:**

• Can file class action before the merger is completed – so can sue to get injunction before the merger is complete (cant do this with an appraisal b/c injunctions only available if FD was breached);

- Even if you lose you can still get merger price and even seek appraisal.

• Litigation fees: *Appraisal* – litigation fees come from individual client’s recovery **BUT** *Class Action* – Attorney’s fees are based on all the SH’s recoveries – may also be shifted.

• Flexibility of damages: (1) Fair price: claim the benefit of the merger; (2) **Rescissory damage**s of the merger (merger was wrongful, so court attempts to put SH in place they would have been if not for merger, which includes post-merger increase in value of firm minus synergies of merger); (3) Value of an existing alternative bid; and 4) if all else fails, drop case and seek appraisal remedy!

• Can file even if fail to perfect appraisal rights

Weinberger: CS of UOP initiates cash-out merger with UOP. SH file derivative suit alleging breach of fid duty via unfair self-dealing transaction.

- **Self-dealing transaction?**

a) Court determines that **CS is indeed controlling** because they own 50.5% of co., they nominated 6/13 directors and the control president, making that 7/13 even in the absence of direct evidence of control.

b) **Exercise control in board capacity**? Yes in that board approved merger.

c**) Exclusive benefit to CS**? Yes, it’s a CS merger.

**So this pops us out of BJR protection AND all actions of the board are imputed to the CS, who is the defendant to this suit.**

- **SH Ratification?**

- Court finds that because not all material facts were disclose to SH, such **violation of candor invalidates SH vote**.

- and moreover, effective **SH ratification would only shift burden of proof on entire fairness**, rather than pop us back into BJR.

- **Entire Fairness analysis**: implicates two factors, neither of which is dispositive:

1) **Fair dealing**: Here, there clearly was not fair dealing because

i) breach of candor to SH,

ii) breach of candor by **feasibility study** guys (employees of CS who sat on board of target and used that position to appropriate confidential info in creating feasibility study for CS, which showed that CS would have paid more than price target got, but never spoke up throughout negotiations) (**notice here:** duty of candor is from directors to corp, but is **imputed to CS via agency** because directors at issue are employees of CS),

iii) sham negotiation (did not appear arms-length),

iv) 3rd party fairness report was rushed as a result of CS’s procrastination

2) **Fair Price**:

- Court takes opportunity to depart from antiquated “Delaware Block” method of valuation, instead allowing “**any generally accepted method of valuation**,” which **can include future value “if known or susceptible of proof,**” but noting to **exclude synergies resulting from merger** since SH cannot simultaneously claim merger was wrongful yet benefit from it.

- On remand, court determined fair price was upper bound of feasibility study.

- No proper business purpose claim? Not a viable claim in Del.

Rabkin: CS had acquired majority share with agreement not to force merger at lower price for at least one year. One year later, they do exactly that.

- Clearly seld-dealing transaction, so we go straight to entire fairness.

- Defense argues that because there was no fraud or misrepresentation, there was sufficiently fair dealing to satisfy entire fairness review.

- But **court takes more nuanced view** of entire fairness **fair dealing prong**: the board failed to address the looming possibility of merger at lapse of K for the entire year, and because **CS manipulation of board can manifest in inaction**, there is a question of fact (resolved in favor of defendants on remand) as to whether CS exercised control over board to undermine fair dealing.

Kahn v. Lynch: Alcatel owns 43.3% of L’s board, and L’s certificate requires 80% SH vote for any business combination. A designates 5 of 11 people on Bd., 2 of 3 on Exec Comm, and 2 of 4 on compensation comm. L wants to by Teleco, but A says wont vote his shares, and wants L to buy one of A’s companies instead. A threatens hostile tender offer and Bd. caves to A’s merger demands.

**Is this CS Self-Dealing Transaction? Essentially hinges on status as CS**

* Although 43% isn’t a majority, it’s a **plurality** on virtually every decision, and a **majority is not far off**.
* There is **direct evidence** A has bullied dissenting disinterested board members into compliance in the past.
* A **used their position on compensation committee to threaten the financial well-being** of certain directors, leveraging their role on the board and **overstepping their role as SH**.
* Taken together, these things establish control and thus, selfdealing, so as in Weinberger, we go directly to fairness.

**Is there burden-shifting 144-style cleansing via independent committee?**

* Board had established independent special committee of **fully informed and disinterested directors** to make decision on merger, **which would successfully establish cleansing under 144**, which as mentioned in Weinberger should shift burden of proof on entire fairness to P.
* But in addition to mimicking 144’s fully informed and disinterested cleansing requirements, the **court adds a requirement that the board have meaningful bargaining power to exercise as if arms-length transaction (must feel they can say “no”).**
* Here, there is insufficient bargaining power because CS will block any alternative mergers and **most importantly, threat of hostile tender offer combined with inability of board to take defensive maneuvers due to CS presence on board.** So no burden-shifting.

Note: had Alcatel left it at refusing to approve of purchase of initially approved telecom company, they would have been OK because they acted in their capacity as SH.

Bottom line: Kahn v. Lynch adds to Weinberger the requirement that boards replicate arms-length negotiations in CS mergers.

**Note on Controlling SH Two-Step Mergers**:

* **Two-step mergers** attempt to reach 251 threshold or short-form threshold by tender offer directly to SH, and subsequent consummation under 251 or short-form.
* **Structural Coercion/Freeze-outs**: Two-step mergers can be coercive in their structure if they offer a higher price to those who willingly tender in getting to 251 threshold, than to those who hold out for backend merger consummation. In this case, SH may be coerced into accepting a lower price than they otherwise might for fear of being relegated to the lower price of the backend step, and collective action problem inhibits organized resistance.
* **Special problem in CS context**: under normal threats of coercive tender offers, the board will take defensive maneuvers, but if a CS hinders that process, as we saw in Kahn, then SH are left defenseless, so Del has applied a number of additional requirements in the CS context.
  + **For exam purposes, go with CNX standard, which adds to Pure Resources standard**:

Board’s action will not be subject to substantive review if:

1. It is subject to non-waivable majority of minority tender condition,
2. CS promises to consummate a prompt 253 short-form at same price as soon as it hits 90%,
3. CS has made no retributive threats, **and**
4. Independent committee of board members have free reign and adequate time to react to tender offer, and **as added in CNX, the authority to take defensive maneuvers and other actions like a truly independent board.**
5. Board Duties During a Contest for Control-----------------------------
6. Duties: Two Standards---------------------------------------------------------

Unocal:

- Mesa makes structurally coercive tender offer by offering front-end equity and back-end subordinated debt (“junk bonds,” which Arlen thinks exaggerates the coerciveness of the tender offer since equity is, after all, subordinate even to subordinated debt at liquidation, but the court accepts as coercive anyways). Board enacts measure to buy back all outstanding stock other than Mesa’s at $72/share (financed by heavy debt) as soon as, but not before, Mesa hits 50%, **reversing collective action problem**, effectively killing deal.

- Mesa complains that board breached its fid duty by saddling firm with huge debt liability to purchase stock at overvalued price and to the exclusion of Mesa as an SH.

**Unocal Standard:** Court finds **inherent entrenchment conflict of interest**, but rather than reverting to entire fairness, the court develops a **new standard to allow board back into BJR**:

1. Board must (BoD on board) after **reasonable investigation** and acting in **good faith**, articulate a **“legally cognizable threat to corporate policy and effectiveness.”**
   * Here, the board articulates threats of structurally coercive and inadequate offer and “**greenmail**,” in which the hostile acquirer threatens tender offer and extorts buy-back premium out of the board to go away, and for which Mesa had an established reputation.
   * Most people think these threats were largely illusory, but the Court allows board to articulate anyways, demonstrating lack of substantive review in prong 1, which is really just a process-based standard reminiscent of BJR (requiring rational, firm-regarding reason, reasonable investigation and good faith). **No real teeth to prong 1**.
   * **Allowable considerations**: **inadequacy of price** to reflect long-run value of firm (later further developed), nature/timing of deal, risk of nonconsummation, quality of instruments exchanged, questionable legality (antitrust), **impact on other constituencies (clarified in Revlon to apply only to the extent the interests of other constituencies impact the interests of the SH)**.
2. **Proportionality: Action must be reasonable in relation to threat posed**.
   * Note: when you move to prong 2, the **court accepts the prong 1 threat as the board conceives of it**, no matter how dramatically they’ve inflated the degree of that threat. For this reason, **court suspends disbelief to allow board to argue that the buy-back price was not a scorched earth overvalutation, but an attempt to reflect control premium in price**, leveling the playing field with Mesa, who was allegedly trying to circumvent control premium.
   * Important that the board construe facts in a way that frames their response as proportionate, since all they really need is a rational basis.
   * Court essentially says that if acquirers want to play hardball with your fellow SH, then the board can strike back by treating you differently from the other SH up to a certain point (further developed in Unitrin).

**Discriminatory Self-Tenders**: After the Unocal decision, the **SEC prohibited discriminatory self-tenders** such as that utilized by Unocal board, so boards have moved to other defensive maneuvers such as poison pill.

**Poison Pill**: If a raider acquires over a certain % of shares, the firm *sells* its own shares at a discount to all of its SHs, except the raider (**dilutes raiders ownership & value of remaining firm** – Bd. can unilaterally do this)

* **Classic Pill:** Bd. issues one right for each share of common stock outstanding. If an acquirer purchases 10-15% or more, then the board has 10 days to redeem the rights for nominal amount, or a **flip-in pill** allows the rights holder to buy the target’s securities/ shares at a discount (excludes acquierer)
  + A **flip-over** entitles the holder to buy discounted acquierer securities, once the back-end transaction is finished
* Rights are attached to common stock and can’t sell them separately until they are triggered (once triggered – the rights are a separate tradable item/ security); Bd. has the rights to redeem the rights for cheap until triggered; Can be created at any time (all firms have a pill even if one hasn’t been created one yet).

Unitrin: Court refines Unocal prong 1 acceptable tests and bifurcates prong 2 into 2-prong subanalysis.

**Prong 1 Threats**: Court acknowledges three classes of Unocal prong 1 legally cognizable threats:

1. Opportunity loss (hostile offer might deprive SH of superior alternative)
2. Structural Coercion
3. Substantive Coercion (risk that SH may disbelieve board’s claims of firm’s intrinsic value, which is **really just inadequacy of price** so “coercion” is something of a misnomer).

**Prong 2 bifurcation**: in assessing proportionality of board’s response to articulated prong 1 threat, court applies two-step test:

1. Is the response “draconian” in that it is “coercive or preclusive,” meaning that it would block all deals, rather than targeting bad deals? If yes, **void response**.
2. If not, is the response in the “range of reasonableness,” the “zone of potential responses,” which has proven to be a wide range/zone in that the response doesn’t have to be the least harmful, and in practice courts have afforded **wide discretion**.

Revlon:

Facts: Revlon makes tender offer at $47. Board adopts redeemable (not preclusive under Unitrin) pill conferring right to SH to purchase underpriced notes from firm as soon as any SH reaches 20% equity trigger point, with automatic redemption at agreement to purchase all shares at $65. Pantry Pride offers higher price in an effort to entice enough SH to allow for board turnover and pill redemption before too much damages is done (demonstrating how staggered boards can add so much potency to pills). Board issues notes, decreasing value of firm. PantryPride, undeterred, offers lower tender price on the theory that the firm has been devalued, but also in an effort to intimidate SH into tendering for fear of further devaluations. Board finds White Knight (alternative bidder who will generally keep current board) Forstmann, who they convince to offer tender of $57 (below their allegedly fair price of $65), with “show-stopper” lock-up provisions that preclude competitor from outbidding them.

**Poison Pill**: Apply Unocal

1. Threat: inadequacy of price cognizable under Unitrin.
2. Response: Unitrin two-step:
3. Coercive or preclusive? Nope, it’s redeemable if fair price tendered.
4. Zone of reasonableness? Sure, you have automatic redemption at fair price, so it’s clearly targeted at threat of inadequate price.

**Forstmann Lock-up provisions**: not analyzed under Unocal because at this point, **sale of the firm is “inevitable**,” so **long-run firm health is not a legitimate consideration**, eliciting the **exclusive duty to seek the highest possible sales price, maximizing short-term SH value**, and because the board is selling the firm, the single most important event in a firm’s existence, the court subjects it to **heightened scrutiny**, as Van Gorkum court did for similar reasons.

* **Preferences for one bidder over another**: expressed via lock-up, etc. allowed only to the extent they benefit short-term SH value such as knocking out coercive bidder, enticing a new bidder to up price, avoiding questionable financing of one bidder…
* **Lock-up provisions**: While lock-up provisions may sometimes be necessary to induce a bidder into investing in research/feasibility studies for tender offer, these are so extreme as to end the auction prematurely (show-stoppers), with the “no-shop” provision being particularly indefensible (though not per-se illegal) so the **court simply invalidates them** **to the extent they require breach of fid duty**.

Note: because of certain disadvantages to the Forstmann bid (delayed payment…), it was determined to be of equal value to the Pantry Pride bid. **Had the Forstmann bid been unequivocally higher, the board may have been able to argue they were just protecting the higher bid (even no-shop provision), but this resembled an unjustified preference for one bidder over another.**

1. Determining Scope of Unocal & Revlon----------------------------------

Paramount v. Time:

Time investigates potential merger partners including Warner and Paramount, and determines that Warner presents the best synergies and proposes stock-for-stock merger which would leave Warner SH in majority control of surviving corp. Paramount makes “all cash, all shares,” “**fully negotiable**” tender offer. Time responds by proposing to purchase Warner in acquisition that does not trigger 251 and therefore, allows board to **circumvent SH vote**.

**Revlon Claim**:

SH argue that initial Time-Warner agreement triggered Revlon duties because it proposed a sale of the firm by virtue of the facts that

* 1. Time SH would be minority SH in surviving co. and
  2. CEO predicted it would be perceived as a sale by the market.

**Supreme Court rejects this claim** on the grounds that

1. Warner merger was not an abandonment of long-run strategy, but an important piece in such a strategy, and
2. even is the original deal could be viewed as a sale, it was clearly not inevitable because it was later replaced by the purchase of Warner.

Note: However, Supreme Court would later adopt the Chancery court’s focus on control premium in QVC.

**Unocal claim**: Although 251 mergers are normally protected by BJR, the purchase of Warner was a defensive reaction to Paramount bid, implicating Unocal concerns re entrenchment, and therefore subjecting the transaction to Unocal scrutiny.

1. Threat to corporate effectiveness:
   * Articulated fear that **SH will be unable to appreciate the superiority of the synergies with Warner** and hinder that superior deal.
   * Reasonable investigation? Yes because they **investigated the relative synergistic advantages of Warner and Paramount prior to initial Warner deal**, and because Revlon duties have not attached to remove consideration of long term interests of firm, the **“fully negotiable” nature of the Paramount bid did not trigger a new duty to investigate since the underlying synergies of the potential mergers remain unchanged**.
2. Proportionate reaction?
3. Preclusive or coercive? Paramount argues that **such a large acquisition was effectively preclusive of future tender offers** because no one could purchase an entity that large. But the court **rejects this argument** as too speculative, a view subsequently vindicated by the regrettable AOL-Time-Warner merger.
4. Reasonably related to threat? Yes, structuring the Warner deal as an acquisition ensured it would be consummated by **circumventing potentially self-destructive SH vote**.

Side Question: Could the board have justified resistance to defensive maneuvers that precluded Paramount on an articulated threat of inadequate price? Possibly, but because the tender offer was “fully negotiable,” the board’s Unocal prong 1 duty of reasonable investigation would have obliged them to negotiate with Paramount to see how high they could push this number.

**Just say “no” doctrine**: boards are **not required to negotiate with hostile tender offerers** as long as **defensive maneuvers are motivated by an alternative business plan** (not sale) that provides **long-run value**, **even if only a strategic self-reorganization**. This confers additional significance to the effective staggered board (classified board + poison pill) in that it mitigates potential fid duty breaches on the part of obstinate boards in sitting behind defenses.

Paramount v. QVC: Paramount and Viacom (CS Sumner Redstone) negotiate deal for the **sale of control** to Viacom. QVC enters with fully negotiable hostile tender offer. Paramount and Viacom enter into intense lock-up provisions including termination fee and no-shop.

**Revlon duties?**

* **Three Revlon Triggers**:

1. **Corp. initiates active bidding process** seeking to sell itself or to effect a business reorg involving **clear break-up of company**,
2. In response to bidder’s offer, a target **abandons its long-term strategy** and seeks alternative transaction involving **break-up of company**, **or**
3. The board **sells voting control**.

* Even though the firm is not breaking up, evincing an abandonment of long-term business plan, **there is a sale of control** because Redstone will control Paramount through control of Viacom. Distinguished from Time-Warner in that even though Warner SH would own a majority of the surviving entity, the Warner SH are as dispersed a group of SH as any, so there not a threat of CS domination.
* Sale of Control Premium triggers heightened Revlon scrutiny because:

1. This is effectively the permanent sale of an asset of the firm, which decreases the value of remaining shares, since under Zetlin, CS do not have to share control premium with minority SH, **and moreover**,
2. Selling control alters the nature of the asset (the stock) in that the presence of a controlling SH implicates new risks of minority SH oppression via CS domination of board.

**Enhanced Revlon Scrutiny**: **Board must show** that

1. Process: Was decision-making process and investigation adequate?
2. Substantive: Was action by directors “**reasonable**,” in view of **exclusive goal of maximizing short-run value for SH**?

**Application in Sale of Control**: obtaining the “best value reasonably available for SH:”

* + Reasonable decision ≠ perfect decision.
  + **Duties**: To be diligent and vigilant in examining various deals, act in good faith, to obtain and act with due care on all material information reasonably available, to negotiate actively and in good faith with all bidders.
  + Defensive measure permissible only to the extent they maximize SH value.

**Here**:

1. Reasonable investigation: in contrast to Time-Warner, **Revlon duties have triggered**, so **Paramount’s previous investigation into underlying synergies** of the QVC merger **will not suffice in assessing the comparative short-run value of the mergers**, so the **board failed to reasonably investigate when it declined to engage in negotiations** with QVC’s “fully negotiable” offer.
2. Substantive review of defensive maneuver, the lock-ups: the court dismisses the board’s excuse that they were contractually bound by their lock-up provisions because **to the extent K terms obligate the board to violate its fid duties, they are void**. And moreover, they shouldn’t have made them in the first place because they were **draconian in that they were preclusive**.

**Revlon-compliant merger comparison**: So how can a board compare merger bids once Revlon duties have triggered? Such comparisons will not generally boil down to one number vs. another number. **Forms and timing of payment are relevant**. Even synergies can come into the mix to the extent they are relevant to short-run SH value if, for example, a deal is structured to include part equity in surviving entity, bringing continued profitability of the firm back into consideration to a lesser degree. And **any factors that might influence the likelihood the deal will actually be consummated**, such as financing contingencies.

Airgas: Hostile acquirer purchased up to poison pill trigger point and is waiting our effective classified board, at this point having waited a year and gotten three directors elected, conferring an SH mandate to consummate the merger.

Analyzed under Unocal because no sale has been agreed to:

1. Prong 1 threat of substantive coercion (inadequate price) has been articulated. Although this is usually justified as a threat due to the board’s inability to fully educate SH on deal, here they’ve had plenty of time to do so. But Chancery court is bound by Supreme court’s recognition of concern that SH (arbs) short-run profit interests may conflict with long-run interests of firm. So the threat persists.
2. Prong 2 poison pill defense has effectively prevented takeover at inadequate price.

So Chancery court is forced to apply precedent. The facts of this case are not great for challenging Supreme Court on this point because even the newly elected members of the board have voted against merger, suggesting a valid threat.

- One way to challenge perpetual resistance would be to more closely scrutinize directorial good faith under Unocal prong 1. But as soon as the board got a 3rd party to validate their opinion, they would be protected under 141(e).

- Explicit time limits also imperfect in that it shifts bargaining power to those acquirers that can wait it out, whether or not the threat actually dissipates. Golden parachutes probably better.

**Del 203** **Anti-Takeover Statute**: Any bidder that acquires 15% of a firm must wait 3 years before they may engage in any “business combination.”

Exceptions:

* If a bidder acquires 85% or more,
* Board approves bid *before* 15% met (so as to prevent creeping merger circumvention via board replacement after initial buy-in), **or**
* If after 15% acquired, the target board **and** 2/3 of disinterested SH approve.

**Opt-out**: Firms may opt out in charter or by-laws, but it does not take effect for 12 months and does not apply to any acquire who purchased up to 15% prior to opt-out.

**Significance**: right now, the statute is not very significant because most firms have poison pill triggers below 15% (as low as 5%), so you’re having to deal with the board already anyways.

1. Shareholder Voting Control & Blasius Duty-------------------------------

Schnell: Board accelerates date of annual meeting in order to deprive insurgents of sufficient time to prepare proxy.

* Board does have technical authority to move meeting, but because they use it to dilute SH voting power contrary to principles of corporate democracy, the court prohibits: “Inequitable action does not become permissible simply because it is legally possible.”
* **BJR doesn’t apply** because of entrenchment conflict of interest.
* If board act with the **primary purpose of impeding SH voting power**, then they have “**heavy burden**” of demonstrating **compelling justification** for doing so.

Blasius: Blasius purchased stock with the intention of forcing a restructuring. They propose consent decree to expand board and pack with members to take control. Board preempts this proposal by unilaterally amending by-laws to increase board size to cert max and, by virtue of 223 default allowing board members to appoint vacant seats, pack the board with their friendlies.

Both Blasius and Schnell implicate not uses of the corp’s property, but of the “**allocation of authority**” in internal governance. SH right to control **nature of board** is fundamental to the legitimacy of corporate governance, and any attempt to dilute it creates “heavy burden of demonstrating compelling justification,” not met by the board’s concern that insurgent board members will harm firm.

**Outer bound of Blasius**: remember that Time Warner deliberately preempted SH vote because they didn’t trust SH judgment, and Blasius wasn’t even an issue! Key is that Time Warner implicated an issue of business judgment, which is the central realm of the board, rather than corporate governance.

1. Federal Regulation of Disclosure and Insider Trading----------------
2. Federal Regulation of Fraudulent Financial Statements: Rule 10b-5----

Philosophy of 10B-5: Rather than attempting to directly regulate the quality of available securities, we take a “let many flowers bloom” approach by ensuring material disclosure and allowing people to make their own decisions arm with that information: **Mandatory Disclosure + Caveat Emptor**.

10B-5 Elements:

1. Misstatement or omission (statement that is misleading in light of omitted fact).
2. Materiality TSC v. Northway “alter the total mix of information” a “reasonable investor” would consider important in transaction decisions.
3. Scienter: Knowing/intentional misstatements, rather than negligent, though recklessness (“**willful ignorance**” to misleading nature of statement) can rise to level of knowledge. Notice: knowledge that you will mislead does not require intent to mislead, just that you know your statements will have that effect. Whereas recklessness is more like you make a statement that you suspect is untrue and would in that case be misleading, but you don’t bother to look it up**. Also implies knowledge of materiality** of statement.

AND FOR PRIVATE ACTIONS

* 1. Standing: transaction involving security during the lie (post-statement, pre-correction).
  2. Scienter: same as above, but higher pleading standard.
  3. **Causation: Two-step analysis**

1. Transaction Causation: but-for causation on transaction (altered in Basic for uncertain events) AND

ii. Loss Causation: transaction resulted in alleged harm.

Basic v. Levinson: CEO denies rumors of **preliminary negotiations** which ultimately led to merger, but temporarily deflated stock price during which time P’s sold their stock, which P’s allege they would not have done had it not been for omission.

Materiality:

* Applies TSC v. Northway total mix. D argues that preliminary negotiations have such a high morbidity rate that their discovery is too speculative to affect a reasonable investor’s decisions. Argues for bright-line rule that prelim negotiations are not material until they reach a stage of certainty at which there is “agreement in principle.”
* Court rejects this instead establishing **two criterion for materiality of uncertain events**:

1. **Probability** that event transpires (informs sliding scale of materiality) **and**
2. **Magnitude** of potential event (greater magnitude, more likely material)

* Here, the sale of a firm is the single most important event in its life, to wit, its death, presenting a magnitude which overcomes the admittedly high morbidity rate of prelims.

Scienter: Board not allowed to weasel out of scienter by claiming they only intended to keep the negotiations confidential in order to ensure their consummation, rather than deceive SH, because knowledge that a statement is false and material is sufficient notwithstanding the best intentions.

* Notice: Court derives scienter requirement from common law fraud, which is integrated in 10B-5.

Reliance/Causation:

* Transaction Causation normally requires the plaintiff to have personally relied on the misstatement. But this is problematic because 1) class actions would never get granted cert. because individualized reliance Q’s would always predominate and 2) in dispersed, liquid markets, most plaintiffs (i.e. those who suffered the harm) will never have even been exposed to the statement personally. To address systemic missing, Court developes:
* **Fraud on the market theory**: establishes rebuttable presumption fraud affected price and SH relied if:

1. SH who buy and sell in active markets rely on price of stock to reflect “fair” (unbiased estimate of) underlying value based on all publicly available information **and**
2. Price was distorted by fraud

Note: implicit in this claim is the “semi-strong efficient markets hypothesis” that price is an unbiased reflection of all publicly available information, with trading on predictions about what new information will be revealed. (My opinion: faulty distinction in-kind between current information and projections because projections are themselves based on currently available information and are undoubtedly reflected in stock price. And as Justice White points out in his dissent, this all presumes some “true” underlying value to the assets, which is difficult to conceive of).

**How to rebut** fraud on the market presumption:

1. Shares don’t trade on efficient market (undermining basis of efficient market hypothesis),
2. No market reliance: look to see if truth entered market in so **credible** a fashion as to complete eliminate effect of misstatement.
3. P didn’t rely on market **price** (not on statement): had planned to make transaction before misstatement happened for example.

Here, despite the fact that price increase during the lie, D cannot prove that price would not have increased more dramatically, causing P’s to stick with stock.

Halliburton: do personalized Q’s of **loss causation** predominate class action sufficient to deny cert? Nope, says SCOTUS, that’s determined at remedy stage. Although Court has interpreted “loss” narrowly to apply only to actual loss, rather than mitigated gains, getting cert. gets you discovery.

Mattrixx: Soto case about loss of smell with Zicam.

* **Materiality**: Court **declines to adopt bright-line rule** with regard to materiality of drug side effects at **statistical significance**, taking a more **nuanced view of consumer behavior**, since that’s ultimately what will drive the reasonable investor under TSC.
* **Scienter:** reiterates this view of materiality when D claims they never anticipated court taking so nuanced a view of materiality, so they were not “knowing” in the materiality of the misstatement. Court says fuck that, consider the reasonable investor rather than our legal asses.

1. Insider Trading: Rule 10b-5 & Rule 14e-3----------------------------------

**Rule 16:** Prophylactic approach to insider tradig

1. statutory insiders (officers, 10% equity holders) must register holdings, report changes with 10 days of close of calendar month of transaction,
2. allows the corp. or any SH to bring suit against **statutory insiders to disgorge** (the to corp. plus attys fees), short-swing profits (or loss avoidance) of securities **on security held for fewer than 6 months**.

Possession of inside information requires that one either disclose to public or abstain from trading.

14e-3: prohibits trading on material non-public information from any involved party (including attys, accts, etc.); doesn’t require fid duty because scope of congressional auth not limited to fraud.

Standing: all you have to prove is that you were selling at same time D was buying.

Scienter: need it.

Chiarella: Printing press dude trades on info re tender offer.

Materiality: but tender offer info has nothing to do with underlying market value of firm; it’s just “market info,” but court says market info can be inside info.

Duty: silence absent a duty to disclose (and there was at best a duty to acquirer, who hired the printing press) is not fraud, and 10B-5 is a fraud statute by Congressional grant and therefore subject to the limitations of common-law fraud.

**Misappropriation theory**: SEC ultimately got Chiarella on misappropriation theory (still valid today): Relatinship of “trust and confidence” such as employer + acquisition of information in context that connotes confidentiality = liability.

**10B-5(2) scope of “trust and confidence” relationship**: A person receiving confidential information owes a duty of trust & confidence to the person from whom he got the information if he trades in the following circumstances:

* + - When the person receiving the information agreed tokeep it confidential
    - When the people involved in the communication had a history or pattern of sharing confidences that resulted in a reasonable expectation of confidentiality
    - When the person who provided the information was a spouse, parent, child or sibling of the other, unless it is affirmatively shown, based on the facts of that family relationship, that there was no reasonable expectation of confidentiality

Dirks: Tipper/tipee liability.

The mere possession of inside information not cause the duty to disclose/abstain to arise.

**Personal benefit test**: Instead, court says that fiduciaries (corporate insiders) violate when they stand to reap some pecuniary gain from tip, either monetary or reputational with eye to subsequent monetary gain, and here this was just a disgruntled employee hoping to expose the fraud.

**Tipee: FN 14:** when inside info is revealed for legitmate reasons to certain people (underwriter, atty, acct…) and firm makes clear they want info kept secret, 3rd party becomes **constructive insider** and subject to 10b-5 duties. Secrist told Dirks to use the info, so Dirks is not constructive insider.

10B-5(1): trading “in possession” of inside info: presumption of trading ON inside info, unless you can rebut.