LIMITED LIABILITY

I. Mechanics of incorporation

A. Formation—DGCL

1. 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; usually two steps: certificate of incorporation and bylaws
   1. Articles of incorporation—filed with Secretary of State; can be amended any time after filing; any class of stockholders who would be adversely affected by the amendment must approve amendment by majority vote
   2. Bylaws—rules governing corporation’s internal affairs, but usually not filed with Secretary of State

B. Certificate of incorporation—registration is required for those corporation with 500 or more shareholders and $10M or more in assets; may be brief, but must include
   1. Name and address of resident agent
   2. Nature of business, usually “any lawful activity” §102(b)(4)
   3. Describe corporate stock and relations among stockholders; if more than one class of stock is created, certificate must describe the qualifications, limitations and restrictions of each

C. Optional provisions

1. Limits on directors or shareholders; §102(b)(1)
2. Supermajority vote of quorums; §102(b)(4)
3. Limits on duration; §102(b)(5)
4. Provisions imposing personal liability; §102(b)(6)
5. Preemptive rights; §102(b)(3)
6. Stock transfer restrictions (see below)
7. Corporations may opt out of monetary damage for duty of care; §102(b)(7); usually bylaws contain more detailed rules and can be amended solely by directors

D. Practical questions

1. One corporation or many—liability issue; no longer tax advantages to multiple incorporations
2. Where to incorporate—out of state incorporation involves qualification to do business in any state in which business is conducted; often easier to incorporate locally
3. Can the incorporator enter contracts before corporation is formed? Usually yes, but liable unless contract disclaims liability
   i. Corporation not liable because an agent may not bind nonexistent principal
   ii. After corporation is formed, promoter remains liable until novation; if he is sued and contract is adopted by corporation, promoter is entitled to reimbursement
   iii. Corporation may adopt a contract, formally by novation or by a course of conduct without novation; either way both corporation and promoter will be liable; if contract expressly disclaims promoter liability, then no contract exists—it remains an offer until corporation adopts the contract

II. Defective Incorporation

1 Delaware General Corporation Law
A. Limited liability—technique in liability avoidance; corporate participant’s liability for corporate obligations is limited to that person’s investment in the corporation; default rule that applies absent of an agreement otherwise
  1. Sometimes corporation is given the advantages of limited liability when formation is defective
  2. WHY?
     1. Allowed for defective because Incorporation creates tax revenues and jobs
     2. Capital formation—by limited losses to amount invested, corporation allows investors to finance business without risking other assets; encourages investors to choose desirable, though risky enterprises
     3. Management risk taking—without limited liability, managers would be reluctant to undertake high-risk projects, even if promises net positive returns
     4. Investment diversification—permits investors to invest in many business without exposing other assets to unlimited liability with each new investment; diversification stimulates capital formation because easier to raise capital through many small investments
     5. Trading on stock markets—limited liability shields all corporate investors equally so securities valuation doesn’t depend on investor’s individual capacity to risk other assets

B. De facto corporation—law authorizing judicial finding of corporation, good faith effort to incorporate, and actual use of corporate powers; See Cranson v. IBM Corp
  1. Total failure to file is consistent with good faith
  2. Filling, but forgetting to answer a question or pay a fee may be good faith
  3. Will apply to both tort and contract cases

C. Doctrine of estoppel—person seeking to hold the officer personally liable has contracted or otherwise dealt with the association in such a manner as to recognize its existence as a corporate body even if no good faith effort to incorporate; See Cranson v. IBM Corp
  1. Evidence can be simple: letter or bill addressing someone as president or business as a corporation
  2. Doesn’t work in tort context because involuntary can’t demand incorporation, production of assets, allocate cost of risk, demand personal guarantee as a voluntary creditor can
  3. Limited to contract cases

D. Problems—incorporation under modern statutes is very easy, so hard to forgive failure in incorporate, but law generally likes advantages of limited liability
  1. Most states have abolished the de facto doctrine and expressly impose personal liability against anyone who purports to do business as a corporation while knowing that incorporation has not occurred
  2. Corporation by estoppel probably survives in some states as a judge-made doctrine

III. Piercing the Corporate Veil—privileged of incorporation taken away as a protection against insider abuse; court is placing creditor expectations ahead of insider’s interests in limited liability; piercing occurs by shareholders and corporation continues to exist once pierced; BUT—strong preference not to pierce

A. Three ways to pierce
  1. Individual owner-corporation—usually need at least two; most commonly last two
  a. Tort v. contract—more likely to pierce in tort case because creditor is involuntary than in contract case where creditor is voluntary
b. Fraud—more likely to pierce where there is fraud or wrongdoing
c. Inadequate capitalization—most likely to pierce if inadequate capitalization, but not enough alone
d. Failure to follow formalities—court more likely to pierce if shareholders have failed to follow corporate formalities (e.g. commingling funds)

2. Parent corporation-subsidiary
   a. Failure to follow separate corporate formalities—both have same boards and do not hold separate director's meetings
   b. Same business—subsidiary and parent are operating pieces of same business and subsidiary is under capitalized
   c. Misled—public is misled about which entity is operating the business
   d. Assets—are intermingled between parent and subsidiary
   e. Unfair manner—subsidiary is operated in unfair manner

3. Enterprise liability—occasionally, court may treat two corporations having a common parent as one individual enterprise, so siblings will be liable for each others' debts

B. Three doctrines
   1. Alterego or instrumentality doctrine—pierce corporate veil in the even that one individual treats corporate assets as if they are personal assets; fails to observe the dignity of the corporate form; See Walkovsky v. Carlton and Laya v. Erin; more like to pierce if
      a. Business is closely held corporation
      b. The \( \text{I} \) is an involuntary (tort) creditor
      c. The \( \text{A} \) is corporate shareholder as opposed to an individual
      d. Insiders fail to follow corporate formalities
      e. Insiders commingled business assets/affairs with individual assets/affairs
      f. Corporation not adequate capitalized
      g. \( \text{A} \) actively participate in business
      h. Insiders have deceived creditors
   2. Undercapitalization—veil will be pierced when assets are trifling compared to risks of business; See Minton v. Cavaney
      a. No required sum of money to start a corporation
      b. Insurance tends to be a pivotal concept, so if you've got minimum insurance and nothing in the bank still probably adequately capitalized
      c. In closer cases than Minton, may want to look at how much capital similar businesses have
      d. Not a frequent basis for piercing the veil because all business involves risk
   3. Fraud—most often used; EX: exaggerating assets, understating liabilities; can get direct damages

C. Problem—general preference of the law is to encourage business formation, but encourage formation so that individuals can form multiple corporations leads to encourage excessive risk and liability avoidance; Solution—focus on enterprise liability concept, allowing only one limited liability advantage per individual regardless of number of corporations

CORPORATE POWERS, CORPORATE PURPOSES AND ULTAR VIRES
I. Modern rules—think of ultra vires as dormant rather than dead
   A. DGCL §101(b): a corporation may be incorporated or organized . . . to conduct any lawful business purposes
B. DGCL §121(a): beyond the long list of specific powers enumerated in §122, every corporation, its officers, director 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 purposes set forth in its certificate of incorporation.

C. DGCL §124: almost totally eradicates the doctrine of *ultra vires*, stating 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 the capacity or power to do such act or make or receive such conveyance or transfer, except in three limited situations.

II. *Ultra vires*

A. Definition—an act is *ultra vires* if it contradicts a term of the corporation’s charter or one necessarily implied by it.

1. Traditionally, acts beyond the corporation’s articles of incorporation were held to be *ultra vires* and were unenforced against the corporation or by it.

2. Modern trend is to eliminate *ultra vires* doctrine.

B. *Ultra vires and torts*—modern cases consistently hold that a corporation may not escape liability for a tort by pleading *ultra vires*.

C. Corporate social duties—when corporation’s behavior was rigidly regulated by its certificates of incorporation, there was likely to be little question that it might owe society or shareholders duties beyond those specified or implied by its charter; BUT—when strict constructive gave way and large corporation came to be an important actor in society, there is little or no corporate law clearly stating what—if any—a firm’s social responsibilities are; REAL QUESTION—more about corporate charitable contributions than about corporate purposes.

1. *Dodge v. Ford Motor Co.*—minority stockholders sued in objection to termination of special dividends and to enjoin construction of larger factory.
   a. Case is about whether corporation can pursue a policy that dramatically decreases profits a reason other than business—NO: primary purpose of corporation is to make money for shareholders.
   b. Business judgment rule will save some decisions, but not where board of directors are pursuing personal gain over shareholder gain.

2. *AP Smith Mfg. Co. v. Barlow*—$1500 contribution to local private university is permissible because it is reasonable in amount and indirectly inures to benefit of the shareholder by generating good will in the community which will increase business.
   a. Indirectly inuring has become synonymous with “is a legitimate charity” or “is recognized by the IRS.”
   b. Requirements: Charitable donations must be reasonable in amount and provide indirect benefit to corporation.

3. BUT—corporations can generally give bonuses, stock options or other fringe benefits to their employees (even retirees).

**DUTY OF CARE**

I. Statutory Background

A. DGCL §141(a)—the business and affairs of every corporation organized under this chapter shall be managed by or under the director of a board of directors.

1. Exceptions
a. **DGCL §141(a)**—except as may be otherwise provided in this chapter or in its certificate of incorporation; especially applicable for close corporations

b. **DGCL §141(c)**—committees may exercise the power of the board except in specified cases such as:
   i. Amendment of certificate of incorporation
   ii. Adoption of a merger agreement
   iii. Recommendation of sale of all or substantially all assets
   iv. Recommendation of dissolution
   v. Amendment of bylaws

c. **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 reasonable believes are within such other person’s professional or expert competence

### B. Argument against boards

—in large corporation, board is unequal to task of managing a corporation because of time and informational constraints and board composition

### C. Corporate governance, compensation and audit committees

—fact that boards don’t do a good job prompted committees these committees because they allow more information to available to directors, provide more outside directors, and have greater director involvement in such fundamental decisions as evaluating tender offers or chief executive officer succession

1. Amplification of powers of audit committees is biggest thing in corporate law today
2. Entirely independent directors, have power to fire, fire and set compensation levels to outside auditor, own staff, meet privately with outside auditor or internal corporate employees

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### II. Duty of Care

—each individual director must discharge his duties in good faith and act in a manner he reasonable believes to be in the best interest of the corporation; See MBCA §8.30

#### A. General rules

1. **Duty defined**—directors have a duty to perform with that diligence, care and skill which ordinary prudent persons would exercise in similar situations; In DE, there is a gross negligence standard
   a. **Good faith**—requires directors to be honest, not have a conflict of interest and not approve or condone illegal activity
   b. **Reasonable belief**—involves substance of director decision making; board decision must be related to furthering corporation’s interests
   c. **Reasonable care**—informed basis and ordinary care standards involve procedure of decision making and oversight; directors must be informed in making decisions and must monitor and supervise management; directors must have at least minimal levels of expertise and skill in both capacities

2. **General standard of care**—minimal requirements of competence, meeting attendance, comprehension of financial statements and law compliance; See *Francis v. United Jersey Bank*

3. **In supervision cases**—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**—must prove that a failure of a director to satisfy a standard of care caused a specific harm
a. *Francis*—cause is shown if failure was a substantial factor
b. Need not satisfy *Barnes v. Andrews*

5. **Burden of persuasion**—director or officer will not be held liable if business judgment is disinterested, reasonably informed and the director/officer reasonably believes the business judgment is in the best interests of the corporation

**B. Why?** Gray area of behavior modification which sets minimum framework by which board members have to behave in order to avoid liability; defines how you operate as a member of the board

**C. Behavior of the Board**—in large corporations, usually not viewed as management because didn’t have to meet a minimum number of times, didn’t have to receive any specified amount of information didn’t have staff

1. **Inside director**—someone who works for the corporation
2. **Outside director**—more effective check and balance, but usually CFO of other company so you scratch my back and I’ll scratch yours mentality arises
3. **Sarveigns Oxley**—try to change old ways of the board; tries to shift control from CEOs office in direction of independent committees, especially the audit committee

**D. Two types of cases**—ones where you can identify specific decisions v. supervision

1. **Bates v. Dressler**—US SC propounding a standard that is reactive—reasonable suspicion of wrongdoing is necessary; board has no responsibility to act until put on notice
2. **Barnes v. Andrews**—no notice here, but court focuses on duty to keep self informed—beginning to impose affirmative duties; BUT—no liability here because ∆ has the burden to prove that you can exactly line up violation of duty of care by ∆ with a specific, identifiable loss
3. **Francis v. United Jersey Bank**—court requires some minimum level of business knowledge and attendance at some number of meetings, etc. by directors; duty to act as someone in like position and similar circumstances would act which means insider has a higher duty
4. **Bottom line**—in supervision cases, three duties that may be breached: duty to respond to red flags, duty to keep informed, and duty to investigation when evidence of wrongdoing; may be a duty to act also

**D. Modern trend**—boards want to avoid liability in the first place so establish compliance systems to try to avoid liability

**III. Business judgment rule**

**A. Reasons for rule**—why allow corporate directors broader insulation from negligence liability than others?

1. Encourage risk taking
2. Shareholders voluntarily invest and assume directors engage in risk taking
3. Rational shareholders can diversify away firm-specific risk through a portfolio

**B. Definition of rule**—where there is an identifiable decision, a ∆ can’t be held liable unless: there is a conflict of interest, you can show ∆ was not reasonable informed or decision was irrational or difficult to defend in business terms

1. Burden of persuasion is on the ∑ who has to prove causation
2. Only applies to state corporate law
3. Under federal law, no violation except in certain circumstances and no business judgment rule

**C. Case law**
1. **Smith v. VanGorkam**—adds to usual rule, that board be reasonably informed; now the determination of whether a business judgment is an informed one turns on whether the directors have informed themselves prior to making a business decision, of all material information reasonably available to them; 3 reasons for ultimate conclusion that initial decision was not reasonably informed
   a. No valuation study
   b. CEO doesn’t accurately describe agreement
   c. Merger agreement wasn’t produced in court
2. **Compare with Francis**—cumulative effect is that duty of care and reasonable investigation are required by board
3. **Informed**—means all information reasonably available
4. **DGCL §102(b)(7)**—board can amend certificate of incorporation so corporation can’t be subject to money damages for duty of care violation

**D. Bottom line:** business judgment rule makes directors bullet proof; justified by following reasons:

1. **Encourages risk taking**—board members should expect board to take business risks
2. **Avoids** judicial meddling
3. **Encourages directors to serve**—no fear of being judged by hindsight so qualified persons will become directors and not fear risk taking

**E. Overcoming the rule**—court places burden on challenger to overcome the presumption by roving either

1. Fraud, illegality or conflict of interest
2. Lack of rational business purpose (i.e. waste—beyond realm of reason)
3. Gross negligence in discharging duties to supervise and become informed

**F. Remedies**

1. **Personal liability of directors**—each director who voted for the action, acquiesced in it or failed to object becomes jointly and severally liable for all damages that decision proximately caused in the corporation
   a. Most states: director who attends a meeting is presumed to have agreed to the action unless minutes reflect directors dissent or abstention
   b. Some states: director who hasn’t voted can register dissent or abstention by delivering written notice at or immediately following meeting
   c. Some states: require challenger to show director’s inaction/action proximately caused damage to corporation; See *Barnes v. Andrew*

**DUTY OF LOYALTY**

**I. General standard**—requires \(\Delta\) carry the burden of showing that a transaction was the equivalent to what would have been negotiated at arm’s length; have to be pretty close to market price because \(\Pi\) has to show conflict of interest and only when that taint is on decision does higher standard get employed

**A. Tests**

1. **Fairness plus board validation**—courts uphold self dealing only if transaction was fair on the merits and was approved by a majority of disinterested directors; See *Globe Woolen*
2. **Substantive fairness**—courts uphold self dealing if transaction was fair on merits and no vote was necessary
3. **Disinterested board approval**—courts uphold self dealing if disinterested directors approve

4. **Shareholder ratification**—courts uphold self dealing if disinterested shareholders (majority or all) approve transaction; don’t need approval of disinterested directors

II. **Conflicts of interest**—duty of loyalty cases start with a conflict of interest; once proven, must usually show fairness (equivalent of a transaction that might have been negotiated by strangers in the market place) of transaction unless safe harbor statute applies

A. **Self dealing**—person dealing with board on which he serves as a director; three conditions must be met
   1. Key play (officer, director or controlling shareholder) and the corporation are on opposite sides of a transaction
   2. Key player has helped influence the corporation’s decision to enter the transaction
   3. Key player’s personal financial interest are at least potentially in conflict with the financial interests of the corporation

B. **Interlocking**—same director serves on two boards doing business with each other

C. **Parent and subsidiary**—parent corporation doing business with a partially owned subsidiary

D. **Case law**
   1. **Globe Woolen Co. v. Utica Gas and Elec Co.**—dominating influence can be exerted in ways more than a vote, so can have a conflict of interest even if you don’t vote; any director present at a meeting has a duty to warn
   2. **Gries Sport Enter v. Cleveland Brown Football Co.**—focus on where the money is: if link is through stock ownership or employment relationships, then can find a conflict of interest; court places burden on Δs to show that fair price was paid once self-dealing is established by challenger
   3. **Problem**—in both these cases, problem is with structure; courts like to solve duty of loyalty cases based on procedure; focus on three elements
      a. **Disclosure about transaction to the board**
         i. If fraud in connection with approval, invalidated transaction
         ii. If no fraud, must be adequate disclosure: some require full disclosure, some say only disclosure of conflict, others say disclosure of all material information
      b. **Compensation of board**—that approved transaction
      c. **Role of interested director**—in transactions initiation, negotiation and approval
         i. Disinterested if not directly of indirectly interested in transaction and not dominated by the interested director
         ii. Old rule said no interested director participation, but modern trend is to allow interested director to negotiate, participate and vote without invalidation, but may be proof of dominance over other directors
   4. **Substantive fairness tests**—courts accept the fairness of self dealing if judge concludes the transaction was in the corporation’s best interests
      a. **Objective test**—transaction must replicate an arm’s length one, courts look closely at price
      b. **Corporate value**—transaction must be one of particular value to corporation
III. **Safe Harbor Statutes**—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 \( \text{∏} \) to prove that an interested transaction was unfair

A. **Marciano v. Nakash**—applies above DE law, which says transaction is not voidable in three situations; no business judgment rule—if \( \text{∏} \) shows conflict of interest and disinterested members approve, \( \text{∏} \) has to show unfairness to win

IV. **Corporate opportunity doctrine**—corporate manager cannot usurp corporate opportunities for his own benefit unless the corporation consents; \( \text{∏} \) has burden of proving existence of corporate opportunity

A. **DE three elements**: same line of business as the corporation or a line in which the corporation has an interest or expectancy; presented to a corporate officer in a corporate rather than individual capacity; corporation was financial able to undertake

1. **Use of diverted corporate assets**—fiduciary cannot develop a business opportunity using assets secretly diverted from the corporation
2. **Existing corporate interest**—if corporation has an existing expectancy in a business opportunity, manager must seek corporate consent before taking the opportunity
   a. Expectancy need not rise to level of ownership interest
   b. Covers opportunities of special or unique importance to corporation for which there is a presumed expectancy
   c. If opportunity came to manager in his individual capacity, courts more likely to conclude opportunity was not corporate
3. **Existing line of business**—broader test employed by modern courts; compare the new business with the corporation’s existing business operations and if project is functionally related to the corporation’s existing or anticipated business, manager must obtain corporate consent before exploiting it

B. **Case law**

1. **Guth v. Loft**—DE test:  did corporation have financial ability to enter into transaction, was it in interest or expectancy of the corporation, was it offered to executive in his person or corporate capacity
2. **Johnston v. Greene**—court holds there was no interest or expectancy and offer was made in purely individual capacity, but still performs duty of loyalty analysis; sometimes can find a violation without interest or expectancy—executive is charged with finding business opportunities is required to deliver them
3. **Northeast Harbor Golf Club Inc. v. Harris**—§5.05 of ALI is different standard than DE; if corporate opportunity, then must go to board, make full disclosure (no false statements) and get permission to take opportunity

C. **Penalties**—most sever in all of corporate law: creation of constructive trust or return property and receive back original investment

**EXECUTIVE COMPENSATION AND SHAREHOLDER VOTING RIGHTS**

I. **Executive Compensation**—if an officer or director influences a corporation’s decision about his own compensation, this is technically self dealing but courts are reluctant to strike down decisions about executive compensation and these decisions receive protection of the business judgment
rule: the directors’ decision will be sustained so long as it is rational, informed and made in good faith

A. Two ways to challenge—interested transaction or waste

B. Waste—synonym for duty of care; irrational prong of business judgment rule; works best for excessive compensation that has been approved by majority of disinterested directors or ratified by shareholders

1. Rogers v. Hill—when does compensation become so high that waste doctrine applies?
   a. Court says not per se unreasonable because ratified by majority of stockholders
   b. Salary is too large to be permissible when there is no quid pro quo
   c. State law provides only a crude outer limit that if compensation is so far out of bounds as to be tantamount to a gift then waste doctrine applies when duty of loyalty won’t cure

II. Shareholder Voting Rights—Weakest device to protect shareholders in the modern corporation; fiduciary duty litigation and mandatory system of disclosure and fraud litigation are much more successful

A. Protection for shareholders—laws against fraud and unfairness, ability to sell shares in stock market and holding stock portfolios

1. General rule—annual election by straight voting: shareholders vote their shares for each open directorship, which means a shareholder holding a majority of shares can elect the entire board of directors

2. Right to inspect—shareholders have right to inspect corporations books and records in general; common law requires proper purpose
   a. Shareholder’s desire to evaluate his investment will usually be proper
   b. Pursuit of unrelated goal will not be proper
   c. If holder wants access to shareholder’s list to contact fellow shareholders to take group action concerning the corporation, this will be proper
   d. If holder is pursuing only social or political goals not closely related to corporation’s business this will be improper

3. Cumulative voting—minority shareholders can accumulate all of their votes and allocate them among a few or even one candidate, increasing the chances of board representation for minority shareholder
   a. Some states require cumulative voting
   b. In others, cumulative voting is permissive and applies if adopted in articles or sometimes in bylaws
   c. Usually, advance notice of cumulative voting is required to avoid surprises

B. Voting theories

1. Minority representation—epitomized by cumulative voting debate
   a. Is cumulative voting permissive (DGCL §214) or mandatory? On mandatory in 6 states
   b. Does it coexist with classified boards (DGCL §141(d)) or are classified boards prohibited? Classification is permitted with mandatory cumulative voting
   c. Cumulative voting is on the decline—85% of all corporations do not use it when it is discretionary

1. Consent of governed—or co-determinism; 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; serious theory abroad but not caught on in US
3. **Contractarianism**—no specified norms; adopt any vote patterns negotiated by shareholders and managers
4. **Relational investment**—focus on institutions such as CalPERS

B. Corporate formalities
1. DGCL §211(b)—annual meeting to elect directors
2. DGCL §211(d)—special meeting may be called by board
3. DGCL §212(a)—unless certificate of incorporation provides otherwise, one common share = one vote
4. DGCL §216—majority quorum rules, but those can be altered by certificate of incorporation
5. DGCL §212(b)—most votes by proxy in a large publicly traded corporation; good up to three years in DE

C. Proxy election expenses—incumbent management is allowed to pay election expense from corporate treasury if it can show expenses are for benefit of corporation and are reasonable in amount; See *Rosenfeld v. Fairchild Engine and Airplane Co.*
1. Outsiders only entitled to reimbursement if they win the election
2. Outsiders tend to try tender offer for control

D. SEC Rule 14a-8—applicable only to covered corporations under §12 and Rule 12g-1 of SEAct
1. Applies to—securities listed on a nation exchange or traded in over the counter market with 500 or more holders of a class of stock and $1M in total assets
2. Substance—shareholder can circulate a proposal for action issues other than director nominations if the shareholder satisfies following requirements
   a. Rule 14-8(c)-(d)—number and length requirements
   b. Rule 14-8(b)—eligibility
   c. Rule 14a-8(b)—not excluded; improper under state law; personal grievance, relevance and ordinary business operations
3. Disclosure and filing requirements
   a. Any proxy solicitation documents that will be sent to shareholders must be filed with SEC
   b. Every proxy solicitation must be accompanied or preceded by a written “proxy statement” which discloses items like conflicts of interest, the compensation given to highest paid officers, and details of any major change being voted on
   c. Proxy rules require that annual report be sent to every stockholder
   d. Any false or misleading statements or omission in a proxy statement are banned

CLOSE CORPORATION

I. Generally—biggest difference between close corporations and public corporation is sociological; controversies tend to deal with succession and unique cluster of unhappy families and distrustful parents; close corporation is one with a small number of stockholders, lack of any ready market for corporation’s stock and substantial participation by the majority stockholders in the management, direction and operation of the corporation

A. Definitions
1. MA says similar to partnership: small number of stockholders, no ready market for corporate stock, substantial majority stockholder participation in management, direction and operations of corporation

2. DGCL §342: fewer than 30 people, §202 restriction limits ability to sell stock; no public offering of stock

B. Problem—ability to exit through stock sale is very limited

II. Heightened fiduciary duties

A. Donahue v. Rodd Electrotype Co of New England—must show opportunity was offered to majority stockholder for same price but not to you; duty elevated to utmost duty

B. Alternative rule—demonstrate stock was purchased and demonstrate unfair price; but, what is fair price

   1. No fair to transfer at original price or some fixed level of appreciation
   2. Book value—snapshot of net worth of a firm at any given point; fixed assets are depreciated over time; has nothing to do with real value of firm
   3. More dynamic approach—appraisal of values using norms for time

C. Wilkes v. Springside Nursing Home Inc.—makes Donahue utmost good faith and loyalty language operational; two basic elements must be proven in Donahue case (suit against the majority alleging a breach owed to Δ):

   1. No legitimate business purpose
   2. Same purpose could be achieved through less harmful chose of action

III. Stock transfer restrictions

A. General rules

   1. DGCL §341—parties must elect to be a close corporation; requirements: fewer than 30 shareholders, §202 share restriction, no public offering
   2. DGCL §202(a)—restriction must be noted conspicuously
   3. DGCL §202(c)—pivot share restriction provision; appropriate provision will include
      a. Prior opportunity to corporation, other holders or any other person to buy
      b. An obligation to the corporation, other holders or other person to buy
      c. A requirement that the corporation or other holders consent to transfer
      d. A prohibition of transfer to designated persons or classes of persons if such designation is not unreasonable

B. Valuation—most difficult transfer restriction problem is how you define the value of shares now to be transferred at a future time

   1. Original price—usually will be less than the value of a successful close corporation’s stock
   2. Book value—based on original cost and may be considerably less than current FMV
   3. Can use more sophisticated valuation techniques, like earnings value or capitalization of earnings, but need an appraiser

IV. Voting agreements—way for founding members to concentrate voting control within corporation

A. Stock pooling agreements—duties and obligations are imposed on the parties which are legally enforceable; more than an agreement to agree; valid if not fraudulent

   1. Ringling v. Ringling Bros.(state court)—stock pool is invented; stock held under agreement should have been voted pursuant to direction of arbitrator employed when dispute arose because court emphasizes deadlock avoidance
      a. Resolution—specific performance, hold new election
      b. No unlawful intent here because agreement does not separate voting rights from ownership because arbitrator only directs votes
c. Public policy support—freedom to contract; parties made arbitration part of agreement and agreement should be enforced as written

2. **Ringling case (DE SC)**—reversed because arbitrator has no power to vote; parties only bound to each other and arbitrator is not empowered to enforce the decision he makes; at least one party must determine that arbitrator’s decision will be carried into effect
   a. Resolution—election is not invalid, but dissenters votes should be thrown out
   b. Can make agreements, but can’t compel stockholder to vote against her will

B. **Voting trusts**—DGCL §218—beneficial owner vests voting power in designated trustee; agreement must in writing, filed with Secretary of State and open for inspection

C. **Irrevocable proxy**—an agreement by which you designate someone else to vote your shares; most common is revocable and latest dated proxy controls; irrevocable is based on an interest and usually part of a loan arrangement

D. **Class AB stock**—most popular post-Ringling; two classes own stock where sets are identical financially but only one class votes

E. **Mediation/arbitration clauses**—always need some sort of deadlock resolution technique

V. **Deadlock avoidance and dissolution**

A. **General rules**—usually need 50% or more of vote to dissolve

B. **Oppressive conduct**—defined in **Kemp & Beatley** as arising only when the majority conduct substantially defeats expectations that, objectively viewed, were both reasonable under the circumstances and were central to the petitioner’s decision to join the venture
   1. **Oppression**—legal term of art meaning frustration of reasonable expectations
   2. NY state law allowed [] to bring suit to dissolve for oppressive action
   3. **Remedy**—dissolution; forced buy out of petitioners’ shares or liquidation of assets is only way for petitioners to get a guaranteed fair return on investments
   4. **Risk**—[]s will use law as coercive tool by making fraudulent claims of oppressive conduct; BUT—only for minority shareholder who is being oppressed by majority and has no other adequate means to cover investment
   5. **Bottom line**—similar to **Donahue**—protection for people who can’t easily exit close corporation

C. **Dispute Resolution in close corporation**
   1. **Types of Disputes**—ways majority can abuse their control
      a. **Freezeouts**—isolate minority shareholders from corporate participation, forcing minority to sell too majority on unfavorable terms
      b. **Forceouts**—majority can manipulate fundamental structure of corporation and forcibly terminate minority interests
   2. **Minority shareholder’s options**
      a. **Market out**—no option to sell to liquid trading market and can’t force majority to repurchase shares at a fair price in absence of contractual or statutory buyout
      b. **Dissolution**—if in a partnership could dissolve, but can’t in corporation without board approval or dissolution rights in shareholders’ agreement
      c. **Involuntary dissolution**—court will grant if shareholder can prove statutory grounds: board deadlock, shareholder deadlock, misconduct
      d. **Fiduciary challenge**—challenge majority’s use of control as a breach of fiduciary duty; modern courts are sympathetic to plight of minority in close corporation
MERGER LAW

I. Delaware Merger Law
   A. General rule—DGCL §251: majority vote by shareholders in both firms; appraisal rights under DGCL §262
   B. Exceptions
      1. DGCL §251(f)—unless required by its certificate, no vote by surviving firm if:
         a. No certificate amendment
         b. Identical stock after merger
         c. And no more than 20 percent of common stock employed
         d. No appraisal right often for survivor’s shareholders, See DGCL §262(b)(1)
      2. DGCL §253
         a. No vote of either surviving parent or subsidiary shareholders
         b. No appraisal right for parent when parent owns 90 percent or more of subsidiary
      3. DGCL §262(b)(1)—no appraisal if shareholder sin a firm 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 substantially all assets
         b. No appraisal
         c. Only DE neither allows an appraisal for sales of assets nor allows the de facto merger doctrine
      5. Tender offers—acquisitions of stock do not create appraisal rights

II. The Appraisal Remedy
   A. Delaware Block approach—object is to give shareholders the value of the stock at the moment before the merger; take into account market value, asset value, dividends, earnings value and any other facts which throw light on future prospects of the firm that was merged
      1. Formula is complicated, but avoids undue reliance on market value
      2. Market value was never given more than 50 percent weigh inappraisal and could be reconstructed
      3. Asset value typically follows generally accepted account principles and is not based on book value, but rather a current appraisal
      4. Dividends are only significant when not paid; substantial negative dividend recognition is then recognized
      5. Earnings value involves averaging the last five years earnings and then multiplying by a multiplier
         a. This could be fewer than five years if there were unusual years; multiplier is meant
         b. Multiplier was meant to equal the price to earnings ration in the relevant industry; now usually done by studying similar firms
   B. Criticisms of approach
      a. High subjective; trial court discretion in assigning weights is typically decisive but rarely explains in a way that can be followed in subsequent cases
      b. Approach reflects hostility to market value in appraisals, but at same time creates a stock market exception
      c. There is no explicit requirement that assets be revalued, although usually done
d. Remedy is technically difficult to commence: written demand before merger vote and vote against merger or abstention
d. Costs of appraisal are uncertain
e. Brudney and Chirelstein add that 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”

B. Valuation of Common Stock of Libby, Mcneill and Libby
1. Court doesn’t rely on market price because low volume of public trading going on, but gives stock value and earnings value more weight than asset value
2. Modern approach—legislature has said there is no such thing as just price—fair price is determined from the market; if no stock market, cross stock market valuation off the table

II. Interested mergers
A. Weinberger v. UOP, Inc.—W sues claiming vote for merger was uninformed and challenges fairness of price; seeks to enjoin merger rather than appraisal because gives bargaining leverage to minority
1. Reaffirms duty of loyalty burden of persuasion rules
   a. ∏ always has burden to show a conflict
   b. If ∏ shows conflict, burden will be on ∆ to prove fairness unless transaction approved by an informed vote of a majority of disinterested stockholders, in which case the ∏ must prove unfairness
   c. Party with burden of persuasion usually looses
2. Fairness is defined to include both fair dealing and fair price
   a. Equity at every level of transaction that can be imagined
   b. Look at all relevant factors to determine fair price
3. The appraisal remedy was broadened to include other valuation techniques—BUT—if only debate is about fair price then no injunction and only remedy is appraisal
   a. You can take account of evaluation methods used in accounting world
   b. Not essential that you use techniques, but they are available
   c. Other than discounted cash flow, courts have not typically adopted other techniques at the trial level
4. Business purpose test dropped in DE, other states continue to apply
5. In place of business purpose test, a merger can be enjoined on a series of grounds, notably fraud, duty of loyalty violations, and waste
6. Bottom line—minority will be protected by fair price in DE and by business purpose analysis in other states

B. Rabkin v. Philip A Hunt Chem. Corp.—avoiding one year commitment to buy at higher price and then buying lower later supports claim of unfair dealing because decided to buy within one year just paid after the dealing

TENDER OFFERS
I. The Phenomenon—an offer to shareholders to tender (sell) their shares to an outside bidder; simultaneous offer to any and all shareholders willing to tender their shares or to all shareholders up to a certain percentage
A. Why do they occur?
1. **Disciplinary**—tender offers replace inefficient managers with more efficient managers
2. **Synergy**—because of unique characteristics of a bidder, a target may be worth more to it then to the market generally
3. **Empire Building**—takeovers are motivated not by the best interests of the offerer’s shareholders but rather by the desire or its managers to receive higher compensation or prestige because of the increased size or visibility of the new consolidated firm or to reduce bidder’s risk of takeover
4. **Exploitation**—two tier bid; coercion and free rider problems
5. **Diversification**—bidder can reduce bankruptcy risk by diversifying into different industries
6. **Wealth transfer**—no real efficiency gains in takeovers, but wealth is transferred to target shareholders from others such as bondholders, employees or taxpayers
7. **Coercion**—bidders attempt to exploit the prisoner’s dilemma or collection action problem experienced by dispersed target shareholders through the offering of unsatisfactorily low prices with the knowledge the target shareholders may accept them, even if they regard them as low because of concerns about lower future market price

**B. State corporate law**

1. **Cheff v. Mathes**—greenmail transaction: hostile bidder paid money above market price to sell shares back to corporation
   a. Δ's will have burden of persuasion in tender offer case
   b. Burden has procedural and substantive elements
      i. Δ's have to show reasonable investigation and good faith as a matter of process
      ii. Δ's have to show some form of threat to corporation as a matter of substance
   c. Permissibility of defensive maneuvers is analyzed by court
2. **Unocal Corp v. Mesa Petroleum Corp.**—adds to Cheff by saying that management has to show threat and an element of balance, that defensive measure is reasonable in relation to the threat posed
3. **Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.**—initial offer rejection okay because directors concluded price was grossly inadequate and had reasonable grounds to believe there was harmful threat to corporate enterprise and reason to protect shareholders in good faith; lock up transaction inappropriate because sell was inevitable and board’s role changed to that of an auctioneer trying to get best price for shareholders and offer to bondholders accrued no benefits to shareholders
4. **Paramount Comm. V. QVC Network**—regardless of whether term is valid on its own, it is invalid when it interferes with duties of directors to get best price for shareholders; when Revlon triggered, duty of board is to make a reasonable decision; decision doesn’t have to be perfect, but can’t impede realization of best value reasonably available to target shareholders

**C. Defensive maneuvers**—target’s incumbent management may use to defeat a hostile bidder

1. **Pre-offer techniques**—generally must be approved by a majority of the target’s shareholders
   a. **Super majority provision**—target may amend its articles of incorporation to require that more than a simple majority of the target’s shareholders approve any merger or major sale of assets
b. **Staggered board**—only a minority of the board stands for election in a given year, so that a hostile bidder can’t gain control immediately even if he owns a majority of the shares

c. **New class of stock**—target creates a second class of common stock and require that any merger or asset sale be approved by each class, then the new class can placed with friendlies

d. **Anti-greenmail amendment**—amend charter to prohibit paying of greenmail

e. **Poison pill**—plans try to make bad things happen to the bidder if it obtains control of the target, making target less attractive to bidders
   
i. **Call plans**—gives stockholder right to buy cheap stock in certain circumstances; usually contain a flipover provision which allows holder of the rights an option to acquire shares of the bidder at a cheap price
   
ii. **Put plans**—bidder buys some but not all of the target’s shares, the put gives each target shareholder the right to sell back his remaining shares in the target at a pre-determined “fair” price
   
iii. **No approval required**—shareholder approval is not usually required

2. **Post-offer techniques**
   
a. **Defensive lawsuits**—usually just buy time
   
b. **White knight defense**—will acquire the target instead of letting hostile bidder do so; white knight is given a lock up, some special inducement to enter the bidding process
   
c. **Defensive acquisition**—target makes itself less attractive by taking on a lot of debt
   
d. **Corporate restructuring**—restructure itself in way that raises short-term stockholder value
   
e. **Greemail**—buy bidder’s stake back at an above-market price, usually in return for a standstill agreement under which the bidder agrees not to attempt to require the target for some specified number of years
   
f. **Sale to friendly party**—target sells less than controlling share to party who can be trusted not to tender to the hostile bidder
   
g. **Share repurchase**—target repurchases a significant portion of shares from public to raise insiders’ stake
   
h. **Pac Man**—target may tender for the bidder

**FEDERAL PROXY FRAUD**

I. **Implied Cause of Action**
   
A. **General rule**—limited to fraud in proxy solicitations (voting process) for corporations subject to §14(a) and generally doesn’t apply to close corporations

B. **JJ Case Co v. Borak**—implied cause of action based on federal jurisdiction to enforce the act, objective of 14a to protect investors and SEC had huge caseload so enforcement of goals of Congress require private right of action

II. **Causation**

A. **Mills v. Electric Auto-Lite Co.**—if you can show vote was essential and fraud was material, it’s not necessary to prove causation; in this case, vote was essential link because didn’t have enough shareholders to go forward with complete takeover

1. If \( \exists \) can’t show the vote would have made a difference, then causation is essential
2. If votes are locked up in the hands of Δ, argument can be made that the vote was essential.
3. Causation never has to be proven where Δ has less than the statistical majority to make a difference.

III. Materiality

A. The basic standard

1. *TSC Indus. v. Northway Inc.*—omitted fact is material if substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote; FN15—materially misleading as a matter of law if corporation doesn’t disclose anything but usually a question of fact.
2. **Quantitative materiality**—good rule of thumb; any fact or set of facts which could have an impact on a stock price move of 10% or the total assets of a firm or net profits of a firm of 10 percent is undoubtedly material; if a fact is unlikely to move a stock price by more than 5%, presumed material; between 5-10% is a gray area.
3. **Tips**—don’t have to disclose what shareholders already know; ask yourself if undisclosed details are still part of the total mix the shareholders would want to know.

B. Contingent Events

1. *Basic, Inc. v. Levinson*—SC explicitly adopted TSC standard of materiality for Rule 10b-5 cases
   a. Contingent information that is the possibility of a future merger could be important to investors—measure importance of contingent info by multiplying probability of fact being true times magnitude of effect it has on company.
   b. Don’t have to disclose but don’t lie if asked; say no comment.
   c. **Bottom line:** not just historical information can be misrepresented, so can forward looking information.
2. *Va Bankshares*—statement of reasons, opinions or beliefs can be misrepresented and are material
   a. Assertion that merger price was high and fair and court said those could be material and misrepresented, but held so in context in which shareholders would reasonably rely on statements to the board.
   b. Many instances in recent years in which off the cuff statements made by executives are not actionable because not reasonable for shareholders to rely.

INSIDER TRADING

I. Should Trading on Basis of Material Nonpublic information be Illegal?

A. Why do we have federal securities laws?

1. Total inability of states to make the jump from fraud concepts developed in face to face transaction to the realities of what it meant to trade through organized stock market.
2. Privity concept doesn’t work well when most transactions involving stock aren’t made with individual, but with brokers far removed.
3. State law had difficulty with jurisdiction.
4. Rule 10b-5 is universal in that it applies equally to face to face, close corporation and stock market transactions.

B. Arguments in favor of regulation

1. **Equity**—congress consistently favors equity of fairness arguments in enacting insider trading information; equity arguments are implicitly 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; assumes investors are risk averse and prefer a fair game

2. **Allocative efficiency**—problem of incentives for research; logically does not reach corporate insiders who typically need no incentive to search for inside information; better achieved through mandatory

3. **Property rights**—confidential business information long recognized as property to which business as exclusive right and benefit

4. **Market integrity**—insider trading undermines the integrity of stock trading markets, making investors leery of putting their money into a market which can be exploited

C. Arguments against regulation

1. **Compensation to insiders**—profits from insider trading are viewed by some as appropriate compensation for insiders or entrepreneurs

2. **Stock price smoothing**—unclear that insider trading would have a significant or long lasting impact on stock prices in the way that new information about a firm would

3. **Private ordering**—if so bad, why don’t corporations themselves prohibit it?

II. Before SEAct of 1934

A. **Goodwin v. Agassiz**—no liability when directors bought stock from shareholders while in possession of material information that was not disclosed

   1. Court didn’t want to deter people of experience and ability from being directors—low point in state law

   2. Now use Rule 10b-5 and state claim is weakest string in the bow

B. **§16(b) of SE Act**—any profit realized by any beneficial owner of 10% or more of any class of stock in equity in a firm registered under 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

   1. Only applies to corporations subject to §12 of SE Act

      a. Those listed on national security exchanges

      b. Those with 500 or more holders of equity security and $10M or more in assets

   2. Problems

      a. Beneficial must own 10% or more both at time of purchase and sale

      b. Only covers equity and securities convertible into equity (options or convertible stock)

      c. In terrorem rule—need not prove insider acted while in possession of inside information

      d. Enforced through reports

      e. Nobody likes it because of reporting requirements and no proof of wrongdoing

      f. Can play around it easily

   3. Not often litigated, but behavioral impact—reminds insiders that there are limits on ability to trade through month reporting basis when insider trades stock within his corporation

   4. Remedy—money is returned to corporation through a derivative claim and attorney can get fees

III. **Rule 10b-5**

A. **Who is subject to 10b-5 rules**

   1. **Insiders**—who obtain material, nonpublic information because of their corporate positions have clearest duty not to trade
2. **Constructive insiders**—those who are retained temporarily by the company in whose securities they trade are viewed as having same duty as corporate insiders

3. **Outsiders**—those with no relationship to the company in whose securities they trade also have an abstain or disclose duty when aware of material, nonpublic information obtained in a relationship of trust or confidence

4. **Tippers**—those with confidentiality duty who knowingly make improper tips are liable as participants in illegal insider trading
   a. Tip is improper if tipper anticipates reciprocal benefits
   b. Liability extends to sub-tippers who know or should know a tip is confidential and came from someone who tipped improperly
   c. Can be held liable even though he doesn’t trade as long as someone down the line eventually does

5. **Tippees**—those without a confidential duty inherit an abstain or disclose duty if they knowingly trade on improper tips
   a. Tippee is liable for trading after obtaining material, nonpublic information he knows or has reason to know came from a person who breached a confidential duty

6. **Strangers**—no duty to disclose

**B. Disclose or abstain rule**—no person may misrepresent material facts that are likely to affect others’ trading decisions

1. **SECv. Texas Gulf Sulfur**—point of 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
   a. Preserve concern from *Goodwin* by saying that an insider has duty to disclose in extraordinary situations that are reasonably certain to have an effect on market price
   b. If valuable corporate purpose, then business judgment rule applies and information can be kept secret, but can use for trading; See FN12
   c. Before insiders may act upon material information such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public; wait until stock prices move in response to information
   d. Must be fraud in connection with purchase or sale, but committing fraud and making purchase or sale is enough
   e. Don’t have to disclose educated guesses or predictions

2. **Damages**—theory at time was look to contemporaneous traders; 2nd Cir says only held liable for his gain/avoided loss; §21A—SEC can seek treble damages when it proves insider trading

**C. Material information—proving fraud under the rule**

1. **Identify a false statement**
   a. **Misrepresentations**—simple false statements
   b. **Omissions**—much more common for corporation to forget to say something

2. **Two types of cases**
   a. **False corporate statement**—misrepresentation or omission or both
   b. **Insider trading**—really classic form of omission case; corporate insider will purchase or sell securities without disclosing material information
3. **Rephrasing TSC for Rule 10b-5**—misrepresented or omitted fact is important if a reasonable shareholder would consider it important in deciding whether to purchase or sell securities; quantitative rule of materiality still applies
   a. **Total mix theory**—part of what a reasonable shareholder if aggregated all the information would want to see before voting for the purchase/sell transaction
   b. **Basic v. Levinson**—investors can analyze contingent information, but if they disclose it it must be honestly disclosed; forward looking information can be material—multiple probability of fact being true by magnitude of the effect it has on the company

4. **Reasons, Opinions or Beliefs**
   a. **Virginia Bankshares v. Sandberg**—statements of reasons, opinions or belief can be misrepresented and material; puffing is not usually actionable but will become actionable if information not equally accessible to both sides of transaction
   b. **Bespeaks Cause Doctrine**—a false forward looking statement is not considered material if it accompanied by cautionary language in the relevant corporation document
      i. Limited to forward looking information, historical information must be true
      ii. Statement must be customized to the falsehood, boilerplate won’t suffice
      iii. Codified in §21E—[?] can’t win unless shows [Δ] had actual knowledge statement was false; but if cautionary statement is so obscure or difficult to understand, it won’t be given weight

D. **Standing**—applies to both types of cases
   1. **Blue Chip Stamps v. Manor Drug Stores**—first case stating there is something potentially dangerous about [?] class actions under 10b-5; those with standing is limited to actual purchasers and seller via the Birnbaum rule; those excluded include
      a. Potential purchasers of shares
      b. Actual shareholders who did sell because of over optimistic outlooks
      c. Those who suffered loss in connection to corporate/insider violations of 10b-5

E. **Scienter**—applies to both types of cases
   1. **Ernst & Ernst v. Hochfelder**—SC refused to hold that 10b-5 could be violated by a negligent misstatement or omission; intent or actual knowledge is sufficient; recklessness reserved, but circuit courts hold that it is enough

F. **Reliance**—only an element in corporate misrepresentation cases
   1. **Affiliated Youth**—don’t have to prove reliance on an omission; don’t have to show [?] in anyway would have done anything differently had there not been a material misrepresentation
   2. **Basic Inc v. Levinson**—limited to material misrepresentation; [?] does have to prove reliance, but fraud on the market presumption can help
      a. **Fraud on the market**—market price reflects all available info and investors rely on market price so if there is a material misrepresentation that is credible, then market price is wrong and investors have been defrauded
b. Still no reliance needed for omission cases

c. Made class actions possible

G. The Duty Element—applicable only to material omission cases, such as insider trading; in
corporate statement case don’t have to show duty element at all if misstatement, only if proceed by
inaction or silence

1. General rule: If you make a false statement, and someone buys or sells stock from
you, the ∏ does not have the burden of showing you have a duty to disclose; the falsity
itself subsumes the duty
   a. Usually applies to insider trading cases
   b. Also relevant to business corporations in making disclosures to public; if
corporation omits to disclose something, a ∏ may bring a lawsuit and claim
corporation had a duty to disclose

2. Chiarella v. United States—not every occurrence of financial unfairness constitutes
fraudulent activity under 10b-5 and element that makes silence fraudulent is a duty to
disclose
   a. SC makes value judgment that system where information gets to public quickly
is more important than market egalitarianism
   b. SC didn’t address theory that ∆ breached duty to acquiring company because
he was an employee
   c. SC didn’t address misappropriation theory offered by Burger—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
information and violated 10b

3. Dirks v. SEC—violation of 10b-5 based on tippee liability—when a person learns of
material corporate information that they know or should is confidential and know or should
know has come from a corporate insider they should disclose or abstain from trading; FN
14—creates huge list of constructive insiders who are outsiders but have similar
expectation of confidentiality
   a. How to tell someone has breached duty?
      i. Look for benefit—money or swapping tips
      ii. Relatives or friends
   b. Exception to Dirks rule—can trade when information is appropriately given
outsiders when conveyed for other corporate reasons and not for the purpose of
trading
   c. Elements to Dirks liability
      a. Violation of fiduciary duty
      b. Culpability of tippee—tippee knew tipper had duty

4. Misappropriation—10b-5 liability arises when a person trades on confidential
information in breach of a duty owed to the source of the information, even if the source is
a complete stranger to the securities traded
   a. US v. O’Hagen—deception of the source needed for misappropriation, but
deception occurs when you say nothing; this has scienter element—only that
person originated the trade misappropriated information with knowledge of
deception on the source; limited to criminal enforcement
   b. Most clear that duty has been breached when information is misappropriated in
breach of an established business relationship
c. Misappropriation can also be the basis of nonsecurities criminal liability through mail and wire fraud

H. Remedies for Insider Trading

1. SEC Injunctions and disgorgement—SEC seeks court order enjoining insider trader or tippee from further insider trading and compels the disgorgement of any trading profits; See SEC v. TGS

2. Civil liability to contemporaneous traders—Insider Trading and Securities Fraud Enforcement Act limits recover to traders whose trades were contemporaneous with the insiders; recover is based on the disgorgement of the insider’s actual profits realized or loss avoided, reduced by an disgorgement obtain by SEC; See Elkind v. Liggett & Meyers

3. Civil recovery by defrauded source of confidential information—owners of confidential information who purchase or sell securities can bring a private action under rule 10b-5 against insiders traders and tippees who adversely affect their trading prices; See Blue Chip Stamp; defrauded company may recover if it suffered trading losses or was force to pay a higher price in a transaction because the insiders’ trading artificially raised prices

4. Civil penalties—Insider Trading Sanctions Act authorizes SEC to seek a judicial imposed civil penalty against traders and tippees who violate rule 10b-5 up to three times profits realized or loss avoided; this is in addition to other remedies—can disgorge and pay treble damages

5. Watchdog penalties—Insider Trading and Securities Fraud Enforcement Act of 1988 extends civil penalties to employers and others who control insider traders and tippers; controlling persons are subject to additional penalties up to $1M or three times the insider’s profits if the controlling person knowingly or recklessly disregards the likelihood of insider trading by person under its control

6. Bounty rewards—1988 act grants SEC authority to pay bounties to anyone who provides information leading to civil penalties

7. Criminal sanctions—maximum fines are $1M for individuals and $2.5M for non-individuals; jail sentence maximum is 10 years.

IV. New developments

A. Rule 10b5-2—adopts knowing possession test to solve question of whether or not violation of 10b-5 must be on basis of material nonpublic information or while in possession of such information

B. Chestment problem—Rule 10b5-1 holds that just as insider couldn’t have bought more stock in old firm based on future tender offer, neither can family

C. Regulation FD—deals with issue of selective disclosure

1. Prohibition on selective disclosure of material information to a broker dealer, investment adviser, investment company or a holder of issuer’s stock

2. Disclosure must be simultaneous if intention or within 24 (promptly) if not intentional

3. Public disclosure not required if information disclosed to: a person who owes a duty of trust or confidence (FN 14 Dirks), a person who agrees to maintain information in confidence; a credit rating agency or in connection with public offering under 1933 Securities Act