In early America, each corporation was created by a special charter, usually with monopoly privileges and perpetual existence; the right to sue or be sued collectively; and the right to hold property collectively. Later fears over the size of companies caused a number of restrictions to be placed on the corporation – these were placed in its charter. The restrictions were enforced through *ultra vires*. This changed when New Jersey and Delaware changed state laws to raise revenue from filing fees.

Are the current mix of state and federal corporate laws effective?

1. **BERLE & MEANS, MODERN CORPORATE REFORMERS:** In virtually all large companies, separation of ownership from control had led to corporate managers with considerable discretion to pursue their personal interests at the expense of other shareholders:

   - State corporate governance statutes largely are enacted to generate tax revenues, resulting in “lax” corporate laws.
   - These statutes allow corporate managers to dominate proxy elections because of spending rules.
   - Directors who do not direct.
   - State corporate law long resulted in ineffective duty of care litigation. After *Smith v. Van Gorkom*, discussed Sept. 12, Delaware adopted a statute permitting shareholders to “opt out” of monetary liability from duty of care litigation.
   - Mandatory disclosure is a favored regulatory approach.

2. **AGENCY COSTS OR LAW AND ECONOMICS VIEW:**

   Existing corporate laws generally are unnecessary, and simply add costs to doing business. Generally, the marketplace adequately restrains managerial cupidity and inefficiency through:

   - Product Markets
   - Capital Markets
   - Takeover Markets
Agency costs theory: A conflict of interest between shareholders and managers is obvious. Rational managers will seek to increase the public market price of shares by using Monitoring Activities (board of directors, auditors) or bonding (restrictions on salary, incentive compensation). However, there will always be a residual or agency cost.

The problems with the agency costs theory include:

1. The theory is based on a “nexus of contract” concept. In reality, shareholders and managers do not negotiate a contract; shareholders can diversify away firm-specific risk and thus are often disinterested.

2. Realistically, shareholders do not rely solely on market forces. Typically they view federal securities fraud and state derivative law actions as important adjuncts to market forces.

3. Agency cost theory assumes a long term time horizon. Many corporate problems such as a response to a takeover or sale of securities have a short term horizon. Managers (the agents) may often find it in their self-interest not to seek to increase the wealth of the corporation, but to preserve their jobs or perquisites at a cost to the corporation.

We will return to these theoretical constructs often throughout the course.

AGENCY DEFINITION AND CONTROL
Pp. 27-33

Agency definition: The manifestation of consent of one person that another shall act on his or her behalf and subject to his or her control. Restatement. This is a hierarchical relationship. Agency is also volitional. It can only be created by mutual consent. An agency relationship does not require a contract. It can be proven by circumstantial evidence. The key is control.

AUTHORITY
Pp. 33-41

I. ACTUAL AUTHORITY
A. EXPRESS: Typically written in a statute, certificate of incorporation, bylaw, or board resolution. Express authority can be oral. Sometimes cases on extravagant language, or mistakenly given or fraudulently procured express authority.

B. IMPLIED ACTUAL AUTHORITY is typically created:
   • Incidental to express authority.
   • Through past dealings.
   • Through custom of trade or industry.
   • Through emergency circumstances, i.e., reasonable under the circumstances.

II. APPARENT AUTHORITY
Although apparent authority is not good authority under Del. Gen. Corp. L. §124(2), apparent authority will bind a corporation to a third party. There are two key elements:

1. Manifestation by principal.

2. Reasonable reliance on a third party.

**Partnership**

In a partnership, there are three basic policies:

a. Generation of capital: This is the purpose of the limited partnership and the new limited liability company.

b. Protection of creditors: This is the underlying purpose of a general partnership.

c. Fairness among partners – The purpose of UPA and Uniform Limited Partnership Act (ULPA) primarily this is achieved through rules that can be varied by agreement.

**THE PARTNERSHIP**

Pp. 41-57

**FORMATION**
It is always preferable to draft a partnership agreement. In that way, normally through nonadjudicatory means, the parties *ex ante* can define their rights and duties in various foreseeable circumstances, see p. 48. Partnership law is notable for the frequency of instances in which partnerships are formed through oral agreements or inadvertence. A partnership is an association of two or more persons to carry-on as co-owners a business for profit. U.P.A. §6, p. 42. Co-owners refers to control. UPA §7(4) does not address issues such as significance of control in the definition in §6 or in the intent of the parties.

The Limited Partnership - at pp. 70-73. One or more general partners with unlimited liability, but limited liability for each limited partner. In order to secure limited liability for each limited partner: (1) a written certificate of limited partnership must be filed. See RULPA §201, at p. 70. (2) Limited partners lose their limited liability shield if they participate in the control of business.

Control in this context is a term of art. See discussion at pp. 70-71.

**PARTNERSHIP FINANCES**

Pp. 48-50

1. No minimum capital is required – no investment is necessary.
2. Each partner owns two types of interest:

- Co-owner of partnership property: UPA §25. Partnership property may only be used for partnership purposes and is not subject to individual property attachment.
- Partnership interest: UPA §26, like a share of stock. Partnership interests are freely transferable and may be assigned. UPA §27. However, the transfer of a partnership interest does not usually create a new partner absent accord by other partners. UPA §18(g).

3. The key Section regarding finances is UPA §18.

Absent agreement:

- all profits are shared equally
- losses shared the same as profits
- partners receive no salary but are entitled to reimbursement of expenses.
Each aspect of UPA §18 is subject to variation by agreement. This is a key role of lawyers in partnership formation: Raising issues for potential partners to include in their agreement before operations begin.

GOVERNANCE

Implicit in the UPA is the notion of collective decision-making. See, e.g., UPA §18(e): “All partners have equal rights in the management and conduct of the partnership business.” Connected with this power are fiduciary duties. Partners owe each other the highest fiduciary duty – we can not allow partners to undercut each other.

LIABILITY
Pp. 54-55

Partnership law is based on the theory of collective responsibility:

1. UPA §9: A partner usually may bind a partnership and ultimately create personal liability for other partners.
2. UPA §13: In the ordinary course of business, partners may bind the partnership for torts.
3. UPA §14: Partners now bind the partnership for breaches of trust.

Need More Info -- These principles are leavened for incoming and outgoing partners – see discussion of UPA §§17 and 36 at p. 55.

Partnership v. Corporation v. Other Forms
1. Tax considerations: Pp. 75-76. This is usually the straw that stirs the drink, as Reggie Jackson put it. To do an appropriate tax analysis requires up-to-date tax information on each potential investor.
2. Limited liability: Pp. 76-77. We will address this topic in detail (See pp. 83-93); Handout 9-11.
3. Ease of Formation: P. 77. A partnership requires no filing fees, no annual reports, and no written document.

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4. **Control**: Pp. 77-78. Partners usually share control. See UPA §§18e, 18h.

In a corporation, control is usually centralized in the board. But the corporate norm, particularly in the close corporation, see October 8 and 10, can be modified to resemble a partnership. The partnership form under UPA §18 similarly can be modified by agreement. This apparent difference is now largely historical in its significance.

5. **Transferability and Continuity**: P. 78. A partnership can be dissolved at the will of a single partner UPA §31(2). A corporation usually has perpetual existence.


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**MECHANICS OF INCORPORATION**  Pp. 79-83

Formation: Delaware General Corporation Law (DGCL): Any person may form a corporation. To do so, a promoter must file a certificate of incorporation with the Secretary of State and pay required fees.

The certificate of incorporation may be brief, but must set forth:

1. Name and address of the resident agent.
3. Describe corporate stock and relations among stockholders. This requirement is easily met if there is only one class of stock; if more than one class of stock is created the certificate of incorporation must describe the qualifications, limitations, and restrictions of each.

There are several optional provisions including:

1. Limits on directors or shareholders. DGCL §102(b)(1). Cf. DGCL §141(a) - see p. 133.
2. Supermajority vote or quorums. DGCL §102(b)(4).
3. Limits on duration. DGCL §102(b)(5).
5. Preemptive rights. DGCL §102(b)(3).
6. Stock transfer restrictions - to be discussed October 10.
7. DGCL §102(b)(7) permits corporations to opt out of monetary damages for duty of care.

Bylaws typically contain more detailed rules and may be amended solely by directors.

See sample Articles of Incorporation and Bylaws found in the Statutory Supplement.

There are also several practical questions including:

1. **One corporation or many**: This is a limited liability issue. There are no longer tax advantages to multiple incorporations.
2. **Where to incorporate**? Out-of-state incorporation also involves qualification to do business in any state in which business is conducted.
3. **Can the incorporator (or promoter) enter contracts before the corporation is formed**? Pp. 82-83. The promoter often signs preincorporation contracts. He or she is normally liable unless the contract disclaims liability. A corporation can not be liable because an agent may not bind nonexistent principal. After a corporation is formed, the promoter remains liable until novation. If he or she is sued, and the contract is adopted by the corporation, the promoter is entitled to reimbursement.

The corporation may adopt a contract, formally by novation or by a course of conduct without novation. In either instance, both the corporation and the promoter will be liable. If the contract expressly disclaims promoter liability, then no contract exists. It remains just an offer until the corporation adopts the contract.

**DEFECTIVE INCORPORATION**

Q. **What are the elements of a de facto corporation?** (1) A law authorizes the existence of corporations (2) An effort in good faith to incorporate under the existing
law (3) actual use or exercise of corporate powers. If all these elements are met, then the officers of the defective corporation get the protection of limited liability.

Q. How was corporation-by-estoppel proven in the Cranson case? Corporation by estoppel prevents an entity that has dealt with the defective corporation from denying its prior relationship in a later suit against the defective corporation.

Q. Would corporation-by-estoppel be available if an employee of Cranson ran over a third party? No b/c the victim would never have dealt with Cranson as a corporation so they would not be estopped from suing officers or shareholders for their damages – more likely to pierce the veil in tort than contract.

Q. Why limit corporation-by-estoppel to contract cases? B/c in a contract setting each party can take their time and investigate the other – if you treat them like a company, then they become a company.

Q. Why permit either doctrine? Why not have a strict rule creating limited liability only when a de jure corporation exists? We want to protect companies and errors b/c of the positives.

Q. Should we only hold liable owner-managers or all shareholders? Model Business Corporation only seeks to hold persons who act on behalf of the company knowing that there is no company.

D. PIERCING THE CORPORATE VEIL

Pp. 87-93; 98-105; Handout 9-11.

THREE BASIC APPLICATIONS

- Alter Ego or Instrumentality Doctrine
- Undercapitalization
- Fraud
These materials address the first two applications - the third application is implicitly covered later in the course when we address securities fraud. See October 29 - November 19.

There are three ways that the veil can be pierced. Each requires similar facts to justify veil piercing:

- Individual Owner ----- Corporation
- Parent Corporation -- Subsidiary
- Enterprise Liability

1. ALTER EGO OR INSTRUMENTALITY DOCTRINE

Pp. 88-98

Walkovszky v. Carlton
18 N.Y.2d 414, 223 N.E.2d 6 (1966)

Pp. 88-93

MF: Plaintiff (P) was run over by a taxicab owned by Sean Cab Corp. Sean Cab Corp. was 100 percent owned by Carlton who similarly owned 10 other taxi cab corporations.

Q. Why did P not succeed in pleading that Carlton personally was liable for the torts of Sean Cab? It only alleged that the company responsible for Ps injury was owned by a man who owned several other companies. It failed to allege that the company was a shell for individual shareholders who are carrying on the business in a personal capacity for personal rather than corporate ends.

Q. How could the plaintiff plead such facts? They could show intentional under capitalization or the movement of personal funds into and out of the company

Q. Why not always require shareholders to be liable when there are not enough assets to cover costs of torts? It would discourage investment and destroy the point of incorporating.
Q. What risk is there that limited liability will inspire excessive risk-taking by corporations? That is fought with by statutory requirements for capitalization and insurance.

Q. Why did the Walkovszky majority not adopt the theory of the Keating dissent that liability insurance was not supposed to be adequate capital? Inadequate insurance is a matter for the legislature not statutory enforcement.

2. INADEQUATE CAPITALIZATION

Pp. 98-100

Minton v. Cavaney
15 Cal. Rptr. 641, 364
P.2d 473 (1961)
Pp. 98-100

MF: This case concerns the liability of a shareholder who was not a party to the initial suit, which was ultimately reversed to litigate personal liability. “The equitable owners of a corporation are personally liable when they treat the assets of the corporation as their own and add or withdraw capital from the corp. at will, when they hold themselves personally liable for company debts, provide inadequate capitalization, and actively participate in corporate affairs.

Q. Why does the California Supreme Court suggest that capital was inadequate here? There was no attempt to provide adequate capitalization – no substantial assets.

Q. Suppose the state had enacted a minimum insurance law - if the insurance had been paid for, could the defendant have been held liable? Possibly – insurance is not adequate funding and insufficient funds might give indication to no corporate purpose.

Q. Suppose this were a contract case - what could the plaintiff do to protect himself or herself ex ante (before the accident)? Investigate the company’s history and business practices.
Q. How much capital must a corporation maintain? Adequate to carry out the business of the corporation.

**Alter Ego** – When there is such unity of interest and ownership that the separate personalities of the corporation and individual no longer exist and that if the acts are treated as those of the corporation alone an inequitable resolute will follow.

Radaswekski v. Telecom Corp.,
981 F.2d 305
(8th Cir. 1992)
HANDOUT 9-11

Missouri law evolved a distinctive test for piercing the corporate veil. See quotation from the Collet case at Handout p. 9.

Q. What costs does Judge Arnold ascribe to investor and parent company limited liability? That some injuries will go uncompensated b/c of insolvency of the corporation.

Q. Why will Missouri pierce the corporate veil for undercapitalization? P must show three things (1) Complete domination of corporate finances, policy, and business practices – thus there must have been no corporate mind (2) Such control must have been used by the D to commit fraud or wrong, to violate a duty, or commit an unjust act upon the P (3) the control and breach of duty must proximately cause the P’s injury or loss.

Q. How did the court here define undercapitalization? Creating a business without a reasonably sufficient supply of money.

Q. Why did the Eighth Circuit reverse the District Court conclusion that there was undercapitalization? B/c the subsidiary had a lot of insurance in an amount necessary to satisfy federal requirement for companies in that line of business.
Early corporate actions were limited through the doctrine of *ultra vires* (literally, “beyond the powers”). Delaware General Corporation Law (DGCL) §101(b) provides that: “A corporation may be incorporated or organized . . . to conduct any lawful business or purposes.” DGCL §121(a) states that beyond the long list of specific powers enumerated in DGCL §122, “every corporation, its officers, directors and stockholders shall possess and may exercise all the powers and privileges granted by this chapter or by any other law or by its certificate of incorporation, together with any powers incidental thereto, so far as such powers and privileges are necessary or convenient to the conduct, promotion or attainment of the business and purposes set forth in its certificate of incorporation.” DGCL §124 almost totally eradicates the common law doctrine of *ultra vires*: “No act of a corporation and no conveyance or transfer of real or personal property to or by a corporation shall be invalid by reason of the fact that the corporation was without capacity or power to do such act or to make or receive such conveyance or transfer” except in three limited cases.

It is more precise to think of the doctrine of *ultra vires* as being dormant rather than dead. The DGCL does permit shareholders to draft corporate certificates with restrictive purposes and power clauses. If this is done, they can be enforced.

**Definition of ultra vires:** An action is *ultra vires* if it contradicts a terms of the corporation’s charter or one necessarily implied by it. This does not mean a corporate violation of a statute. When an act has been fully executed, neither party may seek rescission because it was *ultra vires*. No escape from torts L.
The traditional purpose of the corporation is to create benefits for the shareholders – directors can not directly benefit others and only indirectly benefit their shareholders.

A.P. Smith Mfg. Co. v. Barlow,

13 N.J. 145,
98 A.2d 581 (1953)

Pp. 115-120

Q. What business was A. P. Smith in? Manufactures equipment for water/gas industries and it donated money to universities – it was ruled intra vires. And is appealed.

Q. What was the firm’s charitable contribution? They donated $1500 to Princeton from the corporate treasury.

Q. When may a corporation make a charitable contribution? Under state law a corporation could donate money to charities if the board thought it would contribute to the corporate interest.

Q. Why permit any charitable contribution (or nonprofit seeking activity) (compare view of Milton Friedman at p. 123)? As the corporation is the dominant economic force, it makes sense to allow them to contribute to society with funds. Friedman suggests that there is no way for a corporate official to decide what is the social good – they are supposed to make money for shareholders.
Q. How can it be argued that this contribution had an incidental benefit to A.P. Smith? It aided the university system which is fundamental to the society and promoted the company to others.

Q. Could a corporation donate 90 percent of its profits to Princeton? This would likely violate state laws or be a breach a duty to shareholders as removing their profits. Not Reasonable.
Q. Could a corporation make contributions to a charity established by a corporate chief executive officer’s nephew? It would be possible but the charity would have to be made in furtherance of corporate purposes.

Hypotheticals

1. Should a shareholder be permitted to enjoin a corporation from honoring a contract unenforceable under the statute of frauds? Unlikely, as long as the company could prove that following the contract is preferable to breaking and suffering damages, bad press, etc.

2. An employee with 19 years experience is seriously hurt; his pension vests after 20 years. Could the corporation buy an annuity for him? Yes, it would cost money but could promote morale and create good press.

3. Corporation A hopes to gain a supply contract from Corporation B, a large firm. Profits will equal $5 million over two years. A vice president of Corporation B can guarantee that Corporation A will secure the contract for Corporation A if Corporation A will pay him $200,000. The risk of detection is small. Should Corporation A make this payment? No, as this would maximize profits it would violate the law and this would go against the objective and conduct of the corporation of the ALI.

4. J Corporation runs a restaurant, the controlling interest in which is held by S. S. dies. The restaurant is inherited by T, who converts the restaurant to a strict vegetarian menu. Can a minority shareholder enjoin the menu change?
It is doubtful that a minority shareholder could stop the conversion as long as it is a normal business decision – the new business model could catch on and be a hit.


BACKGROUND: Pp. 133-139

DGCL §141(a): “The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . “

STATUTORY EXCEPTIONS:

1. DGCL §141(a): “Except as may be otherwise provided in this chapter or in its certificate of incorporation”. This is particularly relevant to close corporations which we address on October 8 and 10.

2. DGCL §141(c): Committees may exercise the power of the board except in specified cases such as:

   - amendment of the certificate of incorporation.

   - adoption of a merger agreement.

   - recommendation of sale of all or substantially all assets.

   - recommendation of dissolution.

   - amendment of bylaws.

3. DGCL §141(e): The board is fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the board by any corporate officer or employee, board committee “or by any other person as to matters the member reasonably believes are within such other person’s professional or expert competence.” (e.g., an accountant or attorney).
It frequently has been argued that the board in a large corporation is unequal to the task of managing a corporation because of such reasons as:


Information constraints. See pp. 136-137.

Board composition; e.g., selection of inside directors or passive outside directors. Pp. 137-138.


In 1971 Harvard Business School Professor Myles Mace, in Directors: Myth and Reality, concluded:

1. Directors do not establish policies of the firm.

2. Directors rarely choose chief executive officers.

3. Directors rubber-stamp compensation decisions.

4. Directors rarely ask tough questions.

Yet if the board is supposed to be an auditor of a monitor of managers, a type of check and balance, it is not the only one:

1. In small firms, active outside shareholders may carefully review management.

2. In large firms, institutional owners and lenders perform a monitoring rule.

3. Stock market price may trigger a more active board.
   4. Product market competition.

4. SEC Disclosure and Fraud Rules.
In this context, a better way to view the board in publicly traded corporations is as a monitor, rather than a manager. See pp. 138-139.

How well the board performs a monitoring rule has varied over time. Mace’s work, the 1970s corporate bribery scandals, and the takeovers of the 1980s prompted reforms:

1. Audit committees.
2. More information available to directors.
3. More outside directors.
4. Greater director involvement in such fundamental decisions as evaluating tender offers or chief executive officer succession.

DUTY OF CARE: Pp. 141-167

Duty of Care is the basic negligence concept. Directors and Officers must discharge their duties in good faith and with that degree of diligence, care and skill which prudent persons would exercise under similar circumstances in like positions. Issue: did the directors neglect their duty by accepting the cashier’s statement of liabilities and failing to inspect the depositors’ ledger as this would have revealed the thefts.

Bates v. Dresser
251 U.S. 524 (1920)
Pp. 143-147

The receiver of a national bank charged the president and directors with the loss of assets through employee thefts. On appeal, the administrator of the bank’s estate was found partially liable and he appeals – Dresser’s estate and the receiver both appeal.

Q. Why did Bates sue the board of this “little bank in Cambridge”?

Q. Why do we not hold directors liable for the theft loss without investigation of whether they were at fault? This type of fraud was fairly new and the directors
had always relied on the cashier’s statement of liabilities and the government audits and their faith in the president as a major stockholder

Q. A corporation bylaw had earlier required the board to appoint a committee every six months to audit the bank’s finances. Why wasn’t the failure to obey that bylaw proof of negligence? Based on the information that the board had, all was well – nothing but a detailed exam would have revealed the fraud to the directors – committee or not.

Q. Why then was Dresser held liable? Dresser as president was at the bank and could have obtained the deposit ledger whenever he wanted – furthermore, employees had told Dresser that money was missing and that the cashier was involved in suspicious activities.

Q. Suppose the facts were identical but that knowledge came to the board in 1908 of the fact that Coleman was suspected of robbing a YMCA fund. Could it be liable for failure to investigate? “Some animals must show dangerous propensities before the owners can be liable.” If the board had knowledge of the cashier’s criminal tendencies, then they might be held liable for the embezzlement.

Barnes v. Andrews
298 F. 614 (1924)
Pp. 147-151

Barnes was the receiver for the Liberty Starters Co. and he sued Charles Lee Andrews.

Q. Who was the defendant director? What was his association with the Liberty Starters Corp.?
The director was a director who was brought in by his ownership of stock and friendship with the President. A year after the D resigned the company went bankrupt.

Q. Why was Andrews sued? D was sued b/c while he was a director he failed to give adequate attention to the company, people were hired but lacked jobs, and the engineer was overpaid.

Q. What duty did Judge Hand state that a director has? Directors can only act by counsel and advice – but they have the duty to stay informed in some detail. Here,
D had an active duty to learn whether the company was going to be profitable and he only took his friend’s assurances that all was well.

Q. Why did Andrews fail to perform that duty?

Q. Why then did Hand not hold Andrews liable? The P could not prove that D’s N caused any particular loss to the company – D’s N had to be the proximate cause of the loss.

HYPOS

1. Suppose a bank hired a director who, like Andrews, failed to ask discerning questions. The bank trust department invested savings in corporate bonds whose value was destroyed in a stock market crash. Would the director be liable? Doubtful, if the corporate bonds were a standard investment, then a director would have no reason to investigate the possibility that the stock market could crash.

2. Suppose a bank officer informed the board he was loaning a large percentage of corporation assets to a cousin who was an inventor. The cousin would pay the same interest as the largest corporate clients. The cousin goes bankrupt. Would the board be liable?
   
   Here, the situation is different b/c the loans are to a relative of the employee without the assurances that accompany corporate bonds.

188 A.2d 125 (Del. 1963)
Pp. 151-156

Q. What was Plaintiff’s basic theory of this lawsuit? P alleges that the directors had actual knowledge of the anti-trust violations or they had enough knowledge to be on notice. Later, Ps claimed that the directors were liable as they should have imposed a system to prevent anti-trust violations.

Q. Why were the directors not held liable? Although there was evidence from many years prior, the directors could only provide broad guidance – not insure that
laws were complied with across the company. At the time of the decision, it was not considered mandatory for the directors to institute a compliance system.

Q. Suppose you wanted to design a system that would detect and prevent antitrust violations. How would you design it? You would have to delegate authority to an agent to oversee operations and then have someone make sure that the overseers job was being done.

Francis v. United Jersey Bank
87 N.J. 15, 432 A.2d 814 (1981)
Pp. 157-166

Issue: Is a corporate director personally liable in N for the failure to prevent the misappropriation of trust funds by other directors who were also officers and shareholders of the corporation. To prove this, a director must (1) have a duty to the clients of the co. (2) breach that duty and (3) the breach must be the proximate cause of the loss.

Q. Why did Pritchard and Baird file for bankruptcy in 1975? They had run the business into the ground and the company and them were forced into bankruptcy.

Q. Who is this suit against? The estate of the wife of the founder and mother of the two directors that ran the company into the ground.

Q. What was Ms. Pritchard’s relationship to Pritchard and Baird? Mother

Q. Why did the court hold that Ms. Pritchard was negligent in her duties as a director? She made no effort to discharge her duties as a director – a director should be familiar with the fundamentals of the business and have an obligation to keep informed about the activities of the corp.

Q. As a matter of law, the New Jersey duty of care is set out at p. 160. Why did the court hold this standard imposed a heavier burden on the bank director? A bank director is liable to his depositors as well as the shareholders, so their burden is greater no matter the makeup of the corporation.
Q. Would the duties of a director who also was outside legal counsel be identical to those of an outside director? No, the duty would be higher as the board would turn to the director for advice – the director would wear two hats.

Q. What about an inside director? That would be the highest duty as the director would provide advice and would have all the info as a businessman.

Q. Could someone ignorant of a business ever satisfy her or his duty as a director? Doubtful – a director must have some familiarity with the business and its balances, accounts etc.

Q. Must directors attend every meeting? Not necessarily, but they have a duty to keep up with the info there and should probably have an excuse to miss.

Q. Must directors study financial statements? Study is probably too strong, review and study the reports prepared by committees and auditors.

Q. Suppose you are a director of a large publicly traded corporation and you notice a division has lost money for five consecutive years. What duty would you have? Director should find out why the division is losing money – if presented a reasonable excuse, then move on.

Q. Suppose you were at Allis-Chalmers and you learned of price-fixing, what must you do?
Report it to the gov’t and try to end the price-fixing within the company.
Q. Will a director always be liable if funds are misappropriated? Not if there was no causation or connection to the board’s decision.

Q. How did the Francis case change the proximate cause standard in Barnes v. Andrews? The breach of duty must be a substantial factor in producing the harm – not the sole cause.

Q. Must the defendant’s conduct be the most important factor causing in a specific injury? If it is reasonable to infer that the failure to act would produce a particular result and that result has followed, causation may be inferred.

CLASS DISCUSSION PROBLEM

Caremark is a Delaware corporation. During the relevant period, Caremark had approximately 7,000 employees and 90 branch operations. It had a decentralized management structure. A substantial part of Caremark’s revenues are derived from Medicare and Medicaid reimbursement programs. These payments are subject to the terms of the Anti-Referral Payments Law (“ARPL”) which prohibits health care providers from paying any form of remuneration to induce the referral of Medicare or Medicaid patients. Nonetheless, Caremark did have a practice of entering into contracts for services (e.g., consultation agreements and research grants) with physicians at least some of whom prescribed or recommended services or products that Caremark provided to Medicare recipients and other patients. Such contracts were not prohibited by the ARPL, but they obviously raised a possibility of unlawful “kickbacks.”

In 1989, Caremark issued an internal “Guide to Contractual Relationships” (“Guide”) to govern its employees in entering into contracts with physicians and hospitals. The Guide was reviewed annually by lawyers and updated. Each version of the Guide stated as Caremark’s policy that no payments would be made to induce patient referrals.

In August 1991, the Office of the Inspector General (“OIG”) of the federal Department of Health & Human Services initiated an investigation of Caremark. Caremark was served with a subpoena requiring the production of documents, including contracts between Caremark and physicians (Quality Service Agreements (“QSAs’). Under the QSAs, Caremark appears to have paid referring physicians fees for monitoring patients. In March 1992, the Department of Justice joined the OIG investigation.
The first action taken by management, as a result of the initiation of the OIG investigation, was an announcement that as of October 1, 1991, Caremark would no longer pay management fees to physicians for services to Medicare and Medicaid patients.

On August 4, 1994, a federal grand jury in Minnesota issued a 47 page indictment charging Caremark and David R. Brown, a physician practicing in Minneapolis, with violating the ARPL over a lengthy period. According to the indictment, over $2.2 million had been paid to Brown to induce him to distribute Protropin, a human growth hormone drug marketed by Caremark.

Subsequently, a stockholder derivative actions was filed. The complaint alleged that Caremark’s directors breached their duty of care by failing adequately to supervise the conduct of Caremark employees, exposing Caremark to fines and liability.

What is Caremark’s risk of liability under the state law duty of care?


1. DUTY OF CARE: Directors have a duty to perform with that diligence, care and skill which ordinarily prudent persons would exercise in similar circumstances. In Delaware there is a gross negligence standard. See pp. 181-182.

2. GENERAL STANDARD OR CARE: Minimal requirements of competence, meeting attendance, comprehension of financial statements, and law compliance. Must be analyzed on a case-by-case basis. Key case is Francis v. United Jersey Bank.

3. IN SUPERVISION CASES: The plaintiff must show that a director knew or should have known of facts which would prompt an ordinarily prudent person to investigate or change corporate practices.

4. CAUSATION: The plaintiff must prove that a failure of a director to satisfy a standard of care caused a specific harm. Modern development illustrated by
Francis: Cause is shown if failure was a substantial factor; need not satisfy Barnes v. Andrews.

5. BURDEN OF PERSUASION: In duty of care cases, the burden of persuasion is always on the plaintiff.

6. BUSINESS JUDGMENT RULE: A director or officer will not be held liable if a business judgment is: (1) disinterested, (2) reasonably informed, and (3) the director or officer reasonably believes that the business judgment is in the best interests of the corporation.

Why allow corporate directors broader insulation from negligence liability than all or virtually all other individuals? Three basic explanations – see Joy v. North, pp. 168-169:

1. Encourage risktaking.

2. Shareholders voluntarily invest; shareholders assume directors engage in risktaking.

3. Rational shareholders can diversify away firm-specific risk through a portfolio.

Smith v. Van Gorkom
488 A.2d 858 (Del. 1985)
Pp. 170-205

MF: Van Gorkom, C.E.O. of Trans Union, meets with Pritzker on September 13, 1980, and suggests that Pritzker buy Trans Union for $55 per share.

Preceding this meeting, Van Gorkom had discussed with senior Trans Union management a leveraged buyout at $55 per share. See definition of leveraged buyout, at pp. 1276-1277.

Pritzker agrees to a $55 per share price if given an option to buy 1 million shares of Trans Union at $38 per share and the deal is accepted by Trans Union within three days (from 9/18 when Pritzker agreed until 9/21).
Focus on the meeting of September 20th:

The Court held at p. 181: “The determination of whether a business judgment is an informed one turns on whether all directors have informed themselves ‘prior to making a business decision, of all material information reasonably available to them.’”

Q. Why wasn’t director knowledge that the market price was 37-1/4 and the offer price 55 sufficient to justify this deal?

Q. Must there always be an outside valuation study?

Q. Weren’t the directors entitled to rely on DGCL §141(e) which states “Directors are fully protected in relying in good faith on reports made by officers?”

Q: Suppose Romans’ financial study would have been a valuation report adequate to satisfy the court. Would the court have still disapproved the board’s decision on September 20?

Q. What was the market test that the defendants claimed cured any defects in the initial deal?

Q. Why did the Court not buy the argument that the Board changed these conditions?

Q. What about the curative effect of the September 22nd press release?

Q. Isn’t this whole analysis beside the point? You have five top flight outside directors. They are aware of the longstanding tax problem of the firm and its less than upbeat financial future. Why shouldn’t the Court just defer to their business wisdom?

Q. Weren’t the defects in the merger approval cured on January 26th when all relevant facts were laid on the table?

Q. What about the shareholder vote in February. Didn’t it cure any defects of the agreement?
Q. How would new DGCL §102(b)(7) change the duty of care?

Q. Would DGCL §102(b)(7) change the court result here had it been in operation at Trans Union?
Q. One basic unresolved problem with the duty of care and the business judgment rule is the mismatch between negligent misconduct and amount of liability – here $23.5 million. If Pritzker had not bailed out the board, this level of liability might have bankrupt members of the Trans Union board. What can we do about this mismatch? Should we be concerned?

Q. What would you advise a board before approval of a merger to avoid liability under Smith v. Van Gorkom?

AFTER VAN GORKOM:

(1) Motion Practice: Defendants assert the business judgment role. Plaintiffs occasionally win by showing the lack of a reasonable investigation, or board conflicts of interest.

(2) At trial, the plaintiffs must prove (a) that the duty of care was violated – this requires evidence similar to that evidence necessary to rebut the business judgment rule motion; (b) causation, and (c) damages.

UNLIKELIHOOD OF A DUTY OF CARE SUIT SUCCEEDING:

(1) Plaintiff has the burden of proof.

(2) In Delaware a gross negligent standard applies.

(3) Section 102(b)(7) opt out provision.

(4) Business judgment rule defense.

Cf. FEDERAL SECURITIES LAW FRAUD CLAIMS:

(1) No business judgment defense.

(2) Mandatory disclosure system produces detailed published evidence.

(3) Possibility of a prior SEC investigation.

CAPITAL STRUCTURE AND PROJECTIONS:
State corporate law seeks to provide compensation for investors after they have been injured by a violation by a director or corporate office. Federal Securities Laws generally seek to deter misconduct from happening through a mandatory enforcement system. This system only applies to the largest business firms.

2. TEXTUAL DISCLOSURE
   [Regulation S-K]
   Pp. 258-276

Item 303: Management’s Discussion and Analysis

The MD & A Item is the SEC’s most significant innovation in mandatory disclosure in recent decades. It requires corporate managers to give investors a “big picture” overview of their corporation. MD & A often is an issue in SEC investigations when a troubled company is less than candid about known “material events and uncertainties.” One purpose of Item 303 is to avoid ugly surprises.

Item 303(a) generally requires:

Discuss registrant’s financial condition, changes in financial condition and results of operations. The discussion shall provide information as specified in paragraphs (a)(1), (2) and (3) with respect to liquidity, capital resources and results of operations and also shall provide such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations.

Instructions to Item 303(a) highlight the troubled company emphasis:

The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.

Liquidity: . . .

(2) Disclosure Requirement Item 303(a)(1): Identify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the registrant’s liquidity
increasing or decreasing in any material way. If a material deficiency is identified, indicate the course of action that the registrant has taken or proposes to take to remedy the deficiency. Also identify and separately describe internal and external sources of liquidity; and briefly discuss any material unused sources of liquid assets.

CAPITAL RESERVES: Item 303(a)(2) provides: . . .

(ii) Describe any known trends or uncertainties that have had or that the registrant reasonably expects will have a material favorable or unfavorable impact on net sales or revenues or income from continuing operations.

Instruction 7 to Item 303(a) distinguishes mandatory forward looking disclosures under Item 303 from voluntary disclosures encouraged by Item 10(b):

Registrants are encouraged, but not required, to supply forward-looking information. This is to be distinguished from presently known data which will impact upon future operating results, such as known future increases in costs of labor or materials. This latter data may be required to be disclosed. Any forward-looking information supplied is expressly covered by the safe harbor rule for projections.

Flynn v. Bass Bros. Enter., Inc.
744 F.2d 978 (3d Cir. 1984)
Pp. 262-268

D had purchased 10% of the company and then made an offer to buy the remaining stock. D never disclosed its estimates for the value of the stock although they did alter their offer to state that land held by the company could bring more than the offer if the company was liquidated, but the D had no intent to liquidate the company. P claims that the info in the tender was insufficient under federal and state law. Trial court on directed verdict for D.

Q. Why did the SEC long prohibit disclosure of projections? They did not want investors relying on “soft” info in proxy materials or tender offers b/c they may not be reliable and it would be hard for the SEC to evaluate all such projections to see if they were true.

Q. Why did the SEC change its policy to encourage projections? Companies relied on projections and future growth is the main reason for investment, but investors were not
allowed to judge future growth only past growth while professionals got these company
projections through contact with firm execs.

Q. Does the Third Circuit hold in Flynn that management must disclose asset appraisals?
No, the court states that asset appraisals in certain cases must be disclosed – but it is a
balancing test between the possible aid to shareholders against the possible harm (undue
reliance). The facts surrounding the creation of the report provide the court with
information about how material the info is.

Q. Why did the court not require disclosure of the so-called Prochemco reports here? P
failed to prove D relied on the prochemco reports to make their tender offer, and the
reports were not proven to be by experts but by the employees of prochemco who were
trying to get D to purchase the company to get a finders fee. The other reports suffered
the same faults – not done by experts, no proof of reliance, and no proof of value to be
passed on to shareholders.

Flynn addresses the issue of whether projections should be MANDATORY or
PERMISSIVE.

The case for MANDATORY projections:

1. Projections, at least if prepared by management for internal use, arguably are
   material facts for investors.

2. Only if projections are mandatory will all investors receive equal information.

3. A permissive system might result in only favorable projections being disclosed.

4. The very fact that firm has difficulty making a projection tells much about the
   quality of its management.

PERMISSIVE

1. Business argument: Requires disclosure of competitively disadvantageous
   information.

2. Preparation expenses might be great.

3. A mandatory system would expose firms to risk of litigation.
4. In new firms or with firms entering new fields, there might be insufficient data with which to make a projection.

_Wielgos v. Commonwealth Edison Co._
892 F.2d 509 (7th Cir. 1989)
Pp. 268-276


12/5/83: CE stock sold at $27,625. Internal CE estimates are higher than those incorporated into the prospectus.

Q. Were estimates in the prospectus erroneous? The estimates were erroneous but only because events had changed the estimates – the company had just failed to update its information and its estimates failed to alter its documents on file with the SEC.

Q. Why is there no liability for Commonwealth Edison for its erroneous estimate? The D was protected by the safe harbor of Rule 175 b/c the company made a projection that it filed with the SEC. This projection is protected unless D can show that the company acted in bad faith or there was no reasonable basis for the statement.

Q. Who has the burden of persuasion? The P has the burden of persuasion to show bad faith or no reasonable basis for the statement.

Q. Why doesn’t inevitable inaccuracy of an estimate eliminate the Rule 175 safe harbor? No, Rule 175 assumes a sophisticated investor that understands the limits of projections – if they do not professionals will and the market will reflect that price. D inaccuracy in a qualified looking forward statement does not become a fraudulent statement.

Q. If by December 1983 internal estimates were inconsistent with published estimates, why isn’t this a basis for liability? D claims that this estimate was still under review and thus not finalized – the rule is that new estimates that contradict older ones do not have to be revealed unless they are so correct that there is no other choice.

Q. How do you harmonize this analysis with Rule 175(d) “the term ‘fraudulent statement’ shall mean . . . an omission to state a material fact necessary to make a statement not misleading” i.e., the duty to correct? The court notes that Rule 175 was
designed to release companies from having to suspend operations when they realized that a error had been made in projections — w/o this Rule 175 is not much help.

Q. In Wielgos CE got away by the skin of its teeth. What would you advise it to do next time to avoid liability? A possible press release after the delay in plant authorization or to edit its projections to make them more indefinite.

Reg. S-K Item 10(b): Projections

Some forward looking statements are mandatory – see Management Discussion and Analysis Item 303(a). Item 10(b) in contrast, encourages, but does not require projections. Specifically Rule 175(c) provides a safe harbor for forward looking information about:

1. Revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure or other financial items.

2. Management plans and objectives for future operations.

3. A statement of management future economic performance contained in Item 303, MD & A.

4. Underlying assumptions to any of the above.

Regulation S-K Item 10(b) further explains: “Management, however, must have a reasonable basis for assessment of future performance.”

“Management should take care to assure that the choice of items projected is not susceptible of misleading inferences . . .”

See also Item 10(b)(3)(iii): “With respect to previously issued projections, registrants are reminded of their responsibility to make full and prompt disclosure of material facts, both favorable and unfavorable, regarding their financial condition.”

Rule 175(a) provides a safe harbor for a forward looking statement which is deemed not to be fraudulent “unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith.”
The most hotly contested provision in The 1995 Private Securities Reform Act was the new safe harbor for forward looking statements.

The Section 27A applies to a forward looking statement made by Sec. Act §27A, with several exceptions in §27A(b), by

1. an issuer that, at the time that the statement is made, is subject to the reporting requirements of section 13(a) or section 15(d) of the Securities Exchange Act of 1934;

2. a person acting on behalf of such issuer;

3. an outside reviewer retained by such issuer making a statement on behalf of such issuer; or

4. an underwriter, with respect to information provided by such issuer or information derived from information provided by the issuer.

There are three different types of safe harbor in §27A(c):

1. Securities Act §27(c)(1)(A) and Securities Exchange Act may immunize a deliberately false forward looking statement if the court concludes it was accompanied “by meaningful cautionary statements.” This is a codification of the bespeaks caution doctrine we will study on October 31.

2. The defendant is given a second safe harbor in Sec. Act §27A(c)(1)(B) if he or she cannot offer and prove sufficient meaningful cautionary statements because the plaintiff is still required to prove a higher culpability standard “actual knowledge” rather than the lower recklessness or negligence standard available today under the Securities Exchange Act §10(b) and Rule 14a-9. The culpability standards will be discussed on October 31 and November 12.

3. There is then a novel safe harbor for oral forward looking statements when appropriate reference is made to a readily available written document. Sec. Act §27A(c)(2).
Underlying the complex view new safe harbors is a simple, but as yet unproven belief: “Fear that inaccurate projections will trigger the filing of securities class action lawsuit has muzzled corporate management.” 1995-1996 Fed. Sec. L. Rep. (CCH) ¶85,710 at 87,208. Whether this belief is warranted – or whether corporate management is reluctant to publicly discuss projections for other reasons is an empirical question that time will answer.

THE DUTY OF LOYALTY

The state law duty of loyalty is the most important fiduciary duty of corporate officers and directors. This duty requires that officers and directors not profit at the expense of their corporation – this even applies to mergers of corporations with subsidiaries. Section 8 of the Clayton Act prohibits interlocks between competitors if either firm has $1 million in assets or profits. 19th century law allowed any transaction be voided at the insistence of corporation or shareholders.

Gries Sports Enter., Inc. v. Cleveland Browns Football Co., Inc.
26 Ohio St. 3d 15, 496 N.E. 2d 959 (1986)
Pp. 423-431

P is a minority shareholder that filed suit to prevent the Browns from buying a subsidiary company that was owned by Art Modell. Browns claimed the business judgment rule protection for their purchase and this was rejected by the trial court as it found for P. The appellate court overturned this decision and found for D as a majority of the Browns directors were “disinterested” and they voted to approve the merger. Because disinterested directors approved the merger, the court did not inquire into the fairness of the merger.

Q. Who is the plaintiff? P is a minority shareholder in the Cleveland Browns.


Q. What property did Modell cause to be sold to the Browns? 190 acres in Strongsville
Q. How much had Modell paid for Strongsville land? $800,000
Q. What did CSC pay for Strongsville land? 4 million

Q. At what price was CSC sold to the Browns? 6 million.

Q. How was the value determined? Modell commissioned a report on CSC that told of additional value if acquired by the Browns.

Q. How was the deal negotiated? Modell and Bailey (connected with both companies) and Poplar decided the price with no arms length negotiations or protections.

Q. Who normally has the burden to prove fairness in a duty of loyalty case? “When directors are on both sides of a transaction, they are required to demonstrate their utmost good faith and inherent fairness of the bargain.

Q. Was this an “interested” transaction? Yes, directors of the Browns stood to benefit from the buyout of CSC stock, so it was in their interest to use the Browns to buy their shares.

Q. Why was Berick “interested?” Berick was hired by Modell and under Delaware law was dominated and controlled by Modell.

Q. How did the trial court conclude that the $6 million price was unfair? The way that the price was determined and structured did not satisfy any concept of fairness.

Q. How could the defendants have carried their burden of proving a fair price? They would have had to redo the determinations of the price and had at least some bargaining….or had a majority of disinterested directors vote for the proposal.

“A transaction not given protection by the business judgement rule is subject to strict scrutiny and the directors have the burden of showing that the deal was fair.”

2. Safe Harbor Statutes
   Pp. 434-440
DGCL §§144(a) (1)-(2): If a transaction is approved by a majority of disinterested board members or shareholders, after full disclosure of material facts, the burden of persuasion is shifted back to the plaintiff to prove that an interested transaction was “unfair.” E.g., corporations regularly seek ratification of stock option and other compensation arrangements. If a court were to hold that these contracts were “interested,” the plaintiff’s burden would be to show that they were unfair. As the Note at pp. 439-440 suggests this can be an outcome determinative burden.

Marciano v. Nakash  
535 A. 2d 400 (Del. 1987)  
Pp. 435-439

A joint company had gone bad and the parties sued over the breakup – the Nakashes had loaned the joint company all the money that it was worth. Thus, in bankruptcy, the break-up of the joint company would not pay the Marciano’s anything.
I use this case simply to illustrate the relationship of DGCL §144 to the common law duty of loyalty.

The common law rule, as Marsh earlier informed us, see pp. 415-417, was that a contract or transaction was per se voidable when an interested transaction was initiated in the absence of shareholder ratification, or statutory or bylaw authorization. See p. 437 3d full par.

DGCL §144 significantly “ameliorated” the common law rule. See p. 438, 1st full par.

However DGCL §§144(a) (1)-(2) are not the exclusive ways to validate an interested transaction. P. 438 1st full par. If DGCL §§144(a) (1)-(2) are not available, and the plaintiff shows a conflict, defendants can still validate the contract if they carry the burden of proving fairness. See DGCL §144(a) (3); p. 438 2d & 3d full pars. This, in essence, was the test applied in the Gries case.

CLASS 11: September 26 - CORPORATE OPPORTUNITY DOCTRINE: Pp. 440-454; Handout 36-43

In Delaware the corporate opportunity doctrine traditionally has had three elements:

5. Same line of business as the corporation or a line in which the corporation has an interest or expectancy.

6. Presented to a corporate officer in a corporate rather than individual capacity.

7. Corporation was financially able to undertake.

Guth v. Loft
Pp. 440-442

In this case, Guth was chief executive officer of Loft, a manufacturer of candies. Guth decided not to continue to buy Coca-Cola syrup after an opportunity to
buy Pepsi Cola was offered to him. He personally bought shares in Pepsi and sold Pepsi syrup to Loft. HELD: Loft had an interest or expectancy in Pepsi. REMEDY: Constructive trust.

Q. Suppose Loft was a hardware firm. Could Guth keep Pepsi stock? It would seem not to cause these types of problems as syrup and hardware are not connected.

Q. Why permit a corporate executive to engage in a separate business at all? Directors and executives have other lives and can benefit from what the corporation decides not to do.

**Johnston v. Greene**
35 Del. Ch. 479, 121 A.2d 919 (1956)
Pp. 444-454

This case illustrates both the difficulty of precision in the interest or expectancy test and why that test, imprecise as it is, should be given greater weight than a concern whether the opportunity was presented in a corporate or personal capacity. In the buyout of another company, a president purchased the patents while his company purchased the stock – the court held that the president made the board not buy the patents and this was a breach of fiduciary duty.

**DIAGRAM OF FACTS**

- **Convair**
  - Odlum chairman of the board

- **Airfleets**
  - Odlum president

- **Atlas Corp.**

  Owns 18 percent of Airfleets

  Odlum owns 11 percent of Atlas

  Odlum president

Q. **What was the business purpose of Airfleets?** It was organized to finance aircraft that might be sold or leased to the airlines – it really just used it assets to benefit stockholders.
Q. Was an offer to buy Nutt-Shel stock and patents initially made to Odlum as president of Airfleets or in a personal capacity? Both of the sellers had never heard of Airfleets but they knew Odlum as a businessman in the field – fairly unclear – although they did know he was connected to a larger corporation.

Q. Suppose an offer to Odlum was made after he placed an ad in the Wall Street Journal on behalf of Airfleets, “seeking any and all new business investment opportunities, up to $2 million?” Then clearly the offer was made to Airfleets.

Q. Why did the court conclude that Airfleets had no expectancy in Nutt-Shel? There was no tie between the property and the nature of the business – they were in the same industry but that was about it.

Q. Why after Airfleets bought Nutt-Shel stock did it have an interest in the Nutt-Shel patents?

Q. What is the justification for not requiring Odlum to deliver the patents? Odlum never sought to profit from the patents – he might have done it to make the deal go through.

Q. Suppose Odlum put an ad in the Wall Street Journal – “seeking any and all new investments” and Odlum also worked for Convair, an airplane manufacturer. If an offer was made to buy a new airplane patent – to whom should it go? To Odlum if he paid for the ads – it must not have been offered to him in his capacity as a director.

Q. How could Odlum avoid this problem altogether? He could have let a disinterested board decide this issue and then pursued his options after that fact.

Northeast Harbor Golf Club, Inc. v. Harris
661 A.2d 1146 (Me. 1995)
Handout 36-43
The president of a golf course bought up parcels of land around the golf course and moved towards developing it for residential use. The board sued for breach of fiduciary duty and to act in the best interests of the corporation. The trial court found for the D as developing real estate was not in the club’s line of business, the club lacked the ability to purchase the land, and Harris had demonstrated good faith in the past.
Q. What corporate opportunity did Nancy Harris allegedly take? Harris bought up property surrounding the golf club when the board had discussed buying the property in the past to prevent its development.

Q. Did she disclose her intention to purchase the Gilpin property before the purchase? No

Q. How did the board learn about the Gilpin purchase? She told the board that the property was owned by her but that the club would be protected.

Q. What action did the board take in response to learning of the Gilpin purchase? None

Q. Why did John Schafer later take issue with Harris’s conduct? She represented to the board that she would not develop the property and the directors concluded that she was not acting in the best interests of the club.

Q. What finding did the trial court make with respect to the golf course’s ability to pay? The trial court felt that the club would have been unable to buy the property itself.

Q. Why was the Maine Supreme Court unpersuaded by the finding? The board had shown a capacity for fund raising in the past.

Q. The Maine court contrasts several alternative corporate opportunity tests. Why is its articulation of the Guth v. Loft “line of business” test narrower than the Delaware articulation of this test? The court emphasizes the “close association of business” part of the test as it applies them to the relevant facts.

Q. What is the Durfee v. Durfee & Canning “fairness test”? It bars personal action when the interests of the corporation could be harmed – an application of fair and equitable standards.

Q. Why does the Maine Supreme Court criticize this test? Provides little guidance to directors about what is forbidden and what is allowed.
Q. The Maine Supreme Court adopts the American Law Institute (ALI) test in § 5.05 of the Principles of Corporate Governance. How does this test define a corporate opportunity? Any opportunity to engage in an activity that the director learns about in connection with his duties or if offered to the corporation, or through the use of corporate info.

Q. How does this contrast with the Maine version of the Guth line of business test? The Maine version is just based on the presentation of information to the director.

Q. If a corporate opportunity is presented to a director or senior executive, what should the director or senior executive do if he or she wants the opportunity? He must pass it on to the board and let those disinterested members vote on the proposal.

CLASS 12: October 1 - EXECUTIVE COMPENSATION: Pp. 469-476; Handout 44-61

HYPOTHETICAL: You are a plaintiff’s attorney. A client of yours owns stock in MacroStrong.com (MS). In 2000, MS sales dropped 10 percent and profits dropped 30 percent. The corporate president, however, received a salary increase from $900,000 to $4,800,000. In addition, she exercised stock options issued in 1998 and made a capital gain of $4.1 million.

Q. Can this total salary be challenged as an interested transaction?

Q. Suppose this is an interested transaction. How could the MS president prove that the compensation was fair?

Q. Should it make any difference that $4.1 million of the total compensation of $8.9 million was in the form of stock options?

THE WASTE DOCTRINE
Now let us assume that the MS president could not be challenged for an interested transaction. She could be challenged under the waste doctrine.

Rogers v. Hill
289 U.S. 582 (1933)
Pp. 474-476

Q. How much was Hill paid in total remuneration in 1930? About 1.3 mil

Q. Under what circumstances will a court prevent the payment of a salary? If salaries are so high to constitute misuse and waste of the money of the corporation.

Q. Would Hill’s salary be subject to review if it had been unanimously approved by stockholders in 1912 after full disclosure of its terms?

Q. Could Hill justify the “gift” as necessary to motivate subordinate executives?

Q. How might Hill attempt to prove that his marginal productivity justifies his salary?

Q. Is it relevant in analyzing executive compensation that the earnings of the average C.E.O. were 35 times that of manufacturing workers in 1974 and 120 times in 1990?

Q. How do you determine the value of the services of an executive? Hill was considered the greatest tobacco executive in the country in the 1920s. Suppose in 1928 his contract expired. Hill has the choice of leaving and setting up his own firm or remaining with American Tobacco. If Hill demanded 2½ percent of American Tobacco’s net profits, under what circumstance could Tobacco directors pay this?

Q. Who has the burden of proving waste? The plaintiff has the burden of proving waste.

Brehm v. Eisner
746 A.2d 244
(Dec. 2000)
Issue: Are the directors personally liable to the corporation for lack of due care in the decision making process and for waste of corporate assets?

Mf: In 1995 Walt Disney Company Chairman and CEO Michael Eisner hired Michael Ovitz to be president of Disney.

Ovitz employment contract had a five year term and included four monetary components:

8. A base salary of $1 million per year;
9. A discretionary bonus;
10. Class A Options; and
11. Class B Options.

Q. What was the difference between Class A and B Options? The B options were conditioned on Ovitz having agreed to extend his contract beyond the five year terms and would terminate if Ovitz ended his employment for any reason.

Q. If Disney terminated Ovitz for “good cause” (gross negligence or malfeasance), what would Disney’s obligation to Ovitz be? Ovitz would get no additional compensation.

Q. If Disney chose not to extend Ovitz’ contract after five years, what would Disney’s obligation be? $10 million termination payment

Q. If Disney chose “non-fault” termination, what would Disney’s obligation be? His remaining salary payments until Sept. 2000, $10 mil severance package, 7.5 mil for each fiscal year remaining in the contract, and all the stock from Class A.

Q. Why did compensation expert Graef Crystal state that this compensation arrangement was “shocking”? The cost to fire Ovitz was so great over time.
Q. In December 1996 Ovitz agreed to leave Disney on a non-fault basis. What was his severance compensation? $38 million dollars and the Class A stock options.

Q. Why did the Delaware Supreme Court characterize this severance package as equal to the contract? That amount was contracted for by the parties.

Q. Why did the plaintiff allege waste? Experts stated that the amount was shocking and the board might have tried to fire him for N or misfeasance and would have avoided making the payment.

Q. In Delaware a derivative lawsuit can be dismissed before trial by disinterested members of a board. How does a plaintiff challenge a board vote to dismiss? The P must allege that the board did not make a disinterested decision – This is allowed to let the board figure out if the claim is in the corporation’s best interests.

Q. Why did plaintiff allege that a majority of the New Board was not independent? CEO-run

Q. Why did the Delaware Supreme Court reject this allegation? The CEO suffered from the settlement so there was no reason for him to approve it – Ps never proved enough to get into court.
Q. How does the Delaware Supreme Court define what it means for a board to be “reasonably informed?” The Board is responsible for all material facts that are reasonably available, not those that are immaterial or out of the Board’s reach.

Q. Why did the Delaware Supreme Court reject the Chancery Court finding at 55 with respect to reasonable information? The Chancery Court felt that the Ps alleged that the expert failed to bring all the necessary info to the board, but the Ps really meant that both the expert and board failed to consider this.

Q. Why did this rejection of the Chancery Court not lead to a reversal? The court viewed it as harmless error b/c the board relied on the expert and is protected by the business judgment rule.

Q. At 58 the Delaware Supreme Court concludes “that the size and structure of executive compensation are inherently matters of judgement.” Does this mean that Delaware does not recognize waste claims? They do but such claims are limited to unconscionable cases where directors irrationally squander or give away corporate assets.

CLASS 13: October 3 - SHAREHOLDER VOTING RIGHTS: Pp. 487-511; Rule 14a-8

VOTING

Corporate law has three primary techniques to deter corporate dysfunction:


Electoral rights are the weakest device to protect shareholders in the modern corporation. See data at pp. 487-488.
State corporate law today essentially is based on assumptions of nondemocratic restraints. Shareholders are protected (1) by laws against fraud and unfairness; (2) their ability to sell their shares in a stock market; and (3) by holding stock in portfolios.

Management is disciplined by: (1) Competitive markets; (2) capital markets; and (3) the stock price.

These nondemocratic assumptions long were reinforced by the rise of institutional investors with the Wall Street Rule.

Shareholder indifference can be characterized as “rational apathy.”

Nonetheless shareholder voting long has been the subject of some of the most intriguing theories in corporate law. These include:

1. Minority Representation: This theory is epitomized by the cumulative voting debate. There are two questions today:
   a. Is cumulative voting permissive (like DGCL §214) or mandatory?

   b. Does it coexist with classified boards (like DGCL §141(d)) or are classified boards prohibited? See pp. 490-491.

Cumulative voting is on the decline:

1870-1955: 23 states had mandatory standards.
1992: Only 6 states retain mandatory approach.

85 percent of all corporations do not use cumulative voting when it is discretionary.

Classification is permitted in states without mandatory cumulative voting - see, e.g., DGCL 141(d).

Cumulative voting when permissive may be dropped by a simple majority of shareholders. But see Coalition to Advocate Public Utility Representation v. Engel forbidding one corporation to drop permissive cumulative voting during a proxy contest. See p. 491.
15. **Consent of the Governed Theory:** Chayes, Dahl approach, see pp. 491-492.

Shareholder democracy is misconceived because shareholders are not the governed of the corporation whose consent must be sought. “They deserve the voiceless position in which the modern development has left them.”

“A more spacious conception of membership . . . would include all those having a relation of sufficient intimacy with the case or subject to its power in a sufficiently specialized way.” This is the most serious theory abroad. See discussion of German codetermination at 492.

This theory has not been successfully developed in the United States:
- Labor long unenthusiastic.
- Difficulty defining who the governed are.
- Chris Stone, *Where the Law Ends*, alternatively proposed public directors; e.g., Comsat.
- Nader’s constituency representatives is another alternative.
- At the moment worker ownership of a few large corporations is the most interesting development in this area.

3. **Contractarianism:** No specified norms. Adopt any vote patterns negotiated by shareholders and managers. Underlying this approach are several premises:

   A. Corporate elections are different than political elections.
   
   B. Votes should be subordinated to financial decisions of the corporation.
   
   C. Nexus of contracts theory - managers negotiate with labor and capital suppliers.
4. **Relational Investment.** Focus on institutions such as CalPERS. To date, this approach is highly episodic in nature. See pp. 494-495 for relevant data.

**Corporate Formalities**

Pp. 495-497

- **DGCL §211(b)** Annual meeting to elect directors.
- **DGCL §211(d)** Special meeting may be called by board.
- **DGCL §212(a)** Unless the certificate of incorporation provides otherwise, one common share, one vote.
- **DGCL §216** Majority quorum; majority quorum rules – but those can be altered by the certificate of incorporation.
- **DGCL §212(b)** Most votes are by proxy in a large publicly traded corporation. Proxies are good in Delaware up to three years.

**Proxy Election Expenses**

One reason so few corporate elections are contested is provided by the corporate election financing rules. See pp. 497-498.

**Rosenfeld v. Fairchild Engine & Airplane Corp.**

309 N.Y. 168, 128 N.E. 2d 291 (1955)

Pp. 499-508

Q. **Why did the plaintiff sue?** He seeks to compel the return of money given to reimburse both sides of a proxy dispute.

Q. **According to Judge Froessel, when may incumbents spend money in a proxy contest?** In a contest over policy, not personal power the directors can get reimbursement of reasonable and proper expenses.

Q. **When may the opposition be reimbursed?** By an affirmative vote of the shareholders the opposition could get reimbursed.
Q. Why allow incumbents to spend any money to defend themselves? Corporate business could be interfered with if the board was not able to answer challenges to their leadership and provide information to shareholders.

Q. Can a case be made that incumbent expenses are more like a fairness claim? That is, should directors have the burden to prove they were appropriate? Not really – the expenditures are likely part of being a director – the P should have the burden to show that the expenses were improper or were not for true company business.

Q. What expenses would Judge Von Voorhis permit? The incumbents must assume the burden of justifying and explaining those expenditures reasonably related to corporate affairs.

Q. Why does he reject the Delaware rule? That the distinction between people and policy is often too murky to deal with and accordingly courts must take things on face value from the directors.
Disenfranchisement

Tender offers during the 1980s inspired the New York Stock Exchange (NYSE) to propose abandoning its one common share, one vote policy.

In 1988, the SEC, rather than adopt the NYSE proposals adopted the former Rule 19c-4. In broad terms, this Rule prohibited a listed firm from adopting disparate voting rights by dent of amendments of its certificate of incorporation or dividends, but did not prohibit new firms or leveraged buyouts from creating two tier voting plans.

In 1990, Rule 19c-4 was vacated by the Business Roundtable v. SEC case as exceeding SEC authority. See p. 510. Nonetheless the substance of the former Rule continues to exist in Stock Exchange listing standards.

Securities Exchange Act Rule 14a-8

Rule 14a-8 is applicable only to covered corporations under §12 and Rule 12g-1 of the Securities Exchange Act (securities listed or a national securities exchange or traded in the over-the-counter market with 500 or more holders of a class of stock (“equity”) and $10 million in total assets). There are about 13,000 such corporations today.

Rule 14a-8 allows a shareholder to circulate a proposal for action on issues other than director nominations if the shareholder satisfies the eligibility requirements in Rule 14a-8(b), the number and length requirements in Rule 14-8(c)-(d) and is not excluded under Rule 14a-8(i). Focus in particular on the exclusions in Rule 14a-8(i) (1) (“improper under state law”), (4) (“personal grievance”), (5) (“relevance”), and (7) (“ordinary business operations”).
THE CLOSE CORPORATION

HEIGHTENED FIDUCIARY DUTIES

Close corporations ensure accountability through (1) Heightened Fiduciary Duties (2) Shareholder voting as an accountability mechanism is often nullified by a voting arrangement (3) Fraud enforcement under SEC 10b-5 – no mandatory disclosure under federal securities laws.

STOCK TRANSFER RESTRICTIONS

Under DGCL §341(a), the parties must elect to be a close corporation.

Under §342 there are three eligibility requirements:

1. Fewer than 30 shareholders.

2. Section 202 share restriction.

3. No public offering.

Under DGCL §202(a), a restriction must be noted conspicuously. DGCL §202(c) is the pivotal share restriction provision. An appropriate share provision will include:

- Prior opportunity to corporation, other holders or any other person to buy.
- An obligation to the corporation, other holders or other person to buy.
- A requirement that the corporation or other holders consent to transfer.
- A prohibition of a transfer to designated persons or classes of persons if such designation is not unreasonable.

DGCL §202(d) provides that any restriction to maintain Subchapter S status is conclusively reasonable.
The most difficult stock transfer restriction problem is how you define the value of shares now to be transferred at a future time. There are several alternative techniques, each of which has disadvantages. These include:

**Original price:** See *Allen v. Biltmore Tissue Corp.*, pp. 550-551. This usually will be worth less than the value of a successful close corporation’s stock.

**Book value:** Book value is based on original cost and may be considerably less than current fair market value. (both are easy to do) More sophisticated valuation techniques such as earnings value or capitalization of earnings, see pp. 551-552 or asset value, usually require an appraiser. On October 15 and 17, we will discuss the appraisal process for dissenters in mergers and other fundamental transactions. That discussion is relevant here.

CLOSE CORPORATION AND LIMITED LIABILITY COMPANIES

**VOTING AGREEMENTS**

A different issue that often requires analysis in a close corporation will be the preference of the founding patriarchs or matriarchs to concentrate voting control. Under current law, they have several choices available to them including the following:

Stock Pooling Agreements

Q. What was the defendant’s argument to nullify the agreement? That the right to vote can not be separated from the ownership of the stock except by an agreement that complies with a specific statute.

Q. Why could this agreement not comply with §218? Section 18 does not deal with agreements where shareholders bind each other for voting – it deals with vesting shares in a trustee for a limited time for voting purposes.

Q. Why not characterize this as an irrevocable proxy under DGCL §212(e)? The irrevocable proxy must be secured with an interest sufficient to balance the
bargain, thus it is of limited value to a dominant shareholder attempting to concentrate voting power. It also must state its irrevocability.

Cf. Note 1 at p. 567 for a more recent approach. A similar agreement was enforced with a buy/sell provision that transferred shares when the provision was not followed.

Voting Trusts

DGCL §218(a) The beneficial owner vests voting power in designated trustee. The agreement must be in writing. It must be filed in the Secretary of State’s office, and open for inspection.

§218(d) §218 does not invalidate other voting arrangements.

Previously DGCL §218 was limited to a 10 year term, which could only be extended during the last two years of the trust. This was a question begging restraint on alienation concept.

DEADLOCK AVOIDANCE AND DISSOLUTION

Kemp & Beatley, Inc.
Pp. 583-589

MF: Two stockholders owning 20.33 percent of the corporation’s stock were informed that they would not receive “extra compensation bonuses,” a “known incident to stock ownership in this firm” shortly before or after their employment ended. After this decision, bonuses were only paid to employees.

The plaintiffs brought suit to dissolve the firm under §1104(a) of N.Y. Bus. Corp. Act, which permits dissolution for “oppressive actions.”

Section 1104(a) is available to a stockholder owning 20 percent or more of a firm whose stock is not publicly traded.
Q. How did the court define oppressive conduct? When majority conduct substantially defeats expectations that objectively viewed, were both reasonable and were central to the P’s decision to join the venture.

Q. What was the plaintiffs’ reasonable expectation here? Ps expected de facto dividends based on stock ownership – more or less extra money.

Q. What was the remedy? They ordered dissolution subject to the purchase of Ps shares.

Q. What is the risk that the plaintiffs will use this as a “coercive tool?” The remedy is only available when the P can make a claim that his reasonable beliefs were unmet and if the P can not prove this then no remedy.

Q. Doesn’t this type of stock subvert the purpose of DGCL §218?
CLOSE CORPORATIONS AND LIMITED LIABILITY COMPANIES
STATUTORY COMPARISONS

<table>
<thead>
<tr>
<th></th>
<th>Delaware Close Corporation</th>
<th>Limited Liability Company</th>
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<tbody>
<tr>
<td><strong>Formation</strong></td>
<td>Elective: DGCL §341(a)</td>
<td>Elective: ULLC §103(a)</td>
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<tr>
<td><strong>Eligibility</strong></td>
<td>DGCL §342:</td>
<td>ULLC §103(b):</td>
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<tr>
<td><strong>Requirements</strong></td>
<td>1. Fewer than 30 shareholders</td>
<td>Restrictions or operating</td>
</tr>
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<td></td>
<td>2. DGCL §202 share restriction</td>
<td>agreement</td>
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<td></td>
<td>3. No public offering</td>
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<tr>
<td><strong>Management</strong></td>
<td>1. DGCL §351: Without</td>
<td>ULLC §203(b)-(c)</td>
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<td></td>
<td>directors</td>
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<td></td>
<td>2. DGCL §350: Restriction of directors</td>
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<td>3. DGCL §354: Operating as a partnership</td>
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<td><strong>Special Remedies</strong></td>
<td>1. Custodian: DGCL §352</td>
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<td>2. Provisional director DGCL §353</td>
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<td></td>
<td>3. Shareholders option to dissolve corporation DGCL §355</td>
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Q. Given this pattern, why is the limited liability generally preferred today to the close corporation?

Cf. Handout 1-8

MERGER LAW

19th century law required a merger to have a supermajority votes and provided an appraisal remedy to protect dissenters. The appraisal remedy may have, in part,
been necessary because of the general lack of stock markets to facilitate exit. In the 20th century, public company shareholders are able to sell shares in a stock market and the availability of the appraisal remedy has been reduced. The high vote requirements generally have been eliminated.

**Definition of appraisal remedy** – When a corporation combines with another so as to lose its essential nature and alter the original fundamental relationships of the shareholders among themselves and to the corporation, a shareholder who does not wish to continue his membership therein may treat his membership in the original corporation as terminated and have the value of his shares paid to him.

**DELAWARE MERGER LAW**

DGCL §251 — General Rule:

1. Majority vote by shareholders in both firms can cause merger. DGCL §251(b).

2. Unhappy Shareholders have appraisal rights under DGCL §262.

There are several exceptions:

1. DGCL §251(f) — unless required by its certificate — no vote of the surviving firm is needed if:
   
   a. the merger does not change the certificate of the buyer.
   b. Identical stock after merger
   c. No more than 20 percent of common stock employed. No appraisal right often for survivor’s shareholders. See DGCL §262(b)(1).

2. DGCL §253: Merger of Parent Co. and Subsidiaries
   
   a. No vote of either surviving parent or subsidiary shareholders.
   b. No appraisal rights for parent when parent owns 90 percent or more of subsidiary.

3. DGCL §262(b)(1) No appraisal if the firm’s shares are listed on a national security exchange or held by 2,000 or more shareholders.
4. DGCL §271 sale of assets:
   a. There is a vote if a sale or lease of all or substantially all assets, but the shareholders get no appraisal.

   It is worth emphasizing that Delaware, virtually alone, neither allows an appraisal for sales of assets nor allows the de facto merger doctrine. See pp. 1066-1067.

5. Triangular mergers. See pp. 1067-1068. Parent Co (P) merges a subsidiary (S) with another Co. (T). The stockholders of P do not have the right to vote on the merger or get appraisal.


THE APPRAISAL REMEDY
Pp. 1069-1073

In the traditional Delaware block approach, the object is to give the shareholders the value of the stock at the moment before the merger, the so-called “going concern” value. All factors and elements which reasonably might enter into the fixing of value must be taken into account. These typically include:

(1) Market value  
(2) Asset value  
(3) Dividends  
(4) Earnings value  
(5) “Any other facts which throw light on future prospects of the firm that was merged.”

Why so complicated a formula? This avoids undue reliance on market value and recognizes that each factor may be somewhat speculative.

Delaware case law has further established:

(1) Market value was never given more than 50 percent weight in appraisal and could be reconstructed.
(2) Asset value typically follows generally accepted accounting principles and is not based on book value, but rather a current appraisal.

(3) Dividends are only significant when not paid. “Substantial negative dividend recognition” is then recognized.

(4) Earnings value involves averaging the last five years earnings then multiplying by a multiplier. This could be fewer than five years if there were unusual years.

The multiplier was meant to equal the price to earnings ratio in the relevant industry. Today this typically is done by studying similar firms.
The traditional Delaware block approach has been criticized:

1. It is highly subjective. The trial court discretion in assigning weights is typically decisive, but rarely explained in a way that can be followed in subsequent cases.
2. The approach reflects hostility to market value in appraisals, but at the same time creates a stock market exception.
3. There is no explicit requirement that assets be revalued, although this is usually done.
4. The remedy is technically difficult to commence. See DGCL §262(d). There must be (1) written demand before merger vote; and (2) vote against the merger or abstention.
5. The costs of an appraisal are uncertain. The court has discretion concerning interest. See DGCL §262(i) (j)
6. Brudney & Chirelstein add that the appraisal formula ignores synergical value in an interested merger because DGCL §262 provides for “fair value exclusive of any element of value arising from accomplishment of the merger.”

“fair value is to be determined on the basis of what a reasonable and objective observer would consider to be a price that reflects the intrinsic value of the right of stock ownership – without subjective processes or special benefits.”

INTERESTED MERGERS: Pp. 1096-1115, 1120-1132

Weinberger v. UOP, Inc.
Pp. 1097-1115

Q. How did the Court change methods for proving fair price? They opened the valuation proceedings up to all relevant factors involving the value of the company – a move away from the rigid percent values of block valuation.

Q. Why did the Delaware Supreme Court overrule the Singer v. Magnavox business purpose test? It was no longer needed as the fairness test, expanded appraisal remedy, and the broad discretion of the Chancellor to fashion relief filled in for the protection of the business purpose test. Business purpose was intended to protect shareholders from a going private transaction where they would be
forced to accept cash. Thus, a going private transaction stock for cash would only be allowed when there was a business purpose.

Q. **Is the new expanded form of appraisal the exclusive remedy for a dissenter opposed to a merger?** No, the chancellor has the exclusive power to award relief if cases of fraud or waste are involved. But failing that – expanded appraisal seems to be the solution.

To summarize **Weinberger**, there are five principal holdings;

1. The case reaffirms the familiar duty of loyalty burden of persuasion rules. The plaintiff always has the burden of showing a conflict. If the plaintiff does so the burden will be on the defendant to prove fairness, unless the transaction has been approved by an informed vote of a majority of the disinterested stockholders, in which case the plaintiff must prove unfairness.

2. Fairness is defined to include both fair dealing and fair price. The discussion of fair dealing is significantly more detailed and precise than in other earlier leading Delaware cases.

3. The appraisal remedy was broadened.

4. The business purpose test was dropped in Delaware. Other states continue to apply this test.

5. A merger can now be enjoined on a series of grounds (notably fraud, duty of loyalty violations, and waste). Courts will be attentive when a P alleges fraud, misrepresentation, etc. b/c they can use this to stop the merger.

**TENDER OFFERS: Pp. 1133-1142, 1180-1206**

**STATE CORPORATE LAW**

_Cheff v. Mathes_
Issue: Did D satisfy the burden of proof of showing reasonable grounds to believe a danger to corporate policy and effectiveness existed by the presence of Maremount stock ownership.

- Directors satisfy their burden by showing good faith and reasonable investigation – equivalent to the showings required under the business judgment rule. Still must show a threat to the company’s existence. The threat analysis drives a wedge between the interests of the shareholders and their corporation – a premium on the shares is good for the shareholders but bad for the board, so there is a conflict compared with Dodge v. Ford – “company exists for the benefit of its shareholders.”

Q. Under what circumstance may a corporation repurchase its shares and retain control? When the board based upon direct investigation, receipt of professional advice, and personal observations of the buyer determines that there was a reasonable threat to the continued existence of the company or its existence in its present form.

Q. Who has the burden of proving whether a purchase is for perpetuating control or is for a justifiable reason? The board must show good faith and reasonable investigation – the directors will not be penalized for a reasonable honest mistake. Similar to the business judgment rule

Q. Why is the defendant’s burden similar to that in a duty of care case? Similar to the business judgment rule

Q. Why is an exception to the normal business judgement rule justified in takeover cases? There is a conflict of interest in that the directors might be biased by a desire to keep their jobs and control, so you have to modify the standards to account for the bias.

The practical effect of this case is to supplant shareholder ownership with its voting power with a managerial defense that prevented either a tender offer or a proxy context. See Note 3, at pp. 1191-1192. The key limit in Cheff was that an instantaneous rejection of an offer without any investigation will not suffice. Cf. Condec, at p. 1191.

Unocal Corp. v. Mesa Petroleum Corp.
Q. (1) The Study described at pp. 1199-1200 n.11 may be misleading, since it does not adjust results for stock market price movements. E.g., if a corporation’s stock traded at $25, and the corporation declined an offer at $40 (when the relevant index was 1,000), the fact that the stock later traded at $45 (when the index was 2,000) would not be persuasive proof of management’s wisdom in rejecting the tender offer, but rather of a general market movement.


TENDER OFFERS

Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.

Pp. 1206-1219
The board had rejected the initial tender offer as the price was too low, financed with junk bonds. The board acted in good faith on an informed basis and they found a threat to the corporate enterprise. When they entered into negotiations with another bidder, the obligations of the board changed – they now only had to get the best price for the shareholders. Nothing in the takeover process can interfere with the interests of the shareholders. The impact of other constituencies loses importance once a company is being sold.

Paramount Communications, Inc. v. QVC Network, Inc.

637 A.2d 34 (1994)
Pp. 1240-1260

Material Facts:

In 1993 Paramount and Viacom negotiated a merger. Each Paramount share would be converted into Viacom securities and $9.10 cash.

Q. Were there additional terms? Viacom got a no-shop provision (not allowed to seek other bidders), the termination fee (Viacom got $100 mil if Paramount’s end
of the merger fell through), and stock option agreement (If the merger did not work Viacom got to buy Paramount shares at a fixed price without having to pay cash) all of this was to discourage Paramount from merging with someone else.

Q. What offer did QVC make in response? $80 a share -- $30 in cash and the rest in QVC stock.

Q. Why did Viacom urge that Paramount did not have an unlimited power to negotiate with QVC? Viacom felt that the K provisions in its buyout prevented Paramount from negotiating a new deal with QVC – Paramount could listen to bids but it could not solicit them.

Q. On October 24, 1993, Paramount amended its original bid with Viacom. How? Viacom voluntarily restructured its bid to remain competitive with QVC, but the Paramount board never tried to redo the restrictive provisions.

Q. After QVC raised its offer to $90 per share, what did Paramount do? The VP of Paramount passed around a memo about the QVC offer that discussed its “conditions and uncertainties.” The Paramount board voted against the QVC proposal.

Q. Is this a Revlon case? Yes

Q. When is Revlon triggered? Enhanced scrutiny and the director’s obligation to seek the best value reasonably available for the stockholders where there is a pending sale of control – regardless of whether or not there is to be a break-up of the corporation.


Q. What is target board duty when Revlon is triggered? “When a corp undertakes a transaction which will cause (a) a change in corporate control or (b) a breakup of the corporate entity then the directors are obligated to seek the best value reasonably available to the shareholders.

Q. How can this be done? They can not act with preference to any bidder or enter into Ks that infringe upon shareholder’s rights.
Q. Will a target board be judged under the business judgment rule? No they are applied to enhanced judicial scrutiny to insure reasonableness when (a) a sale transaction is approved or (b) the adoption of defensive measures in response to the threat of corporate control.

Q. Under enhanced judicial scrutiny, were the no shop, termination, and stock option provisions lawful? No it inhibited the ability of other companies to bid on Paramount and when they had a chance to redo them they failed to.

Q. Were these provisions vested rights? Viacom claims that but a board is unable to act in a way that breaches its fiduciary duty to its shareholders – they provisions were in excess of the reasonableness that they are subjected to.

Q. Did the court implicitly analyze the issues under Unocal? Yes, the standard of reasonableness is defined by the Court upon litigation – and the considerations of other parties is not implicated when the company is earmarked for sale.
IMPLIED CAUSE OF ACTION

Basic questions are whether a particular statement or omission is false and misleading and whether the statement or omission is false and misleading and whether the statement or omission is material. Proof of a false/misleading statement or omission and materiality are two separate elements of proof.

*J.I. Case Co. v. Borak*
377 U.S. 426 (1964)
Pp. 785-789

Q. Does §14(a) of the Securities Exchange Act explicitly authorize private rights of action? It appears clear that there is a right of action – but the parties can not agree on what entitles a P to do and what relief is available.

Q. Why did the Supreme Court imply a private right of action in the *Borak* case? It feels that there was a Congressional intent to insure fair corporate suffrage should be afforded to every security. The investor can easily be damaged in such transactions by the misleading proxy statements.

Q. Why not limit the implied right to prospective relief? The investors would then have to turn to state law suits – if no state law existed, then no redress. Also state law might require Ps to pay for the suit and this might prevent relief.

CAUSATION

*Mills v. Electric Auto-Lite Co.*
396 U.S. 375 (1970)
Pp. 791-796

Materiality – is an objective test – involving the significance of an omitted/misrepresented fact to a reasonable investor.

Q. What was the alleged proxy omission here? The buyer failed to disclose in the proxy statement that it owned a large percentage of the sold stock and had appointed several members of the board of directors.
Q. What was the defense? While that might have been a material omission, the Ds argue that the merger was fair so Ps are unable to show causation – that the omission caused a detriment to shareholders or that the omission related to the terms of the transaction.

Q. Why did the Supreme Court reverse? The statute provides that the material omission/statement must have a significant propensity to affect the voting process, so the Ct of Appeals requirement that the defect have an effect on voting is not needed. All the P need show is that proxies necessary to approval were obtained by materially misleading solicitation – this does not address what relief they get.

MATERIALITY

The same law of materiality applies to Rule 14a-9 and Rule 10b-5 and indeed generally in federal securities law.

The Basic Standard

TSC Indus., Inc. v. Northway, Inc

426 U.S. 438 (1976)

Pp. 801-807

Q. Describe National’s relationship to TSC Industries. TSC had bought 34% of National and appointed several board members.

Q. What transaction precipitated Northway’s lawsuit? The TSC board (w/o the National members voting) decided to sell all of its assets to National. Northway brought suit stating that the proxy failed to mention that TSC owned 34% of National.

Q. How did the Court of Appeals define when a fact is material? Materiality was all facts that a reasonable shareholder might consider important.

Q. Why did the Supreme Court criticize this test? It is too low a bar to set liability at – different than two circuits “would a reasonable investor attach importance to the omitted fact/misrepresentation?”
Q. What test did the Supreme Court adopt? An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote – something that would significantly alter the “total mix” of info.

Q. Why not require a material fact to be one which would change the vote? That could result in info that does more harm than good – as buyers blitz sellers with info – this does not help smart decisionmaking.

Q. What facts concerning control of TSC by National were omitted that the Court of Appeals judged to be material? The proxy failed to state the dual allegiances of the TSC and National directors and that in SEC filings both companies had reported that TSC could be called a subsidiary of National.

Q. Why did the Supreme Court not hold these omissions material? As for the directors, it is impossible to say that such info was so important that reasonable minds could not differ as to materiality. As for the subsidiary, there is no evidence that such info with accompanying disclaimers would have influenced a reasonable investor.

Q. Suppose there had been no identification of Yarmuth and Simonelli at all? That could very well be material as the current proxy statement showed that both men had some connection to both companies.

Contingent Events

Basic Inc. v. Levinson
Pp. 810-817
MF: In September 1976, Combustion representatives met with Basic’s officers and directors to discuss a merger. On September 25, October 21, and November 6, Basic three times denied that it was engaged in merger negotiations. On December 20, a merger with Combustion was announced.

The Supreme Court explicitly adopted the *TSC* standard of materiality for Rule 10b-5 cases.

Q. Why doesn’t the Court adopt an “agreement-in-principle” test for materiality of premerger negotiations? It fails to inform investors of facts that are reasonably necessary to investment decisions – the denial makes the info material.

Q. Will a corporation always be liable if it falsely denies merger negotiations? No, if the offer is impossible to occur based on the facts surrounding the transaction the corporation does not have to report it.

Q. How will lower courts know if merger negotiations are material? It is a balancing test between the “indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.”

Q. The magnitude of a merger will always be large for the target of an offer - e.g., average 50 percent premium. How can one determine if the probability of an event occurring is small? The court will have to assess the size of corporate entities and the potential to offer a premiums.

Q. What can a corporation do to avoid liability if it does not wish to disclose merger negotiations? Silence or no comments absent a duty to disclose is not actionable – the court leaves companies and congress free to draft ways to comply with its rules.

Q. At p. 812 n.9: The Court states it will not address earnings projections. Suppose a corporation had an earnings projection indicating a 50 percent rise in next year’s profits. Could the plaintiff argue it was required to disclose this data by analogy to *Basic*? Possibly but the logic in Basic seems centered on the large change that a merger allows – the biggest event for a company. All companies have earnings estimates and the need to know them by investors does not seem as high.
MATERIALITY CONTINUED

Reasons, Opinions, or Beliefs

Virginia Bankshares, Inc. v. Sandberg
501 U.S. 1083 (1991)
Pp. 819-827

MF: VBI owned 85 percent of FABI; 15 percent was owned by 2,000 minority shareholders.

In recommending a merger, the FABI directors stated that the price offered per share was “high” and “fair.”

The case makes one clear holding: Statements of reasons, opinion, or belief can be misrepresented and material.

Q. Why would a statement from a board that a price was “high” or “fair” be material to investors? Under TSC Industries a fact is material if “there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.” A statement of belief by the directors clearly meets that standard even if it the statement of an opinion. Shareholders might even rely on directors b/c of the duty to perform in the shareholders best interests.

Q. Would an executive’s off-the-cuff remark in response to a journalist’s question that “sales of our new product will go through the roof” similarly be viewed as material to investors? It might be considered by some investors to be material to their decision to invest and this type of remark should be able to be investigated by corporate evidence so the situation is a little different.

Q. Why does the Supreme Court hold that a director’s disbelief or undisclosed belief standing alone is not actionable? Liability based on disbelief or undisclosed belief would subject litigation to the secrets of a director and would open courts to
litigation based on Ps theories and not facts. You must have disbelief coupled with false/misleading proxy statements.

At pp. 825-827, the court explores half truths. “If it would take a financial analyst to spot the tension between a [misleading statement] and [one that is not so] whatever is misleading will remain materially so, and liability should follow.” P. 826.

NOTE: THE “BESPEAKS CAUTION” DOCTRINE
Pp. 827-834

Cf. the above statement in Virginia Bankshares with the bespeaks caution doctrine. Under the doctrine, see especially pp. 831-833, a false statement is not considered material, if it is accompanied by cautionary language in the relevant corporate document.

The Donald J. Trump case contains two important doctrinal limitations: (1) the bespeaks caution doctrine is limited to forward looking statements; and (2) vague or boilerplate disclosures do not suffice to mitigate the effect of a false statement. See p. 833.


INSIDER TRADING

SHOULD TRADING ON THE BASIS OF MATERIAL NONPUBLIC INFORMATION BE ILLEGAL?
Pp. 837-847

16. Arguments in Favor of Regulation.

1. Equity

Congress consistently has emphasized equity or fairness arguments in enacting insider trading legislation. That is, all investors should have equal (or roughly equal) access to new material information. See, e.g.:
1. S. Rep. No. 792, 73d Cong., 2d Sess. 21 (1934): “The express purpose of this provision [§16(b)] is to prevent the unfair use of inside information.” See also H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934) addressing §16(b) in a Section entitled, “Control of Unfair Practices by Corporate Insiders” and stating “Men charged with the administration of other people’s money must not use inside information for their own advantage.”

2. H. R. Rep. No. 98-355, 98th Cong., 1st Sess. 5 (1983): “The abuse of informational advantages that other investors cannot hope to overcome through their own efforts is unfair and inconsistent with the investing public’s legitimate expectation of honest and fair securities markets where all participants play by the same rules.”


   The inability of a public investor with whom an insider transacts on inside information ever lawfully to erode the insider’s informational advantage generates a sense of unfairness . . . The unfairness is not a function merely of possessing more information — outsiders may possess more information than other outsiders by reason of their diligence or zeal — but of the fact that it is an advantage which cannot be competed away since it depends upon a lawful privilege to which [other investors] cannot acquire access.

4. Equity arguments implicitly are based on “public confidence” or “integrity of the market” theory: More investors will invest in a market without legal insider trading than in one with legal insider trading. This theory assumes investors are risk averse and prefer a “fair” game.

B. Allocative Efficiency

2. This approach, however, logically does not reach corporate insiders who typically need no incentive to search for “inside information.”

3. Allocative efficiency is normally better achieved through a mandatory disclosure system. To allow an insider to trade on inside information creates moral hazard problems:


   b. Manipulation of information. E.g., an insider will attempt to accentuate stock price volatility by misleading or embellished statements.

   c. Subvert duty of loyalty by creating opportunities to profit from adverse corporate events. See, e.g., §16 of Sec. Ex. Act; Scott, Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy, 9 J. Legal Stud. 801, 815-816 (1980) (37 percent of nondisclosed information was negative in first 183 court and SEC decisions).

   d. Managers might adopt riskier business ventures on the logic that regardless of whether a project succeeds or fails is less significant since they can trade before news of the outcome of the venture is made public. See, e.g., Haft, The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation, 81 Mich. L. Rev. 1051 (1982). More plausibly, they may seek riskier projects to increase the volatility of the corporation’s stock price.

C. Property Rights


2. 3 W. Fletcher, Cyclopedia of Law of Private Corporation §857.1 (rev. ed. 1986): “Confidential information acquired or compiled by a corporation in the course and conduct of its business is a species of property to which the corporation has the exclusive right and benefit, and which a court of equity will protect through the injunctive process or other appropriate remedy.”

2. Arguments Against Regulation

2. Compensation to Insiders


1. But other forms of contingent remuneration equally compensate insiders. E.g., Stock options.

2. Insider trading permits a mismatch. An insider can profit from unsuccessful innovation. Stock options better align rewards to the value of insider contributions.

3. Trading could not be limited to entrepreneurs unless a corporation assumed a substantial investigative and enforcement burden. See R. Clark, Corporate Law 277-280 (1986).

3. Stock Price Smoothing
1. It is unclear insider trading will have a significant or long lasting impact on stock prices in the way that new information about a firm would.

2. Can new information be inferred or “decoded” from insider trades? See Gilson & Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 629-634 (1984). This is doubtful, but if it were true, insiders likely would behave strategically and trade over longer periods of time and/or through more intermediaries. This would frustrate the allocative efficiency goal.

4. Private Ordering

If insider trading is so bad, why don’t corporations themselves prohibit it?

   1. Portfolio theory mitigates against shareholder concern with individual firms.


BEFORE THE SECURITIES EXCHANGE ACT OF 1934

Anything goes.

SECTION 16(b) OF THE SECURITIES EXCHANGE ACT

Section 16(b) provides in relevant part: “Any profit realized [by any beneficial owner of 10 percent or more of any class of equity stock in a firm registered under the 1934 Act, director or officer], from any purchase and sale or any sale and purchase within any period less than six months . . . shall be recoverable by the issuer, irrespective of . . . intention . . .”
This is the original insider trading Section in the Securities Exchange Act. There are five basic elements. Any profit realized by (1) 10 percent + beneficial owners, officer, or director from (2) any purchase and sale or any sale and purchase of any equity stock (3) within any period less than six months (4) shall be recoverable by the issuer (5) irrespective of the insider’s intention.

Scope: The provision only applies to corporations subject to §12 of the Securities Exchange Act. That is, those listed on national securities exchanges, and §12(g) corporations — e.g., 500 or more holders of an equity security and $10 million or more in total assets.

Insiders: Key problem: A beneficial owner must own 10 percent + both at the time of purchase and of sale. E. g., If you own nothing, then buy 11 percent, then sell all 11 percent within six months, there is no liability. But if you own 10 percent, then buy 5 percent and sell it within six months, there is liability on the 5 percent.

Section 16(b) only covers equity (stock) and securities convertible into equity such as options or convertible debt.

Section 16(b) is an in terrorem rule. The plaintiff need not prove that the insider acted while in possession of inside information.

Section 16(b) is enforced through §16(a) reports.

The Section is cordially disliked because of its reporting requirements and absence of scienter requirement. Efforts to repeal §16 have failed. The Section has endured because it discourages insiders from taking advantage of inside information.

**Kern County Land Co. v. Occidental Petroleum Corp.**

411 U.S. 582 (1973)

Pp. 873-882

This case is the leading illustration of the most important interpretative issue that has been raised by §16(b).
Issue: Is 16(b) implicated when a company’s tender offer fails and the ultimate purchaser of the company offers the original buyer a plan to remove itself from the deal?

Q. When did Occidental first secure 10 percent ownership of Kern County Land Company? By May 10 1967 from a tender offer Occidental got 500K. By June it owned 887, 549 shares.

Q. How many additional shares did Occidental buy?

Q. What did Kern do to frustrate Occidental’s takeover attempt? Kern tried to discourage the merger with the proxy and entered into an agreement with Tenneco for $105/share offer.

Q. How did Occidental protect itself from being locked in as a minority holder in Tenneco? They first sued but then compromised with Tenneco to sell them the Tenneco shares they would get at $105/share secured by an option agreement. The money forwarded for the option agreement got applied to the amount due.

Q. Why did the Supreme Court majority characterize this as an unorthodox transaction? It was not a transaction that opened itself up to the types of abuse that the statute was created to prevent. There was no possibility of abuse of inside info and the transaction was involuntary, 16(b) does not apply.

Q. A literal or objective approach to §16(b) would be to mechanistically apply the provision to all transactions within its scope. Why does the Court take a pragmatic approach and not include unorthodox transactions? Economic reasons – no real need to force companies to abide by a law that was never intended to apply to their situation.

Q. What precise legal question does this case resolve? It does not really resolve one – it just suggest that 16(b) does not apply to all transactions – you have to look for abuse of inside info or an attempt at speculative abuse.

Q. Why did the Court rule that there was no sale by Occidental of its shares in Kern on August 30, 1967 when the Kern-Tenneco merger was signed? The court says that there was no sale b/c Occidental lacked access to inside info and it never had an opportunity to reap speculative benefits.
Q. Doesn’t this suit reward a shrewd market operator? Occidental knew it would either buy Kern or sell-out at a profit to a third party. Shouldn’t “objective” enforcement of §16(b) prevent this? Yes, but the court finds an exception by looking at the purposes of the statute.

Q. If the merger of Kern-Tenneco resulted in Occidental “involuntary exchange” of Kern stock, why isn’t an option to Tenneco within six months a sale? The option was negotiated without inside info and lacked the meaning of sale as 16(b) uses it.

Feder v. Martin Marietta Corp.
405 F.2d 260 (2d Cir. 1969)
Pp. 886-891

A second §16(b) interpretative question is explored in this case.
MATERIAL FACTS: Bunker, Chief Executive Officer of Martin Marietta was a director of Sperry Rand from April 29, 1963 until August 1, 1963.

Between December 14, 1962 and July 24, 1963, Martin Marietta bought 801,300 shares of Sperry stock, of which 101,300 share were bought while Bunker was a Sperry director.

Between August 29, 1963 and September 6, 1963, Martin Marietta sold all of its Sperry stock.

Q. How can Martin Marietta be liable for these purchases and sales of Sperry stock?

Q. Why did the court conclude that Martin Marietta was the equivalent to a director of Sperry?

Q. Why did the Supreme Court not hold that a Lehman Brothers partner was deputed in Blau v. Lehman?

CLASS 23: November 7 - RULE 10b-5: Rule 10b-5, Pp. 894-915; Sec. Ex. Act §21A; Rule 10b5-1

Rule 10b-5 is the general antifraud Rule in the Securities Exchange Act.

The Rule normally applies to any person and is broader in scope than §16(b) which is limited to officers, directors, and 10 percent + beneficial owners.

The Rule also applies to any single purchase or sale — unlike §16(b) which is limited to an insider of corporations subject to the Securities Exchange Act who engages both in a purchase and sale within six months.

THE DISCLOSURE OR ABSTAIN RULE

SEC v. Texas Gulf Sulphur Co.
401 F.2d 833 (2d Cir. 1968)
Pp. 896-912
**MATERIAL FACTS:**

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Alleged Violation</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/29-10/30/63</td>
<td>Initial Ground Survey</td>
<td>1. Defendants who purchased stock or calls between 11/12/63-3/31/64.</td>
</tr>
<tr>
<td>11/8-11/12/63</td>
<td>Initial Drill, K-55-1 and Holyk visual estimate</td>
<td>2. Their “tippees”</td>
</tr>
<tr>
<td>early December</td>
<td>Chemical assay in Utah, “remarkable” results.</td>
<td>3. Officers accepting options on 2/20/64.</td>
</tr>
<tr>
<td>11/12/63-3/27/64</td>
<td>Land acquisition.</td>
<td></td>
</tr>
<tr>
<td>3/31</td>
<td>Drilling resumed.</td>
<td></td>
</tr>
<tr>
<td>4/13</td>
<td>Canadian journalist visits drill site; prepares article confirming 10 million ton ore strike.</td>
<td>5. Crawford purchases on 4/15 at 12 a.m. and on 4/16 at 8:30 a.m.</td>
</tr>
<tr>
<td>4/16</td>
<td>Canadian article published.</td>
<td>6. Coates order to buy at 10:20 a.m., 4/16.</td>
</tr>
<tr>
<td></td>
<td>9:40 a.m. Canadian official announcement.</td>
<td>7. Corporation and certain officers before 4/12 press release.</td>
</tr>
<tr>
<td></td>
<td>10:00-10:15 a.m. American press briefed.</td>
<td></td>
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<tr>
<td></td>
<td>10:29 a.m. Merrill Lynch wire carries story.</td>
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<tr>
<td></td>
<td>10:54 a.m. Dow Jones ticker</td>
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tape carries story.

Q. Why did the SEC sue Texas Gulf Sulphur [TGS]? They sued under 10(b)(5) to compel rescission of the Ds securities transactions.

Q. What did the TGS case define as the purpose of the Rule? The rule is to preserve the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information.

Q. How did the court deal with the fear expressed in Goodwin v. Agassiz that good persons will not serve on the board? There are limits – an insider has this duty to disclose on in extraordinary situations that are reasonably certain to have an effect on market price. An insider also does not have to give outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions.

Q. Is it possible to ensure “relatively equal access to material information”? You just have to disclose all basic facts so outsiders can draw their own conclusions. The test for materiality is a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity and if material the failure to disclose those facts.

Q. Must all material information be immediately disclosed? The timing of disclosure is a matter for the business judgment of the corporate officers within the disclosure requirements of the SEC.

Rule 10b-5 is not the only Rule that requires disclosure of material nonpublic information. See Notes and Comments at pp. 912-915: (1) A corporation usually will be required to disclose material information when it sells new securities to the public or complies with the periodic disclosure requirements of the mandatory disclosure system; (2) there is a Rule 10b-5 duty to correct or update prior material statements, see pp. 912-914; and (3) the securities exchanges encourage, but do not require, disclosure of important news developments. See pp. 914-915.
Q. The same materiality standards we have earlier seen in TSC v. Northway, pp. 801-807, and Basic v. Levinson, pp. 810-817, apply to insider trading. But consider the sentence at p. 903: “Nor is an insider obligated to confer upon outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions.” This is similar to the holding in Virginia Bankshares, pp. 819-827, see especially p. 825 about directors’ undisclosed belief or motivation. Unresolved are cases which involve both an insider’s perceptions and more objective facts.

May an insider trade if he or she reasonably believes that the genius CEO has (a) a terminal illness; or (b) a drug or alcohol addiction? Doubtful – the information is not gained through any special expertise of the insider just his position in the company – not much different than reading an internal report.

Q. In TGS what evidence led the court to conclude that all persons knowing of Timmins mining activity after November 1963 possessed material inside information? The insiders at this point were not trading on an equal footing. The core sample while not as accurate as later tests provided the insider with enough info to know that the site was going to very profitable.

Q. Why were Crawford and Coates not dismissed from the case? They were dismissed when the court found their orders were shortly after news about the findings had circulated. This court held that an insider must wait until information has become widely known to the general public.

Q. When could they permissibly act? Before insiders may act upon material information such info must have been effectively disclosed in a manner sufficient to insure its availability to the investing public.
If Rule 10b-5 is limited by the requirement of a fraud such as insider trading “in connection with the purchase or sale of any security,” how can a corporation that neither purchased nor sold stock be held liable? The law only requires that whatever device used causes reasonable investors to rely on it and in connection with it causes them to purchase or sell a corporation’s securities.

BACKGROUND

Trading “on the basis of” or “while in possession of” material nonpublic information: Rule 10b5-1. Damages: Cf. Sec. Ex. Act §21A.


STANDING

Blue Chip Stamps v. Manor Drug Stores
421 U.S. 723 (1975)
Pp. 915-928

Q. Why did Manor Drug Store sue Blue Chip Stamps? Manor claimed that Blue Chip wrote a pessimistic prospectus that discouraged insider investment, so the same shares could be sold to the public for a greater profit.

Q. What is the Birnbaum rule? The P class in a 10b-5 action was limited to actual purchasers and sellers – there was no evidence that Congress or the statute intended for a wider class to be possible.

Q. Did Justice Rehnquist hold that the plain language and legislative history of §10(b) require the Birnbaum rule? Yes

Q. Whom does Birnbaum bar from bringing suit? Three classes of potential plaintiffs – (1) potential purchasers of shares (2) actual shareholders who did not sell b/c of over optimistic outlooks (3) those who suffered loss in connection to corporate/insider violations of 10b-5. Members of second and third classes can bring derivative suits to get around this rule.
Q. Why did commentators and the SEC criticize these exclusions? It was an arbitrary restriction that unreasonably barred some from getting damages that were caused by 10b-5 violations.

Q. Suppose an unduly gloomy prospectus is published and potential purchasers do not buy, will there be no deterrent to material misrepresentations under the Birnbaum rule?

Q. Suppose an unduly optimistic corporate annual report is published and potential sellers do not sell. Will there be no deterrent to material misrepresentations or omissions? State law would provide remedies.

Q. What policies did Rehnquist cite to support the Birnbaum rule? The desire to prevent litigation that disrupts the company and damages that harm shareholders – without a known sale the case would almost always have to go to the jury – most companies would probably just settle.

Q. What limitations on 10b-5 standing did the SEC suggest to mitigate these problems? Additional corroboration of testimony and more limited damages would limit the dangers of the large plaintiff class.

Q. Why did the Court reject this suggestion? The problems of proof are still too difficult and demanding and it would create too many suits.

Q. The Second Circuit applied the Birnbaum rule, yet still held for the plaintiff. Why? It held that Ps status of an offeree of stock served the same purpose as being a defined buyer/seller that 10b-5 required. So P was allowed to proceed b/c the possible class was limited.

Q. Why did the Supreme Court disagree? To follow that logic would expose the preventive rule to endless erosion by courts in a variety of cases.

Notes and Comments
Pp. 928-930

(1) It is impossible to avoid some case-by-case evisceration of Blue Chip in circumstances such as those described in Notes 1-4.
(2) The most controversial aspect of Blue Chip was not its holding but its references to “vexatious” litigation and “strike” suits. See p. 930 Note 5. This later provided support for the Private Securities Litigation Reform Act of 1995, which has enacted new procedural restrictions on securities litigation.

**SCIENTER**

Pp. 930-940

**Ernst & Ernst v. Hochfelder**

425 U.S. 185 (1976)

Pp. 930-938

Q. What fraud did the plaintiff allege in Ernst & Ernst? That Ernst had aided the CEO’s fraud by not investigating his “mail rule” that would have uncovered the fraud.


Q. Why did the plaintiff argue that the defendant should be held liable? If a proper audit was done, then this rule would have been discovered and the fraud brought to light.

Q. Did the defendant know of Nay’s theft? No
Q. Why did the Supreme Court refuse to hold that Rule 10b-5 could be violated by a negligent misstatement or omission? This could not be harmonized with administrative history of the rule and it was adopted under the authority of 10(b) which clearly uses scienter.

Q. Did it matter that the language of Rule 10b-5 seemed broader than §10(b) and could be read to reach negligent conduct? No b/c b-5 follows the restriction to 10(b).

Q. Suppose Rule 10b-5 did reach negligent conduct. How would this change the conduct of Ernst & Ernst? Is this wise? It would either do incredibly through audits or charge more for them – it might actually reduce the amount of info available to investors.

RELIANC

Basic Inc. v. Levinson
Pp. 951-955

This case implicitly relies on the efficient market hypothesis, (for background: see pp. 234-235, 256-258) to presume reliance.

Q. What is the fraud-on-the-market theory? That the market assigns a price for a security based on all material info – any misleading statements will be used by the market and affect all shareholders even if they do not rely on the statements.

Q. Why did the Third Circuit in Peil argue that reliance on stock prices can injure investors just as much as reliance on false statements? Because the false statement are merged into the price – a reliance on one is a reliance on the other.

Q. The fraud-on-the-market theory allows the court to presume reliance when there is a material misrepresentation. Must the plaintiff prove actual reliance in an omission case? No, because the document itself is lacking in some important piece of info and reliance can be implied.

Q. What is the practical significance of creating a rebuttable presumption? It makes the plaintiff’s case easier and forces the D to fight against it.
Q. Suppose the Supreme Court had rejected the fraud-on-the-market hypothesis. How would the plaintiff prove reliance? It would have had to call witnesses or find some other way to show that it acted directly on the basis of the defective information or it could borrow the Total Mix theory from 14(a9) cases.


THE DUTY ELEMENT

While the reliance requirement (normally satisfied by the fraud-on-the-market hypothesis) is only applicable to material misrepresentation cases, the duty element is only applicable to material omission cases (such as insider trading).

Chiarella v. United States
Pp. 962-972

Q. Why did the United States indict Vincent Chiarella? He worked as a printer in a shop that printed proxy statements for companies buying other companies. The proxy statements used false names for the target companies but D figured out what the companies were and bought them before the deal was announced.

Q. Why did the Court of Appeals affirm his conviction? B/c anyone who regularly gets material nonpublic info may not use that info to trade w/o incurring an affirmative duty to disclose.

Q. Would the Court of Appeals hold liable an eavesdropper who overheard a corporate executive mumble about a future dividend cut? It is suggested b/c that theory credits the market as a whole as being protected – but the Court does say regular receipt of nonpublic info.

Q. Why did the Supreme court reject this theory? Not every occurrence of financial unfairness constitutes fraudulent activity under 10(b) and the element that makes silence fraudulent is a duty to disclose – no duty existed in this case.
Q. **Why require a duty?** The Congressional intent and statute is based on duties owed and violations of those duties – there is no basis for a duty owed to the market. When fraud is based on nondisclosure, there can be no fraud a duty to speak.

Q. **Can one identify the same type of efficiency advantages that one associates with financial analysts with the type of activity that Chiarella engaged in?** Not really – Chiarella essentially stole info.

Q. **What alternative duty theory did the United States argue to the Supreme Court?** See pp. 967-969. That D breached a duty that he owed to the acquiring company that had the contract with his employer to produce the proxy statements. D’s buying and selling of securities was a breach of duty on the acquiring corp and the sellers.

Q. **Why did the Supreme Court majority not address this theory?** It was not the theory that D was convicted on by a jury.

Q. **Why did Justice Stevens doubt that the duty to employer theory would be applicable in private litigation?** B/c the companies were not involved in buying/selling of securities they would not be able to sue in private actions.

Q. **Chief Justice Burger offered another alternative known as the misappropriation theory. What does this theory provide?** When the insider has access to information intended for a corporate purpose and not for personal gain and the information is not publicly accessible, he has misappropriated info and violated 10(b).

Q. **Why does Burger favor so broad a duty?** B/c 10(b) was meant to insure that securities trading was fair and unbiased.

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Dirks v. SEC
463 U.S. 646 (1983)
Pp. 973-981

Q. **How did Dirks come into possession of material information concerning fraud at Equity Funding?** A former insider told him about the fraud and he investigated.
Q. What trades in Equity Funding did Dirks initiate? None – he passed the info onto his corporation that told its customers about the fraud – so they got out before the fraud was revealed.

Q. Why did the SEC believe Dirks violated Rule 10b-5? It was based on tippee liability – when a person learns of material corporate info that they know or should know is confidential and know or should know has come from a corporate insider – they should disclose or refrain from trading.

Q. Suppose Secrist traded in Equity Funding while an employee, would this be a violation? Yes as he was a corporate insider and would directly benefit from material info that was not publicly available.

Q. What about Equity Funding’s outside counsel? Same thing. An insider is liable for inside trading when he fails to disclose material nonpublic info before trading on it and thus makes secret profits.

Q. What about a financial printer like Chiarella? Not unless there was a fiduciary relationship that would create a duty.

Q. Why not Dirks? There was no financial gain to Dirks or to the insiders that told him about the fraud – he took no action to make the insiders think that he would keep the info – there was no evidence that the insiders breached a duty that would be imputable to Dirks so no violation occurred.

Q. Why didn’t Secrist violate this duty? No financial gain.

Q. Suppose an employee of corporation X attempted to borrow money from bank Y. May bank Y trade on material information? This would likely violate a duty owed to the applicant and there would be gain to the bank.

Q. To prove an insider gave information with an improper purpose, what type of evidence must normally be proven? There could be a quid pro quo or the insider might share in the profits of the trade.

Q. Why as a matter of policy does Justice Powell want to preserve the ability of market analysts to learn information? B/c it promotes market efficiency.
Dirks is important for two primary reasons:

A. The case adopted the constructive insider theory in footnote 14 — when outsiders have “entered into a special confidential relationship . . . and are given access to information solely for corporate purposes . . .” See pp. 981-983, Notes 1-2.

B. Dirks also held that tippees who knowingly receive information in violation of the tipper’s duty also can be held liable. But the insider must breach a duty and the tippee must know or be reckless in not knowing of the fiduciary duty breach.

Dirks also emphasized that the tippee’s liability is derivative of the tipper. If the tipper did not violate a duty, the tippee can trade to his or her heart’s delight.