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I. Basic Concepts and Terminology
   a. What is a firm?
      i. The Firm
         1. The “firm” is what we call the set of relations that arise when resources are allocated
            by the entrepreneur via commands to her employees rather than the set of relations
            that arise when an entrepreneur allocates resources via contract with outsiders
      ii. The Coasean Firm
         1. Resources are allocated to their highest and best use not in response to governmental
            orders or other communicated commands, but, as if by an invisible hand through the
            separate, self-interested choices of all producers and consumers
      iii. The Principal-Agent Model
         1. Shareholders own a firm, the firm is the shareholders agents and are merely
            delegating control to the board of directors, who delegates control to the officers
            (CEO, CFO, COO, etc.)
         2. Why don’t shareholders own the firm themselves? Why delegate control?
            a. Transaction Costs - Completely inefficient, take too long for day to day
            b. Operating choices are difficult to make day to day
            c. People don’t necessarily have an incentive if they have minimal shares in the
               firm
               i. Collective action
               ii. Rationality
            d. Maybe this would work with a small, ten shareholder company, etc.
            e. Agency Costs: Conflicts of interests between the principals desires and the
               agents desires
      iv. The firm as Nexus of Contracts
         1. The firm is described as a nexus of contracts between the various claimants to a share
            of the gross profits generated by the business.
         2. This method involves both contract relationships and employees, etc.
         3. This model believes The firm is nothing but a series of explicit and implicit contracts
            between all the corporate constituencies
            a. Includes shareholders, suppliers, laborers, customers, directors and officers,
               local community, etc.
         4. Problems
            a. One problem is that in most instances there aren’t contracts (implicit)
               i. Therefore, we engage in hypothetical bargaining
                  1. (1) The goal is to maximize the value of the firm (efficiency);
                  2. (2) Shareholders are the principal residual claimant to this
                     value (they get paid last – they get what’s leftover)
                     a. laborers get first, creditors get first, etc.
                  3. Conc: Shareholder’s goal is to maximize residual profit
            b. Employees don’t worry about insuring the maximum value of the firm, they
               worry about cash flow, and those things that get them paid
            c. Shareholders are also the least able of all the constituencies to protect
               themselves adequately
               i. They are last in line
ii. There is nothing they do after making their initial investment – they are stuck. The employee can leave, can change if his asset specific investment might have more value elsewhere

iii. No chance to renegotiate on a day by day business

v. Berle & Means (Explication of the Nexus of Contracts Model)
   1. “The separation of ownership of control”
      a. In large, publicly held corporations, ownership is separated from control
      i. The specialization of function: delegation of authority to experts specialized in the business
      ii. Board of Directors: Charged with overseeing the officers: the problem is still that the shareholders can’t monitor the board of directors
         1. The officers are the ones who monitor the board of directors
         2. Therefore, although shareholders own the company and are represented by the board, the officers, who have control, ultimately runs the board (now we just relocated the rational apathy and collective action problem)

   b. How do we solve the passivity problem?
      i. (1) Directors and officers are shareholders themselves?
         1. They want to maximize value of the shares for themselves, which may protect the shareholders
         2. You incentivize the agent by making what’s in the agents best interest what is in the principal’s best interests
            a. Stock options
      ii. (2) You have liquidity as a shareholder
         1. If you don’t like how its coming along, you can walk away

   c. Ways to finance operations:
      i. Borrow money
      ii. Sell shares
      iii. Sell assets
      iv. Become more profitable – retain earnings

   d. Dividends
      i. The payout of the company’s earning to the shareholders – board has this discretion of whether to give dividends, shareholders have no say

   e. Other devices that keep management in check:
      1. Product markets (competition)
      2. You can get fired
      3. The Board can be Removed

b. Sole Proprietorship v. Business Association
   i. Sole Proprietorship means a sole owner carries out business practice
   ii. Business associations are more than one owners and are usually organized as a partnership, a corporation, or a limited liability company.

II. Organizing the firm: Selecting a Value Maximizing Governance Structure
a. Business Planning: The Role of the Corporate Lawyer
   i. The lawyer is a planner of the business
   ii. Important to recognize that firms like private settlement of disputes over litigation
      1. This is more efficient and more in line with the pre-dispute expectations of the firm
b. The goal of informed rational choice between competing investment options
   i. Comparative search for Best Investment
      1. The goal is to maximize the value of both our human and money capital by investing efficiently
      2. This is an ex ante choice, and is impossible to visit the future
   ii. Risk and Return
      1. Risk – the degree to which the various possible outcomes will differ from the expected return.
      2. Multiply the possible return by the risk percentage to determine the Expected Return
      3. Investors are categorized as risk-averse, risk-neutral, or risk-preferring
         a. However, a risk-averse person may vow for higher risk if the stakes are very low ($1 lottery ticket)
   iii. Diversifying a Portfolio
      1. You achieve a less risky portfolio by diversifying your holdings so that the range of possible outcomes varies less from the expected return – or mean of possible outcomes – than before.
         a. E.g. Sharon has $200 invested in a company whose Expected Return is $216, and possible return is $240, with 90% positive risk possibility. She can invest either in another company that is exactly similar or in bonds that have an Expected Return of $216, a Possible Return of $216, and thus a 100% positive risk possibility. She would diversify by investing in the exactly similar company, because if one goes bankrupt it is highly likely that she will cancel it out with a $240 return as opposed to a $216 return.

c. Transaction Costs and Choice of Organization Form
   i. Introduction
      1. You must assume two things between partners:
         a. People will use their best efforts to make the venture successful
         b. Profits will be divided according to their relative contributions
   ii. Transaction Cost Factors
      1. Bounded Rationality
         a. We, as people, have cognitive limitations. We cannot always do the most efficient thing.
      2. Opportunism
         a. Open Self-Interest Seeking: actors prefer their own interests to those of other economic actors, but do so while being honest and aboveboard in their dealings
         b. Opportunism: actors seek to further their own ends by taking advantage of the information deficits of those with whom they deal
      3. Team-Specific Investment
         a. When an asset or a person has a higher value in its current team use than its value in its next best use, the person or asset is said to have team-specific value (p. 7)
            i. $U_1 > U_2 \Rightarrow U = \text{utility}$
         b. How this leads to opportunism
            i. If I know you are not as good somewhere else, I can try to exploit you up until the point that you are only slightly better where you are now
She may still be better working with me when I’m taking advantage of her then she would be in her second-best scenario.

iii. Discrete and Relational Contracting
   1. Discrete Contracting
      a. The parties have no pre-existing obligation to each other.
      b. As they approach a venture, the negotiate a contract that seeks to cover all future contingencies
      c. Discrete Contracting is most likely to be successful when the duration of the relationship is short, and the transactions between them are few
   2. Relational Contracting
      a. Parties do not attempt to provide an answer to all contingencies at the time the relationship commences
      b. Instead, the attempt to build a governance structure that allows them to deal with problems as they arise.
      c. The hope is that the parties will continue to act in good faith, and cooperate through controversy.
      d. However, this does not rule out opportunism.

iv. Deciding to organize as a firm
   1. The advantage of organizing as a firm is to avoid the substantial costs from having team members’ compensation and incentives misaligned and from the haggling to correct these misalignments
   2. The disadvantage of organizing as a firm for an employee is that in surrendering autonomous control over her own business she become subject to the employer’s opportunism

ii. State Provided Governance Structures
   i. Entity and Employment Law as Standard Form Contracts
      1. By structuring the relationship as that between employer and employee, or as a corporation, partnership, or LLC, the parties receive the benefit of state-provided rules and dispute resolution processes, as opposed to having to imagine every possible expectations.
   ii. Default v. Immutable Rules
      1. It is important to know which rules are default rules, and can be adjusted by the contractor, and which rules are immutable, and cannot.
   iii. Tailored, Majoritarian, and Penalty Default Rules
      1. Tailored: designed to give contracting parties the exact rule that they would themselves choose if they were able to bargain without cost over the matter in dispute.
         a. This produces substantial costs when trying to determine what the proper resolution should be
      2. Majoritarian: designed to provide investors with the result that most similarly situated parties would prefer.
         a. Designed to provide the results most would have bargained for in a cost-free environment
      3. Penalty Default: The goal is to force the parties to specify their own rules ex ante, instead of relying on the default rule provided by law (which is a penalty for failing to specify)
e. Non-Judicial Mechanisms that supplement and reinforce private ordering
   i. Governance Role of Markets: What plays a role in governing firms
      1. Product Market
         a. Each firm competes to sell its goods or service
      2. Capital Market
         a. Seek to gain capital (loan, etc.) and the investor seeks the best return on investment.
      3. National Securities Market
         a. Thought to provide a relatively accurate measure of the value of a publicly traded firm
      4. Labor Market
         a. The reputation-based costs imposed by exposure as a negligent or dishonest team member may deter poor conduct more efficiently than fear of legal action
   ii. Role of Trust
      1. Cooperation and trust foster a sense of community and unity and everyone does better.
   iii. Role of Norms
      1. NLERS: Non-legally enforceable rules and standards
         a. How you dress at the firm, how you participate in the “corporate culture”, etc. Some of these can be good, and some bad
            i. Note Enron Corporate Culture.

III. The Law of Agency (Introduction to Fiduciary Duties)
   a. Introduction
      i. Agency law may be thought of as a set of standard form rules that provide a backdrop for contracts or market transactions among team members
   b. Agency Law and the Choice of Sole Proprietorship Form
      i. The owner is called the principal
         1. Signals entry into the firm through capital investments and agreeing to employ others
      ii. The employees are called the agents
         1. Signals entry into the firm by agreeing to provide services at the will of the principal
      iii. Unless otherwise agreed, this relationship is terminable at will
         1. Therefore, contracts are necessary to establish a duty
      iv. In most jurisdictions, entry into a firm provides fiduciary duty to its agents that can be violated by opportunistic conduct
   c. Fiduciary Limits on the Agent’s Right of Action
      i. Fiduciary duty suggests agent must deal with principal “in total candor, must account to principal for all profits flowing from information he receives in her service, must not use of disclose principal’s trade secrets, and may not carry on competing business until after the agency relationship is terminated.”
      ii. It is, in short, a moralistic determination, and also it is a contractual device supplied to principal and agents by the state.
   d. Community Counseling Services, Inc. v. Reilly
      i. Reilly was hired by CCS to solicit business for Christian organizations. He asked for leave on January 5 to commence January 29. Prior to leaving, he arranged for business (which he would later receive a substantial sum for in commission) in the same business as CCS. “Before termination of his employment with CCS, Reilly not only formed the intention of engaging in fund raising activities on his own account, but he actively sought
employment for himself and entered into firm agreements on his own account, with the result that there was not substantial hiatus between the termination of his employment by CCS and the commencement of the first of the three campaigns he had lined up for himself. Held, Reilly had no right to engage in competitive business against his employer before termination of his agent relationship. “Until the employment relationship is finally severed, the employee must prefer the interests of his employer to his own.” This is a violation of fiduciary duty, and Reilly must give back the money.

e. Hamburger v. Hamburger

i. David, son of Joseph, nephew of Ted, Hamburger worked for Dad and Uncle in family business. Dispute between Dad and Uncle, David is unsure that he has any long term job security, so he decides to form his own business in the same industry. P contends that David’s arrangements for financing and leasehold arrangements and his solicitation of Dad/Uncle’s customers were wrongful b/c they not only had commenced while David was still an employee, but b/c the customer solicitation was facilitated by David’s wrongful appropriation of confidential customer lists and pricing info of Dad/Uncle’s company, which David is alleged to have obtained with Dad’s connivance, in violation of fiduciary duty. Held, David has not violated his fiduciary duty. No evidence David had commenced soliciting customers prior to his leaving company. Also, customer lists are not trade secrets if they are available from other sources, such as a business directory. If employer wants agent not to compete, must employ a non-competition clause in the contract. Also, David acted in best interest of company when he quoted prices prior to leaving.

f. Notes on Cases

i. Definitions of Fiduciary Duty

1. Can best be described as a device for economizing on transaction costs – imposes a general obligation to act fairly
2. Fiduciary duty “obliges the fiduciary to act in the best interest of his client or beneficiary and to refrain from self-interested behavior not specifically allowed by the employment contract.”
3. “Socially optimal fiduciary rules approximate the bargain that investors and agents would strike if they were able to dicker at no cost.”

ii. Non-competition agreements in bargained-for contracts

1. Courts will enforce them after balancing the legitimate interests of the employer in protecting her business against the legitimate interest of the employee in seeking to redeploy her human capital.
   a. Robbins v. Finlay
      i. Non-competition clause is void because it “prevented the defendant from exploiting skills and experience which he has a right to exploit.”

G. Agency Law and Relations with Creditors

i. Agency law provides standard rules on which the agent and creditor can rely

   1. A third party that deals with an agent does so at his/her own peril
   2. The agent’s action will bind the principal only if the principal has manifested his or its assent to such actions.
      a. Actual authority
         i. Expressed to the agent his will or impliedly assented through previous acquiescence, etc.
      b. Apparent authority(§ 301)
         i. Principal expresses his consent directly to the third party who is dealing with the agent. This also can be implied.
      c. Inherent authority
         i. Springs from a desire to protect the reasonable expectations of outsiders who deal with an agent.
Could be best viewed as an implied term in the contract between a principal and all who deal with its agents

3. Disputes between principals and third parties
   a. Usually two forms:
      i. Cases in which an agent exceeds her authority in an attempt to further the interests of the principal, and
      ii. Cases involving totally opportunist action, where the agent misleads both the principal and the third party

4. **Blackburn v. Witter**
   a. P was represented in stock purchases by employee of Dean Witter, who had her invest in faulty company. Employee misrepresented to P her investment, and returned receipts and procedures markedly different from those used by Dean Witter and another company the employee had previously worked for. Held, Witter is bound by the employee and liable to P. “A principal is bound by the acts of his agent, under a merely ostensible authority, to those persons only who have acted in good faith, and without want of ordinary care, incurred a liability or parted with value, upon the faith thereof.” (3) Principal must bear the risk of the agent’s acts if it seems to be a reasonable transaction to an outsider
   b. Here, P relied on some of the services used by brokerage firms (approval of research department) in accepting the investment from employee. She did not act in bad faith (no business background, etc.) Therefore, P acted with ordinary care.

IV. Traditional Noncorporate Business Associations
   a. General Partnership
      i. Definition of General Partnership:
         1. “Any association of two or more people who carry on a business as co-owners. A general partnership can come into existence by operation of law, with no formal papers signed or filed. Any partnership is a “general” one unless the special requirements for limited partnerships are met.”
      ii. Facts about partnerships
         1. Every state but La. Bases its partnership law on the Uniform Partnership Act (UPA 1914) or the Uniform Partnership Act (UPA 1997)
         2. All that is required to form a partnership is a statutorily specified mutual manifestation of consent
         3. Presumably, many of the provisions of general partnership law save transaction costs for the archetypical general partnership b/c the standard form rules are those that the partners would themselves select if they could rationally and without cost bargain for a fully contingent contract.
         4. The Archetypical Partnership
            a. A small, intimate firm in which each partner participates in all aspects of the business and has substantial confidence in the trustworthiness and skill of fellow partners
         5. Control and profits are generally shared equally
         6. Equality principle is thought to reinforce the notion that partnership is relationally based
            a. You can contract around this
      7. Liability
         a. Are partners are jointly and severally liable for everything – debts, obligations, punishment, civil, etc.
         b. Liability is not limited to the extent of your investments
c. **How to handle liability concerns with a general partnership:**
   i. Prevent unilateral actions
      1. Put checks on anything that could harm the company in any major way
         a. Everyone signs off on it, certain things require majority or supermajority vote of the partners
         b. Maybe you hire a separate independent manager who is not a partner (a CEO)
      2. Another way is to limit partnership distribution – must have to set up a reserve account that can’t be distributed to the partners in order to settle the obligations in the case of liability
   ii. Problem when you go to the partners and say you want all these checks on their control?
      1. Think you distrust them, etc.
   iii. **Major Rules**
      1. All partners have an equal sharing of ownership and management functions
      2. Individual partner’s adaptability to changed circumstances favored over firms continuity and adaptability
         a. Under general partnership law, if the partnership wishes to terminate its association with a partner, it may do so only by dissolving the partnership and paying the expelled partner the value of her interest in cash
      3. **Unlimited Personal Liability in a General Partnership**
         a. All partners are jointly and severally liable for the obligations of the partnership
      4. **Fiduciary Duty**
         a. Each partner owes a fiduciary duty to every other partner
   b. **Limited Partnership**
      i. **Formation**
         1. Can only be created where (1) there is a written agreement among the parties and (2) a formal document is filed with state officials
      ii. **Two Tier separation of Ownership and Management**
         1. General partners are managers: Limited partners have essentially no management power and no authority to act as agents in carrying out the partnership’s business
      iii. **Limited liability**
         1. However, General Partners, and not limited partners, are jointly and severally liable for the firm’s obligations
         2. The limited partners are liable only up to the amount of their capital contribution
            a. But a limited partner will lose this limit on his liability if he actively participates in the management of the partnership
   iv. **Rationale for the Partnership**
      1. Again, the firm’s continuity and adaptability to changed circumstances favored over individual’s adaptability (team-specific investment is better as a team)
   v. **Consequences of being a limited partnership**
      1. Firms may pay less in dealing with limited partners
a. Or, they may try to make them on the hook by forcing them to invest more through a guarantee, or they simply guarantee their obligations through contract, or by forcing them to take on more authority
b. Everything we are saying is focused on voluntary creditors (not tort creditors who don’t have a say prior to the induction of the credit)

c. Joint Ventures
   i. Definition
      1. (1) Two or more persons must enter into a specific agreement to carry on an enterprise for profit; (2) Their agreement must evidence their intent to be joint venturers; (3) Each must make a contribution of property, financing, skill, knowledge, or effort; (4) Each must have some degree of joint control over the venture; (5) There must be a provision for the sharing of both profits and losses
   ii. Rationale for doing a Joint venture
      1. Joint venturers may have greater room to prefer their own interest than fiduciary duty would allow them to as general partner (have more room to pursue their self-interest)

d. Limited Liability Company (LLC)
   i. General
      1. This is neither a corporation nor a partnership, though it has aspects of each (the best of both worlds)
      2. Formed by filing a “constitution,” usually termed articles of organization, with the secretary of state
   ii. Components
      1. Partnership-like central management
         a. Members – analogous to a partner
      2. Also have fallback rules assigning management powers to “managers” and taking away most of the management powers and authority that members would otherwise possess.
      3. The biggest advantage of the LLC compared with either a general or limited partnership is that in the LLC, a member is liable only for the amount of his or her capital contribution, even if the member actively participates in the business.
         a. With the exception of fraud
   iii. Taxed as partnership
      1. The LLC’s biggest advantage is that the LLC’s members can elect whether to have the entity treated as partnership or a corporation.
         a. If they elect partnership treatment, the entity becomes a “pass-through” entity, and thus avoids the double-taxation of dividends that shareholder of a standard corporation suffer from.

e. Limited Liability Partnership (LLP)
   i. Most states now allow this type of partnership;
   ii. In an LLP, each partner may participate fully in the business’ affairs without thereby becoming liable for the entity’s debts

f. Duty to Disclose
   i. You have a duty to disclose everything to your partners.

g. Corporation v. Partnership decision
   i. Superiority:
1. **Corporation Superior**: The corporate form is superior: (1) where the owners want to limit their liability; (2) where free transferability of interests is important; (3) where centralized management is important (i.e. a large number of owners); and (4) where continuity of existence in the face of withdrawal or death of an owner is important.

2. **Partnership Superior**: The partnership form is superior where: (1) simplicity and inexpensiveness of creating and operating the enterprise are important; or (2) the tax advantages are significant, such as avoiding double taxation and/or sheltering other income.

ii. Management

1. Corporations follow the principle of centralized management. The shareholders participate only by electing the board of directors. The board of directors supervises the corporation’s affairs, with day-to-day control resting with the officers.

2. In partnerships, management is NOT centralized. In a general partnership, all partners have an equal voice (unless they agree otherwise). In a limited partnership, all general partners have an equal voice unless they otherwise agree, but the limited partners may not participate in management.

iii. Continuity of Existence

1. A corporation has “perpetual existence.” In contrast, a general partnership is dissolved by the death (or usually even the withdrawal) of a general partner. A limited partnership is dissolved by the death or withdrawal of a general partners, but not a limited partner.

iv. Transferability

1. Ownership interests in a corporation are readily transferable (shareholders just sell the stock).

2. A partnership interest, by contrast, is not readily transferable (all partners must consent to the admission of a new partner).

V. More on Fiduciary Duty

a. **Meinhardt v. Salmon** *(Fiduciary Duty in a Joint Venture)*

i. Salmon wanted to reconstruct a building he was leasing, and Mienhardt donated funds, subject to the repayment by Salmon of profits for a certain length of time. They were joint venturers. Later, the owners of the building wanted to tear down the buildings and replace them with better buildings. After several failed attempts with other investors, the owner contracted with Salmon. Salmon didn’t tell Meinhardt (his joint venturer) about the new lease. When Meinhardt found out about it, it was a done deal but he wanted a part of it as part of the joint venture; however, they denied him. He filed suit.

ii. Rationale

1. Joint adventures, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. A trustee (fiduciary) is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.

2. The problem with Salmon’s action is that he excluded his co-adventurer from any chance to compete, from any chance to enjoy the opportunity for benefit that had come to him alone by virtue of his agency.

   a. This chance, if nothing more, he was under a duty to concede.

3. By not informing his co-adventurer, he breached a duty to him, for we have no idea what Meinhardt might have been able to negotiate. Maybe he might have made a better deal.

iii. Dissent perspective:

1. There was no general partnership, merely a joint venture for a limited object, to end at a fixed time. There is still the utmost duty of care, within the bounds of the joint venture. This lease was outside the joint venture.

b. Fiduciary Duty Notes
i. UPA § 405 recognizes a partner’s right to a formal accounting to enforce fiduciary duties or contractual rights.
   1. A formal accounting is an equitable proceeding. The court, acting through a master, has power to determine the true facts about partnership affairs, to settle disputes about the proper interpretation of partnership agreements, and to determine the relative rights and duties of the partners.
      a. The court may grant a money judgment in favor of a partner, if appropriate, and may grant injunctive or of the equitable relief.

ii. UPA § 403 requires a partner, on demand, to furnish the requesting partner with full and complete information about partnership affairs.

iii. An important aspect of fiduciary duty is its impact on litigants’ burdens of proof. Under the normal rule, fiduciaries must carry the burden of proving by clear and convincing evidence that they have fulfilled their fiduciary obligations.

iv. Perspectives on Fiduciary Duty
   a. Some see it as an immutable feature of partnership law, empowering judges to ensure fair dealing, good faith, and loyalty among partners.
   b. The opposing view is that fiduciary duty is a mutable, quasi-contractual feature of partnership law that must yield to contractual specification of rights and duties.
   c. The compromise is UPA § 103, which sees fiduciary duty, fair dealing, and good faith as partly immutable and partly mutable or definable by private contract.
   d. You cannot contract around duty of loyalty, but you can’t contract around other terms and provide specific examples of conduct the partners agree will not violate fiduciary duties if those aren’t manifestly unreasonable.

VI. The Power to Manage and Bind the Firm
   a. Allocation of Decision-Making Authority
      i. UPA (1997) § 401(f) & (j)
         1. Each partner has equal rights in the management and conduct of partnership business.
         2. § 401(j)
            a. Differences as to ordinary matters connected with partnership business may be decided by a majority of the partners.
            b. Also requires that disagreements as to extraordinary matters must be decided by unanimous vote of all partners.
   b. Responsibility for the Unauthorized Contractual Acts of General Partner
      i. UPA (1997) §§ 102, 301, 303, 306, 603
1. Whether a General partner has authorization is a matter of agency law

ii. *RNR investments Ltd. Partnership v. Peoples first Community Bank*

   1. RNR is limited partnership. According the partnership agreement, the partner could not exceed anything in the Budget by more than 10% or the total budget by 5%. General Partner should not incur debts and liabilities against the partner either. General Partner has loan for 990,000. He was only authorized for 650,000. The partnership felt the bank was negligent in not asking to see the partnership agreement. **Held**, summary judgment for the bank b/c no material issues exist and partner has apparent authority, even if not actual, to enter into loan agreement. (1) General Partner has apparent, even if not actual, authority. (2) The Bank is not required to inquire, and it appears in this case that the bank never had actual knowledge as required by the statute.

iii. Partnership Act §9 and §301: “Every partner is an agent of the business and can carry on the operations of the business as an agent the usual way.”

   1. Partnership is a merger of assets, resources, and talents, and therefore should all have the same authority (not necessarily representative of investment)

iv. When Partner Doesn’t Have Authority and the Third Party Knows This

   1. Agreement designates this partner doesn’t have authority to deal as agent
   2. The action shouldn’t have passed
   3. The burden is on the Third Party to recognize the risk

v. When the Partner Doesn’t Have Authority and the Third Party Doesn’t Know

   1. Then the Partner is the least cost avoider, b/c the burden to discover cannot be placed on the Third Party
   2. Look at *RNR* case, *supra*, for a discussion of this issue (partner agent acting beyond his powers and third party doesn’t know)
VII. The Corporate Form

   i. MBCA §§ 2.06, 8.01, 10.01-10.04, 10.30; Delaware G.C.L. §§ 109, 141(a), 142,242

b. Overview
   i. Articles of Incorporation
      1. Corporations name
      2. Registered Office and Agent
      3. Amendments must be introduced by Board and Approved by shareholder (§ 262 & 242)
   ii. By-laws
      1. Contain provisions for running the business that aren’t inconsistent with the law or AOC
      2. Not public
      3. Can be amended by directors or shareholders alone
      4. Whether shareholders can adopt by-laws that impinge on directors ability to run the business
      5. General
      6. The archetypical corporation separates management functions into three separate roles: directors, officers, and shareholders.
         a. Shareholders provide capital and elect directors
         b. Directors make major policy decisions
         c. Officers Execute those policies and provide day-to-day management
      7. While the corporate form assumes separation of functions, IT DOESN’T REQUIRE IT
      8. By statute, all corporate powers are exercised by, or under the authority of, the board of directors; day to day to officers; direct management role left to the shareholders
      9. Additionally, under state corporate law, the board acts as a unit via majority rule, as do voting shareholders
   iii. The Independence of the Board of Directors
      1. What’s important about the distinction (inside v. outside directors)?
         a. The directors are supposed to monitor the officers, and thus problems are raised when the directors are the officers. The board somehow is supposed to oversee itself – most likely insufficient monitoring
      2. NYSE & NASDAQ
         a. A majority of the directors of a company that trades on these markets must be independent – this has been proposed, but not yet approved
         b. Therefore, you need to worry about the federal law, the state of incorporation’s laws, the listing standards if you are public company that qualifies for an exchange
   iv. Stiffening the definition of “independence”
      1. Other proposals(not requirements, or laws, but recommendations from important people):
         a. Requirement that Chairman of the Board and CEO are separated
         i. Some companies have gone that route, others have not (e.g. AOL)
b. If there hasn’t been a split of CEO and Chairman, then there should be a lead director
   i. Lead director – an outsider who would serve as a counterweight on the CEO/Chairman

v. Can there be too much independence? Are there things that insiders would just be better at?
   1. Insiders understand the day-to-day operations
   2. Too much friction may be caused and things grind to a halt; there might be tension and hostility; and there might be too much hesitance and lack of confidence
   3. Also, what GE needs is not what some smaller company might need
   4. Also, if board members are too independent, they might be in it for the paycheck and not diligently perform their role
   5. Independence under NYSE – no material relationship with the company

c. Directors
   i. General
      1. Locus of all legal power and authority exercised by the corporation
      2. Directors’ management power must be exercised collectively by majority rule and they are not given individual agency power to deal with outsiders
      3. If a director’s decision is challenged in court by shareholders, the court is likely to apply the “business judgment rule” which presumed that directors acted properly.
      4. Who are the Directors?
         a. In a closely held corporation, the major shareholders are usually the board of directors
         b. In some corporations, there is a mix of inside and outside directors
      5. Shareholders can’t give orders:
         a. Shareholders cannot usually order the board of directors to take any particular action
      6. Supervisory Role
         a. The board does not operate the corporation day to day. Instead, it appoints officers, and supervises the manner in which the officers conduct the day-to-day affairs
      7. The Board’s Powers
         a. DGCL § 141(a): business will be managed by or under the direction of the Board except as otherwise provided by the articles of incorporation
         b. “Under the direction” gives board ability to delegate to officers
         c. MBCA § 8.01: similar provision

d. Officers
   i. General
      1. Don’t need to have official names like CEO and CFO, just someone to certify the records under Sarbanes-Oxley
         a. Simply connotes those people that are higher-ups in the firm
         b. CEO often serves as the board of directors
      2. The corporation’s officers are appointed by the board, and can be removed by the board

e. Shareholders
   i. Shareholders have no obligation or liability to the corporation outside of the price they paid for their shares.
Power with regard to directors:
1. Election: Shareholders normally elect the directors at the annual meeting of shareholders. Directors NORMALLY serve a one-year term. MBCA § 8.05(b)
2. Vacancies: Shareholders usually have the right to elect directors to fill vacancies on the board, but the board of directors also usually has this power.
3. Removal: At common law, shareholders had little power to remove a director during his terms of office. But today, most statutes allow the shareholders to remove directors even without cause. MBCA § 8.08(a).

Articles and Bylaws:
1. Shareholders can amend the articles of incorporation or the bylaws

Fundamental Changes:
1. The shareholders have the right to approve or disapprove of fundamental changes not in the ordinary course of business
   a. Mergers, sales of substantially all the company’s assets, or dissolution

Shareholders rarely have sufficient authority to act on behalf of the company or change policy on a day-to-day basis

Breakdown of corporation formation (hypothetical)

Client calls you and wants to form a corporation, what’s the first thing you should do?
1. (1) Check to make sure that this company would be best as a Corporation and not another business form/organizational structure

What does it take?
1. You have to file a Certificate of Incorporation or an Articles of Incorporation (DGCL § 101)
   a. DGCL § 102 – not a whole lot is required in this document

Client wants to include a provision that says officers not liable to corporation or shareholders for breach of best interest or loyalty?
1. This can’t be done – look on 148 of supplement (102(b)(7))
   a. Not an option for officers, but an option for directors (2.02(b)(4)) of the Model Corporation Code

The articles are public documents filed with the Secretary of State and can be amended with the vote of the shareholders and directors
   a. Only directors can initiate amendments (DGCL § 242(b)(1) & 262 and MBCA § 10.03), and the shareholders vote (articles can say whether it is simple majority or quorum majority)
   b. Shareholders don’t have unilateral ability to amend the articles

By-laws of the company
1. Articles are the constitution and by-laws are the statutes, regulations, etc.
2. DGCL § 109
   a. By laws aren’t filed with the Sec. of State, they are just kept in the office
   b. Can be amended by directors alone, as long as directors are given that authority in the articles of incorporation, and this power is shared with the shareholders
   c. Shareholders acting alone also have the authority to amend the by-laws
3. MBCA § 10.20
   a. Shareholders always have the power to amend or repeal the by-laws; some states permit shareholders to initiate it and some don’t
vi. Draft the articles, draft the by-laws, get by-laws approved by the shareholders (in a room, or act by written consent, or both, etc./ just an organizational meeting)

g. Shareholder power to direct the company
   i. May Joan make the proposal at Shareholder meeting that company locate its principal banking business in Timber city?
      1. § 242(b)(1) DCode: As shareholder, she cannot initiate the process to amend the articles of incorporation. Only the Board can initiate this process.
      2. By laws: Can shareholders initiate the amendments to by laws § 109 DCode: This is ordinary business, and the Board has authority to make business decisions under § 141(a)
      3. Can shareholders amend the bylaws in a way that will appear to impinge on the Board’s ability to conduct business? The only carve out in § 141(a) is that the articles of incorporation can delegate power to others besides the Board. Does “otherwise in this chapter” provide for the possibility of bylaw amendments adopted by shareholders pursuant to their authority under 109 that could limit Board’s authority under 141(a)? Smart money is on NO.

VIII. The formation of the Corporation and the Governance Expectations of the Initial Participants
   a. Where to incorporate
      i. States Compete: Delaware is the best for corporate forms
         1. Two competing views:
            a. One, this promotes corporate irresponsibility
            2. Second, that b/c shareholders shop for companies, they will ask a premium for Delaware incorporated companies
   b. Formation: The articles of incorporation (MBCA §§ 2.01-2.06; DGCL §§ 101, 102)
      i. Fill it out and file it with the appropriate official
      ii. The requirements are fairly minimal (MBCA § 2.01)
      iii. After the articles are filed, there is usually an initial organization meeting at which directors are elected, shares are issued in exchange for consideration, and bylaws governing corporate procedures are adopted
   c. Determining Shares to Issue (MBCA § 6.01; DGCL § 151)
      i. Can be of several types and classes
      ii. Corporate norms specify there must be a class of shares delegated to elect directors and exercise shareholders voting rights
      iii. Where you find there are different groups of investors with different risk-preferences, “preferred shares” may be granted which might have better liquidation of dividend benefits with them
   d. Determining voting rights
      i. Straight v. Cumulative Voting
         1. General
            a. In most states, cumulative voting is allowed unless the articles of incorporation explicitly exclude it
         2. Straight Voting (MBCA §§ 8.04, 7.21, 7.28; DGCL §§ 141(d), 212(a), 214, 216)
            a. This is simply that you have one vote for every one share. This may propose problems when you are dealing with a majority that can dominate a board or make overwhelming choices at the expense of the minority.
         3. Cumulative Voting
a. In cumulative voting, a shareholder may aggregate his votes in favor of fewer candidates than there is single votes. This makes it more likely that a minority shareholder will be able to get at least one spot on the board.
b. This helps assist the majority rules problem
c. Your votes are the number of shares multiplied by the number of positions
   i. E.g. H owns 100 shares. There are 3 board slots. H may cast 300 votes for one candidate.
d. Equation (SX / (D +1))
   i. S = number of shares voting
   ii. D = number of director positions elected
   iii. X = the number of directors you hope to elect

e. Class Voting, including Dual class voting schemes
   1. Divide classes of shares, and allow each class a certain number of board members
   2. “Dual Class Common” is a format where you separate the shares and give one class disproportionate power
      a. May be helpful if going public and original team wants to retain power
      b. These schemes have been disapproved of by the SEC and curtailed by stock exchange rules

f. The annual meeting and Other forms of Shareholders actions
   1. (MBCA § 8.06; DGCL § 141(d))
   2. To minimize the risk that directors will act unfairly, corporation statutes specify in detail the substance of shareholders voting and meeting rights as well as the procedural rules that safeguard the shareholders’ exercise of these rights.
      1. The annual meeting and election of directors
         a. Paramount shareholder function – all states require it.
      2. Special Shareholders’ meetings (any meeting other than the annual meeting)
         a. All codes provide for these meetings to address issues identified in the meeting notice.
         b. The Board may call a special meeting; The president, under many bylaws may do so; some statutes allow the holder of a certain percentage of shares to do so.
         c. Delaware is not friendly to shareholders meetings – Only the board or any person listed in the article can call a special meeting
         d. MBCA § 7.02(a)(2) says that 10% of shareholders or more must be present to call the meeting

iii. Written Consent
iv. Voting Issues
   1. Quorum
a. For a vote of a shareholders’ meeting to be effective, there must be a quorum present. Usually, this must be a majority of the outstanding shares. However, the percentage required for a quorum may be reduced if provided in the articles or bylaws.
   i. Minimum: Some states don’t allow for the percentage for a quorum to be placed below a certain number (MBCA sets no floor)
   ii. Alls states allow the article or bylaws to set a higher percentage than majority

2. Vote Required
   a. Once a quorum is present, the traditional rule is that the shareholders will be deemed to have approved the proposed action only if a majority of the shares actually present vote in favor of the proposed action.
      i. Traditional Rule v. MBCA:
         1. An abstention is the equivalent of a vote against
         2. MBCA: § 7.25(c) treats abstentions like votes that are not cast
      ii. Once a quorum is present, the quorum is deemed to exist for the rest of the meeting, even if shareholders leave
   b. Action by written consent
      i. Nearly all states allow shareholders to act by unanimous written consent without a meeting
      ii. A minority of states allow shareholder action in the form of non-unanimous written consent.
         1. E.g. Delaware § 228(a) allows shareholder action nby the written consent of the same number of votes as would be needed to approve the action at a meeting.

3. Record Date (LOOK FOR MORE)
   a. Those who hold on the “record date” are entitled to vote. Not those who hold shares at the time of the meeting.

**g. Hoschett v. TSI International Software, Ltd (De. 1996)**
   i. The company never held annual meetings for the election of directors. The company received a written consent representing a majority of the voting power of the corporation that “elected” five individuals to serve as directors. P wants to compel the D to hold annual meetings. This case presents the single issue whether “stockholder written consent action, which was taken pursuant to DGCL § 228 after the filing of the complaint, and that purported to elect directors for TSI, satisfies the requirement to hold an annual meeting and moots the claim stated in the complaint. Held, the mandatory requirement that an annual meeting of shareholders be held is not satisfied by shareholder action pursuant to § 228 purporting to elect a new board or to re-elect an old one. (1) § 211 holds that an annual meeting shall be held. See § 228 also. (2) Annual meetings are central to Delaware corporation law. (3) An argument based on efficiency is unpersuasive to the court, for reasons stated. (4) The meaning of § 228 must be shareholder action to remove directors from office and to designate persons as directors when there is a vacancy and the constitutional documents of the firm contemplate filling such vacancies by shareholders.
IX. The National Market System and the Efficient Market Hypothesis

a. Trading on a national securities market
   i. NASDAQ if it has 1.1 million shares worth at least 8 million
   ii. The essence of a securities market is to generate sufficient trading volume to justify a centralized matching of buyers and sellers
   iii. Securities markets provide three (3) important services to publicly traded corporations and their shareholders
      1. Liquidity & Valuation
         a. securities markets reduce transaction costs to near zero; all shares have same legal meaning, so no need to do research
         b. Efficient securities markets ensure that shareholders have ongoing, free information as to the current value of their shares
         c. Liquidity refers to the ability to buy and sell at any time
      2. The monitoring of managers
         a. Liquidity and Valuation have important C. Governance functions
            i. Quasi monitor of managers
               1. If they are being run poorly, another company may seek to acquire a majority of shares and change management
               2. As a result, shareholders can avoid the cost, or lessen their reliance on other means of monitoring or disciplining
                  a. Litigation
                  b. Voting
                  c. Direct participation

b. The National Market
   i. Stock Exchanges are a physical place; NYSE is most famous
   ii. Decentralized markets are computer terminals and phone lines where brokers can “buy and sell” orders and stocks; NASDAQ is the most famous
   iii. Specialists
      1. If there are wide shifts in pricing or customers are panicking, and the prices are all messed up, specialists step in and use their own funds to fix the disparity
   iv. The boundaries between decentralized markets and stock exchanges are dissipating
   v. The beginnings of a truly integrated global market are also apparent

c. The Efficient Market Hypothesis
   i. Premise: The more confidence you have that the traded stock price reflects a “fair price,” the more willing you will be to purchase stock, and the higher price you will pay relative to other investments that carry higher research costs and more uncertainty as to value.
   ii. Economists assert that the stock prices are “unbiased prices”; this means that you can buy without worrying about whether the price is fair or not
      1. First, they tested the premise of stock randomness. If stock prices move randomly, then you can’t learn from studying past prices whether the next price change is more likely to be up or down
         a. In the 60’s they believed it was random
      2. The weak form of the Efficient Market Hypothesis (EMH) posits that you cannot develop a trading strategy based on the use of past prices that will enable you to beat the market return (b/c it is a random price fluctuation)
a. If you knew this other info, you could bet against the future pricing. The EMH says that info is immediately factored in

3. In essence, the current market price is unbiased in that it has already incorporated the value of information from past prices and whatever causes the price to move tomorrow will be b/c of new info.

iii. Then economists set about testing two stronger forms of the EMH
   1. **Semi-strong hypothesis** asserts that you cannot develop a trading strategy that will beat the market by using publicly available information relevant to the value of traded stocks (i.e. an announcement about earnings or a change in dividends)
      a. This is b/c the market has already factored this info in.
      b. Most believe that this is exactly what the market is
   2. The **strong-form hypothesis** tests an even stronger claim, that even if your trading strategy were based on nonpublic information, you would not be able to beat the market
      a. Although there is evidence that markets can be strong-form efficient in certain circumstances, there has never been widespread belief that our markets are not strong-form efficient.
      b. This is why we prohibit inside information

iv. How can markets assimilate information so quickly?
   1. Sophisticated market investors who track all information related to certain stocks to capture the “profit” from the old price. These professionals keep buying until the market reaches its new fair price.

v. Since shareholders buy stock at a price reflecting the skills of the corporation’s management team, they have already been compensated by a discounted share price if they buy stock in a corporation with sub-par managers
   1. This is why it is so important that our market is semi-strong form efficient
      a. If markets meet those standards, then a risk adverse investor is smart to put her money in a mutual fund that perfectly duplicates the makeup of the market in which she wishes to invest. The mutual fund will duplicate the market overall. Therefore, if she would risk on the market, and then have to pay an investment advisor, then she would lose money overall

vi. Wall street journal has dart-throwing contests, where dart thrower sometimes beat investment people
d. Why the market doesn’t perform right
   i. Chaos Theory
      1. Noise Traders dominate market
         a. Noise traders have systematic cognitive biases that prevent rational assessment of the value of available information, leading to purchase and sale decisions being made on factors – “background noise” – that are irrationally treated as valuable information by the trader. This fucks up the market
      2. Rational traders sometimes ride the wave of irrationality, hoping to get out with big profits before the market realizes that the current price is irrationally high or low.

e. The shareholder census – the Emergence of Institutional Investors
   i. During the past 40 years, share ownership has been increasingly concentrated in the hands of large institutional investors.
1. By 1998, institutional investors held about 60 percent of those shares, and 85% of coca-cola.

ii. Census has broadened to include not only institutional but other large stakes, repeat investors who affect collective behavior
   1. Arbitrageurs – seek out companies whose stock is in play and seek to encourage the trends that will make them money
   2. Value Investors – actively seek to influence corporate management so as to produce higher share value from underperforming companies
   3. Relational Investors – purchase large blocks in particular companies and seek a long-term relationships with management
   4. Social investors – give explicit priority to social needs in guiding investment decision

iii. These activist can have a large impact on how companies are run

iv. It is difficult for large investors to use the “wall street rule” to sell stocks b/c of the large amount that they have. Rapid sales might panic the market
   1. Some hypothesize that where exit is more costly, investors will be forced to engage the company

v. Two major groups: labor unions and public pension

f. Proxy Voting
   i. General
      1. Proxy is a document in which the shareholder appoints someone to cast his vote for one or more specified actions so he doesn’t have to physically attend a meeting.
      2. Proxy Contest
         a. A competition between management and another faction – usually a group of outside insurgents – to obtain shareholder votes. Typically, a proxy contest is for election of competing slates to the board, and thus is really a contenst for control of the corporation
         b. Thus, proxy provides a means for institutional or other significant investors to collect voting power from smaller investors or each other in advance of actual elections, and thus is a valuable tool for even an active shareholder.

   ii. Proxy has many meanings, refers to:
      1. the legal relationship under which one party is given the power to vote the shares of another
      2. the person or entity given the power to vote
      3. The tangible document that evidences the relationship

iii. The proxy process is federally regulated by the SEC (1934 § 14a)

X. The role of Federal Law for Publicly Held Corporations
   a. Disclosure as the Dominant Approach
      i. Five times you must disclose
         1. Issuing securities SEACT 1933
         2. Periodic Reporting - § 13 of SEACT 1933.
            a. 10-k, 10Q and 8K; can be found on EDGAR at sec.gov
         3. Proxy solicitation SEACT 1934
         4. Tender Offers
         5. Insider Trading
      ii. Other than state or federal law, there are self-regulatory organizations
         1. NASD and the NYSE are the most important
b. Periodic reporting: Disclosure Required Outside of Shareholder Voting or Outside of Stock Transactions with the Corporation
   i. The biggest disclosure obligations have come from the fact that some companies are big enough to have securities traded on a national market
   ii. The importance of disclosure has grown dramatically:
       1. There has been an increase in the amount of mandatory disclosure
       2. Technology has made information widely and quickly available
       3. Growth in information technology has also promoted more voluntary disclosure, which companies make through press releases or websites
       4. There has been a dramatic expansion of the scope of public and private liability

c. Disclosure and Other Regulation Triggered by the Proxy Solicitation Process and Shareholder Voting
   i. General Rules
      1. 1934 Exchange Act 14a-3, 14a-4, 14a-5, 14a-7, 14a-8, 14a-9
      2. Section 14(a) of that Act gave the SEC authority to regulate the proxy or consent solicitation process of a corporation required to register securities with the SEC:
         a. Currently, any (a) exchange-listed company or (b) any company with more that 10 million dollars is total assets and a class of equity securities held of record by 500 or more shareholders.
      3. The SEC has promulgated extensive rules to address the content and timing of proxy solicitation.
   ii. Rules primarily affecting solicitation of proxies whether by management or shareholders
      1. Rule 14a-3
         a. Prohibits any proxy solicitation unless the person solicited is first furnished a publicly filed preliminary or final proxy statement containing the information specified in Schedule 14A of the Exchange Act Rules.
      2. Rule 14a-5
         a. Regulates the form of a proxy statement. The principal requirements relate to readability
      3. Rule 14a-4
         a. Regulates the form of the proxy that solicitors ask shareholders to execute. This is often printed on a rectangular card, and has become known as a proxy card. Must provide shareholders with the ability to affirm, dissent, or abstain.
      4. Rule 14a-9
         a. A catch-all provision designed to supplement and reinforce the specific disclosure mandates. Prohibits the making of false or misleading statements as to any material fact, or the misleading omission of a material fact, in connection with a proxy solicitation.
   iii. Rules Primarily Regulating Shareholder Access to Effective Means of Communication with Other shareholders
      1. Rule 14a-7
         a. Requires a corporation that is itself soliciting shareholders in connection with an annual or special meeting to provide specified proxy solicitation assistance to requesting shareholders. If a shareholder exercises her rights, the corporation must either:
i. Provide the requesting shareholder with an accurate list of those shareholders and financial intermediaries from whom the corporation intends to solicit a proxy, so that the shareholder can mail the information; or

ii. Directly mail the requesting shareholder’s proxy material to shareholders and financial intermediaries.

2. Rule 14a-8
   a. Under 14a-8, a qualifying shareholder may require her corporation to include a shareholder proposal and an accompanying supporting statement in the company’s proxy material. The proposal is for the company to take action. To qualify, must own $2000 or 1% of stock for one year. Can make only 1 proposal. May be a social issue, or about management reform.
   b. Burden of exclusion is on the board; but the board may want a no action letter; it may exclude it on readability, but it must allow you to amend.
   c. There are 13 exclusions under which management may refuse to include the proposal:
      i. It is not a proper subject for action by stockholders under state law
      ii. The proposal would result in a violation of state, federal, or foreign law
      iii. The proposal is not significantly related to the company’s business
      iv. The proposal is beyond the company’s power to implement
      v. The proposal relates to the conduct of the ordinary business operations of the company
      vi. The proposal relates to the election of directors
      vii. The proposal is moot; and
      viii. The proposal relates to specific dividends
      ix. The proposal or supporting statements violate the proxy rules
      x. The proposal relates to a personal claim or grievance or is designed to further an interest not shared with other stockholders
      xi. The proposal is counter to a proposal to be submitted by the company
      xii. The proposal duplicates a proposal of another shareholder for inclusion in the same proxy materials;
      xiii. The proposal deals with substantially the same subject matter as a prior shareholder proposal made at a recent prior meeting, unless the earlier proposal received a sufficiently large vote (specifics on outline 122)

iv. Socially significant shareholder proposals
   1. Exchange Act Rule 14a-8(i)(5)-(7)
      a. The primary means to exclude shareholder “social issues” proposals from a company’s proxy statement are the “economic irrelevance” test contained in 14a-8(i)(5) and the “ordinary business” exclusion found in 14a-8(i)(7).
      b. The former allows omission of proposals that relate to operations that account for less than 5% of a corporation’s total assets, gross sales, and net sales, if the proposal “is not significantly related” to the company’s business.
      c. The latter allows exclusion of proposals relating to the “ordinary business” of the company.
i. However, under this exception, what seems socially irrelevant in one era might be prevalent in another era.

v. The “socially significant” limitation in action:
      a. P owns 200 shares and wants to bar the company from excluding his proxy materials being sent to all shareholders in preparation for the next shareholder meeting relating to force-feeding geese. D relies on 14a-8 and 14a-8(c)(5): “company may omit a proposal . . . if the proposal relates to operations which account for less than 5% of the issuer's total assets . . . or net earnings. P claims that the proposal has social or ethical significance if not economical. D claims that b/c corporations are economic entities, only an economic test is appropriate. **Held,** in light of the economic and social significance of P’s proposal, the proposal must be let in although it does not meet the 5% of business rule in 14a-8(c)(5). (1) Leg hist suggests that the SEC had previously allowed for exceptions even where it only comprised 1% of the business if the proposal raised policy issues. (2) Also, in adopting the 5% standard, commission states that failure to reach the economic threshold isn’t imperative if it can be shown the proposal relates to a significant portion of business.

d. Governance Related Shareholder Proposals
   i. Exchange Act Rule 14a-8(i)
      1. General
         a. Until the 80’s, shareholders couldn’t get majority votes under 14a-8. Then Activist shareholders, initially led by large pension funds, began to use the shareholder proposal process to oppose management efforts to make corporations impregnable to unfriendly takeovers.
         b. Currently, hot topics include proposals to eliminate staggered terms for directors, to institute cumulative voting, to provide confidentiality for shareholder votes, and to preclude the CEO from also being chairman of the board
      2. A typical scenario on page 210-215
         a. Shareholder sends to Corporation a request to put on proxy a proposal to eliminate staggered boards
         b. Company writes to SEC requesting permission to omit the proposal from the proxy because it violates state law and contains false, misleading statements, and is misleading due to vagueness.
         c. SEC writes back saying that it may not be omitted, the SEC doesn’t agree with the Company’s claims
   ii. Ways of getting through a proposal problem
      1. Did shareholder meet procedural requirements?
      2. Is it economically relevant?
      3. If no, then it is properly excluded?
      4. If it is economically relevant, does it go to ordinary business?
   iii. New SEC rules
XI. Fiduciary Duty, Shareholder Litigation, and the Business Judgment Rule

a. The Business Judgment Rule
   i. General
      1. Heavily a product of case law in Delaware
      2. Most states follow the MBCA section
   ii. MBCA § 8.30
      1. Normally, directors owe fiduciary duties to the corporation and not to the shareholders
      2. A shareholder, however, may enforce “directly owed” fiduciary duties via an individual action, or, if class certification is appropriate, as a class action on behalf of all similarly affected shareholders
   iii. Function of fiduciary duty
      1. It instructs directors to be absolutely fair and candid in pursuing personal interests.
      2. Fiduciary duty describes the bounds of acceptable conduct for directors in carrying out their individual and collective duty to manage the corporation
      3. Generally, to optimally reduce the possibility that directors will favor personal interests over the corporation’s interest
      4. Note that if the rules are particularly stringent, directors won’t want to be fiduciaries, so there must be a balance
   iv. Fiduciary Duty determined by the interplay between judicial doctrine, legislation, and corporate planning. This interplay determines
      1. The extent to which a particular corporation may indemnify, exculpate, or insure its directors against liability;
      2. The extent to which shareholders may control litigation enforcing their corporation’s rights against breaching directors; and
      3. The extent to which directors who engage in conflicting interest transactions are subject to judicial sanction.

b. Directors Discretion to Determine General Business Policies
   i. Introduction
      1. To what extent should dissatisfied shareholders be able to obtain a trial to determine the appropriateness of directors policies that the shareholders believe are causing underperformance b/c the directors are pursuing idiosyncratic business policies?

   ii. Shlensky v. Wrigley
      1. The Cubs are losing money, the shareholders believe b/c they won’t put lights in at Wrigley Field and play night baseball. The 80% owner Wrigley says it would be bad for the neighborhood and baseball “is a day game.” Held, it is not for the court to step in and decide the operations of a business so long is there is no fraud, illegality, or conflicts of interest, or something bordering on one of those elements. (1) It is a fundamental rule of Delaware law that a corporation is run by majority rule – and all who buy stock agree to that rule. (2) Our cases show that unless the directors actions are tainted by fraud, illegality, or conflicts of interest, then it is not for the courts to step in and tell the directors what to do. (3) While courts don’t all demand that one of those elements be present, we do feel like something has to border on one of those elements. We do not agree with Plaintiffs complaint.

c. Directors Discretion to consider interests of non-shareholder constituencies
   i. Introduction
      1. Firm contains numerous constituencies:
         a. Officers, directors, shareholders, employees, suppliers, customers, the larger community.
2. Courts in mid-80’s began to state that directors may consider the interests of other constituencies if there is “some rationally related benefit accruing to the stockholders,” or if so doing “bears some reasonable relation to general shareholder interests.”

3. About 30 states have “other constituencies” statutes

4. The clear thrust of these statutes is to assist corporations with takeover problems.

5. Shareholders need fiduciary duty more than any other constituency:
   a. They are residual claimants and only get money after everyone else; therefore, they are unfairly disadvantaged when directors claim they are working for another constituency – who is in a better position than the shareholders

ii. **Dodge v. Ford Motor Co.** (1919) (More BJR background)
   1. Wanted to lower price of cars for the benefit of all people. **Held,** it is not for the courts to interfere with business judgment, even if they seem to be avoiding shareholders for other constituencies. (1) “It is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others, and no one will contend that if the avowed purpose of the defendant directors was to sacrifice the interests of shareholders it would not be the duty of the courts to interfere.” (2) However, we don’t think the directors are doing that in this case. Businesses should be looked at in terms of long-term and short-term profits, etc.

   d. The Fiduciary Duty of Care
      i. Overview (MBCA §§ 8.30, 8.31; Delaware: Case Law)
         1. General
            a. The most widely adopted version is modeled after the pre 1998 MBCA § 8.30(a):
               i. “A director shall discharge his duties as a director . . .: (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interest of the corporation”
            ii. The reasonable person standard is an objective standard
                1. If he has special skills, he must use those skills
            b. The rule prevents “accommodation” or “dummy” directors that only serve as figureheads of a board.

      2. Duty of Care is Limited [Joy v. North]
         a. 1) “The fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labeled the business judgment rule.”
         b. (2) The rational basis behind the rule is:
            i. (a) Shareholders to a very real degree voluntarily undertake the risk of bad business judgment – they have information of the management, etc., the market takes this into effect, and so does the BJR;
            ii. (b) Courts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions;
            iii. (c) Because potential profit often corresponds to potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions
         c. (3) The BJR extends only so far: it does not apply in cases in which the corporate decision lacks a business purpose, is tainted by a conflict of
interest, is egregious as to amount to a no-win situation, or results from an
obvious and prolonged failure to exercise oversight or supervision


4. Personal Liability
   a. A director or officer who violates his duty of due care, and who thereby injures the corporation may be held personally liable for the corporation's damages. True even if the director has paid little or nothing.

5. Breach usually occurs when someone doesn’t act as a director at all:
   a. Fails to attend meetings;
   b. Fails to learn anything of substance about the company business;
   c. Fails to read reports, financial statements, etc. given to him by the corporation
   d. Fails to obtain help when he sees or ought to see signals that things are going seriously wrong with the business;
   e. However, it has also occurred when directors approve a “no-win” transaction: can benefit the company slightly if at all and can damage the company greatly
   f. Also, breach cases are often cases that a guise in self dealing

6. Surrounding Circumstances
   a. B/c it is an objective standard, one must look to the surrounding circumstances:
      i. Nature and Size of Business
      ii. Whether the company deals in the funds of others (i.e. banks) require extra care

7. Reliance on experts and committees:
   a. DGCL § 141(e):
      i. At a minimum, to receive the status, § 141(e) reports must be pertinent to the subject matter upon which a board is called to act, and otherwise be entitled to good faith, not blind reliance
      ii. Also, under § 141, directors are entitled to rely upon their charman’s opinion of value and adequacy, provided that such opinion was reached on a sound basis.
   b. MBCA§ 8.30(b): “A director is entitled to rely on information, opinions, reports, or statements, including financial statements or other financial data” if these are prepared or presented by:
      i. (1) officers or employees of the corporation “whom the director reasonably believes to be reliable and competent in the matters presented”;
      ii. (2) lawyers, accountants or others as to “matters the director reasonably believes are within the person’s professional or expert competence”; and
      iii. (3) a committee of the board “if the director reasonably believes the committee merits competence.”
   c. Note – The reliance MUST BE REASONABLE

8. Duty to detect wrongdoing
   a. Directors have NO affirmative duty to in fact detect wrongdoing
b. Absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.” [Grahm v. Allis-Chambers, infra]
c. If directors are on notice of facts of wrongdoing, they must act

9. Duty to put controls in place
   a. The duty of care does require that reasonable control systems be put in place to detect wrongdoing, even where the board has no prior reason to suspect that wrongdoing is occurring. [Caremark, infra]
   b. SEC Act 1934 § 13(b)(2): requires every publically held corporation to “devise and maintain a system of internal accounting controls” to guarantee accurate financial statements and to guard against misappropriation of assets.
      i. Most companies satisfy this with an audit committee

10. Failure to make disclosure
    a. Often, directors’ or officers’ failure to make accurate disclosures of information will be shown to be a breach of the duty of care
       i. When they solicit shareholder approval, they must communicate truthfully with regard to the fact

11. Causation
    a. Even if a director or officer has violated his duty of due care to the corporation, many cases say that he will not be personally liable unless this lack of due care is the legal cause of damage to the corporation. In other words, in many courts the tradition tort notion of cause in fact and proximate apply in this context.
    b. Delaware Rule:
       i. Delaware rejects the requirement of causation to be shown.
       ii. Once P shows that the directors breached their duty of care, that showing overcomes the protection that directors get from the BJR. At that point, P has established a prima facie case – even if he can’t show that exercise of due care would have avoided the loss – and the burden of proof shifts to the D: Unless the D’s carry the burden of showing Entire Fairness, they will be liable.

12. Amendment in 1998 to §8.30(b):
    a. “when becoming informed in connection with their decision-making function or debiting attention to their oversight function, [directors] shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under the circumstances.”
       i. They did this to avoid courts exercising duty of care under the tort principle of “ordinary care”
    b. The amendment also recognized the dual setting in which directors’ duties arise:
       i. Decision
          1. Directors collectively consider whether to authorize a particular course of action, activity, or transaction – the issue then is the extent to which directors should be liable for good faith, but grossly negligent, business choices.
       ii. Oversight
1. Responsible for monitoring the corporation’s business – thus, one of the major issues in duty of care is the extent to which directors are liable for negligence or misconduct of corporate officers.

13. One of the most important things in this area of law is that a corporation is often now authorized to adopt charter provisions that limit or eliminate a directors’ liability for money damages for breach of the fiduciary duty of care.

ii. Case Law

1. **Joy v. North** (1982) (Duty of Care should have limited role in disciplining managers)
2. **Hoye v. Meek** (director liable for failed oversight)
   a. Cases in which directors of industrial corporations have been found liable solely for breach of duty of care – as opposed to an additional breach of the duties of loyalty or candor – are rare.
3. **Smith v. Van Gorkum** (DE. 1985) [Duty of Care in Making Business Decisions]
4. Action brought by shareholders against the board. VanG decided that a merger was a good way to deal with the company, avoiding tax problems the company was having. He asked comptroller to value the company at $55, and see what possibilities flowed from that. He met with a man who would buy the company at $55 per share. At board meeting, lasting 2 hrs. with 20 minute presentation by VanG, board voted to approve the merger. Set for 90 day test period, though not sufficiently an auction, to see if the price was adequate. Shareholders approve merger.
5. **Held**, these directors, though qualified, failed to meet the requisite duty of care.
6. **BJR**
   a. The BJR assumes these directors acted in an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.
      i. Fulfillment of the fiduciary function requires more than the mere absence of fraud or bad faith.
   ii. Under the BJR, director liability is predicated on a standard of gross negligence
   b. A director may not abdicate his duty (at least in a merger context) by leaving to shareholders the decision
7. The directors (a) did not adequately inform themselves as to VanG’s role in forcing the “sale” of the company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the “sale” of the Company upon two hours’ consideration, w/o prior notice, and w/o the exigency of a crisis or emergency.
8. Under DGCL § 141(e), directors are protected in relying in good faith on reports made by officers
   a. The reports in this case don’t satisfy the § 141(e) definition of reports.
   b. At a minimum, to receive the status, § 141 reports must be pertinent to the subject matter upon which a board is called to act, and otherwise be entitled to good faith, not blind reliance
   c. Also, under § 141, directors are entitled to rely upon their charman’s opinion of value and adequacy, provided that such opinion was reached on a sound basis.
9. The Board can’t be considered good b/c of collective experience and sophistication considering their uninformed choices made, discussed previously.
10. Dictum:
   a. Where a majority of fully informed stockholders ratify action of even interested directors, an attack on the ratified transaction normally must fail. However, this is only if the shareholders are given complete information in their proxy materials.
      i. That didn’t happen here. 255-56

iii. Statutory Exculpation Provisions (DGCL§ 102(b)(7); MBCA§ 2.03(b)(4))

1. If directors are individually liable for errors
   a. (1) they may become overly cautious in carrying out their duties; or
   b. (2) they may refuse to serve at all. Both of these wouldn’t be in the shareholder’s interest.
2. Therefore, 40 states have passed statutes limiting director’s liability regarding duty of care decisions.
   a. DGCL § 102
   b. MBCA article on their exculpation provisions

iv. The Board’s Responsibility to Monitor and Prevent Illegal Activity
   1. General
      a. In *Graham v. Allis-Chambers*, the Court found that the Board had no actual knowledge of illegal dealings. However, shareholder’s sued saying that they should have had a system in place to detect such dealings, and a failure to do so breached their duty of care. The court rejected such a duty, saying that under De law, directors can rely on trustworthy officers, etc.

2. *In Re Caremark Int’l Inc. Derivative Litigation* (DE 1996)
   3. Shareholder derivative suit alleging that directors breached their fiduciary duty of care in failing to prevent violations by employees of federal and state laws and regulations applicable to health care providers. Caremark is a healthcare provider and subject to APRL laws: they can contract with physicians to conduct research projects, but not contract with physicians where real purpose of the contract is to bribes the physician into referring patients to the provider. Caremark straddled the line: provided “research grants” and “consulting contracts” to physicians who referred patients to Caremark. In 1991, the HHS initiated investigations, and the DOJ joined them in early 1992. Caremark responded by discontinuing some risky operations and increased supervision over its branch operation (7000 employees at 90 branches). When OIG initiated an investigation, Caremark discontinued its practice of paying management fees to physicians for services to Medicare and Medicaid. Thus, instituted a policy where regional officers had to approve all contracts between Caremark and physicians. Then increased APRL training among associates, put out an ethics brochure, and told employees to report illegal activity to a toll-free hotline, and also later took several steps to increase branch supervision. In 1994 grand jury indicted Caremark and a physician that had been allegedly violating APRL for several years. This suit followed. Later that year, Caremark terminated all remaining financial relationships with certain physicians in certain departments and rescinded its “research grant” program. The company and no directors were punished. Board approved a settlement. Claim is that directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance.
      a. Director liability for a breach of the duty to exercise appropriate attention: can arise in two ways:
         i. (1) may follow from a board decision that results in a loss because that decision was ill advised or negligent
            1. subject to business judgment rule or
         ii. (2) loss may arise from unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss
      b. This case doesn’t say that “absent some grounds giving rise to suspicion of violation of law, corporate directors have no duty to assure that a corporate information gathering and reporting system exists which represents a good faith attempt to provide senior management and the Board w/information respecting material acts, events or conditions within the corporation, including compliance w/ applicable statutes and regulations. It does say that “absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company’s behalf.”
      c. What is important is that the board exercise good faith judgment that the corporations’ information ad reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility.
      d. Court is of the view that a director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is
adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.

4. Analysis of Third Amended Complaint and Settlement
   a. Court concludes that settlement is fair and reasonable
   b. **In order to show that directors breached their fiduciary duty of care, P must show that:**
      i. the directors knew or
      ii. should have known that violations of law were occurring and, in either event
      iii. that the directors took no steps in a good faith effort to prevent or remedy that situation, and
      iv. that such failure proximately resulted in the loss complained of
   c. Board wasn’t negligent or inattentive. Also, the Board was not negligent or inattentive
      i. Insofar as the court is able to tell on the record the corporation’s information systems appear to have represented a good faith attempt to be informed of relevant facts. If the directors did not know the specifics of the activities that lead to the indictments, they can’t be faulted.
   d. The settlement provides terms to ensure a more centralized, active supervisory system in the future

v. Caremark in relation to. Graham v. Allis-Chambers
   1. In *Graham*, the P’s were not complaining about the directors’ considered judgment, but rather by their allegedly unconsidered failure to act to protect the corporation. In *Caremark*, the P complaint goes to both allegedly ill-informed decision-making as well as allegedly unconsidered failure to act.
   2. Unclear in the Graham opinion
      a. The reasonable person standard lacks precision. Although it may appear to protect only director actions that do not constitute simple negligence, in practice it protects all director action not constituting gross negligence.

vi. Book Problem
   1. Employees embark on scheme to overcharge VA → VA inspector general begins inspection on employees providing false information (notice) → directors had notice five years earlier of schemes
   2. Should they be on notice that anything is amiss? No
      a. Then, the failure to do anything is not gross negligence
   3. Should they be on notice if others in the industry are doing wrong? You are on inquiry notice
      a. If you do nothing, this is probably gross negligence
      b. All you have to do is not act in a grossly negligent manner (this means taking some action)
      c. Think about the kind of steps that should be taken to set up an adequate reporting system (merely sending out a letter from the CEO might not be enough)
      d. Consider the problem and whether they are liable under DGCL § 102(b)(7) – which does not eliminate liability for breach of duty of good faith, loyalty, care

e. The Fiduciary Duty of Loyalty
   i. General
      1. Key Players as Trustees:
         a. It is often said that directors, officers, and controlling shareholders are in effect “trustees of the corporation and have a fiduciary obligation to it.
   2. Self Dealing Transactions
a. Generally, we are concerned when three conditions are met:
   i. The Key Player and the corporation are on opposite sides of the transaction
   ii. The Key Player has helped influence the corporation’s decision to enter the transaction; and
   iii. The key Player’s personal financial interests are at least potentially in conflict with the financial interest of the corporation, to such a degree that there is reason to doubt whether the Key Player is necessarily motivated to act in the corporations best interest

b. Three main categories of self-dealing transactions
   i. Fair transactions
      1. If the transaction is found to be fair to the corporation, considering all the circumstances, nearly all courts will uphold the transaction. This true whether or not the transaction was ever approved by disinterested directors or ratified by the shareholders
   ii. Waste/Fraud
      1. If the transaction is so one-sided that it amounts to waste or fraud, the court will void it if a stockholder complains. This is true even if approved by a majority of disinterested directors or ratified by shareholders
   iii. Middle Ground
      1. If it is in the middle ground, the court’s decision often turns on whether there has been approval by disinterested directors or shareholder approval
         2. The burden of proof is usually on the Key Player:
            a. He must prove that the transaction was approved by either (1) A disinterred and knowledgable majority of the board w/o the participation of the Key Player or (2) a majority of the shareholders after full disclosure of the relevant facts

3. MBCA approach: MBCA Subchapter F § 8.60 (Only a few states)
   a. Two ways in which a director will be deemed to have a conflict of interest regarding a transaction:
      i. Direct conflict
         1. Where the direct or his close relative is a party to or has a large financial interest in the transaction.
         2. This exists if the director “knows at the time of commitment that he or a related person is a party to the transaction or has a beneficial financial interest in or so closely linked to the transaction and of such financial significance to the director or a related person that the interest would reasonably be expected to exert an influence on the director’s judgment if he were called upon to vote on the transaction.” [§ 8.60(1)(i)]
         3. A “related person” covers principally the director’s spouse, child, grandchild, sibling or parent (or any of these people’s
spouse), or any trust or estate as to which the director is a beneficiary or fiduciary

ii. Indirect conflicts

1. These where the other party in interest is not the director or a close relative, but some business entity associated with the director, or some business associate of the directors.

2. Thus a conflict will be deemed to arise where the transaction is brought (or is of such significance that it normally would be brought) before the board of directors, and the director knows that the other party to the transaction is either an (i) entity of which the director is a director, general partner, agent, or employee; (ii) an affiliate of one of the entities listed is subclause (A); or (iii) an individual who is a general partner, principal, or employer of the director.” [§ 8.60(1)(ii)]

b. Two major liability rules of § 8.61

i. Where a transaction is NOT a directors conflicting interest transaction, the court may not enjoin it or set it aside on account of any interest which the director may have in the transaction.

ii. If the transaction IS a director’s conflicting interest transaction, the corporation and the director receive a “safe harbor” for the transaction – and the court may thus not set it aside – if:

1. a majority of disinterested directors approved it after disclosure of the conflict to them [§8.62]; or

2. A majority if the votes held by disinterested shareholders are cast in a vote ratifying the action, after disclosure of the conflict [§8.63]; or

3. The transaction, “judged according to the circumstances at the time of commitment, is established to have been fair to the corporation.”

c. Three important notes

i. Only applies to directors

ii. If it doesn’t fit under the definition of “conflicting interest,” it is exclusively not a conflicting interest transaction

iii. The disclosure and approval can happen even after the transaction has been challenged by a dissident shareholder or third party.

4. Three Paths to avoid invalidation:

a. Thus under the MBCA and the statutes of most states, there are three different ways that proponents of a self-dealing transaction can avoid invalidation:

i. By showing that it was approved by a majority of disinterested directors, after full disclosure;

ii. By showing that it was ratified by shareholders, after full disclosure; and

iii. By showing that it was fair when it was made

b. Disclosure plus board approval

i. General
1. A transaction may not be avoided by the corporation if it was authorized by a majority of the disinterested directors, after full disclosure of the nature of the conflict and the transaction.

ii. Most courts require disclosure of two types of information:
   1. The material facts about the conflict; and
   2. The material facts about the transaction
      a. All that a reasonable observer would consider material.

iii. Timing of Disclosure (circuit split):
   1. Some courts require the disclosure before the transaction.
   2. Some courts allow it to be after if the board then goes and “ratifies” it by stating that they have no objection.

iv. Who is a “disinterested director”
   1. Often, outside professionals to the corporation may be found interested in a transaction that the CEO is a party to.
   2. If interested voters vote, just disregard their votes in most jurisdiction.

v. Unfairness and immunization from it
   1. If a majority of disinterested directors accept an unfair transaction, most statutes say that this is acceptable; courts often try to void it under the waste doctrine.
   2. ALI
      a. The ALI gives the court explicit authority to void grossly unfair contracts that have been approved by disinterested directors. § 5.02(a)(2)(B).
   3. Most States
      a. In most states, approval by the disinterested directors shifts the burden of proof to the side attacking the transaction.

c. Disclosure plus shareholder ratification:
   i. Disclosure required (same as above)
   ii. Disinterested shareholders
      1. Split in the courts:
         a. Some say that shareholder ratification has no effect unless a majority of the disinterested shareholders approve
            i. MBCA § 8.63(a)
         b. Some say that all shareholder, regardless of interest, should have their votes counted.

d. Fairness as the Key Criteria
   i. In nearly all states, fairness alone will cause the transaction to be upheld, even if there has been no approval by disinterested directors and no ratification by shareholders.
   ii. Timing
      1. Fairness is measured by the facts AT THE TIME OF THE TRANSACTION.
   iii. No requirement of prior disclosure.
1. Even if the Key Player does not disclose to directors, officers, or shareholders, if it is fair it doesn’t matter
2. ALI doesn’t agree
   a. Says that disclosure is an ABSOLUTE REQUIREMENT
iv. Delaware and MBCA allow immunization
   1. Delaware allows for either shareholder ratification of disinterested director ratification to immunize the transaction
      a. It invokes the BJR and leaves the judicial review to only gift or waste, with the burden on the party attacking the transaction

ii. The Corporate Opportunity Doctrine
   1. **Broz v. Cellular Information Systems, Inc.** (283)
   2. CIS, had breach his fiduciary duty of loyalty.
   3. **Held**, Broz did not breach his fiduciary duty of loyalty to CIS
   4. **Corporate Opportunity Doctrine (from Guth v. Loft)**
      a. A director may not take a business opportunity for his own if (1) the corporation is financially able to exploit the opportunity, (2) the opportunity is with the corporation’s line of business, (3) the corporation has an interest or expectancy in the opportunity, and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation
      b. **Corollary to the doctrine:** A director may take a business opportunity if (1) the opportunity is presented to the director or officer in his individual and not his corporate capacity, (2) the opportunity is not essential to the corporation, (3) the corporation holds no interest or expectancy in the opportunity, and (4) the director or officer has not wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity
      c. No one factor is dispositive and all factors must be taken into account insofar as they are applicable

iii. Conflicting Interest Transactions
   1. Delaware GCL § 144
   2. MBCA § 8.60-8.63
   3. **General**
      a. The original idea was that the same person cannot act for himself and at the same time, with respect to the same matter, as the agent of another whose interests are conflicting. Traditionally, such a transaction was void or voidable.
         i. A conflicting interest transaction would be **voided if the substantive terms of the transaction were found unfair**, or, even if such terms were found fair, **if the benefiting directors had in any way breached their obligation to disclose fully all relevant facts to the corporation, including, of course, the fact of their interest in the subject matter.**
   4. Delaware GCL § 144
      a. Statute provides that no conflicting interest transaction shall be void or voidable solely by reason of the conflict, and therefore goes to the business judgment rule, if the transaction is:
         i. (1) authorized by a majority of the disinterested directors, or
         ii. (2) approved of in good faith by the shareholders, or
         iii. (3) is fair to the corporation at the time authorized.
Also, § 144 codifies the common law requirement of complete candor and fair dealing by making director or shareholder approval effective only if the director has disclosed all material facts.

5. DE Supreme Court on the effect of Delaware GCL § 144
   a. “The enactment of § 144 limited the stockholders power in two ways. First, § 144 allows a committee of disinterested directors to approve a transaction and bring it within the scope of the business judgment rule. Second, where an independent committee is not available, the stockholders may either ratify the transaction or challenge its fairness in a judicial forum, but they lack the power automatically to nullify it.”

6. The relationship between the duty of loyalty and directors’ disclosure obligations in the context of shareholder ratification of a conflicting interest transaction:
   a. “To obtain [a Delaware Court’s] deference to shareholder ratification, directors and majority shareholders alike must show [the] Court that the shareholders possessed all information germane to the transaction at the time they voted to ratify it. . . . the duty [used to exist and] still exists as an essential component of the duty of loyalty in a situation where the board seeks to comply with its fiduciary obligations by obtaining shareholder approval for the board’s otherwise potentially conflicted interest.”

   a. Three features to the New Approach
      i. MBCA 8.60 defines conflicting interest transactions with substantially greater precision than previous provisions
      ii. MBCA 8.61(a) instructs courts that transaction(s) falling outside of the statutory definition “may not be enjoined, set aside, or give rise to an award of damages or other sanctions . . . b/c a director of the corporation, or any person with whom he has personal, economic, or other association, has an interest in the transaction.”
      iii. MBCA 8.61(b), 8.62, and 8.63 provide that a conflicting interest transaction may not be voided as a result of such conflict if the transaction is ratified by “qualified directors,” or by the vote of “qualified shares,” or is fair to the corporation.

8. Judicial Discretion under MBCA provisions
   a. Official Comment 8.61: “If the transaction is vulnerable on some other ground, subchapter F does not make it less so for having passed through the procedures of subchapter F.”
   b. Official Comment 8.61 “Safe Harbor”: “subject to a critically important predicate condition . . . that the board’s action must comply with the care, best interest and good faith criteria prescribed in § 8.30(a) for all directors’ action.”

iv. Stock Option Grants
   1. Statutes
      a. Delaware GCL § 157
      b. MBCA § 6.24
   2. General
      a. Options are a contract where a Corporation agrees to sell stocks in the future at the current market price.
b. Problems with options are that the value of other shareholders’ equity may be severely diluted by any stock options that are ultimately exercised at prices far below then-prevailing market prices.

3. **Byrne v. Lord**
   a. Pace was an insurance company w/ 6 million shares of common stock. ABC is its wholly owned subsidiary. Before a new board took control in the summer of 1994, the Department of Insurance put ABC directly under their control. ABC had large troubles: financial woes, they had no auditor, and no accounting firm would file their 10K’s so NASDAQ delisted them. Board felt like solving Pace’s problems was a monumental burden. Thus, the Board issued a stock options plan for themselves, the purpose of which was to “retain Pace’s current management and, therefore, it called for pace to issue the current and future Board members options to purchase over four million shares of Pace (which, if all exercised, would be 40% of the company). All exercised their options.
   
   b. *Held,* Option plan is invalid b/c it *fails to provide sufficient safeguards to retain the benefit it sought to obtain* and therefore looks like too much self-interest
   
   i. 8 DGCL § 157 authorizes the issuing of options, but it must meet a two prong test:
       1. First, the plan must involve an identifiable benefit to the corporation (Benefit Prong)
          a. Benefit may be intangible: may issue options for the purpose of inducing key personnel to either continue their employment with the firm or to expend greater efforts on behalf of the firm.
          b. However, if by granting options the corporation expects that it will retain key personnel, then the plan must provide terms or circumstances that ensure that the personnel are employed by the corporation when they exercise the options.
       2. Second, the value of the options must bear a reasonable relationship to the value of the benefit passing to the corporation (Value Prong)
          a. Largely, if the corporation has received some consideration in exchange for the options, then the Court may presume that the exchange is a reasonable exchange of value.
   
   ii. In this case, the board not only failed to offer the plan to the shareholders for ratification, but the board also chose not to provide any information or notification to the shareholders about the plan.
       1. Also, circumstances here fail to provide safeguards ensuring that Pace would receive the benefit of its bargain

f. **Derivative Litigation**
   
   i. **General**
      1. Suits for the breach of duty of care and duty of loyalty are normally *derivative suits.*
         a. Contrary: *direct suits*
            i. Suits by a minority shareholder contending that the majority has acted unfairly
            ii. The ability to vote
            iii. Matters relating to the distribution of dividends
            iv. Requests to have access to corporate books
         
   ii. **Shareholder derivative suit:** an action in the name of the corporation against the wrongdoer;
      1. Two actions brought by an individual shareholder:
         a. An action against the corporation for failing to bring a specified suit
         b. An action on behalf of corporation to individual for harm to it identical to the one which the corporation failed to bring
      2. Also, this does not just have to be a suit against an insider, it can be against an outsider, like someone who breached a contract w/the corporation
      3. Types of derivative suits
a. Breach of duty of loyalty
b. Usurping a corporate opportunity
c. Breach of duty of care
d. Excessive Compensation

4. Pros and Cons
   a. For Derivative Suits
      i. Derivative suits are practically the only effective remedy when insider wrongdoing occurs. The corporation faces a conflict of interest in suing itself. The market effect (loss in stock price) does little to deter wrongdoing, especially if management owns little stock.
      ii. The suits have a deterrent effect, not just on the insider’s of a company being sued, but on other wrongdoers in other companies
      iii. The action is usually without direct cost to the corporation, since the P’s attorney fees will only be paid if he is successful.
   b. Against derivative suits
      i. Waste of Corporate time: simply, it wastes time of senior executives that could be doing more important things
      ii. Risk-Averse Management: Corporate management will so fear the suits that they may become risk-averse, and may thereby fail to maximize shareholder wealth
      iii. Strike suits b/c of the large waste of senior management time when a suit continues through trial, management will often be tempted to settle even suits that have little merit to rid themselves of them.
         1. This has led to the Special Litigation Committee

iii. Demand Requirement
   1. Statutes
      a. MBCA §7.42
      b. ALI, Principles §7.03
   2. MBCA
      a. You must make demand;
      b. Then, you must wait 90 days to sue, unless:
         i. The company has given you notice that demand would be rejected, or
         ii. Irreparable harm would result to the company if you didn’t sue
   3. General
      a. Shareholder-controlled derivative suit is a usurpation of the director’s normal power to manage business and affairs of a corporation justifiable only in circumstances where the director’s are unable or unwilling to handle the litigation in the best interests of the corporation
   4. Delaware Law:
      a. A P who attacks a board decision as wrongful must nonetheless make a demand on the board, unless he carries the burden of showing a reasonable doubt about whether the board either:
         i. (1) was disinterested and independent; or
         1. E.g. Could show the board was all hand-picked by D and when they approved a ridiculous transaction, they were just trying to keep their jobs
ii. (2) was entitled to the protections of the BJR
   1. E.g. they show either that the board members didn’t follow
      a. Adequate procedures in reaching their decision [Smith v. Van Gorkum]; or
      b. That the decision was so irrational as to be outside the
         bounds of reasonable business judgment [Aronson v. Lewis]

b. How Delaware makes it difficult to get demand excused
   i. P must plead with extreme specificity exactly how the directors are
      under the influence of X and thus not independent
   ii. The fact that the board is charged with a violation
       of the duty of due care for having approved X transaction is not enough
       to render demand futile
   iii. The P will not normally be able to obtain discovery in order to make
        the particular allegations
   iv. Even if the case shows self-dealing, gross negligence, etc., and that the
       transaction was approved by the board, demand will still not be
       excused unless there is a particularized showing that the board was not
       independent or acted irrationally

c. Case Law
   1. Aronson v. Lewis (Delaware)
      2. P, Lewis, is stockholder of Meyers. Defendants are Meyers and 10 directors, some of whom are
         company officers. Suit challenges transactions between Meyers and Fink, who owns 47% of its
         outstanding stock. P claims transactions were approved only because Fink personally selected each
         director and officer of Meyers. Meyers and Fink had an employment agreement for 5 year term with
         provision for automatic renewal thereafter indefinitely. Fink could terminate contract at anytime but
         Meyers could only with 6 month notice. Upon termination, Fink was awarded huge severance package
         (150 K first 3 yrs, 125 next 3, and 100 K thereafter till death) Agreement provided that Fink’s
         compensation was not to be affected by inability to perform services. At time, Fink was 75 when
         agreement was approved. (no evidence of poor health) Meyers board also made interest-free loans to
         Fink totaling $225,000. Complaint charges that these transactions had “no valid business purpose” and
         were a “waste of corporate assets” because the amounts to be paid are “grossly excessive”, that Fink
         performs “no or little services,” and because of his “advanced age” cannot be “excepted to perform any
         such services”
      3. Held, demand can only be excused where facts are alleged with particularity which create a reasonable
         doubt that director’s action was entitled to the protection of the business judgment rule
            a. Business Judgment rule:
               i. Protection can only be claimed by disinterested directors whose conduct otherwise
                  meets the tests of business judgment
               ii. To invoke the rule’s protection directors have a duty to inform themselves prior to
                   making a business decision of all material information reasonably available to them
            b. DE court’s rule on demand futility:
               i. Where officers and directors are under an influence which sterilizes their discretion,
                  they cannot be considered proper persons to conduct litigation on behalf of the
                  corporation
            c. Court must decide whether a reasonable doubt is created that:
               i. Directors are disinterested and independent, and
                  1. Court reviews the factual allegations to decide whether they raise a
                     reasonable doubt, as a threshold matter, that the protections of the business
                     judgment rule are available to the board.
2. If this is an “interested” director such that the BJR is inapplicable to the board majority approving the transaction, futility of demand has been established by any objective or subjective standard.

ii. The challenged transaction was otherwise the product of a valid exercise of business judgment.

iii. In this Case
1. Stock ownership alone is not sufficient proof of domination and control
2. Not enough to charge that director was nominated by or elected at the behest of those controlling outcome of corporate election
3. Plaintiff has not alleged any facts sufficient to support a claim of control
4. Complaint does not allege particularized facts indicating agreement is waste of corporate assets

v. Demand Futility Roadmap
1. **Brehm v. Eisner**
   2. Disney hired Ovitz as president. He was long time friend of Charimain and CEO Eisner. Ovitz was important talent broker in Hollywood, but lacked experience managing a public company. Agreement was unilaterally negotiated by Eisner and approved by Old Board. Agreement had initial term of 5 years, salary of 1 mill per year, discretionary bonus, and two sets of stock options that would enable Ovitz to purchase 5 million Disney shares. The options vested in 3 annual increments of 1 million shares at end of 1st full year and the next two. Agreement provided that option A would vest immediately if Disney granted Ovitz a non-fault termination. B option consists of 2 million shares and were conditioned on Ovitz and Disney first having agreed to extend employment beyond five years. Ovitz would forfeit B option if initial employment term of 5 years ended prematurely for any reason. **Claims:** (A) Board of directors of Disney as it was constituted in 1995 (old board) breached its fiduciary duty in approving extravagant and wasteful Employment Agreement of Ovitz as president of Disney; (B) Board in 1996 (New Board) breached fiduciary duty in agreeing to a non-fault termination of Ovitz Employment Agreement, a decision that was extravagant and wasteful; (c) The directors were not disinterested and independent

3. **HELD,** Stockholder derivative Complaint was subject to dismissal for failure to set forth particularized facts creating a reasonable doubt that the director defendants were disinterested and independent or that their conduct was protected by business judgment rule


5. Ovitz had never been an executive for a publicly owned entertainment company. Eisner hired Ovitz on his own, and sent him a letter. Before this, neither the Old Board nor the compensation committee had ever discussed hiring Ovitz as president of Disney. A compensation committee convened. They had little information. No presentations, spreadsheets, written analyses, or opinions were given by any expert for the compensation committee to rely upon in reaching its decision. Immediately after the compensation committee met on September 26, the Old Board met, and they had little information. The minutes of the meeting were fifteen pages long, but only a page and a half covered Ovitz's possible employment. The Old Board did not ask any questions about the details of Ovitz's salary, stock options, or possible termination. Everything bit of negotiating was left to Eisner, Ovitz's close friend for over twenty-five years. Neither the Old Board nor the compensation committee reviewed or approved the final employment agreement. Ovitz was a poor, uneducated corporate executive. Ovitz could only terminate his employment if one of three events occurred: none of them occurred. Still, Eisner and he worked out a “non-fault” termination with Ovitz. Neither the New Board of Directors nor the compensation committee had been consulted or given their approval for a non-fault termination. In addition, no record exists of any action by the New Board once the non-fault termination became public. Ovitz was paid out nearly $144 million dollars. Disney’s by-laws required approval of Ovitz’s non fault termination. The board did not even consider the issue.

6. **Held,** there is reason to suggest that demand would be futile and the P’s shareholders survive a motion to dismiss on summary judgment
   a. To determine whether demand would be futile, the Court must determine whether the particular facts, as alleged, create a reason to doubt that:
      i. (1) the directors are disinterested and independent" or
ii. (2) the challenged transaction was otherwise the product of a valid exercise of business judgment."

b. Plaintiffs may rebut the presumption that the board's decision is entitled to deference if they plead particularized facts sufficient to raise
   i. (1) a reason to doubt that the action was taken honestly and in good faith or
   ii. (2) a reason to doubt that the board was adequately informed in making the decision.

c. As alleged in the new complaint, the facts belie any assertion that the New or Old Boards exercised any business judgment or made any good faith attempt to fulfill the fiduciary duties they owed to Disney and its shareholders.

d. The facts alleged in the new complaint suggest that the defendant directors consciously and intentionally disregarded their responsibilities, adopting a "we don't care about the risks" attitude concerning a material corporate decision.

e. All of the alleged facts, if true, imply that the defendant directors knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss.

vi. Fiduciary Duty and Aronson’s First Prong


2. P filed a motion alleging that the company’s directors committed corporate waste and breached both fiduciary duty of loyalty and due care by rescinding a Contingent Stock Redemption Agreement and funding in part with money made available as the result of the rescission a self-tender offer that they also assert resulted in no consideration to the company. D moves to dismiss based on P failing to meet the pre-suit demand requirements of Rule 23.1. Under the Redemption Agreement, the Children’s Trust acquired the right through January 2006 to make the company redeem 18.75 million shares at $18.75 per share, a put option. It also provided that the Company had a six month window, beginning on July 31, 2006, to buy the remaining shares for $25.07, a call option. The self-tender happened b/c the company wanted to instill pride in shareholders. The only reason that the company bought more shares than they had cash, according to the complaint, was that they wanted to provide an excuse to exercise the rescission premised on a “need” for more cash.

3. Held, there are adequate facts to survive a motion to dismiss for failure to state a claim of breach of duty of loyalty. There are adequate facts to demonstrate demand futility. There are not adequate facts to demonstrate corporate waste or breach of duty of care. Those claims are dismissed on 12(b)(6) motion.

   a. Demand Futility
      i. If a shareholder asserts a derivative suit without making demand of the company, the complaint must allege rationale
      ii. Director Disinterestedness
         1. Directorial interest exists whenever divided loyalties are present, or a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders
         2. Because Mr. Wexner, in his individual capacity and as trustee of the trust, which he negotiated for the benefit of his children, there is a reasonable doubt as to his disinterestedness
         3. Same as his wife Ms. Wexner
      iii. Director Independence
         iv. Because half of the directors were either not disinterested or were not adequately independent, it was adequate for the shareholders not to make demand

   b. Duty of Loyalty
      i. There is adequate facts, considering the non-disinterested or reasonable doubts of independence of the director, to survive a 12(b)(6) motion

   c. Corporate Waste

vii. Special Litigation Committee Issue - Dismissal of Derivative Litigation at the Request of an Independent Litigation Committee of the Board

1. General
a. MBCA § 7.44  
b. Corporations appointed a committee made up of directors who were not involved in the first suit and asserted for this committee the right to claim the board’s power to control derivative litigation

2. Special Litigation Committee Procedure  
a. As soon as P files complaint, the board appoints an “independent committee” to investigate the complaints  
   i. In order to ensure independents, only those directors who have no financial stake in the transaction that P is complaining about are put on the committee  
   ii. The committee then goes through extensive investigation, interviews, and a written report  
   iii. Then, often, the committee decides to dismiss the suit  
b. Typically, these are set up so that the Court’s will give the BJR to the committee  
c. However, if the P can show the committee wasn’t independent, or that they didn’t conduct reasonable investigation or follow reasonable procedures, the court might not follow the SLC

3. Delaware Law and The Special Litigation Committee (SLC) [SUPP]  
4. MBCA [SUPP]  
5. Case Law  
6. Auerbach v. Bennett  
a. Ruled that an interested board retains power to delegate its authority to a special litigation committee composed of disinterested directors whose recommendation that derivative litigation be dismissed would be entitled to normal business judgment rule presumption.

7. Miller v. Register and Tribune Syndicate  
a. Concluded that a conflicted board has power to appoint a special litigation committee to investigate and advise the corporation concerning derivative litigation, but that special committee has no power to control derivative litigation on behalf of the company

8. Zapata Corp. v. Maldanado (Middle Ground of Auerbach and Miller)  
a. Question to be decided is when, if at all, should an authorized board committee be permitted to cause litigation, properly initiated by a derivative stockholder in his own right, to be dismissed? Problem is that the company should be able to rid itself of frivolous, baseless litigation, but the shareholder should also be able to bring a claim that has merit.  
b. Held, the board can delegate this authority. A reviewing court should follow a two step procedure:  
   i. First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions  
   ii. Second, the Court should determine, applying its own independent business judgment, whether the motion should be granted  
c. If the Court’s independent business judgment is satisfied, the Court may proceed to grant the motion, subject, of course, to any equitable terms or conditions the Court finds necessary or desirable  
d. Note 1 on 369 shows the costs associated with the Zapata two step test

9. Oracle Corp Derivative Litigation  
10. Shareholders brought derivative action alleging insider trading by CEO, CFO, and two directors. Special Litigation Committee was formed, and two Stanford directors are on the committee. Among
the directors being investigated is (1) another Stanford professor, who taught one of the SLC members when the SLC member was a Ph.D. candidate and who serves as a senior fellow and a steering committee member alongside the SLC member at the Stanford Institute for Economic Policy Research; (2) a Stanford alumnus who had directed millions of dollars of contributions to Stanford during recent years, serves as Chair of SIEPR’s advisory board and has a conference center named for him at SIEPR, and has contributed more than $600,000 to SIEPR and Stanford Law, both parts of the school which one of the SLC members is closely affiliated; and (3) the CEO, who has made millions of dollars in donations to Stanford through himself and Oracle, and was considering a donation of $100 million and a scholarship at the same time these SLC members were added to the SLC. SLC has moved for dismissal.

II. Held, the ties between the members of the SLC and directors are so substantial that they caused reasonable doubt about the members’ independence.

   a. The SLC bears the burden of persuasion and must convince the court that there are no genuine issues of material fact (Zapata Corp)

   b. The Question of independence turns on whether an SLC is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind

      i. Focuses on “impartiality and objectivity”

   c. In order to prevail on a motion to terminate a Derivative Action, the SLC must prove (1) its members were independent, (2) they acted in good faith, and (3) that they had reasonable basis for their recommendations.

      i. If they prove this, the Court may grant the motion or may, in its own discretion, move to do its own examination of Oracle and apply its own business judgment.

   d. The inquiry is supposed to focus on whether the directors are under the “domination and control” of the board – however, the court thinks this is too minimal. “Our law should not ignore the social nature of humans.”

   e. We consider whether a SLC member is beholden: whether a person is beholden in a financial sense or b/c of a personal or other relationship to the interested party

   f. The question is largely whether the SLC can independently make the decision set before it

XII. Excursion on Corporate Liability (Piercing the Corporate Veil)

   a. General – Individual Shareholders

      i. One of the key attributes of the corporate form is limited liability.

         1. A tenet of that is that shareholders will only be liable for the amount of their investment.

         2. However, in some instances, a court will hold shareholders personally liable for the debts of the corporation (and thus, “pierce the veil”)

      ii. Important components to consider (which courts consider) when piercing the veil:

         1. The court is more willing to pierce in tort cases than in contract cases

         2. Whether the defendant stockholders have engaged in fraud or wrongdoing

         3. Whether the corporation is adequately capitalized

         4. Whether the corporate formalities were followed

            a. i.e. the issuance of stock certificates, the keeping of minutes of corporate meetings, etc.

         5. When the corporate veil is pierced to the detriment of individual shareholders, it is almost always in cases where the corporation is dominated by one or a small number of shareholders (almost never in publically traded companies)

         6. Also, courts generally require at least TWO of these above mentioned problems:

            a. The most common taken together are inadequate capitalization and a failure to follow corporate formalities

      iii. Tort v. Contract Cases

         1. Contract Claims
a. Usually, a creditor involved in a contract is a “voluntary creditor.” Usually, this means that the creditor had the opportunity to investigate the debtor’s credit abilities. Also, the creditor had the right to bargain for a personal guarantee from the debtor, and likely did not do so. Thus, courts are less likely to pierce the veil, even if the debtor’s corporation was undercapitalized.

b. Consumer’s Co-Op v. Olsen

i. There was abundant measures taken to assure that all corporate business was done in the corporation’s name: the corporate name was affixed to, or printed on, virtually all of the property and equipment associated with the day-to-day operations of the corporation. When business worsened, no dividends were ever paid. Company failed to remain current in the monthly payments on its account with Consumer Co-Op. There was no evidence that corporate and personal funds were intermingled. Substantial personal assets were used to fund the corporation. No fraud was involved.

ii. Held, undercapitalization is not sufficient by itself to pierce the veil.

1. (1) You need something else alongside undercapitalization, such as a failure to follow corporate formalities.
2. (2) Consumer co-op had the right to investigate Olsen’s balance sheet – by continuing to extend credit and increase indebtedness, the co-op waived its right to pierce the veil.

2. Tort Claims

a. None of the abovementioned issues are present in tort claims. There was no ability for the creditor to research the debtor, no ability to bargain, etc. Thus, courts are much more likely to pierce the veil in this situation.

b. Western Rock Co. v. Davis

3. However, the abovementioned distinction is not dispositive.

iv. Fraud or Wrongdoing

1. Usually, this refers to some means by which those controlling the corporation have siphoned out its assets, leaving too little in the corporation to satisfy the creditors.

a. If the sole shareholder of a corporation draws a salary that changes from month to month, but is always just enough to leave the corporation with practically no assets.

b. Usually, the fraud or wrongdoing leaves the company with little or no capital, and thus you have met the Rule Of Thumb, two factor test mentioned above.

2. Misrepresentation

a. Also, note that a shareholder could be directly personally liable for misrepresentation, if someone acts in reliance on those statements

i. Telling a creditor the company has 1 billion dollars in the bank

v. Inadequate capitalization

1. Probably the most important factor

2. Usually, the veil will be pierced in situations where there is an “involuntary creditor” (tort usually) who can’t be said to have born the risk of inadequate capitalization.

a. However, even a contract creditor may have the veil pierced if he can show their wasn’t capital for foreseeable business needs and the creditor had no way to ascertain this fact.

3. Minority Rule

a. An involuntary creditor can pierce the veil if there has been grossly inadequate capitalization, even in the absence of the other two factors that are commonly considered (fraud/wrongdoing and failure to follow formalities)
4. Majority Rule
   a. Although grossly inadequate capitalization is a factor, it is not dispositive. Thus, there must also be either fraud/wrongdoing or a gross failure to follow corporate formalities
5. Zero Capital
   a. When the shareholder invests no money whatsoever in the corporation, courts are especially likely to pierce the veil, and may require less of a showing on the other factors than if capitalization was just inadequate.
6. Having Insurance
   a. Where the P is a tort claimant, courts will consider whether the corporation procured insurance against the type of risk that came to pass – if they did, this will make a finding of undercapitalization less likely
7. Failure to add new capital
   a. Few, if any courts, accept this argument from Plaintiff’s, assuming there is no fraud or wrongdoing (siphoning out the capital from the company)
8. Business Grows
   a. Suppose initial capital was enough, but business grows to the point where initial capital is no longer adequate. A strong argument can be made that this is inadequate and should make piercing the veil more likely.
   vi. Failure to Follow Corporate Formalities
      1. Examples of formalities that could be dispositive:
         a. Shares are never formally issued, or consideration for them is never received by the corporation;
         b. Shareholders meetings and directors meetings are not held;
         c. Shareholders do not sharply distinguish between corporate property and personal property; and
         d. Proper corporate financial records are not maintained
      2. When there is an injury to creditor from the abovementioned issues, veil piercing is more likely
   b. Parent/Subsidiary structure
      i. Generally, there is a greater tendency to pierce the parent for the debts of a subsidiary
         1. Naturally, b/c courts are more reluctant to take from an individual’s property than a corporation’s
      ii. General rule of non-liability:
         1. The parent will NOT be liable, so long as:
            a. Proper corporate formalities were observed;
            b. The public is not confused about whether it is dealing with the parent or the subsidiary;
            c. The subsidiary is operated in a fair manner with some hope of making a profit; and
            d. There is no other manifest unfairness
      iii. “Domination of Affairs” is NOT enough
         1. Thus, the fact that a parent drains excess cash from the subsidiary, demands a veto power over significant decisions by the subsidiary, or otherwise exercises some degree of control over the subsidiary’s operations, will not suffice for piercing the veil.
iv. Factors leading to veil piercing
   1. Intertwined operations
   2. Unified business and subsidiary undercapitalization
   3. Misleading to public
   4. Intermingling of assets
   5. Unfair manner of operations

v. Direct liability of parent to subsidiary:
   1. When the parent is found to be “so deeply involved” in conducting “particular
      activities” that has given rise to the claim, the court may find the parent itself
      responsible.

vi. Active v. Passive Investors
   1. Courts are more likely to pierce the veil with regards to active as opposed to passive
      investors:
      a. Active investors are those who invest and run the corporation;
      b. Passive investors are those that just invest some capital.

XIII. Mergers and Other “Friendly Control” Transactions
   a. Statutes
      i. MBCA § 11.01 – 11.05, 11.07
      ii. Del. GCL §§251, 253, 259-261
   b. Rationales for Mergers
      i. Better use of assets
      ii. More capital
      iii. More efficient use of capital
   iv. Synergies – ways to bundle products or assets to more efficiently and save costs, transaction
      costs, etc.
   c. Types of Mergers
      i. Statutory merger
         1. Statutory merger is a transaction whereby two or more corporations are combined
            into one of the corporations
            a. The Key Feature of a statutory merger is that the shareholders of the acquired
               company are not “cashed out” – instead, the continue to have an equity
               participation, though this is in the combined entity
         2. By operation of law, the assets and liabilities of all disappearing corporations pass to
            the surviving corporation, and the outstanding shares of stock in the disappearing
            corporation are cancelled
         3. A short-form merger is this form of merger
      ii. Stock Swap (stock for stock exchange)
         1. The acquiring corporation makes a separate deal with each target shareholder, giving
            that holder shares in the acquirer in exchange for the shares in the target.
         2. Surviving minority interest (stock swap)
            a. If the minority of shareholders refuse to tender their shares, then the acquirer
               will be stuck with these minority shareholders in the target which would
               subject it to fiduciary responsibility of fairness, which may interfere with
               business flexibility [Weinberger v. UOP]
      iii. Stock for assets exchange
1. The acquiring company gives stock to the target company, and the target company gives all or substantially all of its assets to the acquiring company in exchange.
2. The target dissolves, and distributes the acquirer’s stock to its own shareholders.

iv. Triangular Mergers

1. Forward triangular mergers (“Conventional” mergers)
   a. The acquiring company creates a subsidiary for the purpose of the transaction. The target is then merged into the acquiring company’s subsidiary.
   b. The target’s shareholders don’t receive stock in the surviving corporation (the subsidiary), but rather stock in the subsidiaries parent (the acquirer).
   c. Rationale:
      i. Forward merger technique is guaranteed to eliminate all minority interest in the target’s assets – every target shareholder is forced to become an acquiring corp’s shareholder, whereas in the stock-for-stock exchange a target shareholder could decline to participate.

2. Reverse Triangular Mergers
   a. Exact same as the forward merger, except that the acquirer’s subsidiary merges into the target, rather than having the target merge into the subsidiary.

d. Shareholder Approval of Mergers

i. Statutory Mergers
   1. Boards of directors of both corporations must approve the deal.
   2. Shareholders of both corporations must approve (all shares entitle to vote DGCL § 251(c))
      a. Normally, approval is by a majority vote of the shares permitted to vote.
      b. This is the majority of all shares outstanding, not just a majority of shares that are voted.
      c. Voting by classes:
         i. Under some statutes, if there are different classes of stock, they must vote separately and each must approve it.

3. Short Form Mergers
   a. If corporation P owns an overwhelming majority of the shares of the corporation S, so that they are basically in a parent-subsidiary relationship, S may be merged into P without the approval of the shareholders of either P or S.
      i. Both MBCA and Delaware allow a short-form merger where P holds 90% or more of the stock in S.
      ii. In short-form mergers, the remedy of minority shareholders is limited to appraisal rights.
         1. However, in some cases the court allows a minority to bring a class action for damages or an injunction if the terms of the short-form merger are dramatically unfair [Weinberger v. UOP]

d. Asset Sale
   1. Provisions
      a. MBCA § 12.01, 12.02
      b. DGCL § 271
2. Transfer ownership and control of corporate assets by conveying title by one or more bills of sale

3. How it differs from a merger
   a. The corporation selling assets does not automatically go out of existence upon consummation of the sale
   b. The selling corporation need not transfer all of its assets, as would occur in a merger.
   c. The liabilities of the selling corporation will not necessarily pass to the purchasing corporation by operation of law.

4. Rules
   a. If the directors of a corporation wish to sell substantially all of the corporation’s assets other than in the ordinary course of business, they must submit the proposal to their shareholders for approval
      i. Normally by majority vote
   b. In Delaware, the shareholders get a vote but aren’t provided appraisal rights
   c. In both Delaware and MBCA jurisdictions, the shareholders of the acquiring company do not have a right to approve or disapprove of the transaction
   d. If less than all of the corporations assets are to be sold, corporate planners must determine whether the transaction is qualitatively and quantitatively significant enough to require approval by the selling corporation’s shareholders
      i. *Katz v. Bergman*: Holds that 51% of assets sold is “substantially all” b/c the assets were the major functions of the company
      ii. *Oberly v. Kirby*: Test for substantiality: “. . . to be measure not by the size of a sale alone, but also by its qualitative effect upon the corporation.”

iii. Triangular Mergers
   1. Two different forms
      a. Forward subsidiary merger: The acquired corporation merges into the acquiring subsidiary.
      b. Reverse subsidiary merger: The acquiring subsidiary merges into the acquired corporation.
   2. Purpose
      a. From a corporate governance perspective, the purpose of this is to eliminate the voting and appraisal rights that the shareholders of the acquiring parent would otherwise have.
         i. The only shareholders (most states) entitle to voting and dissenter’s rights are the shareholders of the actual parties to the merger.
         ii. Thus, the acquiring parent receives the voting and appraisal rights belonging to the acquiring subsidiary, which are then exercised by the acquiring parent’s board, which obviously will not dissent from the transaction.
         iii. The shareholders of the acquiring parent are shut out of the deal.

iv. Compulsory Share Exchanges
   1. Provisions
      a. MBCA § 11.03, 11.04
2. Elaboration
   a. A new statutory proceeding that allows one corporation to acquire all the
      shares of another while leaving the acquired corporation in existence.
   b. Accomplished by board approval and a simple majority vote of the
      shareholders of the acquired corporation, but only needs board approval of the
      acquiring corporation.
   c. Non-consenting shareholders of the acquired corporation are forced to give up
      their shares subject to their appraisal rights. Shareholders of the acquiring
      corporation don’t have appraisal rights.

e. Protecting Shareholders in Mergers
   i. Three main ways in which legislatures protect shareholders of the acquired company
      1. Appraisal rights, by which the shareholder may demand payment of the value of his
         shares in cash, rather than being forced to accept other securities
      2. Judicial scrutiny of the substantive fairness of the transaction; and
      3. The “De Facto” Merger Doctrine
   ii. Appraisal Rights
      1. DE § 262
      2. Two main sources of unhappiness:
         a. Unfairness:
            i. The majority approval procedure gives no guarantee that the minority
               shareholders (those not approving the transaction) are being treated
               fairly.
         b. Change in company business
            i. A shareholder shouldn’t be forced to have stock in a merged company
               that is substantially different than what he invested in
      3. Usually, most statutes provide that you have appraisal rights if you have voting rights
      4. The market exception to appraisal rights
         a. Shareholders don’t get appraisal rights for publicly traded shares if:
            i. The merger consideration received in exchange is also publicly traded
               stock;
            ii. Designated as a national market system security by Nasdaq; or
            iii. Held by 2000 or more shareholders
         b. Short-form mergers
            i. The shareholders of the subsidiary are granted appraisal rights even
               though they wouldn’t have been able to vote on the merger
               1. No appraisal rights for the majority parent corporations
                  shareholders
   iii. The De Facto Merger Doctrine
      1. General
         a. The theory that a transaction which is not literally a merger, but which is the
            functional equivalent of a merger, should be treated as if it were one for
            purposes of appraisal rights and shareholder vote.
         b. When the doctrine is accepted, most often the shareholders get appraisal rights
         c. Best example is **Farris v. Glen Alden Corp**
         d. Delaware rejects the doctrine in **Hariton v. Arco Electronics**: Each portion of
            the code is there for a reason, and each portion should be given equal respect
2. ALI approach
   a. Shareholders of the parent corporation which uses a subsidiary to effect a
      merger would normally receive appraisal rights as if the parent corporation
      had been a direct participant in the merger.
   b. If the corporation uses its own stock to purchase a substantial portion of the
      assets of another corporation, its shareholders get appraisal rights (along with
      selling corporation) if the transaction results in the acquiring corporation’s
      pre-transaction shareholders owning less than 60% of the stock outstanding
      immediately after the acquisition is effected.

iv. Judicial Scrutiny of the Fairness of the Transaction
   1. General
      a. If a shareholder thinks the deal is very unfair for Corporation’s shareholders,
         courts may overturn the transaction or award damages if they agree. Usually,
         this inquiry can be broken up in three parts:
         i. Most courts do think they can review the substantive fairness
         ii. Arm’s length combinations;
         iii. Strong self-dealing aspect to the transaction
   2. Arm’s length combination: a deal in which the entities do not have a close pre-
      existing relationship at the time they negotiate the deal
      a. Delaware courts will review the substantive fairness of even an arm’s length
         transaction
      b. P must meet two tests to have the transactions set aside for substantive
         unfairness:
         i. He must bear the burden of proof on the issue of fairness
         ii. He must show that the price is so grossly inadequate as to amount to
            constructive fraud
         1. NOTE: Court’s almost never strike down arm’s length
            transactions
      c. Side Payment problems
         i. The insiders of the seller settle for a lower selling price in return for
            some form of payments to themselves (E.g. negotiate lucrative
            employment contracts)
   3. Self-dealing situations
      i. This is a situation in which a key decisionmaker stands on both sides
         of the transaction
      b. Higher standard of review
         i. In Delaware, in this situation you have to show entire fairness (fair
            dealing, fair price)
      c. Common keys for self-dealing
         i. Two step acquisitions:
         1. Acquirer purchases some (usually a majority) of the target’s
            shares in a cash tender offer, then in a subsequent second step
            eliminates the remaining shareholders by a cash or stock
            merger.
      d. Parent-Subsidiary Merger
         i. Courts are vigilant in protecting the subsidiary shareholders
ii. Parent can increase the chance the court will find the transaction fair by the use of an independent committee to consider the deal to the subsidiary

v. Squeeze-out mergers – forcing out the minority shareholders (Delaware’s law)

1. General
   a. Controlling shareholders will oppress minority shareholders and decide to do things against their will
   b. Rational Apathy, Coordinating Problems, etc. – you don’t need to have 51% to make sure your view always win. This goes to the point that you don’t have to be a majority (> 51%) to be a controlling shareholder
   c. Cash-out merger: Minority shareholders receive cash as consideration for the transaction. After which the controlling shareholder is the sole shareholder.
   d. In this situation, one must wonder about the motivation of the controlling shareholder: does he have better information, does he have a stake in the board, more control over the company

2. Rationale Argument against squeeze-out appraisal:
   a. Why we should allow the majority to oppress the minority? One answer is that the minority are getting a premium. Another is that this is the benefit of being the majority – I paid a premium, and part of that premium is the right to squeeze the minority out.
   b. Minority also assumed the risk of being oppressed, and they got a discount on their stock that shows the risk of being squeezed out
      i. Argument is that the court providing protection provides a windfall to the minority – they already bought at a discount

3. Delaware Law
   a. “Entire Fairness Review”: A squeeze-out transaction, or any transaction in which insiders are on both sides of the transaction, will be sustained only if it is “entirely fair,” as measured by (1) Fair Procedures, (2) Fair Price, and (3) Adequate Disclosure [Weinberger]
   b. Burden of proof
      i. In some instances, the burden of proof can shift to the P to show that the terms of the transaction were unfair. This occurs if all of the following three things happen:
         1. A majority of the minority shareholders must vote to approve the transaction
         2. The D’s must carry the burden of showing that they made adequate disclosure of the transaction
         3. There must be a simulation of an arms’ length process, in which representatives of the minority and majority negotiate. Usually, this will occur with a committee of independent directors, who negation with the majority holder [Kahn]
   c. Damages
      i. P’s usually have to deal with money damages, equal to what they would have got in appraisal.
      ii. If P can prove fraud, misrepresentation, or gross and palpable overreaching, the P’s could get an injunction or class action damages
f. Assumptions on which the model for mergers is built on
   i. Lawmakers presumably believe that shareholders can make an informed decision to approve or reject the merger, and that in the normal case the participation of shareholders in the decision-making process adds value for corporations and shareholders
      1. Precept to this assumption: Management will be able to provide the shareholders with sufficient, digestible, and unbiased information about the pros and cons of the planned merger. Further, lawmakers must believe that it will not be unduly burdensome for corporations to await the decision of their shareholders before beginning the critically important and costly process of integrating the assets and personnel

   iii. There is a merger between Hewlett Packard and Compaq. The shareholder vote is extremely close.
        Shareholders file suit challenging vote on grounds that (1) HP knowingly misrepresented material facts about the integration (of the companies) to “Institutional Shareholder Services” that had a large effect on who voted for the merger, and (2) HP coercively forced DeutscheBank to approve the merger in order to maintain future business with HP.
   iv. Held, neither of P’s claims of merits under the facts of this case
   v. With regard to the (1) claim, P would have the burden of proving through analysis of the reports of the integration team that HP management knowingly misrepresented material facts about integration in an effort to persuade ISS and others to approve the merger.
      1. Nothing in the record suggests that HP lied or deliberately misled anyone.
   vi. With regard to (2) claim, the facts of this case do not lend themselves to a believable vote buying claim.

g. Dissenter’s rights
   i. Statutes
      1. MBCA § 13.01(4), 13.02, 13.24
      2. DGCL § 262
   ii. General
      1. If a shareholder dissents when asked to approve a merger or other covered transaction, and if the transaction nonetheless obtains the requisite shareholder approval, the dissenting shareholder may demand that his shares be repurchased by the corporation for fair value (“appraisal”)
         a. If company/shareholder can’t agree – it goes to judicial proceeding
      2. Delaware GCL § 262: Shareholder receives judicially determined fair value, even if that is less than the amount in the merger agreement
      3. MBCA is much more sympathetic
         a. 13.25 requires the corporation to make payment to the dissenter as soon as the corporate action is consummated. This payment represents the corporations good faith judgment as to the fair value of the dissenter’s shares.
         b. If the court finds a higher fair value in the appraisal proceeding, the dissenting shareholder receives the difference.

h. Intersection between Appraisal Remedies and Fiduciary Duty
   i. Cash Out mergers and The Business Purpose Test
      1. General
         a. Cash as consideration in merger
         b. When the statutes were interpreted by courts as not requiring the same consideration for all shareholders, the way was open for controlling shareholders directly to force minorities out of the enterprise via a merger or other fundamental change by specifying that the controlling shareholders
would get equity in the merged enterprise and the minority shareholder’s
would get cash.

c. Thus, several jurisdictions adopted a Business Purpose Test as a means of
closer scrutiny to cash-out mergers, and, correspondingly, creating larger
exceptions to the appraisal exclusivity rule.

2. Progression of Delaware law
   a. **Singer v. Magnavox**
      i. Delaware becomes a user of the Business Purpose Test. In effect,
         **Singer** required controlling shareholders to prove a valid business
         purpose for a cash-out merger.
      ii. This made P’s often seek a class action, b/c in doing so the P’s could
          obtain an entire fairness review.

ii. **Weinberger v. UOP, Inc**. (Modern Delaware Appraisal Issues)
   1. Ultimately, the facts show that the decision to merge the companies was done in a week, the person
      who wrote the report for Lehman brothers was on the board of the company, the company didn’t tell its
      shareholders how much the other side offered. Basically, **Material Information** was withheld.
      a. A primary issue mandating reversal is the preparation by two UOP directors of their
         feasibility study for the exclusive use and benefit of Signal.
      b. Since the study was prepared by two UOP directors, using UOP information for the exclusive
         benefit of Signal, and nothing whatever was done to disclose it to the outside UOP directors
         or the minority shareholders, a question of breach of fiduciary duty arises

   2. **Appraisal Plus**: The expectation of the merger exclusion allows courts to consider all
      relevant factors except speculative consequences of the merger

iii. Issues Regarding **Weinberger**
   1. If the trial court finds that arm’s length bargaining was simulated sufficient to shift
      the burden of proof to the Plaintiff, the Del. Supreme Court mandates that the
      standard of review is still entire fairness.
      a. Rationale is on 630

   2. If the Court finds that the controlling shareholder has coerced the allegedly
      independent negotiating committee, is it still possible for the controlling shareholder
      to carry its burden of proof on the fair dealing component of entire fairness?
      a. Del. Supreme Court says it is: “I conclude that the absence of certain elements
         of fair dealing does not mandate a decision that the transaction was not
         entirely fair. . . The negotiations, although found by the lower court to be
         coercive, were certainly no less fair than if there had been no negotiations at
         all.”

iv. Appraisal and Entire Fairness Review after **Weinberger**
   1. Valuation under Statutory Appraisal
         i. MBCA § 13.01
         ii. DGCL § 262(h)
      b. General
         i. A debate continues over:
            1. Whether minority shareholders who are cashed out are entitled
               to any gains, from synergy or other sources, that may occur
               after the merger; and
            2. Whether “fair value” should reflect a discount b/c the appraised
               stock is a minority interest or is not readily marketable
2. **CEDE & CO v. Technicolor, Inc.** (uncertainties in the judicial appraisal of fair value)

Kamerman, Technicolor’s CEO and COTB decided the business needed to go into one-hour-photo processing, and the board approved his plan. After announcing the venture, the stock rose to a high of $22.13. One-hour-photo sucked, and the stock reached a low of $8.37. In later summer, 1982, Perlman, controlling stockholder in MAF decided to merge its wholly owned subsidiary into Technicolor. By late December MAF had acquired 82.1% of Technicolor’s shares – and MAF and Technicolor were consolidated for tax and financial purposes. Perlman began to dismember Technicolor’s business plan, and expected to make $54 million from the sale of Technicolor assets. Merger accomplished on Jan 24, 1983.

**Held:** The court of chancery erred in valuing the stock without regard to the transient period between step one and two of the two-step merger.

3. **Minority or Marketability Discounts**
   a. **Definition and Justification**
      i. The concept of a marketability discount stems from the fact that marketability problems often affect shares of closely-held corporations, and that as a result, a discount should be applied to reflect the illiquidity of such shares. Thus, a discount for lack of marketability has been justified on the ground that the shares can’t be readily sold on a public market, whether or not they represent a minority interest.
      ii. Marketability discounts are applied to all the stock of a corporation that is not widely traded, whereas minority fair market value discounts apply only to minority shareholders.
      iii. When minority discounts are downward adjustments to the value of dissenting shares due to their lack of voting power to control corporate actions, marketability discounts are downward departures due to the limited supply of potential buyers.
   b. **Strong support for this proposition.**
      i. Reflected in the 1999 amendments to the MBCA.
         1. See MBCA §13.01(4)(iii)
         2. Rationale on p. 641

4. **How do you value a company?**
   a. (1) Take the future cash flow of the business, and then figure out what the present valuation of the stream of earnings, and find out how much it is worth today.
      i. Problems: Bounded Rationality, Imperfect understanding of earnings.
   b. What are other company’s like this one worth?
      i. Maybe there have been recent transactions.

v. **Appraisal as the Exclusive Remedy**

1. **Glassman v. Unocal Exploration Corp**
   2. Unocal owned 96% in UXC (subsidiary), and felt that it would save costs to merge the parent and subsidiary. UXC committee appointed to consider merger consisted of three directors, who were not officers or employees, though directors, of the parent company Unocal. Minority Stockholders filed claims that directors breach fiduciary duty of entire fairness and full disclosure.
   3. **Held:** The Court should return to Stauffer, and therefore absent fraud or illegality, appraisal is the exclusive remedy available to a minority stockholder who objects to a short-form merger. The determination of fair value must be based on all relevant factors, and the duty of full disclosure remains.
i. *Coyne v. Park & Tilford*: statute is constitutional that contemplates payment of cash for whole shares surrendered in a merger and the consequent expulsion of a stockholder from the company

ii. *Stauffer v. Standard Brands, Inc.*: the only form of equitable relief available to minority stockholders who object to a short-form merger is appraisal
   1. Would not be the only remedy in a case of short-form tainted by fraud

iii. *Greene Co. v. Schenley Industries, Inc.*: Court of Chancery applies *Stauffer* to long-form mergers, recognizing that the corporate fiduciaries had to establish entire fairness, but that fair value was the P’s only real concern and therefore appraisal is only remedy.

iv. *Singer v. Magnavox*: Controlling stockholder breaches its fiduciary duty if it effects a cash out merger under § 251 for the sole purpose of eliminating the minority stockholders

v. *Roland Int’l Corp. v. Najjar* (eliminates *Stauffer*): There is nothing magical about the 90% ownership requirement that would eliminate the fiduciary duty requirement the majority owes to the minority.

vi. *Weinberger v. UOP, Inc.*: Court drops the business-purpose test, made appraisal a more adequate remedy, and said that it was returning to the well established principles of *Stauffer* . . . mandating a stockholder’s recourse to the basic remedy of an appraisal.”

vii. *Rabkin v. Hunt Chemical Corp.*: Through interpretation of *Weinberger*, Court effectively eliminates appraisal as the exclusive remedy for any claim alleging breach of the duty of entire fairness. This only affects LONG-FORM mergers

b. In Parent-Subsidiary mergers, the issue is fairness – fair price and fair dealing – that flows from the statutory provisions permitting mergers in DGCL §§ 251-253 and those designed to ensure fair value by an appraisal, DGCL § 262

c. In a short form merger, there is only a unilateral act, the decision by the parent company to decide whether the subsidiary should exist. The stockholders receive no advance notice of the merger, their direct do not consider or approve it, and there is no vote.

d. The entire fairness claim conflicts with the statute. If the fiduciary follows the truncated process established by § 253, it can’t establish fairness. If it hires experts, it loses the benefit of the truncated process. The only way to handle this is to obviate the requirement to establish entire fairness.

vi. Pure Resources Case
   1. Structural Coercion: when you work through the dominant strategies of the minority shareholders, it is to tender your shares in a front-end loaded merger for fear of getting stuck with the shit of the back end
   
   2. What this case says: So long as the offer isn’t coercive, there is no threat of retribution, no fraud, etc., the tender offer as a way of getting rid of the minority is NOT subject to entire fairness review

vii. Combine *Pure Resources* and *Glassman*
   1. The whole point of the short-form merger is to streamline the process for ridding the minority (by the majority) – no vote, just the board decides – inherent in the short-form merger is that their isn’t fair dealing. The short form merger couldn’t ever satisfy this standard. If we demanded entire fairness, we could gut § 253 and short-form mergers. Glassman says it applies to long-form cash-outs. Then, you are left, in the short-form context, with appraisal as the only remedy (Appraisal plus - § 262).
   
   2. Appraisal plus is NOT going to be more generous than entire fairness
   
   3. The other concern to flag is that you, the shareholders, can decide after the fact that you want to bring this suit for breach of fiduciary duty. If you are truly stuck as a minority shareholder with appraisal as only remedy, you have follow the § 262 rules and you can’t wait until after the merger to challenge.
XIV. Hostile Takeovers
   a. Glossary of Defensive Tactics
      1. **Bust-up**: Seeking to break up target and sell it off in pieces
      2. **Junk Bonds**: refers to bonds that are higher risk and therefore bear higher interest rate
      3. **White Knight**: Second bidder, though to be friendly to target management, who makes an offer to rescue the target from a hostile bidder
      4. **White Squire**: friendly party who does not acquire control but acquires a large block of target stock with the acquiescence of target management
      5. **Arbs or arbitragers**: regular market participants who seek to make money by short term purchases or sales of stock
      6. **Golden Parachutes**: lucrative compensation and fringe benefits given to target management to ease their descent if they are fired after a hostile takeover
      7. **Greenmail**: pejorative term for a target’s repurchase of its own shares from a raider where the target pays a premium for the shares to induce the unwanted suitor to go away

   b. Procedures for a bidder in tender offers
      i. Often a bidder will acquire some shares before announcing his offer
         1. However, once he acquires 5% he has to file it with the SEC under 1934 § 13(d)
      ii. Often a bidder will make the tender offer contingent on acquisition of a certain number of shares (e.g. 80%)

   c. Defensive Maneuvers and Judicial Responses
      i. Defensive Tactics
         1. Require that all mergers or asset sales require a supermajority (80%) of shareholder approval
         2. Instituting a staggered board
         3. Placing an anti-greenmail amendment in the articles
         4. Issue a second class of common stock, and require that any merger or asset sale be approved by each class – the new class placed with persons friendly to management
         5. Poison Pills
            a. Call Plans (Flip over pills): Give the stockholders the right to buy cheap stock in certain circumstances. So, lets say it is when 10-20% is acquired by someone, the shareholders have the right to purchase bidder shares at half price, so when GM merges into Ford, if Ford had a flip over plan then Ford’s former shareholders could purchase at half price
            b. Flip in Provisions: These work with other things besides the acquisition of stock – such as asset sales, etc. – so the shareholders can buy cheap stock of bidder and target if X occurs
         6. Put plans: If a bidder buys some but not all of the target’s shares, the put gives each target shareholder the right to sell back his remaining shares at a certain price (this prevents backloaded tender offers)
         7. Lock-up option: To induce someone to become a white knight for you, you may give them a crown jewels option, or anything, such as sweet stock-option plan, that will help them beat the bidder in an auction [Revlon]
         8. Termination Fees
         9. Leveraged Buy-outs
a. Target management may seek to respond to the bidder’s offer by providing shareholders a rearranged financial package that offer shareholders an immediate cash payment for their shares, often financed by huge additional borrowings.

d. Delaware Law on Defensive Tactics

1. The courts apply what should be thought of as a “modified BJR” – b/c of the higher than usual probability that the target’s management and board will be acting for self-interested purposes rather than stockholder welfare when they institute anti-takeover provisions.

ii. Unocal Corp v. Mesa Petroleum Co. (1985)

a. Mesa owned 13% of Unocal’s stock, and it commenced a two-tier “front loaded” tender offer for 37% of Unocal’s outstanding stock at $54/share. Unocal eventually said that the back end of the tender offer would receive “junk bonds.” An expert believed the minimum that should be accepted is $60/share, and that a defensive tactic that could be employed was a $70-$75/share self-tender offer. The board met for over 12 hours, rejected Mesa’s offer, and decided to self-tender for $72. The board knew there would be a lot of debt from the self-tender. The board decided if Mesa acquired the 64 million through it’s front end tender, then the self-tender would buy a remaining 49% of the company. Also, the board excluded Mesa from the proposal.

b. Held, the defensive tactics used here are reasonable in relation to the threat posed by the front-loaded tender offer.

1. Note that after Unocal, the SEC reacted by promulgating Rule 14d-10 under the Williams Act which prohibited selective tender offers.

2. Several states have rules rejecting the Unocal Test in favor of the BJR.


a. Board adopted two defensive tactics to prevent a takeover by Pantry Pride: a poison pill plan and the company’s repurchase of its 30 million shares. See deal with Forstmann, the white night, on 738. DC entered an injunction that barred consummation of an option granted Forstmann to purchase certain Revlon assets, a promise by Revlon to deal exclusively with Forstmann in the face of a takeover, and the payment of a $25 million cancellation fee to Forstmann if the transaction was aborted.

b. Holding: “In our view, lock-ups and related agreements are permitted under our law where their adoption is untainted by director interest or other breaches of fiduciary duty. The actions taken by Revlon directors, however, did not meet this standard.”

i. In this case, Forstmann was given lots of negotiating advantages (p. 741), and this wasn’t fair either.

iv. Paramount Communications, Inc v. QVC Network, Inc (all about triggering Revlon)

1. Viacom is controlled by Redstone, who has a vast majority of the stock. Paramount wanted to merge with Viacom badly. QVC wanted to merge with Paramount. Paramount instilled three defense provisions in its contract with Viacom.

a. (1) No-Shop Provision: Paramount can’t discuss with another third party unless (a) 3rd party makes an unsolicited written, bona fide proposal, which is not subject to any material contingencies relating to financing, and (b) Paramount board finds that to not discuss with 3rd party would violate their fiduciary duty;

b. (2) Termination fee provision: Viacom receives a $100 million termination fee if (a) Paramount terminated the original merger agreement b/c of a competing transaction, (b) Paramount’s stockholders didn’t approve the merger, or (c) Paramount Board recommended another transaction;

c. (3) Stock Option Agreement: Viacom can purchase 19.9% of Paramount’s outstanding common stock at $69.14 if any of the triggering events of the termination fee occurred.

2. QVC put forth a tender offer contingent on the destruction of the termination fee agreement, which had become worth $200 million. In the face of QVC’s bid ($10 more per share than Viacom), Paramount
and Viacom Amended the merger agreement, but Paramount used none of this leverage to eliminate or modify any of the three defensive tactics.

3. **Holding:** A corporation cannot be so narrow-minded that they fail to consider a tender offer that seriously benefits the stockholder, etc.

v. **Paramount Communications v. Time, Inc.** (Definition to the *Unocal/Revlon* framework)

1. **Suit seeks to enjoin Time’s tender offer of 51% of Warner’s shares.** The offer replaced a planned merger agreement that had been abandoned in the face of Paramount’s offer to purchase all of Time’s shares for $175/share. Paramount argues that the merger agreement put Time up for sale, and that b/c that is so, Time is bound by *Revlon* to consider all options for the shareholders, including Paramount’s, and that Time’s response to the Paramount tender offer breached its duties under *Unocal*.

2. **Under what circumstances must a board of directors abandon an in-place plan of corporate development in order to provide its shareholders with the option to elect and realize an immediate control premium?**

vi. **Omnicare, Inc. v. NCS Healthcare and Shareholders**

1. **The Board of NCS** (nearly insolvent) agreed to the terms of a merger with Genesis: all of the NCS creditors would be paid in full and the corporations stockholders would exchange their shares for shares of Genesis. Several months after approving the merger agreement, but before the stockholder vote was scheduled the NCS board of directors withdrew its prior recommendation and recommended the stockholders reject the Genesis offer. The Board decided that a competing transaction w/Omnicare was a better transaction: Omnicare offered a cash bid equal to twice the amount of the shares the holders would receive in the Genesis merger; also treated NCS other stakeholders on equal terms w/the Genesis agreement.

2. **The Merger Agreement between NCS & Genesis:** Provision authorized by DGCL 251(c) requiring that the Genesis agreement be place before the stockholders for a vote, even if the NCS Board no longer recommended it. At the insistence of Genesis, the NCS board also agreed to omit any effective fiduciary clause from the merger agreement. Furthermore, two stockholders of NCS, holding 65% of voting power, agreed unconditionally to vote all of their shares in favor of the Genesis merger. This agreement guaranteed the merger would occur.

vii. **Board may just say no [Paramount v. Time]**

1. It may refuse to take affirmative steps so as to give the shareholders a chance to approve the transaction. Of course, normally shareholder approval for a tender offer is not necessary – the shareholder simply decide whether to tender their shares, and each shareholder acts individually. But where an acquirer makes a tender offer that is conditional upon acts by the board (e.g. conditional upon the board’s decision to redeem a previously-issued poison pill, or the board’s agreement to cancel some other pending transaction, as Paramount demanded that time do concerning the Warner acquisition), apparently the board may simply refuse to take that action, as long as this board response is “reasonable response to a perceived threat” (*Unocal* test). And it will apparently take very little to convince the Delaware courts that this “reasonable response” standard is satisfied.

viii. **Consummation of previously-consummated transaction:**

1. The board is in far better shape if it merely carries out some previously-announced transaction than if it institutes a new action as a defensive measure. Thus Time’s acquisition of Warner was a continuation of a Time-Warner business combination that had been pending before Paramount’s hostile bid; had there been no consideration of any such combination by Time’s board, and had the board hastily responded to the Paramount offer by proposing to make a prohibitively-expensive and highly leveraged purchase of Warner, the court might well have held that this was not a “reasonable response to a perceived threat.” So Paramount puts corporate boards on notice if they think their corporation may be vulnerable to a takeover, they had better
arrange threat-reducing transactions before the threat crystallizes as a hostile takeover attempt.

ix. Delaware courts are particularly harsh when defensive tactics interfere with the target’s shareholders right to vote.
   1. Suppose that a hostile bidder who already holds a minority stake in the target has enough votes to compel a special shareholder vote on a proposal put forth by the bidder. Any action by the target’s management that is taken for the purpose of depriving the shareholders the right to vote on the bidder’s proposal is likely to be struck down as a violation of the target’s board’s fiduciary obligations to its shareholders.

x. Poison Pills and the Moran Case
   1. At least in Delaware, the adoption of a poison pill plan will probably rarely be invalidated. As long as the plan doesn’t substantially foreclose hostile tender offers, it will be sustained if it is enacted in response to the boards reasonable fears of damage to the corporation
      a. Redemption: Once the company’s up for sale, the level playing field rule comes into play, and the board can’t tell only one company it will redeem the poison pill
         i. No hand (can’t redeem) poison pills will likely be struck down on the grounds that it inappropriately limited a successor board’s ability to carry out its fiduciary duties
      b. The shareholders have the ability to hold a special meeting to vote out the board, which in effect redeems the poison pill and allows for the hostile takeover to proceed

xi. Lock-Ups
   1. The lock-up is the most closely scrutinized by courts, and the most likely to be invalidated.
   2. Likely, this could be a problem if the auction is going on, and Target’s board gives the lock-up to one company (A or B); the Court is likely to find that this preference violated the board’s duty to get the highest price obtainable once it was clear the company would be sold

xii. Stock Options Plans
   1. If the option is for so many shares, or for such a low price, or on such burdensome terms, that it’s mere existence has a materially “chilling effect on whether other bidders will emerge”, the option is likely to be struck down. [Paramount v. QVC]
   2. If the options effect is to give the acquirer a fair return for having been the first to put a deal on the table (encouraging others to bid), it will probably be upheld.

XV. Insider Trading and Rule 10b-5
   i. What constitutes insider trading (semi-accurately):
      1. D bought or sold stock in a company. The issuer will be, but not need to be, a publicly traded company
      2. At the time D bought or sold, he was in possession information that was material
         a. Would be considered important to a reasonable investor in the issuer’s stock
      3. The material information was non-public at the time D bought or sold stock
      4. D had a special relationship with the source of the information
         i. Insider, Constructive Insider, Tippee, or Misappropriator
5. D meets the Jurisdictional Requirements
   a. Thus he traded “by the use of any means of instrumentality of interstate commerce of of the mails, or of any facility of any national security exchange.”

ii. Important Background Cases
1. **Cady, Roberts & Co.**
   2. One of the directors of a firm, who was also an associate at a brokerage firm, left the meeting (where a decision to cut dividends was made) and sold his customers’ shares and those in a trust for his children and sold short for his own account. The commission held he violated 10b-5 and announced the principle that a corporate insider who has material nonpublic information about the enterprise is under a duty either to abstain from trading or first to disclose the nonpublic information.

   4. Exploration group looking for metals started to drill the core of a rock in Canada. The DC noted “there is no doubt that the drill core of K-55-1 was unusually good and that it excited the interest and speculation of those who knew about it.” Fogarty drafted a press release designed to quell the rumors that the drill was enormous, and released it on April 13th into general circulation. On April 13th, a reporter for The Northern Miner prepared an article which confirmed a 10 million ton ore strike. An official detailed statement, based on accurate drilling data, was read to representatives of American financial media from 10-10:15 on April 16th, appeared over the Merrill Lynch private wire at 10:29 and over the Dow Jones ticker tape at 10:54 am. Between the April 12th (first press release) and the official announcement on the 16th, Clayton, Crawford, and Coates all engaged in market activity.
   5. **Held**, these people are guilty of traditional inside information.

iii. Defendant must be Insider, Knowing Tippee, or Misappropriator
1. General
   a. The key rule is that the duty to “disclose or abstain” only applies to insiders, tippees, or misappropriators
2. General outline of who is liable (a relationship of trust or confidence)
   a. **Chiarella v. United States**
      i. A printer, who did some work for a company that was thinking of acquiring a target corporation, read their sheets. He learned of the target company, and bought stock in them, and made a lot of money when he sold after the merger was announced.
      ii. **Held**, a person who learns from the confidential documents of one corporation that is planning an attempt to secure control of a second corporation does not violate § 10(b) by trading in the target companies stock unless he had a fiduciary obligation to the stockholders.
   b. **Dirks v. SEC**
      c. P Dirks received material nonpublic information from insiders of a corporation with which he had no connection. He investigated the fraud they spoke of, but did not disclose the news publicly, and a newspaper he spoke to wouldn’t either. He disclosed this information to investors who relied on it in trading in the shares of the corporation.
      d. **Held**, this man didn’t violate § 10(b).
iv. Misappropriation Problem
   1. **United States v. O’Hagan**
      a. O’Hagan was a partner at a law firm that was hired by GrandMet concerned with a tender offer for Pillsbury. Indictment alleged that O’Hagan defrauded his law firm and its client, Grand Met, by using for his own trading purposes material, non-public information regarding his client’s tender offer. He bought lots of Pillsbury stock and then traded them when the tender offer was announced.
      b. **Held**, an outsider who trades on non-public information violates 10b-5 b/c he misappropriates information that is not his property
b. General Issues with Insider Trading
   i. When does silence become fraud?
1. Two approaches:
   a. 11th Circuit strong inference: “When an insider trades while in possession of material nonpublic information, a strong inference arises that such information was used by the insider in trading. The insider can attempt to rebut the inference by adducing evidence that there was no causal connection between the information and the trade – i.e. that the information was not used.”
      i. Suspicious timing of trades and evidence of phone calls were cited as factors which could raise eyebrows
   b. 9th Circuit use requirements: “Suppose that an individual who has never before invested comes into possession of material nonpublic information and the very next day invests a significant sum of money in substantially out of the money call options. We are confident that the gov’t would have little trouble demonstrating “use” in such a situation, or in other situations in which unique trading patterns or unusually large trading quantities suggest that an investor used inside information.”
   c. Regulations FD
      i. In the Matter of Siebel Systems, Inc.
         1. Reg FD prohibits issuers from selectively disclosing material, nonpublic information to certain persons – securities analysts, broker-dealers, investment advisers and institutional investors – before disclosing the same information to the public. Company’s CEO disclosed material, non-public information to persons outside the company at an invitation-only technology conference held by Goldman-Sachs. He said that he was optimistic about 4Q results, contrary to information he had put out weeks earlier saying that the technology industry was in trouble. Prior to the conference, the company and the CEO knew that this was not going to be webcast or broadcast to the public in any way. As a result, he intentionally disclosed material, nonpublic information at the Technology conference. Immediately following the disclosures, certain attendees at the conference purchased Company stock or communicated the disclosures to others who purchased stock. The stock trading was doubled that day. The price of the stock went up 20% that day.