Important legal language for Bullard: not “if you do X, Y will not happen,” but “if you do X, you minimize the risk of Y.”

Cumulative dividends for the purpose of the exam
- Non-participating preferred will received dividends up to % specified – receives 5% of face value before common shareholders can get any dividends; not participating in the other distribution of dividends; focuses only on the percentage of the answer
- If it is cumulative – you will get it for other years too
- Assume in liquidation that they are entitled to all dividends in arrears
- Liquidation preference is face value; preferred gets preference as to first X amount
- $100 preferred means that each share of preferred gets $100 before any common shareholder gets anything
- When figuring this out
  - Liquidation preference
  - Plus, if cumulative, dividends in arrears

Agency
- Corporations are principles and employees are agents; one way in which limited liability can be pierced, informs internal relationship of corporations to employees / directors, external relationship of corporation to outside persons
- Action by one on another’s behalf
- Takes on fiduciary duties of loyalty, care, + “good faith” (really covered by 1st 2)
- Doesn’t matter whether either party calls it agency or says “this is not agency”
- Factors needed to find agency:
  - Principal manifests consent that agent act on its behalf; agent consents to act & does act on principal’s behalf
  - Agent acts on Principal’s behalf and under Principal’s control
  - Example of factors to find control, Cargill:
    - “Principal” is buyer and lender, rights to inspect & see financial statements, directions over which investments the agent can engage in, “strong paternal guidance.”
    - But, lenders can exercise some control to protect their interests
  - Actual Authority, Gay Jensen Farms v. Cargill
    - Runs from principal to agent, may be express or implied
  - Apparent Authority, Butler v. McDonalds
    - Principal gives 3rd party reason to believe that actual authority exists
      - Not principal giving agent reason to believe (that’d be actual)
      - Also, not agent giving 3rd party reason to believe
    - Depends on 3rd party’s subjective beliefs
    - Actual control does not matter
    - Same facts can be used to prove this as used to prove actual, sometimes
      - Ex: management oversight – tends to prove control, would also tend to suggest affiliation to a 3rd party
    - How do you protect the franchise w/o becoming principal?
- Ratification
  - Principle approves agent’s unauthorized act, after the fact
  - May be expressed or “in a manner showing affirmance or acquiescence”
  - Binds the principal, relates back in time
- One reason for agency: to internalize the costs of the agent’s actions to arrive at the efficient level of production for society

pp. 1 – 8

Partnerships
- Now, because pass-through taxation of partnership comes in organizational forms that offer limited liability, partnership law is all about how to prevent people from falling into partnership
  - Can fall into one inadvertently
- Default rules for partnership
  - Partner’s actions will be binding on all other partners
    - If this is carrying on the business of the partnership & not carrying on a separate business arrangement
    - In order for 3rd party to recover, must have ignorance of lack of authority – if they have notice, can’t recover
  - All partners must agree to admit a new partner
  - All partners have equal management rights
  - All share equally in profits and losses, have equal votes
    - Important because if you don’t put it in writing, and one starting partner puts in 90%, he only gets 50%
  - Partners are jointly & severally liable for the liabilities of partnership
  - Business matters must be decided by a majority
  - Modifications of the agreement must be decided unanimously
- A contract establishes a partnership when two or more persons agree to carry on as co-owners of a business for profit. Lenders do not become partners, even if the lenders put lots of restrictions on the business, if they lack this control. *Martin v. Peyton*
  - As above, the specific words of the agreement (i.e. whether they say “partnership” or not) don’t matter
    - But if it’s a pretty clean case and have specified “we’re not partners,” might be given the benefit of the doubt
  - These investors have a lot of oversight and control, and put a lot of restrictions on the business, but they cannot initiate transactions or bind the firm by their own actions. Thus the court views all of the restrictions as merely lender-protecting
  - And it’s a question of degree – even if no one fact leads to the “partnership” conclusion, the facts might produce such conclusion, taken in the aggregate
  - Also, there’s a difference between having an interest as a lender (get paid flat return) and an equity interest (share in upside and downside)
During the partnership relationship, one partner owes another a fiduciary duty (duty of finest loyalty). Can’t start acting on your own in anticipation of partnership’s end. *Meinhart v. Salmon*
  - Duty of loyalty means that anything you get relating to partnership is shared between you
  - Salmon appropriated a partnership opportunity
  - Excluded partner from chance to compete; partner gets 50% - doesn’t matter that partner probably would have been unable to compete
- Partners have equal rights of management and conduct w/ respect to partnership
  - But, for relatively major business decisions (or differing from the ordinary course of the partnership, or outside the partnership’s business) must decide by a majority of partners
  - Not “management,” but “business decisions” characterize matters that need majority approval
- Actual authority: has authority to act in conjunction w/ these equal management rights
  - *Summers v. Dooley*: hiring another employee in disregard of the
    - A lot of this case has to do with the fact that this was a 2-man show; bringing in a 3rd person was outside the bounds of the partnership; were not hiring new employees day-to-day
    - But, other partner might be held liable anyway on “apparent authority” theory (partnership will be held liable regardless)
  - *Nabisco v. Stroud*: even though one partner said “we’re not buying more bread and you lack the authority to make these decisions,” the partnership was bound by the other partner’s purchasing of bread
    - As in *Dooley*, a lot depends here on that this was a managerial level decision, well within the normal actions of the partnership
- Apparent authority: acting partner has power to bind corporation w/ respect to anything w/ which he has apparent authority
  - Can also be a source for a 3rd party to sue partnership
  - There was none in *Nabisco*; but might be some in *Dooley*

Pp. 8 – 15

**Limited Partnerships**
- Until later part of 20th century, limited partnership was the alternative to the corporation for conducting business w/ limited liability
  - Now have Limited liability corporation (LLC), limited liability partnership (LLP)
  - Subject to certain organizational documents filed w/ state that are a legal trigger of status
- Quick lesson on ordering in bankruptcy:
  - Secured creditors (get secured interest in particular property for higher priority and lower loan rate), unsecured creditors, preferred shareholders, common shareholders
- Limited partnership: risk of loss was limited to investment if certain requirements were met.
  o 2 classes of partners:
    ▪ General: have complete control, manage enterprise, subject to full liability
    ▪ Limited partners; similar to firm creditors but subordinate to them in bankruptcy
  o Formed only by compliance w/ statutory formalities like those for creation of corp.
  o Limited partners are not agents of partnership; lack authority to bind partnership
  o GPs owe fiduciary duty to LPs; LPs will owe much lower duty to other Ps, if any (unless they assume control of the business)

- A limited partner is liable for the liabilities of the partnership if he acts “substantially the same as” a general partner or if the persons transacting business with the partnership have actual knowledge of the LP’s participation and control. *Gateway Potato Sales v. G.B. Investment*
  o LP not liable for obligations of partnership unless:
    ▪ Also a GP
    ▪ In addition to LP rights, takes part in control of business
    ▪ If LP’s participation is substantially the same as GP, he’s liable to those transacting business w/ partnership, even w/o their knowledge of LP’s participation and control
    ▪ If participation in control is not “substantially the same” as GP, he’s only liable to persons who transact business with the partnership w/ actual knowledge of the LP’s participation in control
  o LP cannot be liable unless creditor has contact w/ LP and learns of LP’s participation; GP’s representations as to LP’s status (apparent control) don’t create liability

- Partners in an LLP are not vicariously liable for debts or liabilities solely by reason of their membership in the partnership. *Lewis v. Rosenfeld*
  o A partner may be liable for a negligent or wrongful act committed by
    ▪ The partner himself
    ▪ Any person under his/her direct control while rendering professional services on behalf of the LLP

- LLC agreement is any agreement between the members who will make up the LLC; the LLC itself need not be a party to the agreement. *Elf Atochem North America, Inc. v. Jaffari*
  o LLC combines corporate-type limited liability with partnership-type flexibility and tax advantages
    ▪ Members can engage in private ordering w/ substantial freedom of contract to govern relationship, so long as they don’t contravene mandatory portions of the Act.

Pp. 15 – 16
Corporations – Formation and Finances

- 3 categories here:
  o Pre-incorporation liability (promoters’ liability)
  o De facto corporation
  o Ultra vires (why that’s lumped in here I don’t know)

- Promoters’ liability, deals with activities taken before the corporation was founded:
  o Personal liability of promoters for their acts (since limited liability has not yet attached)
  o Determining when corporate liability attaches to pre-incorporation activities
  o Liabilities of the corporation to investors for fraudulent promoters’ activities

- Can be avoided by not taking activity until incorporation
- “De facto” corporation
- When a promoter does not provide in the contract that the corporation will step in & be bound after it is formed, and the “contract” is not treated as an offer to be later accepted by the corporation, then the promoter will be liable and must look to the corporation for indemnity. O’Rorke v. Geary
  o Liability options: him, the corporation, or both
  o For client, we want: the corporation is liable and not him
  o Three options for how the contract could have been understood:
    ▪ Take on behalf of the proposed corporation an offer; this being accepted after formation, becomes a contract
      • Other party won’t want this
    ▪ Make a contract @ time of binding himself, w/ stipulation or understanding that if the co. is formed it will take his place & he is relieved of liability
      • Cannot force the corporation to assume liability, in advance of its incorporation; other side will insist on a provision that the individual continues to be liable if corporation doesn’t step in
    ▪ Bind himself personally, & look to the proposed co., when formed, for indemnity
  o Look to when work was to begin, who intended to pay, when corporation was to be incorporated relative to end date, provisions for substitution of responsibility as important factors

Corporate liability for promoter’s contracts:

1) Adoption – assent to a contract that was made in contemplation of the corporation’s assuming it after organization; takes over contract rights of promoter. Some theories on this:
   - Acceptance of a continuing offer: original promoter’s contract is continuing proposal that corporation may accept once it comes into being
   - Formation of a new contract – for new consideration
   - Novation: Corporation, after assent, is substituted for the promoter
i. Some courts have taken this view, but others have taken adoption / ratification view

ii. What’s the difference? The above 3 seem to make sense in the context of adoption & not as separate theories.

2) **Ratification** – corporate acceptance of an act purportedly on its behalf by agent

Comparing adoption and ratification
- Sometimes “ratification” used loosely
- Adoption and ratification may be shown by any words or acts from responsible corporate officers showing assent/approval (ex: knowingly accepting benefits, continued performance on the contract)
- Some distinction on date:
  i. Ratified contract relates back to date promoter made it
  ii. Adopted contract becomes binding on corp. from date of adoption

Dilution:
- Does the value of a shareholder’s shares change by issuing new shares at whatever the issue price?
  o Ex: Co. has 100 shares outstanding for total value of $10; if the company issues another 100 shares, the new investor must pay $10 to avoid dilution
  o Over $10: investor’s stock diluted, prior investor benefits
  o Under $10: the reverse
- For exam: who gets diluted? How much
- *Old Dominion v. Lewisohn*
  o Corporation has $1 mil in real estate; issues $3.25 mil in stock from the co.
    ▪ At this point, promoters are just fooling themselves
  o But then solicit $500K in company from investors, $25/share:
    ▪ Investors think they’re getting a discount
    ▪ But in reality, they’re paying about 3x the per-share value
  o Holmes finds for the promoters because he views the wrong as occurring at the time of the property being given to the corp.
    ▪ By the time the sale of more stock happened, this was water under the bridge
    ▪ Shareholders must bring claim on behalf of the whole corporation
    ▪ And 13/15ths of the corporation assented to this valuation in the first place
  o Mass. case in the notes went the opposite way; discards the corporate entity, views this as a transaction between majority and minority shareholders
    ▪ And imposes fiduciary duty on majority shareholders to future shareholders
  o SEC is the form of monitoring and bonding that prevents this sort of thing

Mechanics of incorporation, pp. 83-86
**De Facto Corporations**
- Started doing business when you thought there was a corporation, but in fact there was not
About whether you’ll be treated as if you had a corporation, & are therefore entitled to limited liability

- *Pocahontas Fuel v. Tarboro Cotton Factory*
  - Black letter principles:
    - Bona fide effort to comply with the law of incorporation
    - Persons affected … have exercised the functions pertaining to the corporation
    - Persons affected (plaintiffs?) have acquiesced and treated it as a corporation – the way this is phrased makes it sound like “persons affected” are the ones incorporating
  - If there is a de facto corporation, individual shareholders aren’t liable
  - Also, if there is a de facto corporation, only the state can raise issues of the corporation’s power to exercise its powers

- *Cranson v. IBM Corp.* – Separates out into a legal and an equitable test:
  - Legal test:
    - Existence of law authorizing incorporation
    - Good faith effort to incorporate
    - Actual use or exercise of corporate power
      - 1st is never really in dispute, will be 2nd and 3rd
  - Equitable test (estoppel):
    - Person seeking to hold the officer personally liable has contracted or otherwise dealt with the association in such a matter as to recognize and in effect admit its existence as a corporate body
      - This is the 3rd part of *Pocahontas*, kind of
  - Legal test doesn’t work b/c you can’t have “good faith” attempts to incorporate if the charter’s never filed (in this jurisdiction)

- In the absence of a corporation, might have a partnership

- Law under Model Business Corporation Act:
  - P. 89, 5 situations where de facto corporation will be found
  - *Timberline* case in notes (before MBCA revision): treat investors as liable unless they’re “passive”; creates a sort of “de facto limited partnership”
  - If Cranson knows that the corporation is not legit, he loses

Capital Formation
- Priority the same whether company is profitable or in bankruptcy:
  - Must pay bondholders first (interest on bonds when it’s profitable)
  - Preferred stock
    - Can be preferred as to liquidation preference & as to dividends
    - Noncumulative: have dividend preference for one year, but if they decide not to declare dividends, your entitlement to dividends is erased
    - Cumulative dividends – entitled to back-pay before corporation can pay dividends to other shareholders; watch for “dividends in arrears”
  - Then, & only then, do common stockholders get their bit
- Of course, you would be a stockholder because you stand to get more upside
- If you’re a common stockholder and there are noncumulative dividends, you prefer cash to accumulate rather than yearly payout
- Par value: value actually assigned to shares
  o Difference between that and what people actually pay is the “capital surplus"
- Balance sheet another aspect of monitoring and bonding? Pp. 90-96

Pp. 22 – 32

**Limited Liability – Piercing the Corporate Veil**

- 3 doctrines for piercing (p. 107):
  o Instrumentality – focuses on 3 factors
    ▪ Control – complete domination of finances, policy, business practices; corp. has no will of its own (not just maj. stock)
    ▪ Such control used by D to commit fraud or wrong, perpetuate a violation of statutory / legal duty, or dishonest act in contravention of P’s legal rights
    ▪ Aforesaid control & breach of duty must proximately cause the injury or loss
      • Have to show causation, unlike in principal / agency law *(McDonalds)*
  o Alter Ego – more words, less precision
    ▪ Such unity of interest & ownership that the separate corporate & individual personalities don’t exist, and
    ▪ If the acts were treated as the acts of corporation alone, inequity would result
  o Identity – Sounds identical to “alter ego.”
    ▪ Corporation has ceased or never begun b/c of unity of interest & ownership
    ▪ Adherence to “separate entity” fiction defeats justice & equity

- In practice, the 3 are virtually indistinguishable – and don’t try
- P. 108-109 – lists factors that apply in piercing cases
  o Generally: misuse of funds, “shell” corporation, failure to follow corporate formalities, common people btw 2 different corporations (for one corp’s ownership)
  o Holding self out as liable for corporate debts – b/c we want people to take risks that reflect balancing based on accurate info
- “Alter ego” or “disregard of the corporate entity”: *Minton v. Cavany*
  o Ex. Of when this applies:
    ▪ Owners treat corporate assets as their own; add & withdraw at will
    ▪ Owners hold themselves out as personally liable for corp. debt
    ▪ Provide inadequate capitalization + actively participate in corporate affairs
  o On inadequate capitalization: never, by itself, a justification for piercing the corporate veil (here there was 0)
- Plus, act of organizing the corporation and going through the process to get it legal status (and holding a qualifying share of stock), atty is not an alter ego

- Pierce when “someone uses the corporation to further his own (rather than corporate) business.” *Walkovsky v. Carlton*
  - Multiple small cab co.s owned by D
  - To get to individual liability, have to show that the corporation is a tool of the individual (and not just of a bigger corporation)
  - Undercapitalization and intermingling are not sufficient
  - Difference: this was just minimal capitalization (2 cabs + bare minimum insurance) + draining the assets (presumably through dividends); above was no capitalization + no incorporation + conducting the corp. as if it were a corp.
  - But, D points out how capital was (purposely) insufficient to meet liabilities that are certain to arise

- Another take on taxicab:
  - These people don’t have the resources to investigate each cab they get into (and people who are hit have no say)
  - But in a more high $$ case – ocean liners where one’s a “management company” and the other has no assets but does the contracting – the people contracting are sophisticated and should look into this structure

- Following the letter of the law, and the bare minimum that the law requires, probably won’t be enough to pierce.

- Small corporations likely to be analyzed in greater detail than large ones in applying veil-piercing theories; less formal structure, less legal sophistication, owners start out with less assets, and treat it as “their candy store”

- *Costello v. Fazio*: not piercing the veil, but “equitable subordination”
  - These majority shareholders changed the capital that they had contributed to loans, leaving the corporation grossly undercapitalized (1:65 asset: sale ratio); did this for their own benefit, knew or should have known that business failure would have resulted
  - Recapitalized from capital of $52K to capital of $6K and a loans for the rest – partners were trying to move selves up in bankruptcy pecking order
    - Working capital is not any different
    - Instead, court focuses on “legal” or “stated” capital
  - Doesn’t matter that this all happened before incorporation (occurred in contemplation of incorporation, or that the business survived long enough to have a turnover of creditors
  - Doesn’t look like a loan – no specified interest rate
  - Subordinating majority shareholders’ claims to other creditors’ claims, in bankruptcy: “much less drastic,” doesn’t involve affirmatively imposing liability
  - Bullard thinks this case is analytically weak

- Note after: fraudulent conveyance. Corporation formed up, $$ conveyed to people, to prevent creditors from reaching assets & allow debtor to continue in control; creditors can void the conveyance & reach the transferee
When transferee is a “continuation” of the transferor (new, “debt-free” corporation), transferee can be liable for transferor’s debts as well.

Ultra Vires
- Originally, corporations were chartered for a specific purpose *Wiswall v. Plank Roads*
  - If corporation undertook outside activities, minority shareholders could step in and enforce the charter (dividends v. new risk)
  - Reflects corporation as designed to engage in a particular purpose, not as risk management
- Today, corporate charter will say “for any legal purpose”
- Now, without ultra vires, need principles to deal with managers who go out and either lose a whole bunch of money, or make a lot and try to keep it for themselves — see *Meinart*
- Gender discrimination case: *Cross v. Midtown Club*
  - Gender discrimination not a listed purpose in corporate charter — can’t do it — corporation not organized for the purposes of feeding men only
  - More social activism than corporate law, “law used creatively.”
  - Discretion limited by norms, policy in other statutes, etc.

Corporate Responsibility
- Do have the view of corporations as supposed to be responsible citizens, imbued with a sense of personality, as a neighbor
  - And to the extent that they are so viewed, maybe it makes sense to be philanthropic — *Barlow* — can play into this
- Contrary view: Milton Friedman: wealth maximizer for stockholders and that’s it
- Corporations authorized to make charitable contributions now, by law
  - Such payments are not ultra vires
- Book articulates a question: how do you make sure that the corporate contributions aren’t just going to a director’s pet charity (Tom Monahan) and is not helping (or even hurting) the corporation?
- Black-letter principle: make sure there’s some connection between the corporate act and your bottom line, and you’re fine
  - *A.P. Smith Mfg. Co. v. Barlow*: corporation gives donation to Princeton, and that’s fine – spread goodwill, create favorable environment in community for corporation, public expects this; education provides a more qualified and larger workforce – philanthropy is good business
  - *Adams v. Smith*: Corporations can make pension and bonus payments under proper procedure, but cannot just give away corporate assets for no consideration
    - So, if directors die, it’s wrong to just hand over money
    - But if you have a plan beforehand…
Dodge v. Ford Motor Co.: “I am not declaring dividends, and am cutting the price charged for cars, so that I can help my employees and society”: doesn’t fly, doesn’t relate to bottom line (in fact, goes against it). Have a duty to declare dividends
  - Sometimes, it’s about knowing what to say (and what not to)
  - Can’t conduct business for the incidental purpose of benefiting shareholders, with primary purpose of benefits others

Notes, p. 42 – 45

Management of Corporations
- Role of director: provide high-level oversight; don’t interfere w/ day-to-day
  - Hard decision: @ what level do you get involved?
  - Directors have personal exposure; that’s covered by insurance
- Shareholders have no power to elect someone to supervise directors. Charlestown Boot & Shoe Co. v. Dunmore
  - Directors have exclusive authority to oversee management of the firm
  - Shareholders lack the authority to oversee anything, unless the by-laws say otherwise (default rule: 100% of shareholders cannot fire CEO)
  - Shareholders lack authority to make decisions about liquidation, mergers, selling substantially all assets, etc.
- Charter (Articles of Incorporation) and By-laws
  - Board can initiate changes to articles, must be approved by shareholders
  - Shareholders cannot initiate that
  - When it comes to the by-laws (not the constitution, but the statutes)
    - Can be amended by either shareholder or board action
  - So, if you’re representing directors, want stuff in the articles
- Directors like staggered elections; makes it harder to take over company, over course of repeated elections
  - Default is “not staggered”
- Directors will act differently when there’s the threat of shareholder action – less about winning a particular action for the shareholders, more about the threat looming over the board, so they act as you want
- Quorum: # of people necessary @ a meeting for the board to take action
- Proxy: authorization to vote a stockholder’s shares on their behalf
- Dressel
  - Stockholders can call a meeting to express their (nonbonding) opinion on a business matter: “precatory” resolution OK
  - Stockholders who vote on directors (including a group of directors tied to a class of stockholders) have the inherent power to remove them for cause – this is one of those things that stockholders can do
    - Must be service of specific charges, notice, opportunity to meet accusations; but can still do this by proxy
  - Changing the quorum requirements so that a certain # of their directors will always be on the board.
And a class of stockholders that’s empowered to elect (and remove) a block of directors has the power to fill vacancies in those directorships (or can amend the by-laws to give themselves the power to do so).

- “Record date”: if you are a shareholder as of this date, you get to vote
  - If you are a shareholder after this date and want to vote, need to get irrevocable proxy from prior shareholder

- *Campbell v. Loew’s Incorporated*
  - About using proxy machinery to accomplish clients’ objectives
  - Directors, as part of their fiduciary duty, must attend board meetings and participate in corporate democracy; directorship doesn’t (technically) allow for civil disobedience, so if you’re going to miss a meeting to deprive a quorum, you “better be sick.”
  - If empowered to do so by the by-laws, President can call a special meeting of stockholders for any purpose that would be appropriate to stockholder action (like filling vacant directorships), even if they can’t call such a meeting themselves
  - Shareholders have the broad authority to create new directorships (might be in by-laws here) and if they have that authority, they have the corresponding authorities to vacancies resulting from their creation
  - Director can be removed for cause even where there is cumulative voting, even though allowing this could defeat the purpose of cumulative voting
    - Would defeat the purpose because it essentially goes back & re-does the vote with staggering
    - Lack of cooperation, takeover attempts, are not “cause”
    - But a planned scheme of harassment & deliberate obstruction is
  - Same standards from *Auer v. Dressel* – removal for cause – apply when a director attempts to remove a fellow director for cause
    - Matters, like this, for stockholder consideration needn’t be considered w/ the same formality as judicial proceedings
    - Proxies may only be solicited after directors have an opportunity to present their case to stockholders
    - Can’t solicit proxies, get them back, before one side is heard
    - Most efficient way: have both sides included in the same mailing
  - Directors subject to ouster are entitled to shareholder list, I think

- **Cumulative voting:**
  - Straight voting: vote for each directorship independently; for each, vote your # of shares
  - Cumulative: multiply your # of shares by the number of positions on the board; that’s how many votes you get
    - Board gets to break ties – have to watch out for that, as minority
  - Strategic use of shares to get more directorships than otherwise
    - **FIND THE FORMULA FOR THIS; Bullard doesn’t teach it**
    - Example on p. 53 of my notes: 500 votes for 5 directors, 6 candidates (your guy is 6)
      - Who has 500 votes – one shareholder? Or are there 500 total votes available?
- Divide 500 by 6 to tell how many votes you need
  - Is this 500 / (no. of directorships + 1)? Or 500 / (no. of candidates)? Makes a difference
- And this isn’t right anyway, because it’s about what’s the number of shares, if voted against reversal, that will keep someone on the board – not how you divide your votes to get the most people
  - Staggered voting undermines cumulative voting, because the multiplier is the number of positions open at the time you’re voting, and you only vote on that one position
  - REVERSE CUMULATIVE VOTING: IF YOU’RE GETTING REMOVED FOR CAUSE, MAKE SURE THAT THERE ARE ENOUGH VOTES VOTING YOU OUT “FOR CAUSE” AS WOULD HAVE BEEN REQUIRED TO PREVENT YOU FROM GETTING DIRECTORSHIP
    - People who elected you should be the ones to abandon you
    - Example on p. 53 of my notes: 500 votes for 5 directors, 6 candidates (your guy is 6)
      - Who has 500 votes – one shareholder? Or are there 500 total votes available?
    - Divide 500 by 6 to tell how many votes you need
      - Is this 500 / (no. of directorships + 1)? Or 500 / (no. of candidates)? Makes a difference
    - So that’s 83.3 – 84 votes guarantees this guy a board spot.
    - Should be able to retain director if 84 or more votes are cast against removal
- Board responsibilities:
  - 5 meta-functions normally associated w/ directors – p. 153
  - Oversight: over management of corporation, doesn’t require day-to-day managerial involvement
  - Detailed Supervision: of CEO’s compensation
  - Most of the time, dealing with “did they really get into enough detail”
  - Another way to distinguish:
    - Substance of board’s responsibility:
      - Everyone present at meeting, real give & take
    - Process they used to make decisions
      - More formalistic steps to get to decisions
  - Process often frustrates claimants, despite claim that board isn’t living up to substance
- Generally, board meetings must be in person, or over phone (but, need 2 way communication)
  - Exception: when board is unanimous, don’t need to meet & debate
  - Vote must be taken at meeting (again, unless unanimous); deliberative process
  - Can never be sure court will let you off hook for failure to comply w/ technical requirement
- Notice: none required for regular meetings, 2 day default for special meetings (of meeting’s occurrence, not purpose), notice may be waived in writing or by appearance
- Quorum: may be a majority, sometimes supermajority (& for some types of proposals); absolute lowest is 1/3
  - If quorum is fulfilled, vote of all present is act of board
  - Director assents to action unless he records a dissent / abstain
- Much less likely to be held to formalities in a closely-held corporation
- Board can go back and ratify a prior decision that was lacking in formalities
  - Shareholders may also waive the procedural requirements and ratify acts already done
- Formalities may not be necessary when informal conduct has become customary (see Cox bit for getting around formalities)
- Committees – have powers of board in certain types of action(most common types, p. 160):
  - Executive committee: key to overseeing operations of the company
  - Advisory: may contain non-directors (and is the only committee that can)
  - Board committees: made up of directors; authority to act on behalf of board
  - Special litigation committee:
    - Used to decide whether to press derivative suit
    - Ostensibly independent, but picked by the board, which is not
    - Comes back with advice not to prosecute, and lo and behold…
  - Compensation committee
  - Special internal investigations
    - To stave off SEC review, hire someone who will give you ostensibly independent review
  - Audit committee:
    - All must be “financially literate,” one must be “financial expert”
    - Responsible for reviewing audits & audit processes
    - Only applies to reporting companies; incentive to “go private”
- Inside vs. outside directors:
  - Inside = directors who are also corporate officers
  - NYSE: majority of directors in listed co.s must be outsiders
  - Sa-Ox: majority of directors on audit committee must be independent, outside
- Directors’ informal rights:
  - Some jurisdictions: directors have absolute rights to review information, even when they’re acting on behalf of competitor
  - Others: allow restrictions on director access when director purpose is hostile to or threatens a corporate interest; director must act in good faith & can’t use inspection right for purposes that conflict w/ fiduciary relationship to shareholders
  - In other contexts (Delaware) –allow unlimited review power but hold director personally liable for improper use of information

Notes, p. 45 – 57
The Duty of Care

- Directors’ duties: these are owed ONLY to the shareholders, not to other constituencies
- “Duty of Care” = failure to protect shareholders from harm that efficient monitoring could have prevented
- With the understanding that risk involves loss, and there are losses that we don’t want to hold directors accountable for, when will we hold them accountable?
  - Definitely when the expected return on the loss is less than investing in treasuries (i.e., taking no risk)
  - Line is somewhere between that, and the risks we want them to take
- Expect high level of oversight
  - Some problems do not lend themselves to business judgment rule – like, if you knew that someone was stealing; have to see if the procedure supplied red flags
  - Procedures must be reasonably designed to protect co. from risk, and steps must be taken to make sure procedures were working
  - Or, if there’s independently a red flag, then that should prompt new procedure or search for answer
- When will we second guess the directors?
  - Is it about whether the board followed necessary procedures to protect decision? Or analysis of the substantive decision, dressed up in procedure?
- Bates v. Dresser
  - Directors get off for a bank employee stealing essentially all the deposits
    - Reports of assets and liabilities being recorded properly, even gov’t examiner checks and says they’re OK
    - Gov’t comes in and performs oversight, “the pros check it out,” that will be a factor in insulating the directors.
    - Or if the fraud (or whatever else) is a completely new way of doing it, doesn’t raise red flags
    - And on the procedure side, it would be cost-prohibitive to impose procedures that would get at those frauds
    - If the standards are set in the by-laws, you have to follow them, and are probably per se negligent for not following – even if your rules are higher than the prevailing standard
    - Can delegate an investigation, but have to follow through
  - President does not get off – was more intimately associated, got more hints
- Barnes v. Andrews
  - Director has a duty to keep apprised of the affairs of corp.
    - Includes going to board meetings, or having a good excuse
    - And if you’re not going, investigate – don’t just talk to one guy
  - But, have to prove that the damage to the company occurred because of this; hard to do with inattentiveness (like, co. fails for unrelated reasons)
- Shlensky v. Wrigley (lights on Wrigley field.)
Business judgment rule: judgment of directors enjoys the presumption that it was formed in good faith & designed to promote the best interests of the company
  - Fraud can rebut; allegation of fraud will get you past motion to dismiss
  - Don’t want to second-guess Wrigley; possible that not installing lights was a rational business decision (costs of installation & elec., bad relationship w/ neighborhood, would worsen area)
  - Might second-guess the director if there were better proof that the corp. would have made money
  - Don’t really know the point at which court will start to second-guess the director; when enough facts of “bad decision” pile up to “bad faith”

- Smith v. Van Gorkum – the big business judgment case
  - Before WorldCom and Enron, the only real case where it was a close call & directors lost
  - Is business judgment available – is this mistake protected?

Structural aspects of the transaction:
  - Setting up new subsidiary so that you can have multiple layers of limited liability
  - Van Gorkum is undiversified; likely to be susceptible to a shark like Pritzker
  - Tender offer vs. board voting on merger:
    - Tender offer: 2 part process, & have to make the offer to all shareholders, who decide whether to tender stock
    - Generally, get a better deal cooperating w/ board
  - Have a termination fee based on the research he’s already put in (if another co. steps in and buys)
    - Not reasonable to tie termination fees to ultimate price
  - Treasury stock – to make it more expensive for another to come in and purchase
  - Control premium = amount you pay for control, over and above market price for a single share

Source of $55:
  - Figure out the cost of acquisition at different share prices
  - Start with the amount that Pritzker is willing to put in
  - Ask how much it will cost to service the remaining debt, at what interest rate
  - Then, take the amount of profit the company turns; use that to calculate the share price
  - Not meant to be a valuation of the intrinsic value

- Not evaluating whether $55 is a fair price, but whether it was an informed business decision & subject to protection of the business judgment rule
  - So case is not about demand for top price
  - And if $55 was the best deal they could get, no damages

Once business judgment rule is stripped away, the issue won’t be litigated
If there are several stages of a transaction, can apply the business judgment rule to each & ask whether they are entitled to its protection @ one, whether they cured the mistake at the next
o 3 stages of this transaction (may not be right):
  - Initial stage
  - October 8 – push back shareholder meeting
  - Shareholder approval?

What made this decision especially uninformed:
  - Board acknowledges that market price was undervalued
  - Didn’t get outside opinion on price from investment banker
  - Outside counsel was unhelpful: lawsuit risk if you don’t take this
  - Board had very short time to make decision
  - Bound to accept this offer unless another came along; Could not solicit offers (bad way to find competing offers) – lockup provisions
  - Press release describing deal as “definitive”
  - Pushing back the time for the shareholder meeting actually shortens time for consideration (proxy solicitation timeframe)
  - Then, locked into either breaching the agreement (by not recommending this to shareholders) or going forward with uninformed decision

Even though you technically have shareholder approval, it doesn’t work; if the board is not informed enough, unlikely that the shareholders will be informed

About how to paper the file appropriately

Can sometimes do a much better job making your defense as an independent director, rather than “getting in bed” with the offender
  - If they’re all taking the same position, treat them as one for the purposes of the business judgment rule

- Eisner v. Ovitz
  o Executive compensation is one of the “micro” decisions that directors are responsible for
  o Board members only have to consider material facts that are reasonably available in making their decisions
    - They did fail to look at one factor, but that was not enough to overcome presumption
  o To survive motion to dismiss, complaint would have to allege:
    - Non-reliance on expert, bad faith, didn’t believe expert was competent to render advice, outside his specialty, faulty expert selection process attributable to directors
  o Barring such factors, reliance on expert will probably allow the business judgment presumption to apply

- Emerald Partners v. Berlin
  o Directors can be exempted from duty of due car by a by-law provision
    - Statutory response to Van Gorkum
  o But at the same time, can’t exempt directors from the duty of loyalty
And if you’re suing a corporation w/ such an exemption for violation of duty of loyalty, then that gets around summary judgment; exculpatory provision only applies to alleged duty of care violations

- So, if the corporation has one of these clauses, always allege a violation of the duty of loyalty
- Also, courts are the last interpreters of the statute, and they won’t agree to NEVER holding directors liable for breach of duty of care (i.e bad faith)

pp. 57 – 70

The Duty of Loyalty
- 3 types of cases in which duty of loyalty arises
  - Taking property from the corporation: either money (Marciano; deal in Globe Wooden) or the use of some property (clubs in PGA)
  - Globe Wooden v. Utica Gas & Electric: contract made in breach of duty is loyalty is voidable
    - Guy sat on boards of 2 companies, used the one to act as supplier of the other (where he owned most of the assets)
    - The director not voting is not enough to protect the transaction (but it helps in the analysis)
    - Doesn’t inform company of the detrimental parts of this deal
  - To get out of this, transactions are not voidable if (Cox reading):
    - Rely on intrinsic fairness; not a good option
    - Ratification (after the fact) / approval (before) by shareholders
      - Must be obtained through a fully-informed basis
    - Ratification / approval by the independent members of the board
      - Must be obtained on a fully-informed basis
      - Easiest method
      - Need a majority; makes a difference whether you count the chairs of the non-independent directors or not (4 disqualify themselves, 3 vote yes: 3 of 3 vs. 3 of 7)
    - In some jurisdictions, compliance with this puts the burden back on the stockholder. In others, it prevents further analysis, period.
- Transactions between corporations with common directors are not per se voidable. They’re suspicious, but if the transaction is intrinsically fair, then it will stand. Marciano
  - There was a statutory state harbor that did not apply, but the “intrinsic fairness” test is always available
  - Loan terms compare favorably with other lenders
  - Loan was bona fide, made with intention of keeping the debtor company afloat (& not of milking it)
- Gilder v. PGA Tour
  - Player-directors had to vote for rule change; they abstained
- Could have amended the by-law rules before the lawsuit to allow a majority of disinterested directors (w/ the interested directors’ seats not counting) to approve a rule change
- But, cannot amend in the middle of a conflict to moot the suit
  - How much time must pass before you can amend by-laws?
- As a general matter, any law that only allows board to vote under certain circumstance (“these directors must vote”) will be problematic and should be something to be avoided
- *Guff v. Loft*: taking a corporate opportunity, what makes something a corporate opportunity – PepsiCola guy
  - “In the line of business” test
    - Whether it’s what the company was doing before, if they had an interest or expectancy in it
    - Pretty flexible meaning
  - Bottom of p. 243, discussion of what the court is looking for
    - If a corporation is engaged in a certain business, and an opportunity is presented to it of which it has knowledge, practical experience, ability to pursue, which is adaptable to its business (w/ regard to financial position), one consonant to reasonable needs & aspirations for expansion – that is w/in the line
  - Right to appropriate the opportunity depend on circumstances @ time of presentation, & not subsequent events
  - Test is how closely associated the opportunity is with the existing business activities of the corporation
    - Zone of interest for the corp. to seize on opportunities regardless of how the director received it
  - Does “essential to the corporation” mean something different than “in the corporation’s interest or expectancy
  - Remedial device: constructive trust
  - Corporate officer or director is free to engage in independent competitive business, so long as he violates no legal or moral duty in doing so.
- When taking corporate opportunities is fair:
  - Corporation first rejects the opportunity, and one of the following
    - Rejection is fair
    - Rejected in advance, following disclosure, by disinterested director, in a way that satisfies the business judgment rule
    - Rejection is authorized or ratified, following such disclosure, by disinterested shareholders; rejection is not a waste of corporate assets
  - Definition of corporate opportunity, p. 249
    - Offer made & director should reasonably believe that the offeror expects it to be offered to the corporation
    - Through the use of corporate information or property, if director should reasonably believe that the corp. would be interested
Any information of which director becomes aware & knows is closely related to the business in which corporation engages or expects to engage

- *Meisland* case (notes)
  - 3 types of business opportunities
    - Is not one, if it’s extraneous to corporate business
    - If it’s in “the same or direct line”
    - If it’s “complimentary” (vertical integration)

- *Lincoln Stores, Inc. v. Grant*
  - Directors can enter into business in competition with the corporation
  - No duty violated in acquisition (b/c company decided not to expand?)
    - But still, that decision was 5 years prior …
    - Didn’t bring it to their attention here, court says that’s OK
  - But, wrong to use the one corporation’s information in competition with it, when you’re a director (like inventory lists)
    - But, you can bring with you the knowledge that you gain – transferable skills, general understanding of how the business works, etc.
    - Bullard would look at the intrinsic nature of the thing taken
    - Might also matter who is competing, to see what knowledge they should have as part of their job (CEO vs. stocker)

- *Duane Jones Co. v. Burke*
  - Can’t call clients in advance, with intent to compete, and tell them that you’re leaving the company
  - If you’re going to do this, make it subtle
  - To be safe, have to leave before you contact clients about this
  - Can’t contact current accounts and tell them what you’re thinking of doing
    - Might be essential to the business
  - Can’t do this with prospects
    - Have expectancy / interest in those
  - What if it’s not someone on their list?
  - If you’re going to send out a general solicitation (phone book), have to cull current clients
  - If you were going to another business, and THAT business solicited on your behalf, that’s a tort – tortious interference with business

- *Rogers v. Hill*
  - Lawsuit for excessive compensation – waste of the corporate assets.
  - Amounts are so large that they’ll be subject to examination – can’t give away corporate property; payments & salaries can’t be “spoliation” or waste
  - Compensation provisions by how profitable the company is – now it’s too profitable, they’re getting too much. Compensation provision was OK when the by-law was adopted, but the measure of compensation is inequitable now

pp. 70 – 81
Derivative Actions and Indemnification of Ds & Os

- You, the shareholder, are deriving your right to bring the case from some other source of authority, based on the principle that the person harmed brings the case
  o Corporation is harmed, and your shares worth less
  o You get to bring the case if you, as a shareholder, suffers the same loss as all of the other shareholders, b/c of harm to the corporation
  o Corporations have tons of shareholders, are better situated to know the facts & bring the case than shareholders, plus these are the sorts of decisions that the directors are responsible for
  o Allow claims because of conflict of interest – don’t want to leave the “do we sue” decision in the directors’ hands

- Other than derivative suit, could remedy these problems by voting directors out, or selling shares (vote w/ feet)

- If only one class is harmed, can bring the suit on behalf of that class of shareholders

- Procedures for derivative claim:
  o Must first make a demand on the corporation, “sue this director”
    ▪ Futility: don’t have to do this if it would be futile to do so; depends on how many board votes needed to authorize suit, or whether management can do it
    ▪ Explain what the demand was, response to it, & why futile
  o Ensure that P was shareholder @ time of transaction, or acquired shares through some legal action (i.e., inherit them; probably acquisition through merger doesn’t count)
  o Make sure action confers jurisdiction on a US court
  o Alleging w/ particularity that the directors voted for this action contrary to co.’s best interests
  o P must be fair & accurate representative

- Pp. 775-76, lists what is “individual” and what can be basis for deriv. suit

- When can you pierce the “business judgment” shield normally applied to the special litigation committee’s activity (i.e., the committee decides not to press the suit)? Alford v. Shaw. 3 approaches:
  o Auerbach: business judgment applies to special lit. committee, ordinarily precluding judicial review (except for good faith, independence, & sufficiency of investigation).
  o Miller: Directors charged with misconduct are prohibited from participating in the selection of the special lit. committee, otherwise Auerbach
  o Zapata: 2 part inquiry:
    ▪ Investigation into good faith, independence, sufficiency of investigation; corp. has burden of proof
    ▪ To safeguard against structural bias, additional level of scrutiny @ which courts may exercise their own business judgment.
  o Court adopted a “modified” Zapata rule, which is actually not different from the above
What is gained by such an approach, and how are the 2 steps separate?

- General approach is Auerbach
  - Allegations of an illegal act by the board of directors is sufficient to sustain a shareholder’s derivative suit. Miller v. AT&T
    - But mere failure to collect on a debt owed the corporation is insufficient; that falls w/in business judgment rule
    - This was a corporate waste case
    - Court lays out what P will have to prove: 1) made a contribution of money or anything of value to DNC, 2) in connection w/ federal election, 3) for the purpose of influencing that election

- Merritt-Chapman & Scott v. Wolfson
  - Corporation may indemnify any director / employee for costs reasonably incurred in a suit, if the person acted in good faith & in a manner believed to be in the best interests of the corporation.
  - Indemnified to the extent successful on the merits; partial indemnification for partial success. Settlements. do not prevent indemnification
  - Any result other than a conviction (or plea?) counts as success in criminal law – although it can’t be used as an admission in another conviction, nolo operates as a conviction

- D&O liability & insurance
  - Huge spike – 40 securities class-actions since 2000 that have settled above $100 mil
  - Race from plaintiff’s firms to be the first to file class action
  - 3 benchmark developments leading to the spike:
    - No longer necessary to prove intent to deceive; recklessness sufficient (had to have fraud before)
    - Also before, had to have every member of class seeing & relying on the misrepresentation
      - Now, if info is disseminated into the market place, have assumption that the market reflects that information
    - Private Claims Reform Act: designed to help directors, led to worse environment
  - Compared to shareholder derivative suit:
    - Damages are far, far less in derivative suits – don’t have damages in the amount of (loss stock price) x (# of stockholders), but “loss to the company”
    - But, in derivative suits, company can’t indemnify directors (co. will indemnify directors in securities class actions, above what insurance covers)
  - D&O insurance:
    - Now directors are proportionately liable, rather than joint&several
    - Enron & WorldCom – directors had to pay a good chunk out-of-pocket
      - But that was at best a slap on the hand for Enron; insurance was consumed down so they had to pay some
- WorldCom; the guys agreed to pay a certain % (20) of their net worth
  - Probably won’t see forcing individuals to pay in any but the most extreme cases.
    - In securities action:
      - Co’s price going up, inflated under false pretenses
      - When announcement, “correction” is made, price plummets
      - Most of the time, institutional investors on both the good and the bad end; but law does not provide from symmetric recoveries – people on bottom don’t recover from those on top unless they fall w/in definition of dealer, underwriter, issuer of stock under SEC law
      - Instead, people on bottom can (maybe) recover from company.

- Pp. 84-91, Follow-up to Bailey, pp. 94-95 (wraparound)

**Corporate Democracy – State Law**

- Conceptualize this as another tool for corporate monitoring
- Stock increasingly & largely owned by institutional investors (funds) who vote proxies in favor of management
- 3 types of control:
  - Majority control: one investor has 35% or more of stock
  - Management control
    - Largest block of stock not over 5-10%
    - B/c management controls proxy machinery, they have almost complete control of company
  - Minority control
    - Single shareholder controls 10-35% of stock
    - If this shareholder is not participating in management, then control will be shared, b/c either could win a proxy fight
- A shareholder measure getting a minority (say 15%) as a “shot across the bow”
- Cumulative voting formula
  - To see how many votes is sufficient to elect a # of directors:
    - X = (a+b)/(c+1) + 1
    - A = # of directors that the shareholder seeks to elect
    - B = # of shares present and voting
    - C = number of directors being elected
    - X = # of shares necessary to elect “a” number of directors
  - To see how many directors you can elect with a given set of shares:
    - X = [(n-1)(d+1)]/s
    - N = number of shares to be voted
    - D = # of directors to be elected
    - S = total # of shares to be voted by all shareholders
    - X is # of directors that can be elected with “n” shares
- Varying shareholder rights
- Articles of incorporation may authorize stock with varying (or with no) voting rights; and with varying dividend and other rights
- Weighted voting (one class gets 2x or 10x vote per share)
- Class voting: some classes may have ability to vote on certain matters (election of directors, common vs. preferred) or elect a certain block of directors (class A directors vs. class B directors)
- Contingent voting rights to certain classes, or to debt securities
- Today, can have non-voting common stock, but the Articles have to so state. Non-voting shares are entitled to vote on matters that affect them as a class.

- **Lacos Land Co. v. Arden Group**
  - Shareholder vote must satisfy the requirement of shareholder consent
  - Shareholders do not consent when a CEO says “I will block any measure unless you give me X” (here, X was a class of stock that gave control)
  - Shareholder consent is lacking even if this was not a breach of the duty of loyalty
    - Might have been a breach – trying to lock down perks & salary
    - Or, might not have been – trying to protect co. from hostile takeover
  - It is generally ok for shareholders to give up voting control for a lump-sum dividend, or to give up voting authority to prevent takeover
  - This case might really be about how he presented this idea to the shareholders; no problem with the substantive pitch (if interpreted the right way)

- Now, once you’re being offered on an exchange, cannot have dual classes of shares
  - Of course can do this before you go public
  - And this only applies to dual classes of common stock

- Some formalities (pp. 278-80):
  - Annual meeting must be held (can have special meetings, additionally)
  - Held at time & place fixed by bylaws; notice required (and more notice required for special meetings); notice requirements vary
  - Notice of meetings given to all shareholders of record; record dates (70 days under MBCA, 10-60 under Delaware)
  - Quorum requirements: generally majority (Delaware allows as low as 1/3); usually it’s a majority of those voting (not a majority of shares), so abstention disenfranchises
    - Exception: amendments to articles, mergers, share exchanges

- **Schnell v. Chris-Craft Industries**
  - Advancing the date of the shareholder meeting, in the midst of a proxy contest, is impermissible (especially when you think of all the steps you have to go through during the contest)
  - Normally, this is within management power, but here exercised for an inequitable purpose (to perpetuate themselves in office) and to alter the specific vote

- **Pillsbury v. Honeywell**
A shareholder may demand the corporation’s shareholder list, but to force them to turn it over, he must have a proper purpose germaine to his interests as a shareholder.

That means economic purpose; not persuading the corporation to adopt your social views (no war munitions, for ex.)

Like with ultra vires, it’s about how you dress things up – ex: economic consequences to doing business in Angola (sanctions, etc.)

Burden on corp. to disprove proper purpose for shareholder seeking shareholder list, but on shareholder to show proper purpose when seeking other documents.

Also keep in mind federal vs. state tension

- Fed gov’t limited to seeking disclosure of information, but will use this to attain substantive objective (SEC)
- To limit federal influence, state courts want to uphold higher disclosure under state law; balances “race to the bottom”

 Campbell v. Loew’s (again)

- Have a situation where one faction has a majority of directors but the other faction is running the company; neither can get a quorum
- Making up rules because we don’t know what “the board” is
- Can’t treat document requests from another faction of directors as if they’re just shareholders
  - Don’t have to show proper purpose, they’re entitled to it as directors (and as entitled to it as managing, minority directors)
- One group entitled to represent to shareholders that they are “management,” the other that they are the “majority”; but “management” can’t represent that it’s the “majority” and vice versa
- Managing faction entitled to use corporate funds in solicitation of proxies; can’t use corporate facilities or employees in connection with solicitation
  - This is because of fears of divisiveness

 Rosenfeld v. Fairchild Engine & Airplane Corp.

- Reimbursement of losing director’s expenses: OK for a contest over policy, but not for a contest for “personal power”
- How can you tell? And when can a director not articulate a policy reason?
- Protect them by offering reimbursement because we want them to act in the best interest of the company, and fight proxy battles when they should
- Also reimburse winning incumbents, obviously
- Reimburse winning, but not losing, challengers (can’t claim that they’re representing co.’s best interests) – for reasonable and bona fide expense incurred in any such policy contest, subject to like scrutiny.
- In contest over policy corporate directors have right to make reasonable & proper expenditures from corporate treasury to 1) argue their position, and 2) to solicit proxy support – when they believe in good faith that their policies are in best interest of corporation.
  - Of course, a lawsuit could raise the question of whether an expense was for a corporate purpose, if the expense is not “reasonable and proper”
  - Claim that vote-buying led to fraudulent shareholder vote
  - But the last-minute nature of the thing, the misunderstanding about how the bank was going to vote its shares, and scrambling to set up a meeting with the bank was not vote buying
  - No proof that HP threatened Deutsche Bank that it would withhold business if the shares weren’t voted properly, or that it would send business if they were voted properly.

PP. 91 – 98

**Closely Held Corporations**

- Typically, minority stockholder in such corporation has a large % of his assets invested there

  - Close corporation is:
    - Small number of stockholders
    - No ready market for the corporate stock
    - Substantial majority stockholder participation in management, direction, & operations of corporation
  - Very similar to a partnership!
  - Majority can engage in “freeze-outs” which force minority to deal with majority (to sell their shares) at inadequate prices; special vulnerability that leads to heightened duty; can’t sell your shares
  - How do we apply the business judgment rule in this context?
    - Will be subject to a higher duty for decisions not to pay dividends, not to extend opportunity for corporate stock buyback
  - Advantage of selling to corporation rather than to the kids: the corporation pays for it (someone else picks up % of the tab)
  - Old man Rodd thinks that the threat is Donahue, but the real threat is the 3 kids
    - Important to keep an eye on # of shares, see who will have voting control
    - If the kids had 2 shares less each, Donahue could team up with any 1 to take over; as it’s structured, 2 kids need to ally for control
  - Stockholders in such context owe each other a “duty of strict good faith,” similar to duties owed by partners to each other; somehow contrasted to fiduciary duty as “less rigorous,” but it sounds the same to me
    - NOTES DESCRIBE THIS AS FIDUCIARY DUTY
  - Corporation can enter into agreement to reacquire its shares, but this agreement must be entered into in utmost good faith & without prejudice to other shareholders
    - A regular corporation could repurchase stock w/o offering to other creditors (say, 1%) in a way that wouldn’t be bad faith or prejudicial; do this on the market
- But here, must cause corporation to offer equal opportunity to sell shares at an identical price
- Duties are owed to stockholders as stockholders
  - Treat Rodd family as a single controlling group, based on the evidence
  - Donahue must get the same offer (for corp. buying up stock) given to papa Rodd
  - *Meiselman v. Meiselman*
    - Court can force dissolution of a closely-held corporation when liquidation is reasonably necessary for the protection of those rights or interests of the complaining shareholder
    - Have to see whether one shareholder engaged in oppressive conduct w/ respect to other shareholders, or are treating the other shareholders unfairly
    - Meant to protect the shareholder who can’t get out
    - Have to assess what the minority shareholder’s reasonable expectations are
    - These “shareholder rights” are not necessarily narrowly defined in a closely held corporation (“narrowly defined” would be if they were confined to right to notice, right to vote, right to dividends, etc.)
    - This case: one brother cut out the other brother (who was working hard, and was the less favored son)
- *Ringling v. Ringling Bros.-Barnum & Bailey*
  - Pooling agreements
    - Agreements and combinations on how to vote stock are OK
    - Voting can be separated from ownership; shareholders may confer voting rights on others
      - Traditionally, courts had a problem with this
    - Different from a voting trust where people retain beneficial ownership and pool absolute voting right in a 3rd party; in a pool, everyone votes their own shares (unless they disagree)
      - This is OK too – and more formal
      - If you have a voting agreement, you’ll be suing; but if you’ve got a voting trust, are defending – and it’s better to be on the defensive
      - Much more deference given to these
    - Only reason to enter into a pooling agreement, rather than to have a series of individual agreements, is to force other shareholders to conform to your will
    - A person chosen as an arbitor by all the shareholders in the pool can obviously vote in the best interests of the corporation
      - Arbitor does not have legal title; people can vote against his instruction
    - Can enforce these agreements by specific performance, but might also just call for a re-do of the election
- *Ringling Bros. v. Ringling*
On appeal, decides not to hold a new election, but instead not to count the violator’s shares in the previous election – but this undermines what the other member of the pool was trying to accomplish! Gives North control of the board.

Because this will lead to vacancies, and the majority of the board (which after the invalidation, is held by North) gets to fill vacancies

Notes pp. 98 – 105

Controlling Shareholders

- Have parents forcing subsidiaries to take action or do something, and ask “are parents forcing subsidiaries to do something to the detriment of other shareholders, such that the business judgment rule will not apply?”
  - Justified because majority can essentially “become the corporation” (like directors?)
- These cases are not about when 60% shareholder takes 70% of dividends – it’s when he takes 60% of dividends and there’s still some unfairness to remaining 40%
- Majority shareholders have a right to the control premium
  - Have an intervening board that may frustrate ability to have control, which gets to decide what is done on the interests of all the shareholders
  - Moreover, they’re not supposed to fill your designs to power!
  - Does that mean that control premium is intrinsically tied to the votes? Or maybe it does really belong to corporation
- Unlike the “closely-held corporations,” which are always evaluated with an eye toward intrinsic fairness, the “majority shareholder” transactions have another hurdle before overcoming business judgment
  - In some cases (below), described as “benefit to the detriment”
- Can look at these cases as establishing procedural hurdles
- Or, can look at these as a big mess of facts that all go to “how fair was the transaction”
- Courts at least think that they’re doing a 2-part analysis
- **Sinclair v. Levin**
  - Majority shareholders owe the company a fiduciary duty, but there must also be self-dealing or bad faith to get around the business judgment presumption and invoke the intrinsic fairness standard
  - Have self-dealing when majority shareholders receive a benefit to the detriment (or exclusion) of the minority shareholders
  - Detriment has to be connected to the benefit, and vice versa
  - Parent oil company that is making a subsidiary pay out a lot of dividends, and also causing it to contract with another subsidiary
  - Here, the high amount of dividends is fair – they aren’t getting anything that the minority shareholders fail to get
    - So, the business judgment presumption applies
    - “Waste” argument made then, but gains no traction
But the contract between the two subsidiaries was – because the parent received something from the transaction that the minority shareholders did not.

- **Parent owned all of the 2nd subsidiary, so it would gain all of that benefit**

- **Grinnell (note)**
  - Company, knowing that it would have to sell stock, paid out dividends before selling so that it could get maximum value (sell the discounted thing at the least possible price)
  - Doesn’t satisfy the “benefit to the detriment” test, which would allow piercing
  - But then asks whether this is intrinsically fair!
    - Fiduciary obligation (to protect corp) might be in conflict with the contractual right to dividends
    - But on the other hand, hard to say “you shouldn’t have paid investors all that $$”
  - But paying out dividends for no purpose but to benefit yourselves might be bad faith

- **Zahn v. Transamerica Corp.**
  - When a majority shareholder exercises control (is not passive), that shareholder has a fiduciary duty to the minority shareholder (company as a whole?)
    - Notes from later: The majority shareholder does not have the fiduciary duty, as a shareholder, to vote shares in the best interests of the corporation
  - Majority shareholder must prove good faith & intrinsic fairness in their dealings with the corporation (does this presume self-dealing)?
  - Difference btw stockholder voting as stockholder & voting as director
    - When voting as stockholder, can vote w/ view to own benefits
    - But voting as director, he represents all the stockholders & cannot
  - A shares are “callable” – can call, & redeem them at a specified price
    - So if the value of the shares goes up to $70, you buy them back at $60 – then all of the other shareholders have more valuable shares, but the A shareholders are disadvantaged
  - A shares have the right to “convert” to B shares
    - Incentive to convert if the price goes above the call price
  - But, liquidation preference for A shares – get $2 for every $1 to B shares
  - Have an asset that’s gone up dramatically in price, and it’s better for the majority owners (all “B”) to either call or have As convert (in that order)
  - You have to tell the A shareholders the information about the increased asset price, but do not need to tell them that it’s in their best interests to convert
    - Affirmative obligation to disclose, in addition to obligation not to lie
    - They’re on their own to crunch the numbers
- Remedy here is not to let them get the twofer (since that wouldn’t have happened), but to let them get the onefer (since they would have all converted)

  - *Jones v. H.F. Ahmanson & Co.*
    - Where no market exists for stock in a company, controlling shareholders may not use power to control corporation for the purpose of promoting a marketing scheme that benefits themselves alone to the detriment of the minority.
      - Problem: too few stocks
      - Also, might not be able to sell as much as they want and retain control – if they own 85% of a corporation, can only sell 34% - but can sell 49% of a parent corporation and still own 85% of the sub!
    - I.e., a holding company with a lot more stock
    - Must either split the stock to create a market, or create a holding company and allow all to get in on it
    - Once stock in the parent was available, no market for shares of the subsidiary – this hurt the minority
    - @ trial, can produce evidence of good faith or intrinsic fairness that would allow the transaction to hold up.
    - Not clear here how the detriment of shareholders is connected to shareholder benefit
      - Minority doesn’t have anything less than what it had before
      - But, you have to bring them along to share the wealth created by a market in non-controlling shares
    - Seems that Traynor mixes “intrinsic fairness” with “benefit to the detriment of”

- For exam: think about it in terms of there being 10 shareholders, each of whom own 10% of the shares – 5 get together and form the same controlling block as in case
  - Any 1 has same authority as other – only get control by banding together as 5
  - Have they picked up any kind of duty to the others simply by banning together? Do they now have control premium? Etc.
  - Have they denied access to minority shareholders?

- Also think about: how is this related to *Donahue*?
  - Have majority shareholder in closely-held context, is required to provide same offer to minority shareholders
  - Does that make sense in the larger context?
  - Does it make sense to prevent buying out a senior person at the higher price, if it makes good business sense?

- **Transfer of Corporate Control and Duties of Controlling Shareholders (Hazen)**
  - About who owns (and who should own) control premium

- **Zetlin v. Hanson Holdings, Inc.**
  - A controlling stockholder is free to sell, and a purchaser is free to buy, controlling interest at a premium price; except in cases of looting, sales of
a corporate office, sales of corporate assets, conversion of a corporate opportunity, fraud, other acts of bad faith.

- When you think there might be a risk of looting, have a duty to investigate
  - But, no duty to investigate bad managers
  - If you inquire, and you get a good business explanation for the premium, can probably use that as defense

- Easy looting case (not this one, a hypo): company has $100 mil of assets, all in liquid securities
  - Majority shareholder has 51%; someone offers 60% for the $51 mil
  - More complicated looting question: you buy controlling interest in my company, which sells widgets. Before the purchase, you were buying widgets at 50% profit margin. After purchase, you were buying widgets at cost.
    - Are you supposed to investigate their purchase to the extent that you’ll ask them if they’ll maintain the same profit margins? They’ll say that maybe demand will decrease, maybe competitors will enter the market

  - **Gerdes v. Reynolds**
    - Demanding control in advance of payment is fishy; can be breach of majority shareholder / directors’ duty to hand over control when a big chunk of purchase price remains unpaid
    - Price was also grossly excessive
    - Purchasers of majority control do have the right to elect directors; directors do have the right to resign, but …
    - Here, was a breach to resign en masse and use power as directors to enact a new slate preferential to the purchasers, esp. in light of other circumstances

  - **But, Essex Universal Corp. v. Yates**
    - A provision for transfer of management control by en masse resignation and replacement by new majority shareholder doesn’t make a contract for the sale of majority (or effectual majority) control per se a breach of duty.
    - Need to have the other factors

- Determining when you have majority control; 3% case in the notes: 3 approaches
  - If you can negotiate for turning over the board, you have control
  - Control is 51%, anything less needs to be left to democratic process
  - Split the baby: Assume 51% = control, but it may be different based on facts & circumstances

Pp. 105-115

**Publically Traded Stocks – SEC Regulation**

- **Schedule 14a** – has disclosure requirements for proxy solicitations, pp. 442-44
  - Must contain date that proxy was solicited, deadline for shareholder proposals to appear in next solicitation, whether & how proxies are revocable, disclosures of director interest
- List company’s voting securities and the principal holders thereof; nominees (to directorship)’s relation to affiliated co.s & interest in issuer’s activities
- Compensation of executives, comparison chart, compensation committee’s criteria for making these decisions
- Must have ability to vote for or against proposals, abstain
- Also requirements as to typeface, # to be filed w/ SEC

- Sadler v. NCR Corp.
  - CEDE list: lists of shareholder of record (most of the time this will be brokerage firm, holding stocks in their street name)
  - NOBO list: Non-Objecting Beneficial Owners – those holding stocks through brokerage firms who don’t object to disclosure of IDs
  - Have to own a certain % of stock for certain length of time (5% for 6 mo.) and then you can get these lists as a matter of right
  - Fairly liberal approach to shareholder access to information
  - Very liberal interpretation of “agency” – AT&T did not need to be Sadler’s agent under agency law (or vice versa)
    - Once the shareholder demands the list, compliance with the law is assumed, & it’s up to the opposing corporation to show bad faith
  - Another issue: NOBO list doesn’t exist; court demands that it be created

- Treatise on the law of securities regulation (Hazan)

- Long Island Lighting Co. v. Barbash
  - Law will be construed liberally to apply to & regulate speech that we would ordinarily think of as political & protected by 1st amendment
  - Here, “misleading” political campaign through the NY Times, that speech becomes regulated b/c there’s a proxy solicitation going on.

- Schedule 14a-8
  - If a shareholder gives timely notice to management of intent to present a proposal for action @ forthcoming meeting:
    - Management must include proposal + supporting statement of no more than 500 words
    - Must afford shareholders an opportunity to vote for or against the proposal in management’s proxy
  - Management may exclude the proposal from the proxy if (all 3):
    - Proposal relates to operations accounting for < 5% of total assets
    - Same, but for < 5% of net earnings & gross sales
    - Is not “otherwise significantly related to issuer’s business”
      - This is a non-economic test, can encompass social issues
      - But, for legal purposes, should be related to the company’s bottom-line to be successful (so, economic test) – is the bottom line argument necessary? Maybe not necessary, but helpful
  - Pp. 458-63, 14a-8(i), other reasons for exclusion – the above “relevance” standard is #5
    - Impropriety under (state) corporate law
    - Violation of law, generally.
Contrary to SEC proxy rules
Redress of a personal claim or grievance
Relevance
Beyond co.’s power to effectuate
Ordinary business operations
Relating to election to office – shareholders must do their own solicitation
Contradicting management proposal
Mootness
Duplication
Resubmissions

- Process for exclusion:
  - Submit a proposed proxy statement, asking for the SEC’s input
  - They give feedback, issue “no action letter” (we will not take action against you based on X), but no formal statement
  - Doesn’t bar suits, but would be weird for SEC to sue you (and of course, no-action letter doesn’t afford as much protection from private claimant)

- A proposal to ban the force-feeding of ducks was counted as an “otherwise significantly related” social issue. *Lovenheim v. Iroquois Brands, Ltd.*
  - Meaning of “significantly related” not limited to econ
    - But as a practical matter, will want to tie it up

- Proposal to provide same-sex benefits to couples. *Cracker Barrel*
  - On an issue as controversial as this, could impact the co.’s bottom line either way
  - What “being a good corporate citizen” means depends on politics of person
  - General trend of SEC is to allow more of these in.

- SEC rules only have to pass the test of being important to public interest. *Trans-America*
  - An attempt to block a shareholder proposal through restrictive interpretation of a by-law was trumped by 14(a)-8

- Is there any limit to the SEC’s ability to decide that a day-to-day management issue can be the subject of a shareholder proposal?
  - Is a line to be drawn btw what is a day-to-day management issue and what is not
  - SEC probably cannot force a company to include a proposal about having coffee in the mornings, but what about executive compensation or benefits? Is this a “day-to-day” management issue? One that the SEC can interfere with?
  - 2 mushy areas:
    - What is the nature of the significant relationship of the social policy to the company’s business?
    - What is the authority of the SEC to regulate traditional state law principles – how does that comport with their authority? Especially w/ regard to federalism
- Theory of the Firm, Jensen and Meckling
  o If a manager owns a firm 100%, he will make decisions that maximize his efficiency, in terms of perks vs. what he’s gaining from the value of the firm
  o If he no longer owns 100%, interests diverge:
    ▪ Will appropriate more perks (nonpecuniary benefits), $1.00 > $0.95
    ▪ Will have less incentive to creativity
  o Moral hazard here b/c you’re playing with someone else’s money, someone else pays (part of) the cost for your actions
  o Reduces the value of the firm; outside investors recognize agency costs, which fall into 3 categories:
    ▪ Monitoring expenditures (by principal)
    ▪ Bonding expenditures (by agent)
    ▪ Residual loss – the actual money that will be spent internally, and the loss in value due to fear of expropriation
  o Will undertake monitoring activity if the net loss to the firm by paying for monitoring is less than the net loss from manager’s appropriation
  o This is only “nonoptimal” or “inefficient” in comparison to a world of no such costs
  o Examples of monitoring / bonding: audits, budget controls, executive compensation, a board
  o Also, this model assumes that the manager has 100% of his net worth invested in co.
    ▪ Obviously such a manager will suffer a welfare loss & so will diversify; this will lead to further agency costs (need for more outside investors)

- Transaction Cost Economics, Williamson
  o 2 key assumptions:
    ▪ “Bounded rationality”: Incomplete contracts
    ▪ More sinister self-interest seeking: includes calculated efforts to disguise, obfuscate, & confuse
      • People won’t treat contract as (moral) “promise” if contracting agents given to opportunism
      • Goal of corporate lawyer is to minimize the other side’s opportunism
  o That all contracts w/in the feasible set are incomplete means that we have to study gap-filling measures (dispute resolution, etc.)
  o Asset specificity: once assets are deployed, they’re far more valuable in that transaction & lose value if attempted to redeploy
    ▪ Site specificity (building the plant next door)
    ▪ Physical asset specificity (specific tools needed for job)
    ▪ Human asset specificity (knowledge, specialized experience)
    ▪ Dedicated assets (investments in a general-purpose plants made by particular customer)
- Brand name capital
  - Having a large # of bids at first doesn’t mean that you’ll continue to have a large number of bids; once one party has invested in transaction-specific assets, other party will attempt to take advantage of that
  - Transactions efficiently supported by general-purpose assets don’t need protections (and price is highest here)
  - In specific-asset transactions, if there are contractual safeguards, the break-even supply price will be less than if there are not; but the contract will be more stable (safeguards protect against expropriation hazards – more sinister self-interest)
  - Equivalent of monitoring and bonding costs are more complete, farsighted contracts w/ safeguards
- Financial Contracting: Analysis of Bond Equity, Smith and Warner
  - Perverse incentive for risk taking by the stockholders (b/c of limited liability) is the agency cost of debt (bonds)
  - As the debt::equity ratio goes up, managers (and stockholders) have incentive to take greater risks)
    - Your downside is less:
      - Bondholders get paid back the same amount of $$, whatever the upside
      - But if the investment loses money, they don’t get paid back
      - You stand to benefit more from the upside (or just as much) and less from the downside
      - In mathematical terms, you have to deduct the amount paying back to the bondholders from your benefit – but also from your loss.
    - You’ll take risks that you wouldn’t take if it were just your own $$
  - Bond covenants: a means of protecting bondholders, restrict firm
    - Restrictions on issuance of additional debt (if additional debt is issued of the same or higher priority, value of bondholder’s claim is reduced)
      - Want to be sure you’re paid first in liquidation
    - Restrictions on dividend payments (can reduce value of bondholder claim by increasing the rate of dividends & reducing investment)
    - Restriction on investments (bond value is reduced if low-risk investments are replaced w/ high-risk investments)
      - Prevent riskier activities than you signed on for
    - Restriction on merger activities
      - Value of bond might go down if you’re less likely to be repaid (b/c of merger w/ lousy company)
    - Restriction on disposition of assets (secured debt: bondholder holds title to certain assets)
      - Doesn’t reduce risk of loss, but ensures you will get collateral
- **Legal Characteristics of the Corporation: Limited Liability**
  - Lurking behind the corporate veil is joint & several liability for all shareholders
  - No one here thinks that corporations should not have to factor in externalities, no “who cares” approach
  - **Easterbrook & Fishcel, Limited Liability & the Corporation** – reasons for limited liability:
    - If none, would have to monitor other shareholders
    - Transferability would decline; have to do a lot more research before you’re willing to purchase
    - Inflated prices to price in the extent to which owners are liable (so that corp. can pay)
    - W/o limited liability, stock price would not be homogenous: would be lot of noise in the stock price that doesn’t really tell the value of the corp. itself
    - Allows diversification: your house is on the hook for ALL your investments
      - But employees can’t diversify their “human capital” – solution: insure the corporation
    - When piercing occurs, it’s more likely to be in the “closely-held” context
      - These people are more knowledgeable about risk than average shareholder
    - Also, in parent-subsidiary combinations; this doesn’t create unlimited liability for any people
      - And then the veil is pierced when the structured corporate form somehow increases risk
    - Can also reduce moral hazard through other means besides piercing the corporate veil: capitalization requirements, mandatory insurance
  - **Woodward, Limited Liability in the Theory of the Firm**
    - Transferability is what causes limited liability to occur
    - W/o LL, would increase transactions costs & no transfer of stock
    - Thus, homogenous set of shareholders (same net worth, same income levels): no one wants to be richest (they’ll collect from you); everyone wants to be poorest
  - **Hansmann & Kraakman: Toward Unlimited Shareholder Liability for Corporate Torts**
How do we solve the problem raised by Woodward – everyone runs for the exits when bankruptcy looms?

Would only apply when firm is bankrupted by tort – authors want “creditor” to be able to reach shareholder $$ sometimes

Change the date @ which limited liability vanishes:
- When the claim is made, or somewhat before (when corporate management became aware that claim probably would be filed)
- Of course, hard to find a precise moment to fix shareholder group; may be a hopelessly theoretical argument

- Boards of Directors and Fiduciary Duties, Williamson
  - Why should the board represent only stockholders?
    - Node A: no monitoring cost necessary: market force do an adequate job protecting constituency’s interest
      - Employee – can quit / be fired
      - Consumer – can shop elsewhere
      - Short-term lender – relationship expires after loan
    - Node B: there will be a cost; relationship has transaction-specific cost
      - Nobody wants to be in Node B, which is why constituencies will seek protections
      - Customers, with “delayed health problems” or product shoddiness; for some reason market is not enough (will insist on some sort of discount or protection (brand-name security); also, legal remedies)
      - Lender w/ long-term contract (higher rate of return, collateral, oversight over risks)
      - Stuff in ( ) is way of getting to Node C
    - Suppliers:
      - Might be in node A
      - If in node B, will demand either price premium (@ B) or specific governance measures (@ C)
  - Node C: mitigation of node B
    - Representation on board may be warranted for those @ Node B, depending on their contractual relationship w/ firm
    - The board is mitigation for the “shareholder” constituency; would be in Node B otherwise
    - Shareholders are unique in that:
      - Their relationship w/ corp. doesn’t come up for renewal
      - Their investment is not tied to particular asset
    - Board is best to represent those who face “diffuse but significant risk of expropriation”
      - Can’t be protected in a transaction-specific way
    - But unclear how the board can serve as a mitigator for other constituencies
      - More information doesn’t necessarily help labor
      - W/ customers, problems of “who are representative customers, & how do they communicate w/ constituency?”
• The public: can be in contracting relationship (to reduce externalities) or demand that the firm make transaction-specific investments (to put them @ node C and protect community from firm up & leaving)
  ▪ Plus, board will be in conflict if it represents multiple constituencies in Node C
    ▪ If directors couldn’t work, managers would take over; defeats the purpose of directors
  ▪ Managers could be represented on board
    ▪ Might threaten independence of board, since managers have superior knowledge & info; could undermine the primary goal of protecting shareholders
    ▪ But, could give board better information & help board safeguard employment relationship btw management & firm