I. LIMITED LIABILITY: This is the answer behind the evolution of corporate law. Questions of limited liability concern when a company can indeed be given limited liability, as reasons of incorporation concern dispute avoidance. If the corporation is given limited liability, Courts have often declined to deprive shareholders of limited liability in defectively formed corporations.

A. Protection of Limited Liability if Defective Incorporation: Question concerned whether the officer of a defectively incorporated association could be personally liable. Cranson was partner in business, certificate not effective for several months. Cranson’s corporation owed $4K to IBM. Cranson held not personally liable. De Facto and Corporation by Estoppel 1) essentially eases the harm of defective incorporation, not punishing managers or investors. These are two devices of amazing elasticity to prevent people who haven’t incorporated and 2) allows politicians to have companies and thus jobs, entrepreneurialism, risk-taking, many economic benefits. etc. Investors, etc., shielded to extent of proper incorporation.

1) De Facto Corporation: Officer or shareholders of corporation not personally liable if a; b; or c. State can challenge a de facto corporation; outside parties cannot if corporation if not De Jure:

a. Existence of Law: If there is the existence of a law authorizing the existence of the corporation, the corporation is a de facto corporation.

b. Good Faith Effort: There must be a good-faith attempt to incorporate. [No Good Faith effort to incorporate in Cranson, talking to attorney and being told you’re incorporate not enough].

c. Actual Use of Corporate Powers: The corporation must have actually used the corporate form, such as carrying on the business of contracting.

2) Corporation by Estoppel: If a party deals with a corporation, it is estopped from then saying the corporation is not a corporation and seeking personal liability. [IBM estopped in Cranson].

a. Only in Contracts, Not Available in Tort: Corp. by estoppel is only applicable in contract, not tort. Potential plaintiff can protect themselves with high rate, for example, credit card companies. Law likes limited liability, but not too much.

B. Piercing the Corporate Veil: Very Rare exception to limited liability (law doesn’t want to chill capital formation, etc.). The flipside of limited liability is when the privileges of incorporation can be taken away by “piercing the corporate veil” to get at managers, investors, etc. In a piercing case, the corporation has been properly incorporated and is generally structurally proper, however, it shouldn’t get the advantages of limited liability. Done on: a) closely held corporations mostly, usually if individual owner; b) to get the parent corporation if the parent is the owner of a risky subsidiary; c) enterprise liability/sibling of multiple corporations. Generally, though risk of creditors largely shifted to the creditors, so it’s hard for them to pierce. [Walkowsky v. Carlton]: Plaintiff run over by defendant’s taxicab, defendant owned 100% of taxicab corporation as well as ten others similarly. Courts states Privilege of escaping personal liability is not without limits, however plaintiff did not plead well that the defendant corporation was acting in individual capacity, essentially]. Personal liability can still be done for tortuous acts, etc. Facts of piercing generally involve:

1) Alter Ego or Instrumentality Rule: For above situations, closely held, etc., court considers if such are the alter ego or the instrumentality, it would be such an alter ego or instrumentality if:

a. Corporate Formalities: To generally pierce the veil, courts look at corporate formalities such as shareholders meetings, directors meetings, stock issuance, election of officers, corporate minutes, etc. Lack of corporate formalities can demonstrate failure to respect the corporate form by shareholders, etc. Corporation could just be a “shell.”
b. Other General Factors, Varying by Individual Case: Inter alia: 1) commingling of funds and not having separate bank accounts; 2) diversion of funds; 3) identical equitable ownership in two entities; 4) identity of directors; 5) absence of separately held corporate assets; 6) individual ownership; 7) business and office location; 6) similarity of employees, attorneys, etc.; 7) concealment or misrepresentation; 8) diversion of assets; 9) use of corporation as subterfuge; 10) formation to assume another liabilities, etc. [Laya v. Erin].

2) Inadequate Capitalization: In addition to the alter ego or instrumentality doctrine, second major way. Though in Walkovsky insurance met minimum statutory standard, sometime assets are trifling and excessive risk should not be encouraged. If business organized and run without enough money, piercing is justified. [Minton v. Cavaney: Extreme form of piercing, pool corporation personally liable]. Corporations should be expected to have enough money for business purposes.

3) Fraud: (See Securities, 10b-5). Will also allow direct damages.

II. CORPORATE PURPOSES (AND SOCIAL RESPONSIBILITY): Ultra vires (meaning “beyond the powers”) doctrine originally limited corporation to just performing the powers stated in the corporation’s charter. Doctrine not really alive today – it is dormant. It won’t allow a corporation to get out of lease, etc. if it was “beyond the powers.” (Corporate purposes not to be confused with duties. [Dodge v. Ford: Ford decided to not pay a $10M dividend and thus finance the River Rouge plant, lower the price of cars and pay high wages. Held: Ford must pay the dividend. “A business corporation is organized and carried on primarily for the profit of the stockholders.” And Ford can also expand (“Judges are not business experts”). Ford was altruist but it was bad for shareholders. And really Dodge wanted dividend to start its own company, which it did]. Look to business explanations and non-business explanation for corporate behavior.

A. Charity Acceptable: [Smith v. Barlow: Smith Co. donated $1500 from Co. Treasury to Princeton. Donation was in furtherance of “personal rather than corporate ends.” Donation was a) reasonable in amount; (up to 5%) look to tax, 501(c)(3) etc; b) indirect benefit to donee, community, etc. Can’t be pet charity.] Criticized, however, by economist/lawyer Friedman.

B. Other Constituencies than Shareholders: [Unocal v. Mesa Petroleum Co. (1985): In tender offer, Board considered impact of potential tender offer on creditors, customers, employees, etc. Delaware Supreme Court: that’s okay].

BUT Slight Retreat from Unocal [Revlon v. MacAndrews (1986): Regard for other constituencies if rationally related benefits accruing to stockholders.] 25 states have enacted “other constituency” statutes. Not Really Recognized Doctrine in US, though. Other countries heavily value labor unions, etc.

III. DUTY OF CARE: The Duty of Care is one of the two principal duties that directors (or officers) owe to corporations (the second is loyalty). In corporate law, this is the basic negligence concept. FOCUS ON SUPERVISING DUTY However, Delaware is popular, you can be clumsy, still protected. Tough to show DOC.

A. The Basic Standard: There is a limited framework by which Bd members must act to limit liability. Thrust of Sarbanes-Oxley is to change model committees. Largely Supervisory BS limited to.

a) Duty to Supervise and One Bite Rule [Bates v. Dresser: The Board, no responsibility until it is put on notice that there could be a prob Red Flags are needed.]

b) Duty to Perform with skill of Person in Like Position and Keep Informed (But reluctance to Hold Bd Liable): Needed: “good sense” says Hand. [Barnes v. Andrews (1924): Passive director Andrews not liable when president had not done job and director has met just occasionally with president. Though Director had failed to keep apprised and informed of the corporation’s
affairs. What could bd member have done anyway, says Hand. And people wouldn’t become bd members if they’d be liable.]

c) **Breach must be Proximate Cause**: Directors breach must be proximate cuase. This serves as an affirmative defense. [*Barnes v. Andrews*]

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B. **Change in Basic Standard**: If 1) **Violation of Duty: Evidence of Wrongdoing**, duty to investigate, stay informed. Noisy withdrawal is required by director. Thus compliance system is required to be put into effect. [*Francis v. United Jersey Bank* (1981): Suite by bankruptcy trustee against widow and two sons. Widow wasn’t keeping an eye on her sons scamming. Widow was vegetable, on painkillers, her assets would go to sons, thus court allows going after mom. Director can’t just be a figurehead]. Breach of Duty must be 2) **Proximate Cause**: there must be a link between the breach and the plaintiff’s loss and the link must contribute to that loss. Substantial factor, not necessarily biggest factor. Plaintiff must carry the burden. Furthermore, duty of Care violations must be egregious – it is not a close judgment call. These are real outliers.

*EXAMPLE: The Waste Doctrine*: Example of Duty of Care violation is the Waste Doctrine. Plaintiff must show that the compensation was: a) waste of corporate assets; b) had no relation to the value of services given thus being Totally Irrational; and c) was really a gift. Look to other companies in the industry, for ex. [*Rogers v. Hill*: courts generally deferential to bds approval of compensation]. And the “lightbulb can bring shame.” Exposure is best way to challenge.

*BUT*

C. **The Business Judgment Rule Defenses**: To encourage risk-taking and shareholders voluntarily invest knowing that, shareholders can invest elsewhere, directors are encouraged to serve. After showing above Duty of Care claim, Defendant not liable if Plaintiff cannot rebut. Used only in rare, rare cases where defendant is pathological! Mostly paper preceedings in Delaware, little discovery.

1) There was **no conflict of interest**, essentially, judgment was disinterested (lack of good faith);

2) Defendant director was **reasonably informed** and thus not entirely irrational; Informed is question of materiality. [*Smith v. Van Gorkom*: Directors were not adequately informed when they sold the company in a merger. Van Gorkom had done it all].

or

3) Defendant thought judgment was in **best interests** of company.

**OVERALL RULE**:  
1) Plaintiff has burden to show DOC was violated; 2) causation; 3) damages; 4) overcoming BJR defense. And in DE, gross negligent standard 102(b)(7) and according to 102(b)(7), board may amend certif. of incorp. So it won’t be subject to monetary damages. Law protects risk-takers. SEC, though, no BJR defense, dealt w/differently.

**IV. DUTY OF LOYALTY**: Unlike the Duty of Care, the Duty of Loyalty has much more commonly been the basis for liability. FIRST: Focus on Plaintiff showing: **CONFLICT OF INTEREST**. More common. Concern is on shareholder protection.

A. **Self-Dealing Transactions by Management, etc.** Modern corporate law does allow self-dealing when it is fair to the corporation. Self-interest and passive interest of other complicate though. There are three types of fact patterns: 1) Bd and director self-dealing; 2) interlocking Bd; 3) parent to subsidiary self-dealing. The structural bias is that the parties may be less willing to bargain with tough-mindedess.

1) **1880 Law**: Self-Dealing was per se voidable.

2) **CHANGE TO Basic Standard**: Must be Arms-Length Transaction –. The Standard then changed to whether the self-dealing transaction.
Influence exerted in many ways. [Globe Woolen (1918): Dominating director failed to inform Bd. of problems of one-sided supply contract. Influence exerted.]

Must be Arms Length Transaction. [Gries Sports Enter. v. Cleveland Browns (1986): Director not disinterested if they act without independent judgment.]

3) Safe-Harbor Statutes: Rule 144 In Delaware, if majority of disinterested directors authorized the transaction then it was fair. [Marciano v. Nakash (1987)]

OVERALL RULE: 1) Plaintiff must show conflict of interest; 2) Defendant Bd then shows arms-length (takes many lawyers to structure a deal accordingly), use safe-harbor statute if possible, like BJR; 3) Plaintiff then shows deal unfair if it was interested. Outcome determinative.

B. Corporate Opportunity Doctrine: Corporate managers are not flatly prohibited from taking outside business opportunities. Subset of Duty of Loyalty. Balance of corporate interests/opportunities and entrepreneurial interests. Mgr can’t do if:

1) Same Line of Business in Which Corporation has an Interest or Expectancy: Imprecise test but generally the main one. [Guth v. Loft (1939): Guth was CEO of Loft, Loft made candies and beverages, bought from Coca-Cola. Loft started buying shares in Pepsi-Cola, then having Loft buy Pepsi-Cola. Opportunity belonged to the Loft, not Guth. Loft had interest or expectancy in Pepsi-Cola, etc.] Remedy was constructive trust

2) Offer to Executive in Exec. Capacity and not to Individual: [Johnston v. Greene (1956): Look to Interest of Expectancy first, it’s more important, unclear though in Johnston because line of business not certain.][Northeast Harbor (1995): Property offered to golf club president in capacity as club president, not as individual].

3) Corporation was Financial Ability to Undertake Opportunity:

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ALI Principles: The Standard: Exec. must give full disclosure before taking advantage of opportunity. Corporate opportunity is a business opportunity that:

1) Director or senior exec. Became aware of in official capacity.
2) The opportunity is in connection with work, offered essentially to corp.
3) Director, exec. should reasonably believe that opportunity would be of interest to corp.

OR

4) Opportunity is closely related to business activity of corp.

C. Interested Mergers: An interested merger is see above. If offensive to Fair Dealing, etc.

Defendant Carries Burden: of showing fair.
1) Requirements: Inherently conflict of interest. In an interested merger, duty of loyalty requires: 1) Fair Dealing: Concerns the structure of the deal, approvals, procedure, etc. [Weinberger: (1983) Deal not structured fairly, even though it could have been fair price.]

and

2) Fair Price: Appraisal Remedy: Concerns different means of getting price:

Delaware Block Approach: [Libby McNeill (1979)] Percentage collection of earnings per share, asset value per share, market price. Broadened/Overthrown in Weinberger: Price not thoroughly evaluated. Other techniques can be used.

Discounted Cash Flow can be used, too. [Weinberger (1983)]: Take money in future and discount it to today’s value. Essentially other acceptable accounting practices can be used.
V. SHAREHOLDER SUFFRAGE: In addition to Fiduciary duty and mandatory disclosure systems, electoral rights also deters corporate dysfunctionalism. Electoral rights are the weakest tool, though. And management, in addition to law, is disciplined by markets, etc.

A. Cumulative Voting: Cumulative Voting is a technique to ensure that minority shareholders and shareholder blocs could have some representative on the board (versus straight voting). Only 14% of Fortune 500 has cumulative voting. Multiply shares times seats, can be tricky, arithmetical. Cum. voting is on the decline. In 1992 only 6 states have.

B. Proxy Expenses: Voting for companies largely is done by absentee voting. Incumbent Bd is allowed to pay for expenses of incumbent Bd in proxy contests. Corp. will not pay expenses of challengers unless challengers, obviously, win. If they do win, Bd will pay both. Free Rider problem, if there is a benefit by insurgents, all benefit. More institutional shareholders make it less expensive though, less shareholders.

1) Policy: Voting expenses must relate to corporate policy. Courts always support. [Rosenfeld]

2) Reasonable in Amount: Expense must be reasonable in amount.

VI. THE CLOSE CORPORATION: Generally deals with state law. Versus a publicly traded corporation, a close corporation has generally the same: 1) Limited Electoral Rights; 2) Mandatory Disclosure; 3) Fraud Under 10b-5. Basically a close corporation is a small business with less than 50 owners who want less entrepreneurial business driven. There is majority rule and centralized management.

BUT ALSO OTHER REQ.'S

A. Heightened Fiduciary Duties: In corporation you can sell your shares – the Wall Street Rule. But in Close corporation is basically an incorporated partnership. No liquidity, generally – illiquidity. Problems: Freezeout: Majority can isolate minority from participation; Forceout: Majority can manipulate structure and push out minority. So because no market out, there are heightened fiduciary duties. [Donahue v. Rodd (1975): Donahue didn’t want Rodd having 80% of company. Heightened fiduciary duty. Duty of “utmost good faith and loyalty” by majority to minority. Hard to determine value. So Have a higher duty of loyalty. It's Like a Partnership. Equal offer need not be made to all, but equal opp. When repurchase.] Also, it goes both ways for minority! 


a) Legitimate Business Test [Wilkes]

b) Least Harmful Means [Wilkes: Not known how to prove.]

B. Voting Agreements: No longer really true that one share equals one vote. So there are other means. Sometimes preference for patriarchs or matriarchs to concentrate and control voting.

1) Vote-Pulling Agreements: Vote-Pulling agreements are allowed but not directly enforceable. [Ringling Bros. I (1946)] No filing requirement. Thus there There can be big deadlock in close corporations. [Ringling Bros. II (1947)]

2) Vote Trusts: Unlike a vote-pulling agreement, a voting trust must have board and be filed. Legal title to voting is transferred to a voting trustee. Avoids the need for court-ordered specific performance. And transferability of ownership interests.

C. Deadlock Avoidance in Close Corporation: If there is indeed deadlock, oppressive action will justify the dissolution of the close corporation. Oppressive action occurs when reasonable expectations of minority stockholders who joined corp. are not met. There must be 20% or more owned by minority. [Kemp v. Beaty (1984): Law clearly stretched]. Financial payouts can avoid in LLC. LLC is very popular.
VII. TENDER OFFERS: The big question of tender offers is when can a business put up a defense. Tender offers are usually done going after under-performing companies. Cast includes bidders and the target. Target composed of managers, ees, shs (institutional, arb.s, and constituencies) and there are White Knights and lowball bidders. Shareholders may went tender offer, but corporate officers may fear dismissal. TOs occur because as disciplinary tactic, horizontal and vertical growth, exploitation, etc. So what are the takeover defenses when a bidder asks shs to “tender” their shares?

A. Threat: [A Modified Business Judgment Rule]: Burden is on the Bd to show that a TO was a real substantive threat to the company. It must be 1) threat (obviously defendant would be able to show somehow, or bring in experts and make up threat); 2) good faith investigation; 3) reasonable response. [Cheff v. Mathes (1964): Corporate Raider threatened, so company used money to buy its own stock. Company act okay.]

THEN APPLYING Cheff, A CHANGE

B. Heightened Business Judgment Balancing Element: Defensive reaction must be a threat respons: 1) reasonable response to bidder’s action, which would essentially be bad for the company; and 2) response must be reasonable in relation to the threat posed. [Unocal (1985): Well known greemailer, and threat also: inadequacy of price offered, nature and timing of offer, questions of illegality, impact on constituencies, ] Basically, companies have a roadmap to follow, must be for good of shs, and even, yes, constituencies.

THEN APPLYING Unocal, ANOTHER CHANGE

C. However: When Sale of Company Inevitable: [Revlon (1986): Bd. must serve as 1) auctioneer; lock-ups okay if they do not end the auction. Mgrs must maximize the value of the company.]

OVERALL RULE: 1) Burden is on defendant when sale is inevitable, inherent conflict of interest because Bd. could lose its job; otherwise Unocal Bd. must show a) substantial threat; b) reasonable response. Response can’t violate duty of Care, however.

VIII. FEDERAL PROXY FRAUD: RULE 14a-9

A. Rule 14a-9: Rule applies only to fraud when one is seeking a proxy for a corporation under 14a. Deals with the voting processes. So corporate misinformation, essentially. 14a-9 deals with fraud, materiality and culpability. Most cases 14a-9 false and misleading info pre-merger, etc. Requires:

a) False and misleading statement or omission.

b) Materiality of the false statement or omission.

FIVE DECISIONS DEMONSTRATE

B. Implied Cause of Action: Individuals have an implied cause of action under 14a for false and misleading proxy statements. SEC can’t handle it all. Purpose of SEC laws is to protect investors anyway. Private investors supplement SEC enforcement. Federal law handles proxy fraud, not states. [J.I. Case v. Borak (1964)]

C. The Elements: To show 14a-9 proxy fraud:

1) Causation: Look to Essential Link. Causation need not be proved when shareholder votes are an essential link. [Mills v. Electric Auto-Life (1970): Proxy statement to 46% of company to get 2/3 votes was definitely essential link. Case concerned the omission of who offeror was, etc.]

2) Materiality: [TSC Ind. v. Northway (1976): Fact is material “if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”]

a) Mosaic Theory: Look at totality of information.

b) Predictive of Future Events: [Basic v. Levinson (1988) Basic engaged in pre-merger discussions, denied these discussions however instead of just keeping quiet. Info. was
material. Should have said “no comment.”] So calculate: (Probability of Fact becoming true) X (magnitude of fact). Merger is definitely gonna be big. Look at totality of events.

c) **Quantitative Theory**: By quantitative theory, fact is material if it would have an impact on the stock price of 10% or more, 10%+ total assets, 10% annual income. Less than 5% probably note..

d) **Qualitative Theory**: By qualitative theory, any fact such as duty of loyalty violations, criminal activity.

e) **SEC Fact: Material**: Definitely.

f) **Opinions, Motives, or Reasons**: [*V.A. Bankshares* (1991): Shareholder must prove that speaker did not believe opinions, had no reason to believe opinions, and knew something contradictory]. Tough to do, however, statement can be both just a misrepresentation and material. Doctrine of Puffery no longer alive. Bespeaks caution can help.

**IX. SECURITIES FRAUD: RULE 10b-5**: 10b-5 of Securities Act of 1934 deals with two basic types of cases: 1) insider trading and 2) false corporate statements. Can apply to proxies.

1) Fraud
2) Material Misrepresentation = reasonable investor would consider it in trading.

**A. The Elements**: To use, find a purchase or sale, check in connection with requirement.

1) **Standing**: To avoid professional plaintiffs, the plaintiff must have standing by having actually bought or sold the security. 26 specific exceptions to standing. Potential buyer or seller will not have standing. Loss must have occurred. [*Blue Chip Stamps* (1975): As part of antitrust settlement, store ordered to sell stock to competitive retailers. Prospectus very pessimistic. Standing limited to those who had *bought or sold* stock, not Drug Store that might have bought stock].

2) **Scienter**: Actual knowledge is sufficient (for forward looking statements). Recklessness is reserved. Negligence will not suffice. [*Ernst & Ernst v. Hochfelder* (1976): Ernst was accounting firm, not aware that client was embezzling, thus not liable because no scienter.]. Hard to show state of mind and intent. Section 21E culpability standard is much narrower.

3) **Reliance**: Reliance only applies to material misrepresentations. Plaintiff has burden. But, plaintiff does not have burden of proving actual reliance for an omission. [*Basic v. Levinson*]

   a) **Fraud on the Marketplace Rebuttable Presumption**: Need not show that plaintiff read misstatement, etc. This is the applicability of the efficient market hypothesis. Market reflects reliance. Must be impersonal, large national market. Face to face won’t do. Rebuttable by showing that market was inefficient, plaintiff would have traded anyway.

4) **Duty**: Omission – In Insider Trading Cases. Duty arises out of fiduciary relationship when it comes to material nonpublic information. [*Chiarella* (1980): Printer employed to print T.O. documents knew of impending T.O. No duty because EE did not have a duty to abstain or disclose information. No duty to target corp.; duty to ER reserved, misappropriation reserved.] Awkward and unsatisfactory, though. Capital information hampered and egalitarian principle [*Texas Gulf-Sulphur*] not effective.

   **Tipper/Tippee**: [*Dirks* (1983): Dirks was tippee, Secrist was tipper telling Dirks about big insurance fraud. For Secrist to be liable: 1) tipper (Secrist) must have been violating
fiduciary duty; 2) tippee (Dirks) must have known tipper was violating fiduciary duty; 3) there must be some benefit to the tipper (Secrist)]. Basically Quid Pro Quo. All this is hard to show. Analysts and whistle-blowers immune. Tipper can be liable, if down the line sub-tipper trades even if Tipper doesn’t trade. If sub-tippees know or should know that info. came from fiduciary breach, they’re liable.

&

Constructive Insiders: FN14 [Dirks]: Accountants, lawyers, investment bankers as have same 10b-5 duties as corporate insiders.

Strangers: Strangers with no 10b-5 duty (thus no fiduciary relationship are not liable).

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Misappropriation Theory in Criminal Cases: This is deception on the Source of information. [O’Hagan (1997): Lawyer using inside info. had fiduciary duty to the corporation from where he got the source]. Requirement is to protect integrity of securities markets from outsiders. O’Hagan stands for outsiders (insiders already covered). And don’t forget mail and wire fraud.

5) “In Connection With”: The fraud must be “in connection with” a securities trade. [Texas Gulf Sulphur] [O’Hagan]. Outright theft is not a 10b-5 violation, that’s just criminal.

B. Regulation Fair Disclosure (Reg FD): To get around disclosure problems of companies not knowing bad trading from good. Rules encourage release of information, stops problem with analysts getting a lot of info so favor curried. Enforceable only by SEC.

1) Prohibition On: Companies from selectively disclosing information to: a) broker-dealer; b) investment-adviser; c) investment company; d) holder of issuer’s stock.

2) Public Disclosure Disclosure: If intentional it must be simultaneous. If unintentional, w/in 24 hours.

3) Public Disclosure Not Required If: a) to person with duty of trust and confidence; b) person who agrees to maintain info; 3) credit rating agency; 4) someone in connection with public offering under ’33 Act.