Corporations Course Outline

Exam: 20 MC, 1 essay question.

I. Overview of Economic and Legal Aspects of the Firm

A. Economic backdrop: Corporation law seeks to help business actors organize firms through value-maximizing governance structures. The goal is to promote capital formation, productivity, and financial gain for as many individuals as possible.

1. Conceptualizing “the firm” –
   i. Principal-agent model. Shareholders own the firm; they delegate control to the board of directors, which in turn delegates control to the corp.’s officers. Shareholders delegate b/c of collective action problems and b/c of rational apathy (i.e., I don’t care if I only own 100 shares). Agency costs arise when there’s a divergence of interests bet. the principals (shareholders) and the agents (officers).
   ii. Nexus-of-contracts model, popular among academics. The firm is nothing but a series of explicit and implicit contracts among all the corp. constituencies – shareholders, employees, the community, customers – who are all claimants to a share of the gross profits generated by the business. Shareholders aren’t really owners. Shareholders are the principal residual claimants; employees and creditors take first. Shareholders have an incentive to maximize the residual – profits. Their claims aren’t fixed; they might lose part of their investment, and they can’t do anything about it. In that sense, they have a firm-specific investment.
   iii. Coase defined the firm as the antithesis of the mkt. He focused on the nature of the allocation of resources. The firm is the set of relations that arise when resources are allocated by the entrepreneur by means of commands to her employees, rather than the set of relations that arise when an entrepreneur allocates resources by means of contracts with outsiders. Why do some transactions take place in a firm and not simply in an open mkt.? Because of transaction costs.
   iv. Blair and Stout have analyzed behavioral studies and suggested that people are more sensitive to social signals that frame expectations regarding trust and trustworthiness than one might imagine. They argue that judicial opinions that sermonize on fiduciary duties while simultaneously setting or affirming a weak standard of review may actually promote fiduciary conduct more than would the establishment of a strong standard of review. The argument is that a stronger standard of review might lead to a proliferation of cases in which trust is litigated, which would in turn signal to directors and officers that fiduciary duty breaches are common and that they could be suckers for continuing to make other-regarded decisions when the terms are uneconomic. Also, they argue that allowing fiduciary duties to be treated as standard form contract provisions that parties could dispense with as they wish could discourage investors by forcing them to research whether such duties have been dispensed with. The labels “director” and “officer” would no longer communicate as strongly the kind of trustworthiness that comes with a universal fiduciary mandate.

2. Transaction costs and the choice of organizational form – Consider bounded rationality, opportunism, and firm-specific investment.
   i. Bounded rationality: We have limited cognitive abilities and limited info, so we can’t foresee every contingency when contracting w/ others.
   ii. Opportunism: There are trust implications in that actors are discouraged from taking risks they’d otherwise take if they did trust the other.
iii. Firm-specific investments (asset-specific, relationship-specific, etc.): Sometimes
the value of the investment when put to its present use is greater than its value
when put to its next-best use. Sometimes the skills an employee gains from a job
are transferable; sometimes they’re not. If you’re in a relationship w/ someone
who has made a team-specific investment, you have an incentive to be
opportunistic and expropriate value. Corporate law is structured to address this
risk.

3. Discrete contracting vs. relational contracting – Discrete contracting, which attempts to
account for all contingencies, is appropriate when the team’s expected duration is short
and the number of exchanges between team members will be few. In relational
contracting, the parties build a governance structure that will allow them to solve
problems when and if they arise.

4. Default vs. immutable rules – Look out for misguided paternalism.

5. Tailored, majoritarian, and penalty default rules – Tailored rules are designed to give the
contracting parties the exact rule that they would themselves have chosen if they were
able to bargain costlessly over the matter in dispute. Majoritarian rules are designed to
provide parties w/ the result that most similarly situated parties would prefer. Penalty
default rules are designed to motivate parties to specify their own rules ex ante, instead of
relying on a default rule provided by law. Consider the extent to which we want to
courage ex ante (private; transaction costs borne by the parties) vs. ex post (judicial;
legal-resources costs borne by society) decision-making.

6. The governance role of mkts. – The product mkt., the capital mkt., the nat’l securities
mkts., and the labor mkts.

i. The rise of institutional investor activism. Shareholder service firms: Institutional
Shareholder Services (ISS) and Investor Research Responsibility Council (IRRC).

7. The lemons problem – The riskier the investment, the greater the demanded discount.
People who are leery of buying lemons (e.g., used cars) – either b/c they just bought one
or because of recent industry scandals – demand discounts. What do you do if you’re an
honest used car salesman, or any honest actor? If you price higher, you’ll have a higher
margin for bargaining, but you’ll lose customers. You need to signal to the mkt. that
you’re honest and good in a way that’s costly for others to mimic.

B. The role of agency law in employer-employee relations: We looked at two contexts, the
scope of an employee’s duty to his employer while at the firm, and the scope of an ex-
employee’s duty to his ex-employer after the employment obligation is terminated.

1. Community Counseling Service v. Reilly (p.15) – A professional fund-raising organization
(CCS), working principally for Catholic parishes and institutions, sought an accounting
from a former salesman-employee based on allegations that he disloyally solicited the
organization’s clients for his own new fund-raising business before resigning. Holding:
Until the employment relationship is severed, Reilly should have preferred the interests of
his employer to his own. He was wrong to solicit for himself future business which he
was required by his employment to solicit for CCS. Above all, he should have been
candid w/ CCS and withheld no information which would have been useful to CCS in the
protection and promotion of its interests.

i. The conflict of interests here was direct. Is the scope of the duty of loyalty such
that any employee must prefer his employer’s interests (of which he reasonably
should be aware) no matter what, or just those interests that relate to the scope of
his employment? The ct. suggests the former rule, that an employee must prefer
his employer’s interests, even in the case of an opportunity that doesn’t bear any
specific relation to his employment obligation. “[W]hen, during his employment,
he solicited the business of the three parishes for himself, he was untrue to his
employment obligation and was disloyal to his employer. … Employment as a sales representative demands of the employee the highest duty of loyalty. … Above all, he should be candid with his employer and should withhold no information which would be useful to the employer in the protection and promotion of its interests.” So all employees have at least a duty of candor (i.e., to disclose), if not a duty to prefer categorically the employer’s interests. The answer to the question probably also depends on the nature of the conflict of interest – whether it relates to the core of the employer’s business, or some less material matter. Usurping client business is pretty core.

2. **Hamburger v. Hamburger** (p.18) – D left his family’s business (Ace Wire and Burlap, Inc.) and started his own business, which was similar and competitive. D’s uncle sued, alleging *inter alia* that D wrongfully appropriated confidential customer lists and pricing info from Ace. Holding: Customer lists aren’t considered trade secrets if the info is readily available from published sources, such as business directories. Generally, use of “remembered information” (general knowledge, skills) is non-actionable; use of proprietary info (trade secrets) is.

   i. If an employer wants to further restrict the post-employment competitive activities of a key employee, the employer can do so through a non-competition agreement. Cts. will enforce such agreements if they’re reas. given the duration, the geographical coverage, and the nature of the employer’s risk from such competition. Have to balance the interest of the -er in protecting her business against the interest of the -ee in seeking to redeploy her human capital.

C. **The role of agency law in a firm’s relations with creditors:** The traditional common-law rule that a principal will be bound by an agent’s actions only if the principal has manifested its assent to such actions has been watered down to better protect third-party creditors. Also, efficiency: We wouldn’t want to make third parties track down the principal every time they want to get something done. Manifestations of consent can take the form of actual authority, apparent authority (a/k/a ostensible authority, third party must have reas. believed agent was authorized), and now inherent authority (what society would expect). Once the third party (or reas. person) realizes that the agent doesn’t have authority (i.e., warning signs that something is amiss), the risk shifts from the principal to the third party.

   1. **Blackburn v. Witter** (p.37) – An investment advisor at Walston & Co. and later Dean Witter & Co. defrauded the elderly widow of a dairy farmer. The brokerages were held liable on the basis of D’s apparent authority b/c they put D in a position in which D was enabled to take money from P and give his personal note rather than a security in exchange. Even though D acted solely for his own purposes, and even though the brokerages may not have received any benefits from the transactions. The employers are the least cost avoiders – they can make smart hiring decisions, monitor.

II. **Partnerships and Limited Liability Companies**

   A. **The general partnership:** It’s very easy to form a partnership. Under UPA (1997) § 202(a), a partnership as an association of two or more persons to carry on as co-owners a business for profit, whether or not those persons intend specifically to form a partnership. General partners are all partners in a general partnership and they’re the managing partners in a limited partnership. They have power to participate in mgmt. of the business and are personally liable, jointly and severally, for the obligations of the business if the partnership hasn’t elected to be a limited liability partnership. The potential for personal liability incentivizes monitoring. No double-taxation (“pass through”) – no tax imposed at the level of the partnership. See p.515 Supp. for provisions of the Uniform Partnership Act (1997).
B. Joint ventures: A joint venture is a limited purpose partnership largely governed by the rules applicable to partnerships. Examples: a joint research project, a joint marketing venture. The terms of such relationships are carefully negotiated and specified in written agreements that preserve the separate identity and purposes of the venturers.

1. Factors determinative of joint venture status: (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; and (5) there must be a provision for the sharing of both profits and losses.

C. The limited partnership: An LP is a partnership consisting of one or more limited partners whose liability is limited to the amount invested, and one or more general partners who have unlimited liability. A limited partner who participates in the mgmt. of the partnership business may inadvertently assume the liability of a general partner. To create an LP, a certificate must be filed w/ the secretary of state. See p.569 Supp. for provisions of the Uniform Limited Partnership Act (2001).

D. The limited liability company: An LLC is an unincorporated business form that provides limited liability for its owners and may be taxed as a partnership. Hybrid: no double taxation (as in a corp.) and no control issues (as in a partnership). To create an LLC, a certificate must be filed w/ the secretary of state. See p.543 Supp. for provisions of the Uniform Limited Liability Company Act (1996).

E. The limited liability partnership: An LLP is a general partnership that has elected to register under state statutes that provide protection against liability for actions of co-partners. To create an LLP, a certificate that is renewable annually must be filed w/ the secretary of state.

F. Determining the legal nature of the relationship: If the business relationship sours, the legal nature of that relationship may become a prime focus of litigation bet. the parties. The label they place on the relationship isn’t dispositive. Have to distinguish bet. a partnership (incl. any one of the legal entities described above) and a simple employment agreement, client referral agreement, or joint venture.

1. Bailey v. Broder (p.53) – The existence of a partnership depends upon the individuals’ intent to do the acts that in law constitute partnership. There has to be a mutual promise or undertaking of the parties to share the business’s profits and losses, or liabilities. The ct. characterized the relationship bet. the lawyers here as an agreement for the referral of aviation cases, rather than a partnership.

G. Fiduciary duty in this context: A fiduciary duty is stronger than a duty of good-faith. Not taking advantage vs. affirmatively looking out for another’s interests.

1. UPA (1997) § 404 (p.528 Supp.) – A partner’s duties of loyalty and care to the partnership and the other partners are set out. Duty of loyalty – “to account to the partnership” and avoid situations involving a conflict of interest w/ the partnership. Duty of care – “to refrain[] from engaging in grossly neg. or reckless conduct, intentional misconduct, or a knowing violation of law.”

2. Meinhard v. Salmon (p.57) – The parties had a real estate joint venture. Cardozo’s widely cited description of joint venturers’ and partners’ fiduciary duty of loyalty: “Joint venturers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arms length, are forbidden to those bound by fiduciary ties…. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.” Salmon appropriated an oppity. (a new lease) that was incident to the parties’ enterprise and didn’t tell Meinhard of his intention; the ct. found that Salmon had a duty to disclose.
3. *Covalt v. High* (p.69) – The parties were officers and shareholders of CSI at the time they formed a partnership for the purpose of purchasing real estate and leasing office space to CSI. They were aware at the outset of the potential for conflict bet. their duties as corp. officers to further the business of the corporation, and their role as partners in leasing realty to the corp. for the benefit of the partnership business. In the posture of being both the landlord and the representatives of the tenant, they had conflicting loyalties and fiduciary duties. B/c each party’s conflict of interest was known to the other and was acquiesced in from the beginning, and b/c the parties didn’t account for increasing the rent of the partnership realty in their contracting, the ct. refused to hold one partner liable for breach of fiduciary duty for refusing to go along w/ the other partner’s demand to increase the rent. The remedy for such an impasse is a dissolution of the partnership.

i. Private ordering – Good in that people don’t have to deal w/ the heavy hand of the state, but they can’t come running to the cts. when they strike a bad bargain.

H. The power to manage and bind the firm:

1. An agent’s act is binding on the firm when – UPA (1997) § 301 (p.523 Supp.) – (1) Each partner in a partnership is an agent of the partnership for the purpose of its business. An act of a partner that’s apparently in the ordinary course of business binds the partnership, unless the partner had no authority to act for the partnership in the particular matter and the third party knew or had received notification that the partner lacked authority. (2) An act of a partner that’s not apparently for the ordinary course of business binds the partnership only if the act was authorized by the other partners.

2. Partners’ liability – UPA (1997) § 306(a)-(b) (p.525 Supp.) – The partners’ liability for the partnership’s obligations is joint and several, but it doesn’t extend to before one’s admission to the partnership.

3. Decision-making – UPA (1997) § 401(j) (p.528 Supp.) – A difference arising as to a matter in the ordinary course of business may be decided by a majority of the partners in a partnership. An act outside the ordinary course of business and an amendment to the partnership agreement may be undertaken only w/ the consent of all the partners.

4. Limited partnerships, limited partners, and general partners – ULP A §§ 301-408 (2001) (p.579 Supp.). A limited partner does not have the right or the power as a limited partner to act for or bind the limited partnership, and may not under any circumstances be held liable for the partnership’s obligations. A general partner – the rules are the same as for partners in an ordinary partnership.

5. LLCs – ULLCA (1996) § 301 (p.549 Supp.) – An LLC may elect to be member-managed or manager-managed. The former entails rules like those in the general partnership; the latter entails rules like those in the corporation or limited partnership.


7. *RNR Investments v. Peoples First Community Bank* (p.72) – A limited partnership argued that a bank was estopped from foreclosing b/c the bank had negligently failed to investigate the general partner’s authority to execute notes, a mortgage and a construction agreement. The ct. held for the bank on the theory that the risk of loss from partner misconduct more appropriately belongs on the partnership than on third parties who don’t knowingly participate in or take advantage of the misconduct. What a partnership can do to protect itself against liability for unauthorized actions by a rogue partner: (1) Partnership may notify third party of partner’s lack of authority. Such notice is effective upon receipt, whether or not the third party actually learns of it. (2) Partnership may file w/ the secretary of state a statement of partnership authority restricting a partner’s authority.
III. The Corporate Form and the Specialized Roles of Shareholders, Directors, and Officers

A. The formation of the corporation and the governance expectations of the initial participants. Consider whether the traditional division of control among shareholders, directors, and officers is still appropriate now that the census of shareholders has changed (the rise of institutional investors).

1. Form a corp. – just file articles of incorporation w/ the secretary of state. See DE Code §§ 101-102. Not much info required in this document.

2. Amendments to the articles of incorporation – may be initiated only by the directors. Amendments must be approved by the board and the shareholders. See § 242(b).

3. Bylaws – fill in gaps in the articles. Similar in substance to a partnership or LLC agreement, they don’t have to be filed. Shareholders may amend. DE provides that directors may amend if given the authority in the articles. See § 109. 109(b) provides that the bylaws may contain provisions relating to the business and affairs of the corp. Might be able to push back on 141(a) through this; see also “except” clause in 141(a).

4. Directors manage the business and affairs of the corp., unless otherwise provided by the articles – See § 141. In the exercise of such authority, they may rule out of order any shareholder’s attempt to propose an amendment to the articles or bylaws that would intrude on their authority to make ordinary business decisions or to establish corporate policies. Shareholders simply have no authority to act for the corp. in such matters, unless empowered by a preexisting provision in the articles.
   i. Shareholders lose in pro-management schemes. Or do managers (the board and the mgmt.) have enough incentives to adopt shareholder-friendly policies? Is the stock price reflective of mgmt. choices in this regard? (Big debate.)
   ii. What can shareholders do if they don’t like something? Can sell their shares. Can sue. Can request that the directors take a particular action or adopt a new policy. Can initiate amendments of bylaws – BUT can’t initiate amendments to articles, and see limitations above. Can informally contact directors (write letters, etc.). Can try to shame the mgmt. by taking out a newspaper ad.

5. Election of directors – The default rule is that directors are elected annually by a plurality of the votes cast in straight voting. The votes must be cast by a majority of the shares (1) present at the annual meeting and (2) entitled to vote, assuming that a quorum is present.
   i. Straight voting vs. cumulative voting. Suppose I own 26 shares and the three candidates w/ the most votes in the election win. With straight voting, I can vote 26 shares for each of any three candidates. With cumulative voting, I can vote (26 x 3) shares for just one candidate if I want, or spread out the votes over more candidates. Cumulative voting increases minority participation on the board. Under § 141(d), articles may provide for cumulative voting.
   ii. Annually elected boards vs. classified (or “staggered”) boards. The theoretical justification for classification is that it ensures experience of service on the board, since only half or a third of the board will be elected each year; as a practical matter, however, experience may be provided by the reelection of the same individuals as directors year after year. Under § 141(d), articles or bylaws may provide for classification. Hard to remove a classified board b/c you have to do it over a series of annual meetings. See § 141(k) re: removal of directors by shareholders.
   iii. Removal of directors – see § 141(k).

6. Limited liability provisions in articles of incorporation for directors and indemnification – § 102(b)(7) allows corps. to amend their charters to eliminate or limit the personal liability of directors for monetary damages, except in situations of (i) breach of the director’s duty of loyalty to the corp, (ii) acts or omissions “not in good faith or which
As of 8/24/2006

involve intentional misconduct or a knowing violation of the law,” and (iii) self-dealing. Similarly, § 145 allows corps. to indemnify “if the person acted in good faith and in a manner the person reas. believed to be in or not opposed to the best interests of the corp., and, w.r.t. any criminal action or proceeding, had no reas. cause to believe the person’s conduct was unlawful.”

7. Board committees – A board may designate committees, a cmte. to consist of one or more directors of the corp. A cmte. may be permitted to exercise all the powers and authority of the board, except taking any action that requires stockholder approval and adopting or amending a bylaw. See § 141(c)(2).

8. Hiring corporate officers – a corp. may have officers as specified in the bylaws or in board resolutions. See § 142.

B. Shareholder investment and governance in publicly held corporations, and the impact of federal law.

1. Considerations unique to publicly held corps – the presence of a market for shares, the impact of institutional shareholders among the census of shareholders of publicly held corps, and the practical necessity for shareholder action in public corps to be by proxy.

2. Securities mkts provide – liquidity, valuation, and monitoring of managers. Types of investors/traders: rational traders, noise traders, arbitrageurs, value investors, relational investors, social investors, large institutional investors…

   i. Weak form: You cannot develop a trading strategy based on the use of past prices that will enable you to beat the market return.
   ii. Semi-strong form: You cannot develop a trading strategy that will beat the market by using publicly available information relevant to the value of traded stocks (e.g., an announcement about earnings or a change in dividends), because the market will be efficient in incorporating such information before you can effectively trade on it.
   iii. Strong form: Even if your trading strategy were based on non-public information, you wouldn’t be able to beat the market. (Markets assimilate and reflect new information rapidly. The most common explanation is that there are enough extremely sophisticated investors.)

4. The role of federal law for publicly held corps. Fed law requires disclosure (and some ancillary regulation) in 5 contexts: issuing securities, periodic reporting, proxy solicitation, tender offers, and insider trading.

5. Shareholder meetings. Shareholders may attend annual meetings; only the board may call special meetings. Shareholders may act by written consent in lieu of meeting. See § 228.

6. Shareholder proxy proposals. A shareholder may require her corp. to include a proposal and an accompanying statement in its materials sent out before the next annual meeting. Rule 14a-8 addresses when a corp. must include a shareholder’s proposal in its proxy statement. If corp. excludes shareholder’s proposal, shareholder may still create and send out proxy materials on her own, but that would be considerably more expensive.
   i. Eligibility: Must have continuously held at least $2,000 in mkt. value, or 1%, of the corp.’s securities entitled to be voted on the proposal at the meeting for at least one year prior to submission of the proposal.
   ii. Procedural requirements: May only submit one proposal per meeting, may not exceed 500 words (incl. supporting statement). Must meet the deadline for submission. If you don’t comply, corp. may exclude your proposal, but only after it has notified you of the problem.
   iii. Substantive requirements: See pp. 852-53 Supp. Note that more than one basis of exclusion may be available. Mgmt. just has to find one.
iv. **Lovenheim v. Iroquois Brands** (p.205) – A minority stockholder brought suit seeking to bar Iroquois/Delaware from excluding from the proxy materials being sent to all shareholders in preparation for an upcoming shareholder meeting information concerning a proposed resolution he intended to offer at the meeting re: paté de foie gras, a type of paté that Iroquois imported in a negligible quantities annually (< .05% of its assets implicated). Ct. held that Rule 14a-8(i)(5) allows a social-policy proxy proposal like P’s that is “otherwise significantly relevant to the company’s business” – socially, ethically, or whatever – even if the matter it relates to accounts for < 5% of the company’s net earnings and gross sales.

v. **U.S. Bancorp, Request for “No Action” Letter** (p.210) – A minority stockholder wanted to introduce a proposal at the next annual mtg. that all directors be elected annually and not by classes. Corp. requested no-action letter from SEC. Corp. argued that implementation of the proposal would require the corp. to violate DE law in that it directed the board to unilaterally amend the articles of incorporation to declassify the board, in violation of the amendment procedure described in § 242. Actually, proposal requested that board “take those steps necessary to cause annual elections…” Corp. also argued that the proposal and supporting statement contained false accusations and misleading insinuations, and that the proposal was too vague. SEC refused to grant corp.’s request.

vi. **Cracker Barrel** (p.203) – NYCERS, an institutional shareholder of Cracker Barrel, proposed to the board that the corp. expressly prohibit discrimination on the basis of sexual orientation. NYCERS called for a shareholder vote and asked CB to include the proposal in the proxy materials for the next annual shareholders meeting. CB excluded the proposal under the ordinary business operations exception in Rule 14a-8(i)(7). SEC initially issued a no-action letter, saying that the fact that a shareholder proposal concerning a corp.’s employment policies and practices for the general workforce is tied to a social issue will no longer categorically prevent its exclusion from proxy materials under the ordinary business operations exception in 14a-8(i)(7). After public outcry, however, SEC reversed its position. “We have gained a better understanding of the depth of interest among shareholders,” the SEC explained, implying that if there’s enough shareholder interest in something that may properly be voted on by the shareholders, then it shouldn’t be treated as spam/junk mail and excluded.

vii. Recent corporate governance proposals that are becoming common: redeem poison pill or block board from adopting poison pills; declassify board (as in U.S. Bancorp); get rid of super-majority shareholder voting requirements; adopt confidential voting; separate chairman/CEO. Shareholder proposals re: executive compensation traditionally have been rejected under 14a-8(i)(7). But may be able to frame in terms of a policy proposal as opposed to a specific ordinary business decision. There’s pressure b/c of the recent scandals.

IV. **Fiduciary Duty, Shareholder Litigation, and the Business Judgment Rule**

A. **General statutory provisions:**

1. § 141(e) – 141(e) states what type of info the director is entitled to rely on in discharging duties.

2. § 144 – A conflicting-interest transaction shall not be void or voidable for solely this reason if: (1) a majority of disinterested directors in good faith approved the transaction with full information about the director’s or officer’s interest, even if the disinterested directors constituted less than a quorum; (2) the shareholders in good faith ratified the
transaction with full information about the director’s or officer’s interest; or (3) the
transaction was fair to the corporation as of the time it was approved/ratified.

B. Business judgment rule: A judge-made doctrine consisting of a rebuttable presumption that
directors and officers are better equipped than the cts. to make business judgments, that the
directors acted w/o self-dealing or personal interest, and that the directors exercised reas.
diligence and acted w/ good faith. A party challenging a board of directors’ decision bears the
burden of rebutting the presumption that the decision was a proper exercise of the business
judgment of the board.

offered: (1) Shareholders voluntarily undertake the risk of bad business judgment. (2) Cts. recognize that after-the-fact litigation is an imperfect device to evaluate corporate
business decisions. (3) Because potential profit often corresponds to the potential risk, it’s in the interest of shareholders that the law not create incentives for overly cautious
corporate decisions. Note that the rule does not apply in cases, e.g., in which the corporate
decision lacks a business purpose, is tainted by a conflict of interest, amounts to a no-win
decision, or results from an obvious and prolonged failure to exercise oversight or supervision.

C. The fiduciary duty of care: The duty of care arises in two contexts: the decisional setting and
basic oversight.

1. Shlensky v. Wrigley (p.223) – A minority stockholder brought a derivative suit against the
directors of Chicago Nat’l League Ball Club, Inc., seeking damages and an order that the
Ds cause the installation of lights in Wrigley Field and the scheduling of baseball games
at night. Ct. held that P didn’t state a cause of action. Reasoning: P didn’t show fraud,
illegality, or conflict of interest on the part of the directors in making their decision not to
schedule night games, P failed to allege damage to the corp, and P failed to show how the
corp’s failure to follow the example of other major league clubs in scheduling night
games constituted negligence. Bottom line: Cts. won’t intervene in business decisions of
this nature.

challenged the company’s actions in refusing to pay dividends while expanding the
company’s facilities and lowering the price of its cars. Henry Ford took the opportunity to
grandstand, saying that the company had made too much money and needed to share
some of the profits w/ the public. Ct. refused to interfere w/ Ford’s selling price and
expansion plans, but did order a dividend. “A business corp is organized and carried on
primarily for the profit of the stockholders.” That said, a ct. will give the board the benefit
of the doubt wherever possible.

3. Smith v. Van Gorkom (p.241) – Shareholders brought suit seeking rescission of a cash-out
merger of Trans Union into Pritzker’s New T Company, a wholly-owned subsidiary of
Marmon Group. The ct. held that the standard for the business-judgment rule is gross
negligence, and w.r.t. the directors’ approval of the merger here they didn’t deserve the
rule’s protection. “The directors: (1) didn’t adequately inform themselves as to Van
Gorkom’s role in forcing the ‘sale’ of [Trans Union] 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, without prior notice, and without the
exigency of a crisis or emergency.” Under DE law, a transaction that is not the result of a
valid business judgment can be ratified if a majority of stockholders, fully informed of all
material facts, vote to approve it. The ct. went on to hold that the stockholder approval
was illegitimate b/c there were material deficiencies in the proxy materials.
i. A leveraged buy-out is a way of borrowing money to purchase a business and then paying off the debt with the projected revenue stream. Why use debt and not equity to finance? Debt holders get principal plus interest but no upside, whereas shareholders do get some of the upside. Also, interest payments are tax-deductible, whereas dividends aren’t.

ii. Van Gorkom was 65 and nearing retirement – shorter-term perspective than that of the other shareholders. He wanted to cash-out soon and was perhaps more risk-averse. The $55/share price was suggested arbitrarily. VG didn’t ask what’s a fair price, what’s the company worth to a buyer who can take advantage of the tax credits. Instead asked what price could Pritzker afford to finance. The current stock price didn’t reflect the value of having control of the company, or the value of the tax credits. There was no premium. VG left too much value on the table – value that he should’ve extracted on behalf of the shareholders as a seller.

iii. Dissent: These directors were well-qualified and they knew Trans Union well. The majority didn’t fairly evaluate the process they went through. They were so smart and experienced that they could have reas. evaluated the proposed transaction in the space of 2 hours. The kind of due diligence that the majority expected was unnecessary for them. Response: The directors needed more info so that they could have actually brought their experience and sophistication to bear.

4. *Graham v. Allis-Chalmers Mfg. Co.* – DE S. Ct described a board’s responsibility to monitor and prevent illegal activity (basic oversight): “[D]irectors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. If such occurs and goes unheeded, then liability of the directors might well follow, but 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.”

5. *In re Caremark Int’l Derivative Litigation* (p.266) – Caremark employees broke a law which prohibited a health care provider from bribing physicians to refer patients to the provider. Holding: As far as their basic oversight responsibilities are concerned, directors have (1) a duty to ensure that “a corporate information gathering and reporting system exists which represents a good faith attempt to provide senior mgmt. and the board w/ info respecting material acts, events, or conditions within the corp., incl. compliance w/ applicable statutes and regulations.” (2) If the directors have such a system, and they don’t have grounds for suspecting a material problem or deception, they can assume the integrity of employees and the honesty of the employees’ dealings on the company’s behalf. But if they do have grounds for suspecting a problem, the directors then have a duty to make a good-faith effort to investigate and follow-up. Even then, “only a sustained or systemic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reas. info and reporting system exists – will establish the lack of good faith that is a necessary condition to liability.”

i. Why is the standard set so low? The standard encourages good-faith performance but (hopefully) doesn’t discourage qualified people from serving on boards.

D. **The fiduciary duty of loyalty:** In circumstances where a director’s interests conflict w/ those of the corp., the director must prefer the corp.’s interests.

1. The corporate opportunity doctrine – “If there is presented to a corporate officer or director a business opportunity (1) which the corp. is financially able to undertake, (2) is, from its nature, in the line of the corporation’s business and is of practical advantage to it, (3) is one in which the corp. has an interest or a reas. expectancy, and, (4) by embracing the opportunity, the self-interest of the officer or director will be brought into conflict w/
that of the corp., the law will not permit him to seize the opportunity for himself.” (Broz, citing Guth v. Loft, Inc.)

i. What does it mean for an opportunity to be in the line of the corp.’s business? When the oppty. embraces an activity as to which the corp. has fundamental knowledge, practical experience, and ability to pursue; which, logically and naturally, is adaptable to its business having regard for its financial position, and is consonant w/ its reas. needs and aspirations for expansion. (Broz, citing Guth.)

2. Broz v. Cellular Information Systems (p.283) – Broz, the president of RFB Cellular (“RFBC”), also served on the board of Cellular Information Systems (“CIS”). He purchased a cellular telephone service license for RFBC when another company, Pri-Cellular, had bid on the license and had made a tender offer for CIS. Even though CIS wouldn’t have been interested in the license, did Broz breach his fiduciary duty to CIS by not telling the CIS board about the opportunity, given the articulated business plans of Pri-Cellular? Holding: Broz didn’t breach his duty. (1) “[A]lthough a corporate director may be shielded from liability by offering to the corp. an opportunity which has come to the director independently and individually, the failure of the director to present the opportunity doesn’t necessarily result in the improper usurpation of a corporate opportunity.” (2) “If a corp. is a target or potential target of an acquisition by another company which has an interest and ability to entertain the opportunity, the director of the target company doesn’t have a fiduciary duty to present the opportunity to the target company.” Broz didn’t have to account for the contingency of the Pri-Cellular acquisition of CIS, a subsequent event.

i. Corollary to the corporate opportunity doctrine: An officer or director may take a corporate opportunity if: (1) the opportunity is presented to the officer or director in his individual and not his corporate capacity; (2) the opportunity is not essential to the corp.; (3) the corp. holds no interest or expectancy in the opportunity; and (4) the officer or director has not wrongfully employed the resources of the corp. in pursuing or exploiting the opportunity.

3. Conflicting interest transactions – § 144 provides that no conflicting interest transaction shall be void or voidable solely by reason of a conflict of interest bet. the corp. and one or more of its directors if the transaction (1) is authorized by a majority of informed, disinterested directors, or (2) is approved in good faith by informed shareholders, or (3) is entirely fair to the corp. at the time authorized. Directors have burden of proof for (3). If a transaction is found to be unfair to the corp., the shareholders may then demand rescission or payment of rescissory damages; otherwise, the transaction is protected from shareholder challenge.

4. Byrne v. Lord (p.318) – Ps, shareholders of Pace American Group, challenged a stock option plan for Pace’s directors. Holding: “To uphold the validity of a stock option compensation plan, the plan must meet the requirements of a two-prong test: (1) The plan must involve an identifiable benefit to the corp. The plan must contain conditions or circumstances to ensure that the corp. receives the benefit for which it bargained. And, (2) the value of the options must bear a reas. relationship to the value of the benefit passing to the corp. Who bears the burden of proof: the interested directors if shareholders haven’t ratified the plan, or the challengers if shareholders have ratified the plan. The plan here was invalid mainly b/c the circumstances surrounding the plan indicated that the plan wasn’t reas. calculated to retain the directors’ services. For example, one of the director-beneficiaries had resigned before the plan was even formally ratified by the Pace board.

i. The proportionality inquiry actually isn’t that strong; cts. don’t like to second-guess business decisions. § 157 undermines this inquiry even more by saying that “[i]n the absence of fraud, the judgment of the directors as to the consideration for
the issuance of such rights or options and the sufficiency thereof shall be conclusive.”

E. **Derivative litigation and the demand requirement:** The shareholder derivative action developed in equity to enable shareholders to sue in the corp.’s name where those in control of the company refused to assert a claim belonging to the company. The action has two aspects: (1) it’s the equivalent of a suit by the shareholders to compel the corp. to sue; (2) it’s a suit by the corp., asserted by the shareholders on the corp.’s behalf, against those liable to the corp. The action is a usurpation of the directors’ normal power to manage the business and affairs of the corp., justifiable only in circumstances where the directors are unable or unwilling to handle the litigation in the best interests of the corp. A shareholder has to make a strategic decision upfront: (1) She can send a demand letter, explaining the claims she wishes investigated and remedied. If the board decides not to pursue the claim via litigation, the shareholder may challenge the board’s decision as a breach of fiduciary duty, but has no right to directly pursue the original claim that was the subject of her demand, unless the board’s action in refusing to institute litigation is found not to be protected by the business judgment rule. Many states have a universal, pre-suit demand requirement. (2) In DE and in some other states, she can invoke the demand futility exception.

1. **Aronson v. Lewis** (p.326) – Stockholder sued Meyers Parking System and its directors, w/o first making a pre-suit demand, w.r.t. an employment agreement w/ a retirement-age director. Ds motioned to dismiss for P’s failure to establish demand futility. Holding: A corp.’s decision whether or not to pursue a shareholder’s derivative claims is a business decision, within the scope of the board’s authority under § 141(a), which means that the board’s decision falls into the realm of the business judgment rule. Therefore, a P’s refusal to make a demand can only be excused when P alleges facts that create a reas. doubt that the directors’ action was entitled to the protections of the business judgment rule. P can do this by alleging facts that create a reas. doubt that either (1) the directors were disinterested and independent [loyalty], or (2) the challenged transaction was the product of a valid exercise of business judgment [care]. P’s complaint here might have been sufficient if P had shown that the director had majority ownership of the company, and that, b/c of his personal or other relationships w/ the other directors, he influenced the other directors’ performance of their duties. P’s allegations here were insufficient b/c they went to the results of the transaction and not the process.

   i. **Note:** Conversely, directors seeking to maintain the protection of the business judgment rule need to emphasize that: (1) either they were disinterested, or, if director interest was present, the transaction was approved by a majority consisting of disinterested directors; and (2) they ensured that they were informed of all material information reasonably available to them before they approved the transaction and didn’t act w/ gross negligence in the discharge of their duties. (The opposite of what P has to prove.)

   ii. **Note:** If P meets either prong of **Aronson**, then P has gone a long way in proving her loyalty (first prong) or care (second prong) claims and will probably go on to survive a motion to dismiss for failure to state a claim.

2. **Brehm v. Eisner** (p.334) – Shareholders brought suit, w/o first making a pre-suit demand, w.r.t. Michael Ovitz’s $140mm employment compensation and severance package at Disney. The ct. went through the **Aronson** analysis to determine whether Ps’ demand could be excused and held that Ps’ complaint failed both prongs.

   i. **In re the Disney Derivative Litigation** (2003, on reserve) – Considering just the second **Aronson** prong, the ct. explained that Ps’ burden under this prong was just to raise a reas. doubt as to whether the board’s action was taken on an informed basis, or whether the directors honestly and in good faith believed that the action
was in the best interests of the corporation. Ps met their burden in their amended complaint by showing that the negotiations bet. Eisner and Ovitz, close friends for 25 yrs., didn’t amount to arms-length bargaining, that the compensation cmte. took only a few minutes to cursorily review the agreement, and that the board as a whole didn’t inquire about important conditions and terms before approving the agreement.

ii. Note: The 2003 opinion noted that the Ps overcame the limited personal liability provisions in Disney’s articles of incorporation w.r.t. Ovitz (a director); see § 102(b)(7). “Where a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director’s actions are either ‘not in good faith’ or ‘involve intentional misconduct.’ Thus, Ps’ allegations support claims that fall outside the liability waiver provided under Disney’s certificate of incorporation.”

iii. Note: The corporate waste test is virtually impossible to meet. To show that a transaction is a waste, and that therefore the process must have been an invalid exercise of business judgment, P has to show that it’s so one-sided that no business person of ordinary, sound judgment could conclude that the corp. received adequate consideration.

3. In re The Limited Shareholders Litigation (p.353) – Shareholders alleged that D corp.’s directors committed corporate waste and breached their fiduciary duties of loyalty and due care. The directors rescinded a Contingent Stock Redemption Agreement and funded, in part w/ cash made available as a result of rescission of the Agreement, a self-tender offer that the shareholders also asserted resulted in no consideration to the corp. Holding: (1) The Ps were excused from having not sent a demand letter b/c they raised a reas. doubt as to half of the directors’ disinterestedness or independence. Ps thus rebutted the business judgment presumption and met the first prong of Aronson. (2) Ps stated a claim for breach of the duty of loyalty b/c the challenged transactions were at least unfair to the shareholders and they weren’t approved by a majority of independent and disinterested directors. (3) Ps’ corp. waste claim failed. Identifying viable alternatives to the board’s decision wasn’t enough when the board’s decision had at least some reasonable basis. (4) Ps’ duty of care claim failed b/c their complaint failed to allege gross neg. or the insufficiency of info upon which the board based its decision.

i. Note: What allegations in Ps’ complaint raised a reas. doubt as to the disinterestedness or independence of certain directors? M/M Wexner weren’t disinterested b/c the Redemption Agreement was for the benefit of their children. The remaining directors didn’t have any personal financial interests in the challenged transactions. As for independence, allegations as to one’s nomination or position as director and the receipt of director’s fees aren’t enough. But one director also served on the board of a subsidiary – we can doubt his independence. One director was an officer under Wexner – we can doubt his independence. One director was a university official but received $150K in consultancy fees from the corp. – the ct. found that the $150K was material enough to him that we could doubt his independence. One director used to be a university official; he had successfully solicited enough money for the school from Wexner that the ct. found he probably felt a sense of “owingness” to Wexner. Lastly, one director also was a principal of a company that supplied in-store music and received revenues of $400K/yr. – Ps failed to show that the $400K was material to his business, so we didn’t have enough to doubt his independence.
F. **Dismissal of derivative litigation at the request of an independent litigation committee of the board:** Suppose you have a derivative suit in which demand is excused (futile) and therefore the protective business judgment review isn’t available to the Ds. A corp. can appoint a cmte. made up of directors who weren’t involved in the first suit and assert for this cmte. the right to claim the board’s power to control the derivative litigation. The cmte. then can file a motion to dismiss the Ps’ claims. The Delaware judiciary’s approach to such motions:

1. **Zapata Corp. v. Maldonado** (p.364) – Stockholder sued 10 officers/directors of Zapata, alleging breaches of fiduciary duty. Four yrs. later, 4 of the director-Ds were no longer on the board, and the remaining directors appointed 2 new outside directors. The board then created an Independent Investigation Cmte., composed solely of the two new directors. The Cmte. motioned to dismiss P’s suit. Holding: Cmte. is allowed to file a pretrial motion to dismiss in the DE Ct. of Chancery. The Ct. of Chancery should evaluate the motion by applying the following test: (1) The corp. has the burden of proving that the cmte. was independent, acted in good faith, and went through a reas. investigation. If corp. can’t prove these things, ct. has to deny motion. (2) Even if the corp. meets the burden, the ct. can still deny the motion in its own, independent business judgment if it comes up w/ compelling fairness or policy arguments. Otherwise, the ct. can grant the motion.

2. **In re Oracle Derivative Litigation** (2003, on reserve) – Two Stanford professors were recruited to the Oracle board and asked to investigate, as a two-person special litigation cmte., a fellow professor and two benefactors of Stanford who had been accused of insider trading. Noting that there can be other bias-creating factors besides economically consequential relationships, the ct. held that the ties among the cmte. members and the Ds were s.t. the cmte. failed its burden of showing the absence of a material factual question about its independence. Although the cmte. members were tenured professors, weren’t key fundraisers at Stanford, had refused compensation for their cmte. work, there were enough connections that they couldn’t reas. be considered impartial.

   i. Note: What were some of those connections? With respect to Grundfest, one of the cmte. members, one could infer that he “would have more difficulty objectively determining whether Boskin engaged in improper insider trading than would a person who was not a fellow professor, had not been a student of Boskin, had not kept in touch with Boskin over the years, and who was not a senior fellow and steering committee member at SIEPR.” A reas. person in Grundfest’s position would think about these kinds of affiliations – and the ramifications of “either causing serious legal action to be brought against a person with whom he shares several connections (an awkward thing) or not doing so (and risking being seen as having engaged in favoritism toward his old professor and SIEPR colleague).”

3. **Suppose P actually does make a demand** ("demand required” case), and the corp. refers the decision to a litigation cmte.: A decision by the cmte. is protected by the business judgment rule. If the decision meets the lenient standards of that rule, there’s no basis for a ct. to apply its independent business judgment or consider fairness/policy arguments.

V. **Shareholder Liability – Piercing the Corporate Veil**

A. **Piercing the corporate veil:** Consider under what circumstances cts. should ignore the separate existence of a corp. and allow a corp.’s creditors to impose personal liability on the corp.’s shareholders. Tort claimants vs. contract claimants. Piercing to reach other corps. (parent-subsidiary cases) vs. piercing to reach real persons. Piercing to reach shareholders of publicly held corps. vs. piercing to reach shareholders of closely held corps.
B. **Piercing to reach real persons in contract cases:** A creditor P argues for piercing by establishing the 3 elements of the instrumentality (a/k/a alter ego) test:

1. D had majority stake and completely dominated policy, finances, and business practice w.r.t. the transaction attacked so that D’s mind was the mind of the corp. at the time of the transaction.
2. The control was used by D to commit fraud, to breach a duty, or to act dishonestly and unjustly in contravention of P’s legal rights (e.g., conscious undercapitalization, disregard of corporate formalities, etc.).
3. The control and breach of duty proximately caused P’s injury or loss.

Shareholder D’s defenses: P had the oppty. to investigate the capital structure of D’s corp. and knowingly failed to exercise the right to investigate before extending credit, or investigated but then failed to demand a personal guarantee, or raise the interest rate, or include special covenants (e.g., alert creditor early if things start to go sour) before extending credit. P therefore (1) waived the right to claim inadequacy of capitalization as a basis for piercing (waiver argument) and (2) caused D increase its indebtedness in reas. reliance upon P’s relinquishment of its right to examine its capital structure before continuing to demand protective measures as a condition to the continued availability of credit (estoppel argument).

1. **Consumer’s Co-op v. Olsen** (p.504) – Consumer’s Co-op (CC) sued Chris Olsen and his parents, who owned ECO, for the overdue balance of a corporate charge account after ECO went bankrupt. Holding: No personal liability. (1) CC’s waiver argument failed b/c CC knew, given the delinquency of the payments on ECO’s account, that ECO’s business was failing. Yet CC continued to extend credit, notwithstanding and in contravention of its own policy to terminate credit after 60 days. (2) CC’s estoppel argument failed b/c ECO increased its indebtedness in reas. reliance upon CC’s decision to not terminate credit, when ECO’s financial difficulties were obvious. (3) CC’s instrumentality argument failed by not meeting the first and second prongs of the test. Prong 1: All business was undertaken in the name of ECO. Ds didn’t drain ECO’s assets; actually, they committed their personal assets to ECO. Although the directors failed to regularly record meeting minutes, they did meet frequently. Prong 2: Even if the first prong had been met, in view of the fact that ECO began as a part-time operation, its capital wasn’t “obviously insufficient.” A corp. is undercapitalized when there is an obvious inadequacy of capital, measured by the nature and magnitude of the corporate undertaking.

C. **Piercing to reach real persons in tort cases in which the tortious act is committed in the ordinary course of the corp.’s business:** Easiest to pierce when the Ds are both active participants in running the business as officers (and are directly responsible for the tortious act) and are benefiting financially from the business as shareholders; harder when you have only one of these factors.

1. **Western Rock Co. v. Davis** (p.518) – Ps sued Western Rock, Stroud, and Fuller seeking damages for harm to their properties caused by alleged neg. blasting operations conducted in a rock quarry. Western Rock had four shareholders – Stroud, Fuller, and their wives – and the Strouds and the Fullers each owned half of the company. The physical assets used by Western Rock in the conduct of its business were leased from Fuller and Fuller’s family corp., and there was evidence that Fuller controlled every aspect of the business (called himself the “father-confessor”). After Stroud and Fuller learned of Ps’ lawsuit for damages and injunctive relief, and the fact that the company had no insurance protection, they decided to keep blasting. Ps’ won their suit, and Fuller’s family corp. repossessed all of Western Rock’s assets. Holding: Fuller and Stroud held personally liable. Fuller was the dominating force behind Western Rock, a shell corp. Western Rock served as a device through which Fuller and Stroud could carry on destructive blasting activities at the expense of the property owners while remaining personally insulated from the legal and
financial responsibility for wrongs that they knowingly permitted and directed. No longer; veil pierced.

D. **Piercing in the bankruptcy context:** Under the “Deep Rock” doctrine (a/k/a equitable subordination), a bankruptcy ct. may subordinate claims presented by a controlling shareholder to claims of other creditors if the shareholder acted inequitably or unfairly (e.g., taking unreasonable amounts as salary, manipulating the affairs of the corp. in disregard of standards of honesty, selling assets to the corp. at inflated prices, etc.). The competing creditors don’t have to show that the shareholder’s claim is a sham; they just have to show that their claims should be treated as superior.

VI. **Mergers and Other “Friendly” Change-in-Control Transactions**

A. **The statutory merger:** A statutory merger is a transaction whereby two or more corps. are combined into one of the corps., usu. referred to as the surviving corp. When the merger is effected, the legal existence of all constituent corps., other than the surviving corp., ceases. By operation of law, the assets and liabilities of all constituent corps. pass to the surviving corp., and the outstanding shares of stock in the disappearing corps. are cancelled. The shareholders of the disappearing corps. usu. receive shares of the surviving corp. in exchange for their cancelled shares. In a consolidation, the surviving entity is not one of the constituent corps. but rather a newly created consolidated corp.

B. **How to effect a statutory merger:** For the procedure for effecting a merger, see §§ 251, 253, 259-261. Essentially, the board of directors of each constituent corp. adopts a resolution approving an agreement of merger or consolidation. The agreement has to include certain things. The boards then submit the agreement to their respective shareholders for a vote. You need for shareholder approval a majority of the votes entitled to be voted, not majority of votes actually cast, so you need a big turn-out if you want the deal to receive shareholder approval. The agreement must be filed w/ the secretary of state. If the boards want to abandon the agreement, they can do so w/o shareholder approval.

1. **Questionable assumptions underlying the policy of shareholder approval** – Does the participation of shareholders in the decision-making process add value for corps. and shareholders? Can mgmt. really provide shareholders w/ sufficient, digestible, and unbiased info about the pros and cons of a planned merger? Isn’t it unduly burdensome for corps. to await the decision of their shareholders before beginning the critically important and costly process of integrating their assets and personnel?

C. **What shareholders who are opposed can do:** Several options. (1) Can contest the shareholder vote, as in *Hewlett.* (2) Can demand statutory appraisal under § 262. (3) Can sue for fiduciary-duty breach (controlling shareholder or board) and/or lack of entire fairness. (4) If transaction was structured to cut out voting and appraisal rights, can sue under de facto merger doctrine. Of course, can do nothing and go along with the transaction, maybe try to sell shares in the open mkt.

1. **Hewlett v. Hewlett-Packard Co.** (p.582) – § 225 allows shareholders to contest elections of directors and corporate officers, as well as elections involving other matters, in the Ct. of Chancery. P brought an action pursuant to § 225(b) challenging a shareholder vote approving a merger between Hewlett-Packard Co. ("HP") and Compaq, seeking a declaration that the merger wasn’t validly approved. First, P claimed that HP mgmt. secured proxies in favor of the merger through knowingly false misrepresentations about the progress of the integration of HP and Compaq. Second, P claimed that HP mgmt. engaged in “vote buying” by improperly inducing and coercing Deutsche Bank – with the promise (or loss) of future business – to switch from voting approx. 17mm (out of approx. 25mm) of its HP shares against the merger to voting those shares in favor of the merger. **Holding:** P lost on both claims. (1) The ct. was persuaded by HP’s arguments about the
value capital updates – in particular, why there were such discrepancies bet. the bottom-up numbers generated by the business units and the top-down numbers generated by mgmt. (2) Fiorina’s “we may have to do something extraordinary” comment in Wayman’s voicemail was explainable, as was her comment in the conference call w/ Deutsche, “[this merger] is of great importance to our ongoing relationship.”

2. Statutory appraisal – Shareholders have the right to dissent from certain types of transactions, incl. mergers, and obtain the appraised value of their shares through a judicial proceeding. See table below to see which transactions have appraisal rights. Have to follow strict procedures described in § 262 – inform the corp. in writing before the shareholder vote who you are and that you want appraisal, or within 20 days after the merger if merger was short-form or shareholders acted by written consent (§ 228). The statutory appraisal remedy is usu. exclusive in the absence of fraud. That is, you can either demand statutory appraisal or sue for fiduciary-duty breach and seek entire-fairness review.

i. How to determine the value of the shares: § 262(h) says you don’t get any value attributable to the merger, although Weinberger pushes back on this.

ii. The market exception to the appraisal remedy: Many state statutes say that the right to dissent doesn’t exist if there’s a liquid mkt. for the shares in question. The theory behind the exception is that the appraisal remedy is only necessary for minority shareholders locked into the corporation. Critics of the exception argue that the modern purpose of the appraisal remedy is to protect minority shareholders against unattractive cash-out transactions, and the exception allows the corp. to time the transaction to minimize the cost of paying those shareholders.

iii. Legal costs of an appraisal proceeding? If only a few stockholders seek an appraisal, it may not be economically feasible to mount a legal battle. Plus, ct. may determine the fair value to be less than the merger consideration.

3. Suing for fiduciary-duty breach getting entire-fairness review – If you go this route, you can bring your case after the transaction has been consummated (i.e., you don’t have to follow the procedures for statutory appraisal), and ct. has broad equitable discretion in fashioning remedy. Can get appraisal and perhaps other monetary damages, or an order setting aside the transaction. See G and Weinberger and Cede below.

i. “At the most general level, the [rescissory damages] remedy is premised on the idea that (1) the transaction whereby the party gave up an asset was wrongful in some way and (2) the nature of the wrong perpetrated is s.t. plaintiff is entitled to more than his ‘out-of-pocket’ harm, as measured by the mkt. value of the asset at or around the time of the wrong.” (Cinerama v. Technicolor, p.663) To calculate rescissory damages, ct. might take value of stock now and subtract amt. shareholders received at time of tender offer, or take amt. shareholders received as merger consideration and figure out how much shareholders would have received had they invested that amt. in the stock mkt. Ct. factor in any mitigating circumstances.

ii. § 102(b)(7) allows corps. to amend their charters to eliminate or limit (note: not indemnification) the personal liability of directors for monetary damages, except in situations of (i) breach of the director’s duty of loyalty to the corp, (ii) acts or omissions “not in good faith or which involve intentional misconduct or a knowing violation of the law,” and (iii) self-dealing. So – pointless to bring only a due care claim if corp. has 102(b)(7). Recast a care claim as a loyalty or a good faith claim. Also, suits to enjoin transactions before consummation aren’t affected.
as of 8/24/2006

by 102(b)(7), since they don’t involve the imposition of personal monetary liability.


D. Exceptions to the norm that shareholders must approve a merger:
   1. The de minimis change exception – This exception denies voting rights to shareholders of the surviving corp. in a merger the terms of which will not require a change in the articles of incorporation, nor significantly affect the pre-merger shareholder’s voting or equity rights. See § 251(f) – to get this exception, no more than 20% of the surviving corp.’s shares may be acquired in the merger agreement.
   2. The short form merger exception – The short form merger is a procedure that allows a corp. that owns most of the shares of another corp. (the “subsidiary”) to merge w/ that subsidiary by director action alone. See § 253, which says parent has to already own at least 90% of the subsidiary. See also § 251(g).
   3. Asset sales, triangular mergers, and other alternative transactional forms – (See below.)

E. Contracting around appraisal and voting rights: Some transactional alternatives to the statutory merger include the sale of a control block of stock, the asset sale, and the triangular merger.
   1. Sale of assets – How different from a merger: the corp. selling the assets doesn’t automatically go out of existence upon consummation of the sale (although it can, by following the sale with a dissolution); the selling corp. need not transfer all of its assets; and the liabilities of the selling corp. don’t necessarily have to pass to the purchasing corp. See § 271.
   2. Triangular mergers – One point on the triangle is the corp. financing and masterminding the acquisition (the acquiring parent), which transfers the merger consideration to a wholly owned subsidiary corp. – the second point on the triangle. The merger then takes place bet. the acquired corp. – the third point on the triangle – and the acquiring subsidiary. In a forward subsidiary merger, the acquired corp. merges into the acquiring subsidiary. In a reverse subsidiary merger, the acquiring subsidiary merges into the acquired corp.; in form the acquired corp. is the surviving corp., but the acquiring corp. ends up with all, or at least a controlling amount of, the acquired corp.’s stock.
   3. Tender offers – A tender offer is a public invitation to shareholders of a corp. to tender their shares for purchase by the offeror at a stated price. In reality, this is tough to accomplish b/c the target corp.’s board has a lot of authority to prevent the bidder from taking over, even when the target’s shareholders want to sell. The bidder has to appease the board.
# TABLE comparing shareholders’ voting and appraisal rights under the various provisions:

Note: We’re focusing on the; we can compare the MBCA if we want. Basically the same; one difference is that DE has the market exception while the MBCA doesn’t.

<table>
<thead>
<tr>
<th></th>
<th>Acquiring corp.’s shareholders – voting rights</th>
<th>Acquiring corp.’s shareholders – appraisal rights</th>
<th>Acquired corp.’s shareholders – voting rights</th>
<th>Acquired corp.’s shareholders – appraisal rights</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ordinary merger</strong></td>
<td>- DE § 251(c) says that shareholders of each constituent corporation get to vote.</td>
<td>- DE 262(b)(1)-(2) says shareholders do <em>not</em> get appraisal rights if their shares (i) are traded on a national securities exchange (NYSE, NASDAQ, etc.), or (ii) are held by more than 2,000 shareholders, AND the shareholders receive (a) stock of the surviving corp, or (b) stock of some other publicly traded corp, or (c) cash in lieu of fractional shares, or (d) some combination thereof.</td>
<td>- DE § 251(c) says that shareholders of each constituent corporation get to vote.</td>
<td>- DE 262(b)(1)-(2) says shareholders do <em>not</em> get appraisal rights if their shares (i) are traded on a national securities exchange (NYSE, NASDAQ, etc.), or (ii) are held by more than 2,000 shareholders, AND the shareholders receive (a) stock of the surviving corp, or (b) stock of some other publicly traded corp, or (c) cash in lieu of fractional shares, or (d) some combination thereof.</td>
</tr>
<tr>
<td><strong>Merger w/ de minimis change</strong></td>
<td>- If the merger won’t affect the shareholder’s pre-merger voting or equity rights, nor require a change in the articles of incorporation, and the shareholder remains a shareholder of what becomes the surviving corp., then the shareholder gets no voting rights and no appraisal rights. See §§ 251(f) (20%), 262(b)(1). Shareholders on the other side of the merger for which this doesn’t hold true get the same rights they would ordinarily get with a merger.</td>
<td>- No appraisal rights.</td>
<td>- DE § 253 allows a parent corp. to merge certain subsidiaries into it without a vote of the subsidiary’s shareholders. The parent has to already own at least 90% of the subsidiary. (The vote would be pointless anyway.)</td>
<td>- § 262(b)(3) says they do get appraisal rights.</td>
</tr>
<tr>
<td><strong>Short form merger</strong></td>
<td>- Assuming no change in the articles of incorporation, a one-for-one share exchange, and no issuance of shares exceeding 20% of the shares already outstanding: no voting rights. See DE § 251(f), the de minimis change concept.</td>
<td>- No appraisal rights.</td>
<td>- No appraisal rights.</td>
<td>- No appraisal rights.</td>
</tr>
<tr>
<td><strong>Sale of assets</strong></td>
<td>- No voting rights.</td>
<td>- No appraisal rights.</td>
<td>- The shareholders of the selling corp. only get to vote if the directors wish to sell substantially all of the corp.’s assets not in the ordinary course of business. Note: It’s not always clear where the “all or substantially all” line should be drawn.</td>
<td>- No appraisal rights.</td>
</tr>
<tr>
<td><strong>Triangular merger</strong></td>
<td>- In most states, the only ones entitled to voting and appraisal rights are the shareholders of the actual parties to the merger. So the acquiring parent receives the rights belonging to the acquiring subsidiary, which are then exercised by the acquiring parent’s board, which obviously won’t dissent from the transaction. The shareholders of the parent – who would’ve received voting and appraisal rights if the action were cast as a</td>
<td>- They get the same rights that they would get in an ordinary merger.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
straight merger – are shut out of the decision-making process and receive no dissenter’s rights protection.

F. **De facto mergers:** Often parties will choose a transaction form that denies shareholders voting and appraisal rights that would have been available had the parties chosen to structure the transaction as an ordinary merger. The shareholders may ask cts. to intervene and recharacterize the transaction as a merger under the de facto merger doctrine. A transfer of assets from one corp. to another, and the subsequent dissolution of the former corp. soon after, constitutes a de facto merger. Note: DE is different from other jurisdictions – “independent dignity” of different statutory provisions – de facto merger doctrine is not as strong. (See Hariton.)

1. **Appelstein v. United Board & Carton Corp.** (p.602) – United Board and Carton Corp. (“United”) and Interstate Container Corp. (“Interstate”) entered an agreement, which they characterized as a purchase by United of Epstein’s shares of Interstate (Epstein was the sole shareholder), and thereby the property of Interstate, followed by a merger of United, as the parent corp., w/ its wholly owned corp., Interstate. Under this characterization, United shareholders had limited voting rights and no appraisal rights; they sued arguing the de facto merger doctrine. Holding: Every factor present in a corporate merger is found in this plan, except the formal designation of the transaction as a “merger”: (1) a transfer of all the shares and all the assets of Interstate to United; (2) an assumption by United of Interstate’s liabilities; (3) a pooling of interests of the two corps.; (4) the absorption of Interstate by United, and the dissolution of Interstate; (5) a joinder of officers and directors from both corps. on an enlarged board of directors; (6) the present executive and operating personnel of Interstate will be retained in the employ of United; and (7) the shareholders of the absorbed corp., Interstate, as represented by the sole stockholder, Epstein, will surrender his 1,250 shares in Interstate for 160,000 newly issued shares in United, the amalgamated enterprise. Accordingly, the shareholders of United were entitled to be notified and advised of their statutory rights of dissent and appraisal. United’s failure to take these steps and to obtain stockholder approval of the agreement by the statutory two-thirds vote at a properly convened mtg. of the stockholders would render the corporate action invalid.
   i. Policy: Shareholders shouldn’t be forced against their will into something fundamentally different from that for which they bargained when they acquired their shares.

2. **Hariton v. Arco Electronics, Inc.** (p.606) – Arco and Loral entered an agreement whereby Arco sold its assets pursuant to § 271 to Loral in exchange for Loral shares of stock, Arco dissolved, and Arco’s former shareholders received the shares of Loral from the asset sale. P, a former Arco shareholder, had the opt to vote but instead sued, arguing de facto merger. Holding: Even though this reorganization plan achieved the same result as a merger, it’s legal. The merger and sale-of-assets statutes overlap some but offer corps. independent options. P even conceded that an asset sale, followed by a separate proceeding to dissolve and distribute, would be legal, even though the same result would follow. To attempt to make any such distinction between sales under § 271 would be to create uncertainty in the law and invite litigation.
   i. Policy: We want the law to allow corps. contractual freedom by offering different transactional forms. There are significant tax, accounting, and liability differences bet. the traditional merger form and the alternative transactional forms. We also want there to be certainty in this area of the law.
G. Special issues in transactions involving controlling shareholders: Controlling shareholders, who have determinative shareholder voting power and influence on the board, have judicially imposed fiduciary duties to minority shareholders. But the scope of those duties is unclear. When, beyond unlawfulness, fraud, and misrepresentation, is appraisal an exclusive remedy for minority shareholders, and when can they bring fiduciary-duty/entire fairness claims? The law is messy in this area – have to make arguments.

1. What kind of value does the majority shareholder get when it squeezes out the minority?
   No longer has to worry about owing fiduciary duties to the minority. No more directors’ and officers’ insurance for fiduciary-duty breach. No more expensive shareholder meetings and votes.

2. Should we worry about the minority in a squeeze-out? A controlling shareholder has paid a premium for its majority ownership stake. Some would argue that minority shareholders, in turn, assume the risk of being squeezed out when they purchase their shares, and they can factor this risk into the stock price they pay. (Counterargument: Now that we have Weinberger, shareholders legitimately might not assume this risk.) Essentially, if minority shareholders can protect themselves *ex ante*, then is it really fair to give them *ex post* judicial protection?

3. The old rule for duty-breach claims was the business-purpose requirement – Fiduciaries (i.e., the controlling shareholder) in a self-dealing transaction used to have to prove (1) that the transaction was for some legitimate business purpose and not for the purpose of squeezing out the minority shareholders, and (2) that the transaction was entirely fair. *Weinberger* extinguished this requirement in DE, on the theory that minority shareholders have adequate remedies w/o it.

4. *Weinberger v. UOP, Inc.* (p.619) – Four directors of Signal were also on the board of UOP, of which Signal was a majority shareholder, and they participated on both sides of a cash-out merger bet. the two companies. Signal sought the merger b/c it had a cash surplus; in the transaction, Signal bought the rest of the outstanding shares of UOP. Former UOP shareholders sued, claiming that Signal lacked a proper business purpose, had failed to prove the transaction’s entire fairness, and had breached its duty of candor, entitling Ps to rescissory damages. The DE S. Ct. held:
   i. (1) The ct. affirmed that the controlling shareholder of the parent owes a fiduciary duty to the minority. The burden of proof is on the majority to show entire fairness and complete disclosure of all material facts relevant to the transaction to minority. No business judgment rule here b/c we have the omnipresent specter that the majority shareholder may be acting primarily in his own interests, to the detriment of the minority shareholders – the majority shareholder is on both sides of the transaction. The minority, however, has the initial burden of production to allege sufficient facts to show that the majority needs to show entire fairness. (Burden of production vs. burden of persuasion.)
   ii. (2) The Signal-UOP directors breached their duty of loyalty to the UOP shareholders. For instance, two UOP directors, who were also Signal directors, used UOP information to prepare a feasibility study for the exclusive use and benefit of Signal. They didn’t share this report w/ the other UOP directors. They also didn’t tell UOP that Signal was imposing time pressure b/c it needed an outlet for its excess cash, that the Lehman Bros.’ fairness opinion about the price was prepared in a cursory manner, or that Signal considered a price of $24 to be a good investment. They should have abstained from participating in the transaction, or disclosed the conflicts of interest they faced, or appointed for UOP a negotiating cmte. of UOP’s outside directors to deal w/ Signal at arm’s length.
iii. (3) Moreover, the transaction failed to meet the standard of intrinsic fairness. Intrinsic fairness has two aspects: fair dealing and fair price. Fair dealing would have entailed fairness in the initiation, structuring, negotiation, and disclosure (“complete candor”) to the UOP outside directors and minority shareholders. There wasn’t fair dealing – see (2) above. Fairness of price is evaluated by examining “all relevant factors” that affect the intrinsic value of the subsidiary’s stock price. Can consider market value, asset value, dividends, earning prospects, the nature of the enterprise, similar transactions involving similar companies, and any other facts which were known or which could be ascertained as of the date of the merger, including those facts which throw light on the future prospects of the merged corporation. The ct. interpreted 262(h) narrowly, as excluding only value to be attributed to speculative consequences of the merger. The ct. rejected the Delaware block method for valuing stock, used in other jurisdictions, in favor of broader judicial discretion. The block method involved determining the corp.’s asset, mkt., and earnings values, appropriately weighing those values, and then adding the weighted values together to arrive at a “fair value.”

iv. (4) What’s the remedy for the minority in a situation like this? Injunctive relief if the deal hasn’t been consummated. If the minority has waited until after the deal has been consummated, what’s the appropriate damage remedy? Rescission? – No. Weinberger says the appropriate remedy is appraisal. But we can take into account value arising from the transaction, so long as it’s not too speculative – appraisal-plus. More robust approach to appraisal than one might think by reading the Code. And if there’s evidence of overreaching, bad faith – then Chancellor sitting in equity has ability to fashion additional relief.

v. Note that the ct. determined the fair price as closer to the max. that the acquiring corp. was willing to pay than the min. that the minority shareholders were willing to sell for. We make the buyer pay a premium b/c we’re worried about the buyer taking advantage of the sellers, who lack bargaining power, possibly inside knowledge, time to consider, etc. In sum, we impose on buyer a duty to disclose and remedy any shortcomings in what is otherwise not an arms-length transaction; we want the sellers to be able to make an informed decision to sell. And we further protect and compensate them by moving the “fair price” towards what the buyer is willing to pay.

5. Minority discounts and marketability discounts – Minority discounts are downward adjustments to the value of dissenting shares due to their lack of voting power to control corp. actions. Marketability discounts are downward adjustments to the value of shares due to the limited supply of potential buyers. Most cts., incl. DE, say that both discounts are inappropriate b/c “the appraisal process is not intended to reconstruct a pro forma sale but to assume that the shareholder was willing to maintain his investment position, had the merger not occurred. … More important, to fail to accord to a minority shareholder the full proportionate value of his shares imposes a penalty for lack of control…” (DE S. Ct. in Cavalier Oil Co.)

6. Cede & Co. v. Technicolor, Inc. (p.633) – Minority shareholders (collectively “Cinerama”) of Technicolor brought a statutory appraisal action after a 2-step transaction in which MAF made a tender offer for shares of Technicolor and then effected a reverse subsidiary merger bet. MAF’s wholly owned subsidiary and Technicolor. The issue was whether the Ps’ shares should be appraised as of before the tender offer, or after the tender offer but before the merger, when MAF’s mgmt. began implementing a successful business strategy for Technicolor. The DE S. Ct. held: (1) The underlying assumption in an appraisal valuation is that the dissenting shareholders would be willing to maintain
their investment position if the merger hadn’t occurred. So the corp. must be valued as an operating entity. (2) In a 2-step merger, to the extent that value has been added following a change in majority control before cash-out, it’s still value attributable to the going concern on the date of the merger. (3) Here, on the date of the merger, Technicolor was operating pursuant to the Perelman/MAF business plan. So Ps were entitled to an appraisal w/ the ascertainable value of that plan taken into account – same remedy as in Weinberger.

i.  *Cede* says the *Weinberger* interpretation of “fair value exclusive of value arising from merger” in § 262(h) applies to the statutory-appraisal context, too (here there were no fiduciary-duty breach claims, ct. didn’t apply entire-fairness review).

ii. The mkt. price of shares may not be representative of true value; mkt. price is just one factor to be considered in the valuation.

7. *Glassman v. Unocal Exploration Corp.* (p.642) – Unocal effected a short-form merger under § 253 with UXC, of which it owned 96% of the stock. UXC’s minority shareholders sued, claiming that Unocal and its directors breached their fiduciary duties of entire fairness and full disclosure. The DE S. Ct. held that absent fraud, illegality, or misleading/inadequate disclosures, statutory appraisal (w/ the scope of appraisal as interpreted in *Weinberger*) is the exclusive remedy available to a minority stockholder who objects to a short-form merger. Otherwise, the fair dealing prong of the entire fairness claim would vitiate the purported benefit of § 253, to provide a simple, fast, and inexpensive process for accomplishing a merger.

i. Although the ct. didn’t require fiduciaries to establish entire fairness in a short-form merger, it affirmed the duty of disclosure, even though there was no shareholder vote. “Where the only choice for the minority shareholders is whether to accept the merger consideration or seek appraisal, they must be given all the factual info that’s material to that decision.”

8. *In re Pure Resources, Inc. Shareholders Litigation* (on reserve) – Unocal owned 65% of Pure Resources’ stock; the minority consisted of some institutional investors. Unocal made an exchange offer for balance Pure stock, subject to the condition that it got 90%; then it would do a short-form merger for the same consideration. Minority shareholders of Pure brought action to enjoin offer. Holding:

i. (1) A controlling shareholder’s tender/exchange offer will *not* be subject to entire-fairness review if it is non-coercive and involves complete disclosure of material information relevant to the transaction. Even though a controlling shareholder’s power to force a squeeze-out or cut dividends is no different after the failure of a tender offer than after defeat on a merger vote – inherent coercion in both contexts – non-coercion and proper disclosure (see below for what these mean) minimize the distorting influence of the tendering process on voluntary choice.

ii. A tender is *not* actionably coercive if the majority shareholder decides to: (i) condition the closing of the tender offer on the support of a majority of the minority shareholders who aren’t affiliated with either the majority shareholder or the board; and (ii) promise that it would consummate a short-form merger promptly and on the same terms as the tender offer.

iii. The controlling shareholder also needs to permit the independent directors on the target board to hire their own advisors, provide the minority w/ a recommendation as to the advisability of the offer, and disclose adequate info for the minority to make an informed judgment.
iv. (2) The Unocal offer was coercive b/c it included in the defn. of “minority” directors and officers of Unocal and Pure officers whose incentives were skewed b/c of their employment, severance agreements, and put agreements.

v. (3) The Pure board and Unocal didn’t disclose material info, incl. a fair summary of the substantive work performed by the investment bankers that the Pure board relied on in its (voluntary) recommendation to not tender. The investment bankers evaluated the sufficiency of the consideration being offered to the minority for their shares – pretty material. There also wasn’t disclosure of the fact that the Special Cmte. of the Pure board had asked for and been denied certain powers – the full powers of the Pure board, incl. the power to block the Unocal offer through a rights plan.

vi. (4) Injunction granted, subject to adequate disclosure and to provision for genuine majority of the unaffiliated minority condition.

vii. The upshot: If a controlling shareholder complies w/ the non-coercion and proper-disclosure conditions, it can get away with making a low offer and refusing to allow the target board to use a poison pill. The minority shareholders have sufficient protection through the conditions.

9. Suppose a majority shareholder wants the minority gone for as little money as possible. Fair value (appraisal) is a less litigation-intensive area than fiduciary conduct.

i. In the negotiated merger context, we can do 2 things, according to Weinberger:
   (1) Can make the deal contingent on approval by not only the majority of shareholders overall, but also a majority of the minority shareholders, so that the minority would have the power to block the deal. (2) Can appoint an independent board cmte. that would represent the interests of the minority shareholders, to remove the ability of the majority shareholder to both offer and accept and to replicate an arms-length decision-making for the minority on the sell side. The majority would still be required to prove entire fairness, including full disclosure. But if we had the two things just listed, the burden would shift to the minority shareholders to prove that the transaction was unfair, and they’d have an uphill battle. These two things would go a long way in establishing entire fairness.

ii. In the tender/exchange offer context, we can structure the transaction to avoid entire-fairness review by having a tender offer for 90% followed by short-form merger at the back end. Need to disclose to the minority shareholders info that’s material and relevant to the transaction, need to condition the closing of the tender offer on the support of a majority of the minority shareholders (those who aren’t affiliated with either the majority shareholder or the board), and need to promise to consummate a short-form merger promptly and on the same consideration terms as the tender offer. (Combine Pure Resources and Glassman.)

VII. Changes in Control: Hostile Acquisitions

A. The market for corporate control. A potential acquirer who seeks control w/o the consent of the current control group can (1) make a tender offer seeking to buy sufficient shares to gain control of the board, or (2) launch a proxy fight seeking the authority to vote sufficient shares to gain control of the board of directors.

1. Procedural protections for shareholders faced w/ a tender offer – SEC Rule 14e-1(a) requires that a tender offer remain open for 20 days. If more shares are tendered than the bidder sought to purchase, the bidder must buy a pro rata portion from each shareholder. SEA § 14(d)(6). Also, the bidder must pay the same price for all shares purchased, and if the offering price is increased before the end of the offer, those who have already tendered must receive the increased price. See SEA §14(d)(7).
2. **Academic speculation re: why bidders pay such lucrative premiums** – 1. Bidder thinks stock is undervalued to the extent that it (the bidder) can do a better job of managing the business. (Hubris.) 2. Bidder attaches higher value to stock than market does b/c bidder anticipates synergistic gains. 3. Bidder may simply have overpaid – the “empire building” hypothesis. 4. Bidder may be exploiting shareholders through either a two-tier bid or bargain purchases during temporary stock price depressions. 5. Winner’s curse – bidders tend to win when they overestimate an asset’s true value, so they overpay. 6. Would-be investors may rationally mistrust managers’ future investment decisions – the “misinvestment” hypothesis. 7. Share prices may discount asset values for reasons endogenous to the formation of market prices – the “market” hypothesis. For example, different types of traders might have different priorities in valuating a stock, or sometimes there’s noise trading, etc. Some of these rationales are welfare enhancing; some are welfare reducing.


**B. The general enhanced scrutiny framework (modified business judgment rule):** Two possible avenues of analysis: *Unocal* and *Revlon*.

1. **Unocal Corp. v. Mesa Petroleum Co.** (p.721) – Mesa, owner of 13% of Unocal’s stock, began a two-tier front-loaded cash tender offer for 64mm shares, or approx. 37%, of Unocal’s outstanding stock at $54/share. The back-end was designed to eliminate the remaining publicly held shares by an exchange of junk bonds. Unocal’s board responded by adopting a resolution rejecting Mesa’s tender offer as grossly inadequate, and adopting another resolution providing that if Mesa acquired 64mm shares of Unocal stock (the Mesa Purchase Condition) Unocal would buy the remaining 49% outstanding for debt securities worth $72/share. The self-tender (or exchange) resolution included other conditions, as well, incl. the exclusion of Mesa from the proposal (the Mesa exclusion). Unocal began its exchange offer, and the directors, to show their confidence in it, tendered their own Unocal stock. Mesa sued, contending that its exclusion from the Unocal exchange offer was invalid. The DE S. Ct. held: A board addressing a pending takeover bid has an obligation to determine whether the offer is in the best interest of the corp. and its shareholders. (1) Because of the conflict of interests, the board must show that it had reas. grounds for believing that the bidder’s bid constituted a danger to corporate policy and effectiveness, a danger to the corporate enterprise. The board can meet this burden by showing good faith and reas. investigation. (2) Moreover, the defensive measure must be reas. in relation to the threat posed (i.e., no abuse of discretion). If the board proves these things, it’s entitled to business-judgment deference. Here, the board met its burden. The selective exchange offer was reas. related to the threats posed – a coercive offer w/ an inadequate price, potential greenmail.
   i. Prong 1 essentially reduces to the business-judgment rule. And it’s tough for Ps to win on Prong 2 – inadequacy of price suffices as a threat, even when there’s no structural coercion.

2. **Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.** (p.736) – Pantry Pride sought to acquire Revlon. The Revlon board fought Pantry Pride’s attempted takeover, entering an agreement w/ Forstmann Little & Co., a limited partnership affiliated w/ the board, and also making a self-tender offer w/ senior subordinated notes as consideration. Eventually it became clear that both buyers intended to break up the company. The DE S. Ct. held: In this situation, the directors no longer may exercise business judgment to prefer one bidder over another, but instead they have the duty of obtaining the best possible price for the company. A decision to use a lock-up to defeat a higher bidder and favor a lower bidder violates this duty of care; this cannot be protected by the business judgment rule.
i. A lock-up provision is an option given to a potential acquirer to purchase certain of the target’s assets.

ii. A no-shop provision is a promise by the target to deal exclusively w/ a potential acquirer in the face of a takeover.

C. **Filling in the gaps within the Unocal/Revlon framework:** The next cases discuss the contours of the directors’ duty to auction, what legitimate threats to corporate policy are under the Unocal test, and when a board has to remove takeover defenses to allow shareholders to consider a hostile offer. Raging debate in corporate law: Defensive tactics can be used to get target shareholders a better price, but can they be used to say no to a transaction when the target shareholders might want to say yes?

1. **Paramount Communications, Inc. v. Time, Inc.** (p.743) – Paramount made an all-cash offer to purchase all of the outstanding shares of Time; Time sought to merge w/ Warner Communications instead. The Time board contended that Paramount’s offer was inadequate and included conditions that skewed comparative analysis; also, the Time-Warner transaction offered a greater long-term value to stockholders and, unlike Paramount, wasn’t a threat to Time’s survival and its “culture.” Time recast the Time-Warner merger as an acquisition to vitiate the requirement of a shareholder vote, and adopted other defensive tactics (no-shop provision, etc.). The DE S. Ct. held: (1) Because Time didn’t initiate an active bidding process seeking to sell itself or to effect a business reorg. involving a clear break-up of the company, and because the proposed Time-Warner transaction didn’t make dissolution/break-up of the corp. entity inevitable, Revlon duties weren’t triggered. So the ct. went through a Unocal analysis. (2) The Time board’s decision that Paramount’s offer posed a threat to corporate policy and effectiveness, didn’t lack good faith, and wasn’t dominated by the motives of entrenchment or self-interest. (3) The restructuring of the Time-Warner transaction, incl. the adoption of defensive measures, was a reas. response to a perceived threat. It wasn’t coercive, and Paramount still could have made an offer for the combined Time-Warner. That Time would incur a heavy debt to finance the Time-Warner transaction didn’t render the board’s decision unreasonable; the debt load wouldn’t have jeopardized the corp.’s well-being.

   i. “DE law confers the mgmt. of the corporate enterprise to the stockholders’ duly elected board representatives. § 141(a). …Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there’s clearly no basis to sustain the corporate strategy.”

2. **Paramount Communications, Inc. v. QVC Network, Inc.** (p.752) – The action arose out of a proposed acquisition of Paramount by Viacom through a tender offer followed by a second-step merger, and a competing unsolicited tender offer by QVC. Defensive provisions: a no-shop provision, a $100mm termination fee, and a stock option agreement with unusual features which became draconian (the note feature and the put feature). The DE S. Ct. held: The Paramount board in effect initiated an active bidding process to sell the corp. when it agreed to sell control of the corp. from disaggregated public stockholders to Viacom (with Sumner Redstone as the majority stockholder) in circumstances where another potential acquirer, QVC, was equally interested in being a bidder. When a corp. undertakes a transaction that will cause a change in control or a break-up of the corporate entity, the directors’ obligation is to seek the best value reasonably available to the shareholders (i.e., Revlon duties). The Paramount board should have recognized that the stock option agreement, coupled with the termination fee and no-shop clause, was impeding the realization of the best value reasonably available to the Paramount shareholders. At a certain point, the QVC offer became worth over $1 billion more than the Viacom offer. QVC’s offer presented the opportunity for
significantly greater value for the stockholders and enhanced leverage for the directors. 
But instead of taking advantage of those opportunities, the Paramount directors chose to 
wall themselves off from material information which was reasonably available and to 
hide behind the defensive measures, which they could have modified, as a rationalization 
for refusing to negotiate with QVC or investigating other alternatives. The court found 
that the directors’ decision-making process was uninformed and that their decision to 
cling to the Paramount-Viacom deal couldn’t be justified on any reasonably basis. The 
“significant disparity in value cannot be justified on the basis of the directors’ vision of 
future strategy, primarily because the change of control would supplant the authority of 
the then current Paramount Board to continue to hold and implement their strategic vision 
in any meaningful way.”
3. **Omnicare** (on reserve) – NCS Healthcare, struggling financially, agreed to merge with 
Genesis Health Ventures. After the NCS board approved the merger agreement, but 
before the stockholder vote, another corp., Omnicare, made a superior bid for NCS. Two 
NCS stockholders, who held a majority of the voting power, agreed irrevocably to vote 
all their shares in favor of the Genesis merger. Moreover, the NCS-Genesis agreement 
contained a provision requiring a stockholder vote, even if the NCS board no longer 
recommended the merger, and omitted a fiduciary-out clause. Genesis conditioned its 
merger offer on the voting agreement, the § 251(c) provision, and the omission of a 
fiduciary-out clause b/c it had a history of being out-bid at the last minute by Omnicare. 
NCS stockholders sued, claiming that NCS directors violated their fiduciary duty of care 
in failing to establish an effective process designed to achieve the transaction that would 
establish the highest value for them. Omnicare also sued. The DE S. Ct. held: (1) Analyze 
the case under **Unocal** b/c the deal protection measures had a defensive quality to them. 
(2) In the absence of an effective fiduciary out clause, the required stockholder vote and 
the majority NCS stockholders’ voting agreement – which functioned as interlocking 
defensive measures and amounted to a complete lock-up – were preclusive and coercive 
(i.e., draconian), and therefore per se invalid and unenforceable.
   i. A response is “coercive” if it’s aimed at forcing upon stockholders a 
management-sponsored alternative to a hostile offer. A response is “preclusive” if 
it deprives stockholders of the right to receive all other tender offers or precludes 
a bidder from seeking control by fundamentally restricting proxy contests or 
otherwise.
   ii. Note: The general consensus is that no one knows what this case means. It has 
received a lot of attention and criticism. As a result of this case there is a lot more 
uncertainty over what directors can do w/ negotiating friendly transactions. 
Atypical b/c it was a 3:2 decision. Unclear whether something less than complete 
lock up is allowable. The essence of the C.J. Veasey’s dissent is that the business 
judgment rule is very important, when a deal is done it’s not done in a vacuum. 
There was no indication of bad faith or a breach of the duty of care or loyalty. 
Business judgment rule case, not **Unocal** case. Makes ex ante, ex post distinction. 
Dissent also doesn’t like having a bright line rule when these cases are so fact-
specific.

**VIII. Material Misrepresentations and Insider Trading**

A. **Liability under SEA § 10(b), Rule 10b-5.** Anyone who makes a material misstatement or 
misrepresentation, or engages in a scheme to defraud, can be liable under SEA § 10(b)/Rule 
10b-5. Not just corp. insiders – the 13-yr.-old in New Jersey, too. The S. Ct. defined the 
materiality standard in **TSC Industries** (p.841): A material fact is one which would have 
assumed actual significance in the deliberations of a reas. investor, which would’ve been
viewed by the reas. investor as having significantly altered the total mix of info available. Rumors, speculation – can argue not material. Insider trading is prosecuted under SEA § 10(b)/Rule 10b-5 on the theory that it constitutes a scheme to defraud.

1. **Rule:** If material misrepresentation, then automatic 10(b)/10b-5 liability. If material omission, then have to show duty to disclose – by arguing classical theory (Cady, Roberts duty), constructive-insider theory (footnote 14 in Dirks), misappropriation theory, or tipper-tippee theory.
   i. Suppose CEO buys debt securities (bonds) in company. No duty of trust and confidence to bondholders b/c bondholders are fixed claimants. Contractual, not fiduciary, relationship. Convertible securities (debt into equity) might be different. Always have to ask – is there a duty.

2. **In re Cady, Roberts & Co.** (p.999) – [Classical theory] SEC decided that a corporate insider must abstain from trading in the shares of his corp unless he has first disclosed all material inside information known to him. His duty to the other shareholders of the corp with whom he transacts arises from (1) the existence of a relationship affording access to inside info intended to be available only for a corporate purpose, and (2) the intuitive unfairness of allowing a corporate insider to take advantage of that info by trading without disclosure. The theory applies to permanent insiders (corporate officers, directors, executives – those who have permanent responsibilities at the corp) and to temporary fiduciaries (lawyers, accountants, consultants, takeover specialists, investment bankers, etc. – see footnote 14 in Dirks).

3. **How shareholders can sue when directors/officers are trading** – Shareholders can sue them individually or bring a derivative suit. Derivative suit appropriate b/c Ds breached fiduciary duty of loyalty and corp. was harmed. “When officers and directors abuse their position in order to gain personal profits, the effect may be to cast a cloud on the corp.’s name, injure stockholder relations, and undermine public regard for the corp.’s securities.” (Diamond v. Oreamuno) Note: Private plaintiffs don’t have standing to sue in misappropriation cases.

4. **Chiarella** (p.998) – [Classical theory] An employee of a financial printer prepared documents announcing corporate takeover bids and made strategic trades based on the info he saw prepublication. The names of the corps were blacked out, but he was able to deduce their identities from other info. S. Ct. did not hold him liable for insider trading b/c he wasn’t a fiduciary, he wasn’t an agent, and he didn’t have a relationship of trust and confidence with the shareholders of the corporation (the target company) in which he traded stock. Thus, no duty. The trades were impersonal mkt. transactions; there was no duty to reveal material facts. (Note: Chiarella today could have been prosecuted under the misappropriation theory. He owed a duty to his employer, which in turn owed a duty to the acquiring company.)

5. **O’Hagan** (p.1022) – [Misappropriation theory] Lawyer who worked for firm that represented Grand Met re: a potential tender offer for Pillsbury stock made trades on the basis of the confidential tender offer plans. He was held liable for mail fraud, securities fraud, and insider trading, even though he did no work for Grand Met and the firm ceased to represent Grand Met a month before Grand Met announced its tender offer. The misappropriation theory: D committed fraud “in connection with” a securities transaction, and thereby violated § 10b and Rule 10b-5, when he misappropriated confidential info for securities trading purposes, in breach of a duty owed to the source of the info, his employer. The fraud was consummated when, without disclosure to his firm, he used the info to trade. (Note: Why wasn’t this classical insider trading? Because D’s duty was to his firm, the client corp and the corp.’s shareholders, not to the shareholders of the target company.)
6. **Dirks** (p.1004) – [Tipper-tippee] Dirks, an officer of a broker-dealer firm who specialized in providing investment analysis of insurance company securities to institutional investors, received info from a former officer of Equity Funding re: fraudulent corporate practices. The former officer asked D to investigate the fraud and disclose it. D did investigate, and some employees corroborated the charges. D passed on the info to a WSJ reporter and to his clients, some of whom sold their Equity Funding holdings. S. Ct. held that he was *not* liable for securities fraud. He wasn’t a classical insider or temporary fiduciary of Equity Funding. He didn’t steal the info, so he couldn’t be held liable under the misappropriation theory. And the insiders didn’t breach their Cady, Roberts duty to shareholders in disclosing the info to D – didn’t derive personal/monetary benefit by disclosing to D – so neither they as tippers nor he as tippee could be held liable under 10b-5. The insiders were motivated by a desire to expose the fraud, not personal gain. A tippee is liable only if (1) if the tipper has breached a duty in tipping, (2) the tippee knows or should know that there has been such a breach, and (3) the tippee breaches a duty of trust and confidence to the tipper by either trading himself or deriving a personal benefit from tipping someone else.

   i. A tipper has breached a duty in tipping only if (1) the info was material, non-public info, (2) the tipper had a duty to refrain from trading on the basis of the info while it was non-public, and (3) the tipper received some sort of personal gain from the tipping. Look for quid pro quo pecuniary gain, reputational benefit (which could translate into future earnings), and/or a tip to a friend/relative (which may be characterized as a trade by the tipper followed by a gift to the friend/relative).

7. **Chestman** – The stockbroker (Chestman) of a couple (Susan and Keith Loeb) that was related to the founder of a publicly-traded supermarket chain (Waldbaum) made trades for his own account and for his clients’ discretionary accounts on the basis of info he received improperly. The info related to the pending sale of Waldbaum to A&P. The stockbroker was *not* held liable for insider trading. “Because Keith owed neither his wife nor the Waldbaum family a fiduciary duty or its functional equivalent, he didn’t defraud them by disclosing news of the pending tender offer to his stockbroker. Absent a predicate act of fraud by Keith, the alleged misappropriator, the stockbroker couldn’t be derivatively liable as Keith’s tippee.”

   i. Was it a tip or mere indiscretion? Coach Switzer case.

8. Rule 10b5-2 – Addresses the question, considered in Chestman, of when non-business relationships may give rise to a duty of trust and confidence for purposes of the misappropriation theory of insider trading. Section (b)(3) stands Chestman on its head – we now start with a rebuttable presumption that there is a relationship of trust and confidence whenever someone receives material, non-public info from a spouse, mother, etc. Section (b)(1) – agree to maintain info in confidence; (b)(2) – pattern and practice.

9. Rule 10b5-1 – Addresses the question of when a person in possession of material nonpublic information trades “on the basis of” the information. Definition in (b) codifies Teicher rule, that “on the basis of” means knowing possession when the person buys/sells. But the affirmative defenses in (c) accommodate some of the concerns of the Teicher defendants.

B. **Regulation FD (“Fair Disclosure”):** Whenever (1) an issuer that’s a reporting company, or person acting on its behalf (senior officials, CEO, CFO, investor relations officer, public relations officer – not low-level employees), (2) discloses material nonpublic info (3) to certain enumerated persons (in general, securities mkt. professionals or holders of the issuer’s securities who are likely to trade on the basis of the info), (4) the issuer must make public disclosure of that same info (a) simultaneously (in the case of intentional disclosures), or (b)
promptly (in the case of non-intentional disclosures – as soon as is reasonably practical but in no event after 24 hours or the commencement of trading the next day). An issuer who fails to comply w/ FD is subject to an SEC enforcement action for violations of SEA § 13(a) or 15(d) and Reg. FD.

1. Regulation FD addresses the problem of selective disclosure – e.g., the practice of securities analysts seeking “guidance” from issuers regarding earnings forecasts. There are 4 specific exclusions from coverage: (1) communications made to persons who owe the issuer a duty of trust or confidence (e.g., lawyers, investment bankers); (2) communications to persons who expressly agree to maintain the info in confidence (e.g., offerees in a private placement if they agree to keep the info in confidence); (3) communications to credit ratings organizations (whose own purpose is ultimately public disclosure); and (4) communications made in connection w/ securities offerings.

2. A selective disclosure is intentional – when the person making it knows, or is reckless in not knowing, that the info being communicated is both material and non-public. Things that are likely to be material include new products/discoveries, mergers/acquisitions, new customers/suppliers, new mgmt, events regarding issuer’s stock (issue or cut dividend), bankruptcies, earnings.

3. Disclosures involving fiduciary-duty breach – won’t be charged to the issuer. Issuer won’t be held liable for violating FD. But – may be able to get person who disclosed for insider trading on tipper theory.

4. What’s a sure-fire way to comply with FD? Post the info on your website and hold a conference call which is open to the public. A reasonable time before the conference call, issue a press release and post on website the time and call-in number for the conference call. And disclose the info again in another press release.

5. In the Matter of Siebel Systems, Inc. (p.1013) – At a Goldman Sachs Technology Conference, Siebel’s CEO disclosed that the Company was seeing a positive sales trend, and that fourth-quarter earnings would be similar to those in the previous 2 yrs. – remarks which contradicted earlier public statements. The CEO knew that broker-dealers, investment advisors, investment companies, and institutional shareholders would be in attendance, and he was given a list of the questions beforehand. Heavy trading in Siebel stock began only minutes after the CEO’s remarks. The SEC found that “the Company knew or was reckless in not knowing that it was selectively disclosing material nonpublic info at the Conference – amounting to an intentional selective disclosure w/in the meaning of FD.”

C. Liability under SEA § 14(e), Rule 14e-3. SEA § 14(e), analogous to § 10(b), prohibits making untrue statements and misleading omissions of material facts, and engaging in fraudulent, deceptive, or manipulative acts, in connection with any tender offer. Corresponding Rule 14e-3 proscribes (1) purchasing or selling a security (2) sought in a tender offer towards which a substantial step has been taken (3) on the basis of (4) non-public info about a pending tender offer (5) acquired directly or indirectly from anyone at the offeror or the target – unless within a reas. time before any purchase or sale the info and its source are publicly disclosed by a press release or otherwise. 14(e)/14e-3 applies to everyone – even an eavesdropper who doesn’t owe a fiduciary duty to anyone could be held liable for trading on the basis of undisclosed info about a pending tender offer.

D. Policy question: Is insider trading harmful? Yes: it permits smoother changes in stock prices than would occur w/o insider trading and conveys info to the mkt. (in terms of stock price movement). No: mkt. efficiency impaired short-term. Corp. harmed by trading in a target’s stock if the corp. plans to take over the target. Traders on the other side of the transaction harmed – but if transaction occurs in open mkt., other trader would’ve been trading in the mkt. anyway. Biggest reason why harmful: loss of public confidence in the mkts.