Corporations—Gross 2006

I. Introduction

   a. The Role of Agency Law in Business Associates
      i. Agency is the fiduciary relationship that arises when a person manifests assent to another that the agent shall act on behalf of the principal and subject to the principal’s control
      ii. The agent acts with actual authority when an action has legal consequences for the principal and the agent reasonably believes the principal wants him to act
         1. Reasonable if it reflects a meaning ascribed by the principal or as a reasonable person in the agent’s position would interpret the manifestations
      iii. Respondeat Superior: An employer is liable for torts committed by employees while acting in the scope of their employment

   b. Business Forms
      i. The Proprietorship: A business owned by a single individual and the owner is personally liable for all business obligations since there is no separation between the owner and business
         1. If the company becomes larger and successful it will usually be transferred into corporation or LLC, so the owner’s personal assets aren’t available to creditors
      ii. The General Partnership: Default form of businesses that are owned by more than one person. It is formed if two or more people go into a co-owned business without any thought or planning of what the relationship is—an oral agreement to share profits may be sufficient to establish the relationship
         1. May be dissolved by a partner at any time simply by a statement of his or her express will
      iii. The Limited Liability Partnership: A general partnership in all respects except that the statute provides that partners have no personal liability for firm obligations that exceed the assets of the general partnership
         1. Partners have full personal liability for claims arising from their own misconduct
            a. No liability for partners debt that would usually accrued under a general partnership
         2. Popular with law and accounting firms
      iv. The Traditional Limited Partnership: They were not allowed under general common law and have only begun to be authorized by statute since the early 20th century. Purely a creature of statute—created with a written document unlike general partnership
         1. A partnership with one or more general partners who are ultimately liable for debts of the business (limited partners are only liable up to the amount of their investment)
         2. Limited partners are usually passive investors with limited management powers, under some laws, however, they can take a role in management without becoming personally liable
      v. The Limited Partnership with a Corporate General Partner: Corporations as well as individuals and entities can be limited partners even though they are also officers, directors or shareholders of the corporate general partner.
         1. There may hundreds of thousands of limited partners and an active market for limited partnership interests
2. This essentially relieves the problem of personal liability if the general partner is adequately financed

vi. **The Limited Liability Limited Partnership**: A limited partnership with both general and limited partners, but the general partners have the protection of LLP election.
   1. GP’s have the protection against malpractice and tort claims allowed under LLP (they are only personally liable for things they did themselves)

vii. **Limited Liability Companies**: Limited liability for all participants, whether or not they are active in the management of the business, and permits total flexibility in internal management. Provides the benefits on incorporation without the limitations and rules applied to corporations

viii. **The Corporation**: The corporate existence begins with the filing of articles of incorporation and this creates a new legal entity, a fictitious person with sole responsibility for its own obligations (shareholders are not liable).
   1. The corporation itself enters into contracts, borrows money, sued and may be sued in its own name—conducts business as it were its own person
   2. **Publicly held**: Corporation has shares that are traded on public securities markets subject to federal rules
   3. **Closely Held**: Corporations without publicly traded shares
   4. **Three Tier System**: 1) Shareholders, 2) Board of Directors, 3) Officers
   5. Principals (shareholders) give their agents (the board and officers) manage the business

II. **The Partnership**
   a. **The Need for a Written Agreement**: A partnership can be formed without a written agreements, but it to the benefits of the partners
      i. Will help future disagreements about what the agreement was
      ii. Allows the partners to create an organization based on their own expectations, rather than those imposed by statute on partnerships without written agreements
      iii. Agreements identify who contributed what, which helps protect the investor’s interests
      iv. Allows attorneys to put their advice and ideas in concrete form (they must suggest that partners at least consider an agreement or face malpractice)

   b. **Sharing of Profits and Losses**: An important decision in partnerships (may share equally, as a percentage of investment or may allow them to readjust on other factors)
      i. Partnerships often fail to discuss losses, only profits, which leads to trouble
      ii. *Richert v. Handly*: The respective rights and duties of partners cannot be determined until all agreements between them have been ascertained
      iii. *Richert v. Handly II*: Absent a writing, profits and losses are split equally
      iv. All partners are jointly and separately liable for the partnership

   c. **Law Firm Partnerships**
      i. The Economics of Law Firms in the 21st Century: Hire as many associates as possible to create profits which will then be split among the partners
      ii. Retirement Policies in Law Firms: Until recently very few firms set aside pensions, assuming partners would set aside their own money, but this has changed
         1. *Bane v. Ferguson*: Current partners do not owe a fiduciary duty to a former partner, just currently active partners—they cannot be negligent, but are not required to act with any extra reasonableness

   d. **Limited Liability Partnerships**
i. The entity is still a partnership even though it has limited liability
   1. Must be organized for profit
   2. Must have two or more partners
   3. Subject to dissolution or disassociation

ii. Partners may avoid personal liability that exceeds partnership assets

iii. Must exhaust partnership assets before proceeding directly against the assets of one or more partners

iv. Individual partners can become personally liable for their own misconduct and the protection of the LLP can be pierced under theories of misrepresentation, fraud, duty of full disclosure, etc.
   1. Protects innocent partners against malpractice and tort claims and in some cases contract claims

v. Partners can take active role in management

III. Limited Liability Companies

a. Introduction: Provides direct limited liability and ability to secure partnership classification for tax purposes (flow through taxation); legal in all 50 states
   i. Non-corporate in nature—not subject to management and finance restrictions imposed on corporations (no dividends or board of directors required—can have these if it chooses)
      1. Simply required to “check a box” on tax forms to be an LLC
      2. Limited partnership with no general partners

b. The Uniform Limited Liability Company Act: In many ways follows the corporate model (the name of LLC’s must include LLC in them, must have a registered office and registered agent

c. Contractual Aspects of Limited Liability Companies
   i. Elf Atochem NA v. Jaffari and Malek: The Delaware Act intends to give maximum effect to freedom of contract and to the enforceability of agreements (the Act only provides a few default provisions if not included in the LLC Agreement).

d. Characteristics of an LLC
   i. Poore v. Fox Hallow Enterprises: An LLC is more like a corporation than a partnership (only taxation is similar to partnership), so it is to be treated as a corporation for legal purposes and must have licensed legal counsel in court

IV. Development of Corporation Law

a. Corporations are creatures of state law and investors commit their funds to corporate directors on the understanding that state law will govern the affairs of the corporation unless federal law expressly states certain requirements

b. Delaware has the most liberal standards, has an excellent court system and is well organized with a lot of precedent (very predictable results)

c. Ownership has been separated from control and removed many of the checks on the corporation’s power, so they have become very significant in society since they became huge

V. The Formation of the Closely Held Corporation

a. Where to Incorporate
   i. Look at two factors when deciding:
      1. An analysis of the relative costs of incorporating as a foreign corporation under the statutes of the states under consideration
      2. A consideration of the advantages and disadvantages of the substantive corporation law in these states
ii. If the corporation is going to be closely held and its business is to be conducted largely within one state, local incorporation is almost always preferred.

iii. Operating through Delaware will cost more to qualify, income and franchise taxes will be paid in two locations (more expensive), and you may be forced to defend a suit in Delaware.

b. How to Incorporate

i. File articles of incorporation: limit the provisions in this to whatever is required by law to appear in this public document; can often file electronically
   1. Usually includes name, number of shares of stock, registered office and agent, and name and address of the incorporator as well as some other additional topics
   2. The name of the corporation needs to be unique in a "absolute or linguistic sense" and the competitive nature of the two companies is irrelevant

ii. Bylaws: Not filed in public; guide decisions of board of directors
   1. Number and qualification of board members
   2. Resignation or removal procedures
   3. Filling vacancies
   4. Powers and duties
   5. Meetings of directors
   6. Committees

iii. Shareholder’s Agreement: Not filed in public

iv. Corporations are granted “perpetual duration and succession of its corporate name” unless otherwise provided in the articles of incorporation

v. Sometimes required to list purpose of business, which seems restrictive, but most choose not to do this
   1. Corporations may be engaged in businesses subject to regulations on their activities
   2. Some investors may be uncomfortable investing or working with a company that has an indefinite and complete absence of a mandate (even if these aren’t followed closely)
   3. People in a closely held corporation may want to limit the company to certain business

c. The Decline of the Doctrine of Ultra Vires

i. Common law doctrine that corporate acts must be within the stated purposes of the corporation; the activities are usually not inherently unlawful, simply beyond the scope of the corporation

ii. Were a means of limiting what a company could do (provided predictability for creditors, investors and directors)
   1. This scares modern corporations, however, who might be prohibited from many actions
   2. Some corporations were using it to set aside tort claims or contracts it regretted claiming they arose from things outside their business, so they should not be responsible

iii. 711 Kingshighway v. FIM Marine Repair: Modern ruling that no act of a corporation shall be invalid by reason of the fact that the corporation was without capacity to do the act, unless lack of capacity is asserted in:
   1. an action brought by a shareholder
2. an action brought by or on behalf of the corporation against a former officer
3. in an action brought by the attorney general

iv. *Sullivan v. Hammer*: The **business judgment rule** is important here because there is a presumption that the directors of a corporation acted on an informed basis, in good faith and in the honest belief that their actions were in the best interest of the company
1. They may have expanded the business past the limits of its stated purpose, but it was done in good faith

**d. Premature Commencement of Business**

i. **Promoters**

1. A promoter is a person who, acting alone or with others, directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer (also called founder or organizer)
   a. They raise funds, obtain assets and employees, arranges for the formation of the company
2. The promoter owes a significant fiduciary duty to other people in the venture—they act in good faith and cannot be making secret profits in the name of the company—they must advise members and creditors who may be involved in the business of their interest in the business
3. When the corporation comes into existence, it can bring suit against the promoter since there had been no one to enforce the rights of the corporation before shareholders came in (if the promoter committed fraud, self-dealing and would otherwise place the company in debt)
   a. Shareholders can object to deals the promoter made with the company (taking a significant block of stock, etc.) once the company is operational if they feel that the company was overvalued or he took too much
   b. If the corporation is already in existence and the promoter is simply doing other work, contracts will be signed in the name of the corporation and he won’t have liability
4. *Stanley J. How v. Boss*: A promoter, even if he claims to be acting on behalf of a corporation and not for himself, can be personally liable on a contract unless the other party has agreed to look to someone else for payment (he was liable until the corporation came into being and paid the bills)
   a. Fees incurred by the promoter should be charged to the promoter unless the attorney/contractor, etc. agreed to look to the company
   b. Company can only be expected to pay reasonable fees since it cannot choose to turn down expenses or what ones to take on (it may “adopt” these fees)
5. Attorneys would usually recommend that a corporation or LLC was formed and that all contracts were signed in its name (relieve personal liability)

ii. **Defective Incorporation**

1. Happens when promoter attempted to organize a corporation but there was a technical defect
   a. **De facto corporation**: So long as a good faith attempt was made to incorporate, the court would find it a de facto corporation (not legit to the government, but satisfactory for creditors) and the shareholders would have no personal liability
i. Modern laws abolish de facto—you will have personal liability if you purport to business as a corporation that is not in fact incorporated (if you knew you were acting without being a corporation)

ii. Passive investors who just put up money without taking an active role are usually protected

b. **Corporation by Estoppel**: A creditor agrees to look to the corporation rather than the assets of the individuals even though there is no actual corporation in existence (creditor is estopped from denying the corporation’s existence)

   i. Most courts have recognized it in certain circumstances, but many states outlaw

2. *Robertson v. Levy*: A corporation was not properly incorporated before making a deal even though the directors had claimed it would be, so the principals were personally liable.
   
   a. No limited liability until the certificate of incorporation is filed (it is so simple and cheap that there is really no excuse for not having filed)

3. *Frontier Refining Co. v. Kunkel’s*: When two or more people hold themselves out to be a corporation and it is neither de jure or de facto, they will be held liable as partners
   
   a. The lessor: don’t enter into a business relationship without double-checking to make sure that a proper filing has been made with the relevant authorities

VI. **Disregard of the Corporate Entity**

   a. **The Common Law Doctrine of Piercing the Corporate Veil**

      i. The corporate form is never pierced to reach individual shareholders in a publicly held corporation—they are only passive investors

         1. Looks to see if the corporation is truly a separate entity, completely apart from its owners

         2. This comes up when there is a debt the company cannot pay and someone must be found to incur it (should it be the creditor or the shareholders)

         3. Look at whether the case involves tort or contract, if there was fraud, if the corporation was adequately capitalized, whether corporate formalities were followed

      ii. *Bartle v. Homeowners Coop*: You should be allowed to **pierce the corporate veil and impose personal liability on owners to prevent fraud and achieve equity**. There was no liability here because the corporation was operating on its own and creditors assumed they were dealing with the corporation (rather than the individuals/coop behind the corporation). Dissent says that the corporation was only in existence to do the bidding of the coop and had no chance to earn a profit, so plaintiffs should be able to pierce.

      iii. *DeWitt Truck Brokers v. Flemming Fruit*: Simply because stock is owned by one individual will not be sufficient to disregard corporateness, but here there were no corporate formalities (undercapitalized, no board meetings, etc.), the man siphoned funds and never paid dividends—basically a corporate façade and he used it to commit fraud

         1. Saying that one creditor can pierce does not mean that others can, it depends on the relationship and situation
2. If the veil can be pierced to hold one person liable also does not mean that it can be pierced to reach other shareholders

3. Often, such as in this case, the veil can be pierced when the corporation is an “alter ego” of the defendant

4. The company was the “instrumentality” of the individual to allow him to avoid personal liability while also acting wrongfully

iv. *Baatz v. Arrow Bar*: When continued recognition of the corporation would produce injustice and inequitable conduct (if people hide behind the corporate veil simply to avoid torts, creditor, etc and for their own benefit) you can pierce.

   1. Torts are unique because the claimant did not have a chance to decide whether to deal with the corporation and did not decide to take a risk with them (unlike in contract); though studies show that courts are less likely to pierce for torts than contract claims

   2. In tort cases, look to whether the company is adequately funded and has liability insurance

v. *Radaszewski v. Telecom Corp.:* A company is not improperly undercapitalized to deal with suits if it has liability insurance since it is available to injured members of the general public

   1. Tripartite Test To Pierce the Corporate Veil:

      a. **Control and complete domination** of policy and business practice must be practiced so that the corporation had no separate mind in the transaction

      b. Control must have been used to commit fraud or violate the rights of the plaintiff

      c. The control and breach of duty must proximately cause the injury or unjust loss

   2. Undercapitalization: Usually relevant in court cases, if a business insufficiently capitalized to cover its debts and liabilities that will reasonably arise in their business (not all conceivable debts, just those that are likely)—without proper capitalization the plaintiffs should be allowed to go after the shareholders

vi. *Fletcher v. Atex:* A plaintiff must show that 1) the parent and subsidiary operated as a single economic entity and 2) that an overall injustice or unfairness is present. If these aren’t present, you cannot pierce the veil of a subsidiary, even if undercapitalized, to reach the parent.

   1. Some argue a business with many subsidiaries should be considered a single entity for liability purposes

   2. If the parent uses divisions rather than subsidiaries, those divisions will be part of the parent company for liability purposes—no legal separation

   3. Much of the direct control over subsidiaries has economic benefits that were allowed (parents get favorable lending rates, economy of scale, unified taxes to relieve some of the issues) that are encouraged partially by not giving them legal consequence—one key is to look at how the funds are used (is there commingling, etc.)

   4. Domination over subsidiaries is not enough; so long as the relationship remains within the usual bounds of American business, it will not be pierced
vii. Most states have different standards now for piercing the corporate veil, so you need to look at the case law and legislation to determine; most are very pro-defendant so hard to pierce

b. Should the Piercing Doctrine be Abolished?
   i. Judicial decrees are so vague and unpredictable that no one can know when it will happen and shareholders can’t be certain their they’re safe behind the corporation
   ii. Transactions that are fraudulent may be attacked in other ways, so unnecessary

c. The Piercing Doctrine in Federal/State Relations
   i. The federal government should govern questions involving the rights of the government arising from nationwide federal programs
   ii. Stark v. Flemming: Woman denied social security because she’d set up a corporation to put her assets aside and give her a low salary, so that she could qualify for social security. The government tried to pierce to recover payments, but not allowed since she’s properly operated the corporation
   iii. Roccograndi v. Unemployment Comp. Bd.: Corporation was owned by a family and laid people off on a regular schedule and those people would collect unemployment benefits. The government wanted to pierce to recover damages from the family rather than the company and they were allowed to do so.

d. Reverse Piercing
   i. Sweeny v. Kane: A corporation’s veil will be pierced where the corporation’s controlling shareholder formed or used the corporation to defraud creditors by evading liability for preexisting obligations. The assets of the corporation are also accessible when it has been used to hide assets to avoid preexisting personal liability.
      1. People used the corporate form only so they could avoid their own problems and essentially committed fraud against their personal creditors
      2. An insider and a corporation is supposed to be treated as the same person in these situations in order to collect money from them
   ii. Pepper v. Litton: The single shareholder of a corporation never collected a salary from his corporation until a creditor sought to collect royalties it was owed and then the owner decided to claim all of his backpay, which would have prevented collection by the creditor. The court did not allow such a scheme and allowed the creditor to seek money from the corporation.
      1. Deep Rock Doctrine—unfair or inequitable claims of controlling shareholders (insiders) may be subordinated to claims of general or trade creditors.

e. Successor Liability
   i. What happens to a corporate liability when a company is acquired by another company? Courts are split whether it is fair to impose it on the successor (the party most capable of bearing it) or not to because it would disrespect the corporate form and would not be fair to impose one someone who did not incur the obligation
      1. Imposition of successor liability makes it harder to transfer assets
   ii. Nissen Corp. v. Miller: A corporation which acquires all or part of the assets of another corporation does not acquire the liabilities and debts of the predecessor, unless:
      1. there is an express or implied agreement to assume the liabilities
      2. the transaction amounts to a consolidation or merger
      3. the successor entity is a mere continuation or reincarnation of the predecessor, or
4. the transaction was fraudulent, not made in good faith or made without sufficient consideration

iii. The dissent would have included continuity of enterprise with regard to defective products (if it is the same company they can be sued for defective products which were on the market)

iv. A company should not be worse off because it chooses to acquire a company with some liability—it would discourage all such transactions

v. If the company basically carries on the business of the seller than they are going to be liable against a tort claimant most likely

VII. Financial Matters and the Corporation

a. Debt and Equity Capital:
   i. Debt (bonds, loans) must be repaid and interest on that amount accrues. The payment of the principal and interest is not contingent on the success of the business.
      1. Sometimes known as “fixed claims”—creditors are entitled to be repaid the principal and interest owed to them
      2. Interest payments on debt are tax deductible and earn leverage—you are making money on someone else’s money
   ii. Equity is synonymous with ownership and the value of their shares are the market value at the time (what you could sell it for) minus the debt of the company
      1. “Residual claims”—they have a claim on everything that is left over after the fixed claims have been paid
      2. Dividend payments on shares are not deductible and must make filings with the states and SEC
      3. Get dividends and voting power with equity shares

b. Types of Equity Security
   i. Shares Generally: Units into which proprietary interests are divided and they may be issued in different classes with different preferences, limitations and rights
      1. All shares within a class are required to have identical rights
      2. Articles of Incorporation set out the rights of each class
      3. With common shares you are entitled to vote and are entitled to the net assets of the corporation (dividends or liquidation allocations)
   ii. Common and Preferred Shares: Can either offer just common stock or a mix of the two; can also issue different series within the same class
      1. Can either make dividend payments (payments from current or retained earnings) or distributions (payments out of capital)
      2. Common stock comes with voting rights and share of net profits
         a. They also have the right to inspect the books, sue on behalf of the corporation to right a wrong against it, a right to financial information
         b. They are fully transferable and can increase in value
         c. Can be pledged for collateral on a debt
         d. Decisions to pay dividends or distributions to common shareholders is a matter of business judgment
      3. Preferred Stock: Usually non-voting but have a preference in respect to distribution and liquidation (will get a certain amount before common shareholders)
a. Voting rights are often assigned if a distribution is missed
b. Often guaranteed a dividend or distribution

iii. Special Rights of Publicly Traded Preferred Shares
1. Cumulative Dividend Rights: If a guaranteed preferred dividend is not paid in a given year, it must be paid (along with the following years’ unpaid dividends) before any dividend can be paid on common shares
   a. Noncumulative: Not carried from one year to the next, if no dividend is declared the preferred shareholders lose the right to it
   b. Partially Cumulative: Cumulative if there are earnings in a given year, noncumulative with respect to excess dividend preference.
2. Voting Rights: Preferred shares are usually nonvoting (exceptions exist, particularly in closely held corporations): also entitled to vote after missed dividends so they can vote in directors they feel will be more responsive to their interests
3. Liquidation Preferences: The preferred preference in liquidation is usually set at a specific price per share before anything is paid to the common shares
4. Redemption Rights: May be redeemable at the option of the corporation, usually at a price fixed by the articles of incorporation—the corporation can buy them back at a fixed price and the shareholder has no right to stop it
5. Conversion Rights: Preferred Shares can often be made convertible into common shares at the request of the holder in a fixed ratio specified in the articles of incorporation—therefore an active market exists for the shares
6. Protective Provisions: Protect the shares from losing too much value
7. Participating Preferred: Shares entitled to the specified dividend and after the common shares receive a specified amount, they share with the common in additional distributions
8. Series of Preferred: You can have different series so you can price the shares favorable to market conditions at the time

iv. Classes of Common Shares: Different classes can vary in terms of management, financial and voting rights

c. Issuance of Shares: Herein of Subscriptions, Par Value and Watered Stock
   i. Share Subscription and Agreements to Purchase Securities
      1. Used to be a way to raise capital for new corporations where pre-incorporation subscriptions were solicited before the corporation was formed and it would only go through if a sufficient amount were obtained. At that time the corporation would make a call on subscribers to pay what they had promised.
      2. This became less important as the investment banking industry came along which permitted people to have the banks raise the capital for them and people simply use contractual agreements to buy-in rather than subscription agreements
   ii. Authorization and Issuance of Common Shares Under the MBCA
      1. The Articles of Incorporation detail how many shares are authorized to be sold, so the actual number of shares issued must be equal to or smaller than that (probably good to authorize more than it initially issues in case it needs more money later; may not want too many more though since some states tax based on the number of authorized shares and it protects minority shareholders to know that there won’t be many more sold)
2. The price of the shares sold to investors initially must be the same

iii. Par Value and Stated Capital

1. Par value is an arbitrary value assigned to shares of stock, which represents the minimum amount for which each share may be sold (in most states share may have no par value)
2. It is an amount stated in the articles of incorporation and can be whatever the drafter wants it to be (used to be the price at which shares were issued and investors could have confidence that all like shares would cost the same)
3. Watered Stock is stock that the corporation sold for less than par value, so if creditors rely on the number of shares issued to determine if the company has a certain amount of capital, they might be deceived
   a. Usually only arises with the original issuance of shares; after they are in the market the company can buy back and then resell them for whatever price they like
4. Hanewald v. Brian’s Inc.: Shareholders are obligated to pay for their shares as a prerequisite for their limited liability in the corporate scheme (if the people take control of the shares without paying for them, they are still personally liable for the debts). This is because paying for the shares gives the corporation the capital to settle debts, otherwise the alleged buyers need to be responsible for the debts

iv. Eligible and Ineligible Consideration for Shares

v. Par Value in Modern Practice

1. Usually use a nominal par value (1 cent. etc.) for shares, but you must avoid having watered stock. This allows certain protections but also affords great flexibility in pricing shares
2. Torres v. Speiser: While a company cannot issue stock for less than par value, that has no bearing on a re-sale of issued shares among shareholders

d. Debt Financing

i. Bones are long term indebtedness (loans) the company promises to pay a sum in the future and to make periodic interest payments until then—they are issued in registered form and interest is paid directly to the registered owner (no longer required to clip coupons)
ii. Zero coupon bonds sell at a significant discount but don’t pay any interest along the way
iii. More important than equity financing because it is a regular part of business whereas a company rarely issues more equity
iv. Popular during periods of high inflation because the loans will be paid off in inflated dollars
v. The Concept of Leverage: Created when debt owed to a third person. It is favorable to the borrower if the borrower can earn more on the borrowed capital than the cost of borrowing—you get to keep the excess money you make rather than distributing it
vi. Tax Treatment of Debt: Interest payments on debt are deductible by the borrower
  1. There is controversy whether a loan from a shareholder (in a C corp.) should be classified as equity (if the company does not default and pays regular interest it should be a loan, otherwise it is an investment in the capital)

e. Planning the Capital Structure for the Closely Held Corporation: An important part of the business because you need to look at tax treatment, whether it is legal, whether it provides the proper mix of equity and debt, and the clients contributions are properly protected
f. Issuance of Shares by a Going Concern: Preemptive Rights, Dilution and Recapitalizations
   i. Stokes v. Continental Trust Co.: A shareholder has an inherent right to buy a
      proportionate share of new stock issuance (in order to maintain their ownership share)—
      this allows the shareholder to keep the same vote and protect his interests
   ii. Pre-emptive Rights: A shareholder is allowed to maintain their % voting in a company if
      new shares are created (otherwise would lose ability to have a say in the management of
      the company and might lose value)
      1. Some states are “opt-in” and you must include pre-emptive rights in your articles
         of incorporation or the shareholders don’t get them
      2. If your stock is sold on a public market not a huge advantage to have pre-emptive
         rights, but it is important for closely held companies
   iii. Katzowitz v. Sidler: The equity of existing shareholders cannot be diluted and
      determining the price of new shares must be in the interest of all shareholders—directors
      cannot sell shares to themselves for lower prices if it hurts another shareholder; can only
      do it if they sell for fair market value and give everyone a chance to buy-in (even if the
      directors gives shareholder pre-emptive right, can’t sell to themselves for less $$$)
   iv. Lacos Land Co. v. Arden Group: Corporations should have great flexibility in creating
      the capital structure of their companies, but directors have a fiduciary obligation to
      protect the interests of shareholders
      1. Directors can usually determine when to sell stock at their own discretion, but
         cannot abuse their own power for their own benefit at the expense of the
         shareholders

 g. Distributions by a Closely Held Corporation
   i. Gottfried v. Gottfried: If a company has the money to pay a dividend (such as one that
      has been paying large dividends to preferred shareholders with a surplus left over), it
      cannot withhold dividends from common shareholders in bad faith.
      1. Good faith here means that the directors are looking first to the interest of
         shareholders, which in this case often depended on dividend payments because
         this was a closely held company and they could not sell their stock on the open
         market if they disagreed
      2. Also look if the companies are using the surpluses to improve the business
         (research, development, etc.)
   ii. Dodge v. Ford Motor Co.: Usually requires bad faith, fraud or abuse of discretion by
      directors that is not in the interest of the shareholders—essentially they choose to sit on
      profits for no reason (though if there is a legitimate business reason, even long term
      plans for what the money will be used for in the future, you need not distribute)—Ford
      said he had legitimate business reasons, but also said he would rather help the public than
      his shareholders
   iii. Wilderman v. Wilderman: The authority to compensate corporate officers is normally
      vested in the board and is a matter of contract, but it should not be the case if the recipient
      is one with voting power (and he can’t be overruled)
      1. The salary must bear reasonable relation to the success of the enterprise and the
         cannot be so excessive that non-directors and minority shareholders do not
         receive dividends
      2. When a person sets his own salary, he has the burden of proving fairness
iv. *Donahue v. Rodd Electrotype*: The stockholders in a closely held corporation owe the same fiduciary duty (or duty of fairness) in the operation that partners owe each other (cannot have the corporation buy back their shares at a favorable price without giving the opportunity to others)

1. The controlling shareholder in a closely held corporation must cause the corporation to offer each shareholder an equal opportunity to sell a ratable number of his shares to the corporation at the same price (otherwise they have no where else to go with their shares and will lose all value)—can’t have preferences in these situations
2. Criticized by some as setting a per se test and not giving the opportunity to prove that it is actually a valid sale
3. **Corporate redemption**: all shareholders should have the right to redeem their shares in a ratable shares for the same price (protects minority shareholders)

h. **Non-Model Act Statutes**
   i. **“Impairment of Capital” Dividend Statutes**
      1. All states have limits on the financial limits of payment of dividends—protect creditors from the company paying out everything to immune shareholders
      2. Delaware permits dividend payments out of a company’s surplus, which includes everything in excess of the aggregate par value of the issued shares plus whatever the company keeps in its capital account
      3. Other states “impair capital” and prohibit dividends except from the surplus or net profits of the company—these “impairment of capital statutes” are less restrictive than other kinds—allow money out of any kind of surplus

VIII. **Management and Control of Corporation**
   a. **The Traditional Roles of Shareholders and Directors**
      i. *McQuade v. Stoneham*: Stockholders may not control the directors’ exercise of judgment by virtue of their office to elect officers and fix salaries. Their motives may not be questioned as long as their actions are legal. The directors must be left free to exercise its own business judgment
         1. The corporation should be managed by a board that is only subject to reasonable limitations imposed by shareholders agree to when they buy stock
         2. ***“A contract is illegal and void so far as it precludes the board from changing officers, salaries or policies”—don’t want the courts looking into and judging the motives (unless all shareholders are parties to the contract, in which case the contract should be enforceable (*Clark v. Dodge*))
         3. The directors cannot contract away their rights (this would be against public policy)
      4. **Basic rules:**
         a. No harm to creditors or public
         b. Must involve innocuous variance from general categories that boards are responsible for
         c. All shareholders must consent—can’t only be a few of them
      ii. *Galler v. Galler*: A contract can remain valid if it is not against public policy (doesn’t harm anyone) even if it slightly impinges on a relevant statute, if it protects the interests of minority shareholders
1. Any arrangement concerning management which is agreeable to all shall be enforced if there is 1) no complaining from the minority, 2) no fraud or apparent injury to the public, 3) no clearly prohibitory statute

2. Many states in response to Galler now have closely held company statutes (opt-in) which allow companies to declare themselves closely held and give them more management flexibility and in electing non-traditional governance
   a. You can put authority in the hands of non-directors that would usually be left to the board
   b. May also be able to do away with many corporate formalities (annual meetings, by laws, etc.)

iii. Zion v. Kurtz: The written agreement of shareholders of a closely held corporation is not invalid so far as it restricts the discretion of directors
   1. The company should be managed this way because all the shareholders agreed to it and such contracts should be allowed—dissent would rather leave directors with more power and agree with McQuade that they shouldn’t be allowed to abdicate their powers

b. Shareholder Voting and Agreements
   i. You get to vote if you are on the corporate books as of the record date (declared by the corporation)
   ii. Proxies are substitution forms—you can vote on them (or have someone else vote on them) and return them to the company so investors don’t have to go to the meeting
   iii. Straight voting: In electing directors you get your full allotment for each candidate so the majority shareholder wins on all of them (90 shares outstanding, the person with 65 of them will get 65 votes for each candidate and will win on every ballot)
   iv. Cumulative Voting: Shareholders have a total number of votes and they are split among all the candidates—if you split them between several candidates, it is more likely that minority shareholder will win at least one director vote
      1. \((S/D+1)+1\) — \(S\) = number of total shares outstanding; \(D\) is the number of directors—this tells you how many shares a minority shareholder will need to elect a director
   v. Salgo v. Matthews: Beneficial ownership does not carry with it the right to vote without having the shares transferred on the books—an election inspector needs to recognize the votes
      1. Shares are held in the name of someone (registered owner) even if they are actually owned by someone else (beneficial owner); the registered owner has the right to vote, sell the stock and collect dividends
   vi. Humphrey’s v. Winous: When a minority shareholder has a cumulative vote, it does not ensure them a director
      1. Companies can “classify” their directors so only one of many is elected each year and thus the cumulative vote is the equivalent of a straight vote (restricts the effectiveness of a cumulative vote)
      2. Classifying directors allows companies to fight takeovers and have continuity on the board
      3. Cumulative voting is usually an “opt-in” process
vii. *Ringling Bros. v. Ringling*: No agreement can be irrevocably separated from the ownership of stock except by a legal agreement that deposits stock of original issue with another person for the purpose of voting
   1. Pooling agreements are legal, but in a situation where there is no one who is charged with voting for shares and there is a disagreement, whoever backs out should not have their votes counted
   2. Should be allowed to trade your vote if you want; you are also not required to vote

   1. A written agreement between two or more shareholders may provide that any voting rights shall be voted in a particular way with a procedure agreed to by them
      a. A proxy appointment granting another the right to vote your shares is usually revocable whether it says so or not
      b. Maximizes the power of the shares where cumulative voting is involved
      c. The pooling agreement is simply a contract and sometimes have limited periods during which they operate, but very few regulations
      d. Most requires shareholders to get together to discuss how they are voted and it goes to arbitration if they are different; if the shareholders in an agreement are in disagreement and refuse to vote that way, the court usually enforces the contract

ix. *Lehrman v. Cohen*: A voting trust is valid if a) the voting rights are separated from other attributes of ownership, b) the voting rights are revocable and limited in duration, and c) the principal purpose of the grant is to acquire voting control of the corporation
   1. This family creates a third type of stock to create deadlocks and leaves that vote in the hand of an independent trustee
   2. Cannot divest voting rights permanently
   3. **Voting trusts**—different from voting agreements because you give a trustee specific instructions that are filed in a registered office in the state
      a. In a voting agreements you vote your shares and can be sued if you do it improperly, in voting trust the job is left to an independent trustee (you retain a beneficial interest in the shares)—the trustee has broad fiduciary duties
      b. An independent trustee will be more likely to make a good, unbiased business decision and not side with squabbling shareholders
      c. Can be used in public corporations and closely held corporations

x. *Ling and Co. v. Trinity Savings and Loan*: A corporation may impose restrictions on the transfer of stock if they are expressly set forth in the articles of incorporation and copied at length or in summery on the stock certificate and they do not unreasonably restrain transferability
   1. They can have restrictions that stock must first be offered to the company and existing shareholders before being sold to outsiders for instance
   2. Often useful in closely held corporations to keep ownership in tact and operating as intended
3. **Buy-sell agreements**: A company or other shareholders are required to buy shares at a certain price if a certain triggering event occurs—this is good protection for minority interests and other shareholders.

xi. **Valuation Controversies**: In valuing a company, the expert must use internal consistency (the same method each time so that it can be reliable and valuations won’t be arbitrary) and intellectual honesty (do not necessarily give the answer your client wants to hear, consider the interests of both the plaintiff and defendant).

c. **Deadlocks and Dissolution**

i. Deadlock occurs when a closely held corporation is unable to act because the shareholders or directors who each own 50% of the stock can’t agree

   1. Doesn’t mean that corporation can’t continue, just makes it harder, often the management (if it is independent from the director) will simply run it on their own
   2. Easiest solution is for one side to buy out the other may also choose arbitration

ii. *Gearing v. Kelly*: If a person intentionally avoids board meetings to prevent a quorum and the company is at a deadlock, if eventually a quorum does result (a board member resigns, etc.) and someone else is voted in, the election will be legal

   1. Any vacancy in the board of directors may be filled by the affirmative vote of a majority of the remaining directors, though less than a quorum of the board of directors

iii. *In re Radom v. Neidorff*: If a corporation has an even number of directors who are evenly divided, the holders of one half of the stock may present a petition for dissolution

   1. If the management remains efficient and effective it will not be dissolved though. Only if the “corporate existence cannot be attained” even if there is a complete impasse
   2. A dominant shareholder cannot simply abandon the company and start a new one in competition, because that would violate their fiduciary duty to the other parties

d. **Modern Remedies for Oppression, Dissension or Deadlock**

i. Involuntary dissolution was an original statutory remedy for deadlock situation, now statutes have expanded involuntary dissolution be valid include for oppressive behavior as well

   1. A shareholder seeking involuntary dissolution often requires:
      a. The directors are deadlocked and irreparable harm is occurring during the deadlock or is being threatened, or
      b. The directors have acted in an illegal, oppressive or fraudulent manner or
      c. The shareholders are deadlocked in voting power and have failed on multiple occasions to break it or
      d. The corporate assets are being wasted or misapplied

ii. *Davis v. Sheerin*: A receiver can be appointed for aggrieved shareholders who can establish that they’ve been subject to oppressive conduct and the receiver can order a buy out of the shares—if the majority won’t allow the minority to have their standard remedies, they can be forced to buy out

   1. Without buying him out they may have continued to try to squeeze him out and since there is no public market he would have been in big trouble
   2. Buy-out is the most common remedy; some states only allow it in closely held corporations
iii. *Abreu v. Unica Indus. Sales:* Instead of dismissing an action the court may appoint a provisional director or appoint a custodian (does not need to be an impartial person—often preferable to have a person with experience in the industry or at the company.

1. The right to vote for directors does not automatically mean that you will get your way.

e. **Transactions in Controlling Shares**

i. *DeBaun v. First Western Bank:* In any transaction where the control of the corporation is material, the controlling shareholder must exercise good faith and fairness from the viewpoint of the corporation and those interested therein.

1. The seller must be some investigation into who they are selling their controlling share to in order to ensure that everyone else will suffer for their decision.
2. The duty is that of a prudent man who would be on his guard against potential buyers who may loot the company—the seller must conduct reasonable investigation.
3. They should have been on notice that the buyer was bad and they would have known if they had done some investigation, so they owe damages to the minority shareholders.
4. Some argue that you shouldn’t punish people for not knowing what someone would do after taking control of the company you should only punish the buyer who is a bad apple, but others argue that if it is clear someone will be bad, you have a duty not to sell.

ii. *Perlman v. Feldmann:* In a time of market shortage where a product could demand a premium (steel in short supply), a fiduciary may not appropriate to himself the value of a premium and not share it with the minority shareholders.

1. The company could have made a fortune, but because the majority chose to sell out to a steel user who would not pay a premium for the steel like others may have, they hurt the minority. They also sold their shares at a premium (which might be valid since control of the company went along with them—control premium).
2. The buyer continued to pay market price for the steel and it seems that shareholders should be allowed to sell for whatever they can get—seems odd.

IX. **Duty of Care and Business Judgment Rule**

a. *Litwin v. Allen:* Directors are like trustees and they have a fiduciary relationship to the company. They owe the company and shareholders loyalty and may not profit at the expense of the shareholders.

i. Directors here agreed to buy convertible bonds that earned 5% interest, but the company could buy them back at the sale price after 6 months, so the directors were assuming all the risk for their own company.

ii. The directors here did not have the “minimum rationality”—they engaged in a transaction that was patently irrational—this applies mainly to banks and other public welfare companies which have a special duty to the public and shareholders.

b. *Shlensky v. Wrigley:* Directors must be permitted to control the business of the corporation in their own discretion when now in violation of its charter or some public law, or corruptly and fraudulently subversive to the rights of the corporation.

i. The decision does not need to be a purely economic decision on its face, can be a longer term interest of the business.
ii. Directors must act in good faith and if they do you can’t find them at fault for falling values

iii. Business judgment rule

c. *Smith v. Van Gorkom*: The proper standard for determining whether a business judgment is informed is predicated on concepts of gross negligence.

i. A CEO arbitrarily set prices for a sale against the advice of certain officers, but the directors failed to look into the decisions and do their own investigations—they failed to inform themselves properly and were thus negligent—selling a business is a huge decision so perhaps directors should be forced to look deeper and has a heightened duty

ii. Should have sought out an investment bank’s opinion or at least done independent analysis

iii. Seems to imposes a lot of duty on the directors and present a lot of liability—many states have enacted statutes to protect directors against this burden (either limit or eliminate personal liability for monetary damages in almost all situations)

1. Gives directors piece of mind when taking on these duties and encourages people who disagree with a potential transaction to sue before the deal is completed—monetary damages after the fact seems harsh

iv. Many commentators have said this was the worst case in corporate law history even though it may have had good social and political ramifications (scare the hell out of directors)

1. Claim this only makes the process more formal, slower, and raises transaction costs

d. Del. Gen. Corp. Law

i. The by-laws can eliminate or limit personal liability of a director to the corporation, but cannot be limited for:

1. Any breach of the director’s duty of loyalty
2. Any actions or omissions not in good faith
3. Any transaction where the director got an improper personal benefit

e. *In re Caremark Intern. Derivative Litigation*: The directors are only required to use their good faith and judgment and put forth a good faith effort in their exercise of power.

i. The company violated some federal laws and settled a number of law suits for a lot of money, which the directors approved—the court says the directors did not violate any laws in doing so, however.

ii. Directors need to protect the best interests of the investors and must be active monitors of corporate performance, but unfair to say that any decision must be profitable and that directors should be responsible for all decisions at the company (when decisions are made way down the food chain it isn’t the fault of the directors and they shouldn’t be liable—there were some protections already in place)

iii. Whether the settlement is approved or not depends a lot on how likely it would be for the plaintiffs to win (they get more in a settlement the more likely they are to win in court)

f. *Malone v. Brincat*: When the director’s disseminate information to shareholder when no action is sought (just basic information in an annual report or statement of profits), the duties of good faith, loyalty and care still apply. They must be honest in their statements.

i. The information must be **material** which means that a shareholder’s decision to buy or sell stock may be based on that decision
g. **Gall v. Exxon Corp.**: When a shareholder launches a **derivative suit** (a suit on behalf of the company) it must be approved by the board (because it will cost the company a lot of money and publicity).

i. The board should appoint an independent committee (or at least disinterest directors) to determine if the action is in the best interest of the company

ii. The eventual decision whether or not to assert a cause of action rests with the business judgment of management

iii. Derivative suits give shareholders a little power over the board and enable them to keep the board honest, but they can also bog down the company because there could be many frivolous ones every time a shareholder gets angry—need to balance these two interests

iv. This is the first time a suit wasn’t automatically pursued and the board was able to say the company wouldn’t pursue the matter

h. **Zapata v. Maldonado**: Shareholders cannot sue on a company’s behalf without the director’s approval, but this has exceptions

i. If the demand to the board from a stockholder would be futile because the officers are under other influences and are not in a position to make a proper decision, the suit can proceed

ii. The court should look if the litigation committee is not independent enough and did not act in good faith and then if the board acted with the appropriate business judgment (the court will use its own business judgment

1. Give the court a lot of power and may be overreaching because they get to determine if it is a proper business decision

iii. Showing the futility of going to the board requires showing financial self-interest on behalf of the board

i. **Aronson v. Lewis**: It should be presumed that directors acted in good faith and on an honest belief. The directors must have the chance to determine if a suit should proceed and then shareholders are required to try to resolve it internally before going to court

i. The only time the court should use the Zapata standard of review is when demand (of the board) is excused, but the parties need to plead specific facts about the board’s self-interest at the pleading stage, which is hard when no discovery has been done

ii. Demand is almost always required unless a majority of the board is so directly self-interested that there is serious doubt that the business judgment rule would protect that transaction

X. **Control and Management in the Publicly Held Corporation**

a. **Social Responsibility or Lack Thereof**

i. 51 of the largest 100 economies in the world are corporations, but they don’t necessarily have control over people or actual territory even if they do have a lot of power

ii. The director’s job is to increase profits and financial returns, this may mean helping society or the environment, but only if that serves the ends of the shareholders

1. Successful businesses often need to help their employees, customers, environment, etc.

b. **Shareholders**

i. **In General**: They have the right to vote for governance that they want, what incentive do they have though to spend time looking at resumes and weighing proposals/candidates?

1. Most people don’t care and will defer to management’s decisions
ii. **The Growth of Institutional Investors** (mutual funds and pension funds): This is good because they have the same interests as most investors (making money) and they have huge stakes so they’re willing to take the time to do research

c. **Directors**
   i. Directors job is to make money for the shareholders, not necessarily to look at what is best for the community unless that might have long term benefits (consider the impact of decisions on employees, suppliers, customers)
   ii. How do you ensure that directors will have the best interest of the company at heart?
      1. Give them stock options to align their interests with the shareholders
   iii. They essentially have nothing to do with the day to day operations of the company
   iv. If there is no crisis, their essential function is to advise and counsel management and to provide discipline

d. **Corporate Governance in 2005**
   i. The Response to Substantial Misconduct
      1. As companies began to collapse and their management was shown to be corrupt, securities holders bailed out and the stock market declined in value adding to the woes of investors
   ii. **The Enactment of Sarbanes-Oxley**
      1. The bill was passed with very little debate and things were moving too fast for companies and policy organizations to analyze it, so it had many glaring holes, conflicted with state laws in some situations and was not as efficient and effective as it should have been
   iii. **The Campaign Against Fraud and Misconduct**
      1. The SEC has continued to be all over companies, the NY Attorney General has been active, shareholders have brought private suits as well
   iv. **Who Should Pay for Settlements**
      1. If it is the company paying investors, then they are just being hurt themselves and nothing happens. In Worldcom, directors and managers were required to pay part, even though the settlement wasn’t an economic bonanza by any means for the investors
   v. **Sarbanes Analysis**
      1. Some say this is merely window dressing and is very expensive without providing much benefit to shareholders and the economy
      2. Very difficult and expensive to comply, particularly for small companies that don’t have the resources to invest
      3. Many companies are required to have independent audit committees
      4. Prohibits audit companies from doing some non-audit business
      5. Prohibits extending credit to managers and directors
      6. CEO and CFO must certify annual reports under criminal penalty
      7. Internal controls and procedures for financial disclosure

e. **Proxy Regulation and Disclosure Requirements**
   i. **Scope of Regulations**
      1. **Securities Act of 1934 §14(a):** It shall be unlawful for any person by use of the mails or any means of interstate commerce…to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security
registered pursuant to §12 (The SEC has the right to set proxy solicitation regulations)

2. §12(a): It shall be unlawful for any member, broker or dealer to effect any transaction on a national securities market unless a registration is effective as to such security (must register if on a national securities exchange)

3. §12(g): Every issuer engage in interstate commerce shall register (over the counter companies fitting this criteria):
   a. Within 120 days after the last day of its first fiscal year, if the corporation has total assets exceeding $10,000,000 and a class of security held by more than 500 people…register such security with the SEC (this is not registration of the company, just the class of stock)
   b. Registration of any class shall be terminated within 90 days after the issues a certification with the SEC that number of holders of a record of such class falls below 300

4. *Studebaker v. Gittlin*: A person is forbidden to solicit any proxy or consent or authorization in respect to any contravention of such rules as the SEC prescribes as necessary to the public interest—if you want to make a proxy solicitation to get people to join you, you need to follow the SEC’s regulations
   a. Shareholders shouldn’t be allowed to solicit proxies because there is no guarantee that the will tell others the truth and the SEC will be powerless to protect shareholders
   b. What is a solicitation? Even asking more than 10 people to join with him to obtain the shareholder’s list from the company is considered a proxy (this was a New York Law)
   c. In order to solicit from more people in §12 companies, you are required to file with the SEC
   d. This decision limits the ability of institutional investors to communicate with each other and present a common front when approaching management
      i. The cost of preparing an actual proxy statement to be sent through the company is prohibitive
      ii. There is now a safe-harbor however and solicitation no longer applies to:
         1. Speeches in public forums, press releases, published or broadcast opinions
         2. When it is made to someone the security holder (say a mutual fund) owes a fiduciary duty to
         3. When it is made in response to unsolicited requests for additional information with respect to a prior communication
         4. Also, anyone who does not request the actual power to serve as someone’s proxy or someone who specifically requests a revocation, abstention, consent or authorization (not a candidate basically)

**ii. Proxy Forms, Proxy Statements and Annual Reports**
1. The forms themselves are regulated to ensure that votes shareholders have the option to vote to approve or disapprove issues submitted to them and to vote for or against directors proposed by the person soliciting the proxy (usually management)
   a. Generally does not confer power to vote for a person as a director unless he is named as a nominee

2. **Management’s Discussion of Financial Condition and Results of Operation**: Needs to have a discussion of the manager’s understanding of the financial condition and information that is used or is necessary to understand the condition
   a. Gives investors both a long and short term look at the business
   b. This includes opinions and predictions as well as facts
      i. The directors and managers are protected from private liability in these situations as long as the forward looking statements are properly identified and there is no intentional misleading or false statement

3. **In the Matter of Caterpillar, Inc.**: The SEC requires registrants to describe any unusual or infrequent events or transactions that affect the resources and operations of the registrant in their annual report. Also requires a discussion and analysis to enable the reader to assess material changes in the financial condition of the company
   a. This allows them to make informed decisions about their investment and a view through the management’s eyes

iii. **False or Misleading Statements in Connection with Proxy Solicitations**

1. **Regulations 14(a). Solicitation of Proxies**
   a. No solicitation may be made by proxy statement containing any information that at that time is known to be false or misleading with respect to any material fact
      i. Cannot directly impugn a candidate’s character and some predictions of future market values need to be watched out for (these are dangerous)
   b. Proxies are voted for management unless specifically said to be withheld; if you want to have your own proxy, you need to abide by SEC regulations and send it out
   c. The only person who can vote using a proxy is the person who is registered

2. **J.I. Case v. Borak**: Federal courts have the option of granting relief to private parties who allege that an action was allowed because of false or misleading proxy statements
   a. There is a private right of action since private enforcement provides a necessary supplement to Commission action—civil damages and injunctive relief are the most effective weapons of enforcement
   b. This is necessary or else companies could basically lie in their proxy statements with impunity and no one would enforce it
   c. The misstatement must be material

3. **TSC Indus v. Northway**: Proxy statements that are false or misleading with respect to the presentation or omission of material facts are barred.
a. An omitted fact is **material** if there is a **substantial likelihood** that a **reasonable shareholder would consider it important in deciding how to vote**
   i. This is a limiting test because it is something that is sure to influence a rational shareholder, not simply something that could possibly influence them

4. *Virginia Bankshares v. Sandberg*: In a freeze out merger (where the minority shareholders do not have a say in the merger), a bank solicited proxies from them even though it wasn’t necessary and said that the value of the buyout was “high.” Some shareholders did not approve it and claimed that the statement that it was a high value was intentionally misleading
   a. This was not an actionable statement because it was a fact, whether the directors believed it or not (i.e. it was above book value and thus was high, even if it wasn’t an great price) and the facts that underlay that opinion enabled people to come up with their own opinions
   b. The minority also has no right to question such statements because their vote was meaningless (there was **no causation**)

iv. **Shareholder Proposals**
   1. Regulation 14(a)(8): A company must include a shareholder’s proposal in its proxy statement and identify the proposal in its proxy form at the company’s annual meeting (even if it opposes the proposal), though the company does not need to include it in many circumstances (they will pay for it)
      a. One of the few ways minority shareholders can communicate with fellow shareholder
      b. A proposal is a recommendation or requirement that the board take a specific action and has an accompanying statement of support (often for social causes, such as not doing business in South Africa, not doing tests on animals, making bombs, etc)
      c. In order to submit you must have held $2,000 worth of stock or 1% of the company’s securities for at least 1 year and promise to hold them at least until the date of the meeting of shareholders
      d. May submit one per year
      e. The proposal and accompanying statement can be no longer than 500 words
      f. Must submit by a certain deadline
      g. Must attend the shareholder meeting in person or have a representative do it
   2. The company may exclude the proposal if you did not follow the rules and were given a chance to fix them
      a. Can be rejected if it would **violates any law**, is simply a **personal grievance**, is **not relevant** to something that affects more than 5% of the company assets, deals with a matter that relates to the company’s **ordinary business operations**
   3. If the company rejects it the SEC will review it and the person who makes the proposal can make a statement
4. These rules make it hard for someone to introduce something into a proxy and intentionally limits the number of shareholder proposals and restricts the use of proxies to affect management—still allows shareholders some freedome

5. *Rauchman v. Mobil Corp.*: If the proposal is related to an election for membership on the board, it can be rejected.
   a. Here it proposed not to let people of certain ethnicities from sitting on the board, essentially to prohibit a Saudi from it, but the company properly rejected it because it related to an election
   b. It is theoretically possible to win a shareholder proposal, but very expensive and hard to do (management rarely gets beat)

v. Communicating with Shareholders

1. **Regulation 14A**: If the registrant has made or intends to make a proxy solicitation in connection with a security holder meeting or action by consent, at the request of any record or beneficial holder of securities of the class entitled to vote at the meeting, the company must provide a list of securities holders or request the company to mail them (for a fee) and the security holder needs to reimburse the company (Reg. 14(a)(7))
   a. Every shareholder has an absolute right to inspect the voting list

2. **Regulation FD**: This requires full disclosure of sensitive information—the company cannot hand it out selectively to industry professionals, analysts and that type
   a. If a disclosure is made unintentionally, it must be made promptly thereafter; if it is made intentionally the public disclosure must be simultaneous
   b. May be met by a press release distributed through widely circulated news or wire services, press conferences or conference calls

XI. Duty of Loyalty and Conflict of Interest

a. Self-Dealing
   i. *Marciano v. Nakash*: Directors have a fiduciary relationship which limits the extent by which they can benefit from dealings with the corporation.
      1. Voting for and taking compensation may be fraudulent in the absence of shareholder ratification or statutory or bylaw authorization
      2. There is a presumption of self-dealing when a director loans money to a company, but if it passes the **intrinsic fairness** test with interests if the company at heart and the directors not actually benefiting, then the presumption can be rebutted
   ii. *Heller v. Boylan*: A company had grown tremendously and officers had been receiving enormous bonuses which were a % of the profits that had been the same for years. A shareholder sued claiming the bonus was wasteful and excessive
      1. The court should not trim the bonuses because they would not be based on scientific analysis—they cannot fairly be compared or evaluated by the court
      2. The directors should continue to determine the bonuses even if they are very large, because they have the mandate of the shareholders and know the business
      3. If salaries and bonuses are not even remotely related to performance than it might constitute unfair corporate waste, but courts will only step in at that point
iii. *Brehm v. Eisner*: The corporate waste test requires that there be an “exchange that is so one-sided that no businessperson of ordinary sound judgment could conclude that the corporation has received adequate consideration”
   1. This is a very liberal standard and probably hard to prove
   2. Usually in these situations the board has done plenty of due diligence and the market demands a lot of pay—can’t look back in hind sight whether the deal worked out or not
   3. It seems strange that despite the outcry about huge executive salaries and benefits that people won’t do anything about it and courts won’t help

iv. *Sinclair Oil v. Levien*: A parent owes a fiduciary duty to its subsidiary, but this does not require an intrinsic fairness test if there is no actual self-dealing (there was no self-dealing here because all shareholders got their share of the dividend)
   1. Apply the business judgment rule when the minority is getting the same benefit (dividend, voting power) that the majority gets (whether a corporate parent or otherwise), because there is no self-dealing
   2. Business judgment used instead of intrinsic fairness (actions are upheld unless there is a showing of gross and palpable overreaching”) when there is no self-dealing which was the situation here
   3. These problems could have been solved by Sinclair buying out the minority shareholders

v. *Weinberger v. UOP*: The directors of a subsidiary who are appointed by a parent owe a duty to the subsidiary and the shareholders (can’t vote to sell the business to the parent at a discounted rate). They cannot be in on the negotiations with the parent because of their conflicting interests
   1. This is a cash-out merger, so the majority is allowed to compel the minority shareholders to accept cash for their shares (has to be cash rather than shares of the continuing corporation) in an amount determined by the parent subject to appraisal rights (the minority must be allowed to disinvest at a fair price)
   2. The directors from the parent will have superior information from both sides so it is unfair (they will provide inside information to the parent)
   3. There was self-dealing so the intrinsic fairness test is applied (look at fair dealing as part of intrinsic fairness
      a. They were not negotiating at arms-length
      b. Should have outside directors negotiate for both companies if the deal is going down—this would be much more fair
         i. This has led to independent directors being added to many boards
   4. Must seek **quasi-appraisal** damages rather than **rescissory damages**
      a. Rescissory damages are what a company would have been worth today had the deal not occurred
      b. The damages should take into account the value of the company after the merger if you can show fraud (may also get an injunction)
      c. If you only show that the price was too low, but no fraud, you might only get actual damages

b. **Corporate Opportunity**
   i. Don’t want key players in the corporation competing with the business
ii. *Northeast Harbor Golf Club v. Harris*: **Corporate opportunity**: Before a director is allowed to make a transaction that affects her company and will benefit herself, she needs to make full disclosure and the corporation must choose to reject the deal. The rejection must be fair to the shareholders and made by disinterested directors.

1. The court considered and rejected three other tests of fairness because they were too vague and difficult to define:
   a. **Line of Business**: If a deal is presented to an officer which the corporation could afford to undertake, but it is not in the line of business of the corporation then the officer is allowed to make the deal.
   b. **Fairness**: Was it fair for the director to make the deal when the corporation’s interests might have been benefited?
   c. **Two-Step Analysis**: A combination of the above where it is determined that the it was in the line of the corporation’s business but was still fair.

2. The hard part of the corporate opportunity doctrine is that it cannot be determined by hard and fast rules, rather it requires a particularized analysis of the circumstances—if the company would never enter a certain type of business, then the director probably doesn’t need to offer it.

3. Look how and when the offer came about to see in what capacity the person had received it; did they learn about it because it was offered to the company; did they use corporate resources and time to investigate it.

c. **Duties to Corporate Constituencies Other than Common Shareholders**

   i. Limited duties also exist for preferred shareholders and creditors

   1. **Preferred Shareholders**: the duty is contractual and the scope of it is defined by the stock contract.
   2. **Holders of Convertible Securities**: there is no fiduciary duty to the security holders.
   3. **Creditors**: There is no open-ended fiduciary duty here, the duty is specifically defined by contracts with the debtor.

XII. **Transactions in Shares: Rule 10b-5, Insider Trading and Securities Fraud**

a. **The Development of a Federal Remedy: Rule 10b-5**

   i. It is illegal for someone to use interstate commerce to use or employ, in connection with the purchase or sale of any security, any manipulative or deceptive device or contrivance.

   1. **10b-5**: Illegal to employ any **scheme or artifice to defraud**; make **untrue statement of a material fact** or to **omit to state a material fact necessary in order to make the statements made not misleading**; to engage in any **act, practice or course of business which operates or would operate as a fraud or deceit upon any person**

   2. Applies no matter what the size of the company.
   3. Uses the same “material” standard as other legislation.
   4. You have to be the principal actor, aiding and abetting are insufficient to warrant punishment.

ii. **There is a private right of action for insider trading**

   1. There is no explicit remedy listed in the statute, but it is implicit under the principles of the law.

iii. Provision relied upon for claims of improper trading by insiders, claims of securities fraud, deception or trading in securities on the basis of undisclosed information.
iv. *Blue Chip Stamps v. Manor Drug*: 10b-5 should only be applied to people who actually buy or sell a security, if a person does not sell, you can’t hold them liable for their misstatements
1. Other claims will cost a lot of time and money and Congress did not explicitly allow them; will also give juries a lot of authority to make questionable judgments
v. *Ernst & Ernst v. Hochfelder*: Auditing firms shouldn’t be held liable unless they participate in any knowing or intentional misconduct—if they don’t cause it they are not responsible, even if they maybe should have uncovered the misbehavior
1. **Scienter** (intentional wrongdoing, mental state embracing intent to deceive, manipulate or defraud) is a critical element of 10b-5 cases; but it can be replaced by recklessness or reckless disregard for the truth
vi. *Santa Fe Indus v. Green*: If a company carries out a transaction that is unfair to minority shareholders but discloses that fact, it will not be subject to federal laws. If the transaction affects other corporations with its deception, it is likely to face state law and regulations, so you don’t want to interfere with that
1. Non-disclosure and misrepresentation are all that 10b-5 covers, so other judicial controls over transactions need to rely on state law
vii. *In re Enron Corp Securities, Derivatives & ERISA Litigation*: Private plaintiffs may not being aiding and abetting claims under 10b-5 (only the government can prosecute)
1. Professionals including lawyers and accountants, when they take the affirmative step of speaking out about their client’s financial condition have a duty to third parties not in privity not to knowingly or recklessly issue materially misleading statements (otherwise become principals in the action, not merely aiders and abettors—they are no longer tacitly involved, they are key players)
2. You can get out of it by making a “noisy withdrawal” and publicly stating that the documents are false and you get some leniency

b. **Insider Trading**

i. Insider trading is bad because insiders have the opportunity have the opportunity to sell short and then intentionally hurt the company (not good for shareholders)

ii. Insider trading might be good, however, because it saves enforcement costs for the government and companies, and promotes economic efficiency because people will work harder to find out the information and others can merely watch what insiders do and follow their lead
1. It should flatten out the stock price (less volatility)

iii. **Types of insiders:**
1. **Classic insiders**: corporate insiders who are officers, directors or beneficial owners of companies
2. **Misappropriation theory**: people who breach their fiduciary to their company which was entrusted with inside information (trade on information owned by your employer—say Wall Street Journal)
3. **Tipper/Tippee**: If you are a tipper and reveal inside information in exchange for personal gain you are liable. If the tippee knows the tipper breached a duty he is also liable

iv. *SEC v. Texas Gulf Sulphur*: Anyone in possession of material information must either disclose it to the investing public or must abstain from trading in or recommending the securities concerned.
1. These men had material information (if they had disclosed it, it would have had a serious effect on the market price and would have changed the decisions of reasonable investors) about new mines and chose to say nothing but invest based on their inside information

2. Ended up being forced to repay the profits they earned on the shares of stock they bought

3. Want directors and officers to have an interest in the companies, so thus they should have stock, but it should only be sold on an automatic schedule out of their hands or after important information has been released

v. Chiarella v. U.S.: The duty to disclose arises when one party has information that the other party is entitled to know because a fiduciary or trust relationship between them.

1. This guy had no duty to the company or the seller and came about the information in a different way (probably violated the trust of his employer and may be in trouble for that), so he had no requirement that he disclose material facts—he got information and acted on it, this is the way people make money
   a. The SEC passed 14e-3 shortly thereafter to prohibit trading with undisclosed information about a pending tender offer, so this would have been illegal even though he wasn’t an insider

2. In Carpenter v. U.S, a guy was a reporter for the Wall Street Journal who got inside information and then published it the next day. He invested before making the announcements and made a bunch of money and was convicted because he misappropriated information owned by the Wall Street Journal to make money

vi. U.S. v. O’Hagan: A partner in a law firm that was representing a company in a tender offer (was not playing an active role) bought shares of stock on his information about the pending deal

1. He used confidential information that he misappropriated from his company in breach of a fiduciary duty (lawyers, accountants, etc. are often considered temporary insiders)

2. Discusses trading “on the basis of” insider information, which seems to imply that you could trade while you have the information if you had some other reason to make the trades—this has been interpreted to mean that knowing possession of the information is enough though (you can’t choose not to act on the information, it is always in your mind (not like a loaded gun you can choose not to shoot))

3. Misappropriation Theory: a person commits fraud in connection with a securities transaction when he misappropriates confidential information in breach of a duty he owes to the source of the information (essentially stepping into the shoes of an insider)
   a. He is in trouble because he is connected with the purchase even though he is not an actual insider—he owes a duty to the insider who provided him with the information (two-step process)
   b. Breaching a duty to his firm

vii. Dirks v. SEC: A duty to disclose arises from the relationship of the parties, not merely from one’s ability to acquire information because of his position in the market

1. If someone does a transaction with someone they know has a fiduciary duty, they are also liable—their purchase is just as forbidden as the transactions of the trustee himself
2. A tippee inherits an obligation to share any inside information he uses that he learned from an insider; tipper breaches his duty by sharing the information
3. If there is no personal gain (as here where a guy was simply trying to assist a whistleblower), the duty does not arise to inform publicly
4. If you are simply an eavesdropper and come about information innocently you can use it without disclosure
5. Regulation FD prohibits selective disclosure to only certain insiders or tippees

viii. U.S. v. Chestman: A man who was related to the owners of a company found some information and told his broker even after he was told not to tell anyone. He was not guilty though because it would be unfair to impose a fiduciary duty simply because they were married
1. Marriage without more does not create a fiduciary relationship (must also have repeated disclosures of business secrets (confidences) or a showing that he had an influence over business decisions)
2. 10b5-2 now lists a number of relationships (spouse, child, sibling, etc.) under which you have a presumption of a fiduciary relationship and must rebut it
3. Rule 14e-3 (rule against inside information related to tender offers) upheld here

ix. The SEC has adopted a zero tolerance approach to insider trading and pursues all cases now
x. There is also a private right of action against the inside trader, so you can be punished criminally and civilly by the government and private citizen (who bought or sold to you)

v. Judicial Development of Liability for Securities Fraud
i. Basic Inc. v. Levinson: An omitted fact is material fact if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.
1. There must be a breach of duty by an insider for there to be a claim, so here it was:
2. Fraud on the Market Theory is created in this case and it is a rebuttable presumption that each investor relies on the accuracy of the going market price in deciding whether to buy or sell, so if the price is affected by false statements the investor has relied on the underlying misstatements
   a. Look at whether investors would have made the same investment decision if they had full, accurate information
   b. This theory requires an assumption of an efficient market which doesn’t really exist, so prices are going to be affected by more than some incorrect information (no proof that with perfect information an investor will make a different decision)
   c. **Misstatement must still be material
   d. Rebuttal must show that the information they gave or omitted was not material

3. Nondisclosure is legal except in a few situations:
   a. Disclosure is required if undisclosed information renders previous public statements by a corporation misleading
   b. The corporation has reason to believe that investors are engaged in trading in the market on the basis of the information that has not been disclosed
   c. If they are rumors going through the brokerage community that are generally, but incorrectly, being attributed to the issuer

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ii. *Jammies International v. Lazarus*: Rule 16(b): For the purpose of preventing the unfair use of information which may have been obtained by a beneficial owner, director, or officer because of his relation to the issuer, any profit realized by him by any swing sale within a period of less than 6 months shall be recoverable by the issuer

iii. **Private Securities Litigation Reform Act**

1. Makes it harder to pursue securities litigation by imposing many requirements on plaintiffs
   a. Incentives for class action lawyers are reduced (fees are capped)
   b. Discovery delayed (no fishing expeditions)
   c. Heightened pleading
2. Has not been very successful

XIII. **Takeovers**

a. **The Beginning of the Takeover Movement**

i. **Proxy Fights**

1. A non-management group owning a small minority of shares compete with management in an effort to obtain sufficient proxy votes to elect a majority of the board of directors and take control of the company
   a. Essentially a political campaign to get shareholders to support their candidates
2. Rarely used because it is expensive and very risky—not really feasible at all for large companies.
3. To wage the fight they needed a list of shareholders and this notified the management of the impending fight—no surprise (you need to go to court to get a recent shareholder list—the one on record is from the previous shareholder meeting) and it not of much use because of the use of street names, etc.
   a. The SEC doesn’t require companies to give out actual lists, they can agree to do the mailing themselves to withhold the names (and this make it harder to advertise and communicate in other ways)
   b. Some state laws require companies to disclose the list
4. Proxies are solicited by mailings, personal contact, commercials—they must register with the SEC before this begins
5. Often not successful
6. Corporations can usually charge the costs of defending to the company (if they are doing it based on policy rather than the personality of the firm), but the insurgents have to pay by themselves if they lose and if they win they have to argue that it was in the best interests of the company to get reimbursement

ii. **Cash Tender Offers**:

1. A person trying to acquire control of a corporation goes directly to shareholders and makes them an offer to “tender their shares”—basically sell their shares—and get a nice premium
2. If something is called a tender offer it is regulated under the **Williams Act**
   a. 13(d): disclosure requirements if they get 5% of they company
   b. 14(d)—disclosure relating to tender offer
   c. Rules regulating tender offer itself
   d. Designed to protect shareholder, targets and aggressors
   e. States also have anti-takeover statutes
3. There is an 8 part test to determine if it is a tender offer:
   a. They make a public announcement
   b. The offer is made for a substantial percentage of the target’s stock
   c. The offer is made at a premium over the prevailing price
   d. The terms of the offer are firm rather than negotiated
   e. The offer is contingent on a fixed % of the shares and possibly a maximum
   f. The offer is open for a limited period of time
   g. The offerees are subject to pressure to sell
   h. Announcements of the sale preceded or accompany purchase of large amount of target company shares

4. You can acquire up to 5% of the target company’s shares without disclosing to the SEC

iii. Leveraged Buyouts
    1. An aggressor purchases almost all the outstanding stock of the target at a substantial premium over the market price and it was financed through loans and junk bonds
    2. Repayment would be expected by the target company—the company basically bought its own shares and the payments came from selling the acquired company’s component parts and its cash flow, which was increased by tax savings. Eventually when debt was sufficiently paid off, the company would once again go public
    3. Banks made these loans because they got a lot of money to agree to them (which they kept if the deal failed) and if they did go through they were almost assured they would be paid off and got very good rates

4. Bootstrap acquisitions: the acquired company provides the funds to finance its own purchase
   a. Many companies fought these by using their excess cash and restructuring their financing to have more debt which makes the company less attractive

b. Defenses: State Legislation
   i. CTS Corp. v. Dynamics Corp.: Absent an explicit indication by Congress to preempt state law, a state statute is only preempted where compliance with both the state and federal law is impossible. The Indiana regulation prohibited companies who purchased a certain % of the company from using its voting power without approval of other shareholders—made it very difficult to take over the company
      1. State anti-takeover regulations that are intended to protect shareholders and corporations registered in that state—this furthers the federal policy of investor protection and the local benefits allow it to impose these restrictions even if it hampers transactions
      2. Can’t outright prohibit transactions, but it can regulate them

c. Defenses: Poison Pills
   i. Poison Pill=Shareholder Rights Plan:
      1. Basically bad things will happen to the acquirer if he chooses to takeover the company
      2. Create new classes of shares that increase in rights if an aggressor obtains a certain percentage of shares (the aggressor would not share the rights), which
encourages them to negotiate rather than go for a hostile takeover; or they will offer call offers that can be bought for half the market price if the company is taken over, which becomes a liability for the acquirer

3. Most plans allow the target to “redeem the rights” (if they get the right price they will withdraw the poison pill)
   a. This allows the acquirer to take over the company and then change the board which will redeem the rights and immediately take over the company
   b. Some plans now have “dead hand” or “no hand” provisions which restricts the ability of the board or the acquiring board to redeem the rights (courts may find them unfair and can be withdrawn)

ii. Mentor Graphics Corp. v. Quickturn Design Systems: A company can amend its bylaws to delay special meetings after a company acquires a certain percentage of the outstanding stock, but it cannot prevent the company from voting its shares at that meeting (so the new company can thus elect in its own board right away)
   1. Poison pill which precluded a board of directors from redeeming a poison pill interfered with directors’ ability to manage the company so it was illegal
   2. Some states then passed regulations allowing boards to bind subsequent boards

iii. International Brotherhood of Teamsters v. Fleming: A board can place restrictions or conditions on the exercise, transfer or receipt of shareholder rights which can dilute the shareholding power of one seeking to control a company (slow it down, a poison pill)

d. Takeover Defenses and Judicial Review
   i. Shareholders of target corporations will almost always realize more for their shares if the offer succeeds than if it fails, which conflicts with the idea that the sole goal of the directors should be to maximize shareholder profits, but management faces a crisis since they’ll lose their jobs and their prestige. Also worried about massive layoffs, etc.

Justification for defenses must be offered, common ones include:
   1. The offering price is too low
   2. The aggressor’s reputation is bad
   3. The aggressor is assuming a debt burden it can’t support
   4. It is in the best long run interests of investors to defeat the deal
   5. Management has embarked on long range plans to improve profits
   6. The resulting combination would result in antitrust violations
   7. The deal is unfair to shareholders by coercing them to tender

ii. One very effective and popular method is to have a three tier plan:
   1. Classify the board into three groups, one group being elected each year
   2. A prohibition against removing directors except for cause
   3. A provision prohibiting certain designated amendments to the bylaws and articles of incorporation unless approved by a supermajority of shareholders

iii. Panter v. Marshall Field: The Marshall Field board adopted an expansion plan so the deal ran into antitrust problems, but once the other company pulled out the stock price plummeted and shareholders sued to recover money. The court said the directors had used their business judgment and the presumption was that they’d acted in good faith
   1. The dissent argued that the board essentially had immunity and the court should have intervened to protect shareholders
iv. *Unocal Corp. v. Mesa Petroleum*: Unocal was going to be taken over and the shareholders who did not tender their shares would receive junk bonds subordinated below other debt (bad news), so Unocal implemented an exchange offer where they could exchange their shares for debt that would be senior to Mesa’s—hurt financing (no one wanted to loan them money if they would already owe a lot of debt). The court held that the plan was legal. The threat was real and the board took a reasonable measure to combat it.

1. They were self tendering for their own shares and if the other company took them over it would be swimming in debt
2. Court determines that if the board is going to be protected by the business judgment rule the threat must be in a reasonable relationship to the defensive tactics—enhanced judicial scrutiny; proportionality
3. SEC rules now prohibit selective stock repurchases (purchasing everyone's shares except for the aggressor)

v. *Revlon v. MacAndrews*: A company offered to buy Revlon shares instituted a series of defensive tactics including buying back their stock (hoping to avoid the company being broken up) and the other company upped its offer. Revlon found a “white knight” and sold it to them, but the other company offered a higher value

1. The court agreed that the company could fight off lower offers, but once it agrees to sell to a friendly company, it becomes an auction situation and they are required to take the highest bid

vi. *Unitrin v. American General*: The company initiated a major share repurchase plan in the face of an unwanted all-cash and proxy contest. The court allowed the defense—the tactics were proper and proportionate. The action cannot be “coercive or preclusive” or draconian, but they can prevent suitors from getting to their shareholders