I. LIMITED LIABILITY

A. Cranson v. IBM p. 84-95: Appellee was granted summary judgment in the lower court on the theory that a defectively-formed corporation was neither a de jure nor a de facto corporation, and that appellant, as a partner, was personally liable for its debts, namely, the balance due on electric typewriters purchased by the corporation. After examining the doctrine of de facto corporations, the court reversed, holding that, even though one or more of the requisites of a de facto corporation were absent, application of the estoppel doctrine was not precluded. Neglect in defective formation could not be used by a corporation as a defense to an action to enforce its liabilities, and, since estoppel was based upon the inequity of permitting the denial of corporate existence by those dealing with it as such, appellee was estopped from denying the legality of that which was not even a corporation de facto. Judgment reversed because, although appellant lacked one of the requisite factors of a de facto corporation, appellee, who had dealt with the corporation as such, was estopped from denying its existence.

1. De Facto Corporation (See p. 85)
   - Existence of law authorizing incorporation
   - Good Faith Effort - to incorporate under the existing law Failure to file papers all together is not good faith, would be if you left off seal or forgot to pay a fee.
   - Actual Use or exercise of Corporation Powers would not occur if before a corporation began to operate there was a lawsuit of some sort to prohibit it’s incorporation (?)

2. Corporation by Estoppel – employed where the person seeking to hold the officer personally liable has contracted or otherwise dealt with the association in such a manner as to recognize and in effect admit its existence as a corporate body–
   - requires someone to treat you as if you were validly incorporated; correspondence or checks addressed to “incorporated”
   - Frequently invoked in contracts cases because outside party has capacity for self help
   - Almost never works in tort (in contrast to self-help)
   - Reflection of how cherished doctrine is for inspiring economic activity
     - Corporations inspire employment, higher levels of economic development
   - Corporations are often validly incorporated and they will be challenged

B. Piercing the Veil (i.e. circumstances when the courts will override their strong policy preference for limited liability)

1. Alter Ego or Instrumentality Rule – refer to the various situations that are an abuse of the corporate privilege;
If you treat a corporation as if it is your agent, your personal property, then the veil can be pierced

a. Corporation formalities: Whenever anyone uses control of the corporation to further his own rather than the corporation’s business, he will be liable for the corporation’s acts; If you had commingled corporate assets, a single number for cabs, used cabs for corporate and personal use

1) Waslkowsky p. 88-93: Plaintiff alleged that he was injured when a taxicab struck him. Defendant was stockholder of ten corporations, each of which had two cabs registered in its name and carried the minimum automobile insurance required by law. Although independent of one another, the corporations were alleged to have operated as a single enterprise. Plaintiff contended that he was entitled to hold defendant personally liable for his damages because the multiple corporate structure constituted an unlawful attempt to defraud members of the public. Defendant appealed the court's ruling that plaintiff had stated a cause of action. The court held that, whenever anyone used control of a corporation to further his own rather than the corporation's business, he would be liable for the corporation's acts under the principle of respondeat superior. However, the decision was reversed because plaintiff’s complaint failed to allege that defendant was doing business in his individual capacity.

b. Kinney Shoe at Handout 23-24 footnote: don’t treat the corporation with the dignity it deserves
   - Mere fact that you have a single shareholder does not qualify to pierce the corporate veil
   - Court do not like doing this, general presumption in favor of corporate-ness

2. Inadequate Capitalization: there are no minimum sums of dollars one needs to form a corporation; you will only pierce the veil for inadequate cap when the capital is trifling as compared to actual need of corporation
   a. Minton p. 98-100: Defendant, the estate of a former director of a defunct corporation, appealed from a trial court judgment holding it personally liable for a wrongful death award against the corporation in a prior litigation. Defendant argued that decedent, an attorney, merely accepted director status to accommodate the defunct corporation, and the evidence did not support the determination that the "alter ego" doctrine was applicable. The court disagreed, holding that the trial court was not required to believe the statement that decedent was only a "temporary"
director and officer "for accommodation." However, the court reversed the judgment on the grounds that decedent was not a party to the wrongful death action against the corporation, and the judgment in that action was therefore not binding upon him.

b. “The equitable owners of a corporation for example are personally liable when they treat the assets of the corporation as their own and add or withdraw capital from the corporation at will; when they hold themselves out as being personally liable for the debts of the corporation or when they provide inadequate capitalization and actively participate in the conduct of the corporate affairs.”

c. The evidence is undisputed that there was no attempt to provide adequate capitalization.

3. Fraud - puts out a statement claiming to have a certain amount in assets and does not

A corporate veil can be pierced either to reach:
- An individual or individual shareholders
- A parent corporation
- “sibling” enterprises

II. CORPORATE PURPOSES

A. **Dodge v. Ford** p. 109 Defendant corporation's directors decided to exercise their discretion and hold back part of the company's capital earnings for reinvestment, thereby denying certain expected dividend payments to plaintiffs. Plaintiffs contended that the reason defendant corporation was holding back dividends, partially to reinvest in the company and bring down the ultimate cost of buying a car, was semi-humanitarian and was not authorized by the company's charter. The trial court held that defendant corporation was entitled to reinvest surplus capital gains at their discretion and did not order further dividends paid out. The appellate court reversed that decision and held that the accumulation of so large a surplus established that there was an arbitrary refusal to distribute funds to stockholders as dividends and ordered that such dividends, plus interest, should be paid by defendant corporation.

- When you have a corp incorp for profit and no language to the contrary in the certif. of incorp it must act primarily for the benefit of the shareholders, you can make contributions to the community but only to the extent that you can show a benefit to the shareholders

B. **Smith v. Barlow** at 115-120: Plaintiff company made a donation to Princeton University, and defendant stockholders sought a declaratory judgment to question the legality of plaintiff's donation. The lower court determined that plaintiff's donation was intra virens, and defendants sought review. On appeal, the court held that corporations were permitted to make contributions where the activity being promoted by the gift promoted the goodwill of the business of the corporation. Pursuant to N.J. Rev. Stat. §
14:3-13.1, et seq., corporations could make charitable donations provided that the contribution was not made to a donee institution that owned more than 10 percent of the voting stock of the donor and provided that the contribution had not exceeded one percent of capital and surplus, unless such donation was authorized by the stockholders. The court held that plaintiff's donation was valid. The court affirmed a judgment of the lower court.

- Primarily for benefit of shareholders

**Hypotheticals**

1. Should a shareholder be permitted to enjoin a corporation from honoring a contract unenforceable under the statute of frauds?

2. An employee with 19 years experience is seriously hurt; his pension vests after 20 years. Could the corporation buy an annuity for him?

3. Corporation A hopes to gain a supply contract from Corporation B, a large firm. Profits will equal $5 million over two years. A vice president of Corporation B can guarantee that Corporation A will secure the contract for Corporation A if Corporation A will pay him $200,000. The risk of detection is small. Should Corporation A make this payment?

4. J Corporation runs a restaurant, the controlling interest in which is held by S. S. dies. The restaurant is inherited by T, who converts the restaurant to a strict vegetarian menu. Can a minority shareholder enjoin the menu change?

**B. Charity – reasonable in amount**

1. Indirect benefit

**C. Unocal v. Revlon, Constituency Statutes at 124-125:**

- Unocal: The DL S.C. appeared to dramatically tilt the traditional notion of a corporation’s basic purpose when it reasoned that a board of directors could take into account, when analyzing the appropriateness of a tender offer defensive measure, its “impact on the ‘constituencies’ other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally”

- Revlon: “A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders.”

- maybe the purpose of the corporation isn’t just to the benefit of the shareholders, but also reaches out to other constituencies; half the states in the country have adopted constituency statutes (mostly limited to takeover statutes) Constituency Statutes at 124-125

**III. DUTY OF CARE**
A. Basic Standard: basic negligence concept Directors and officers, their duties in good faith and with that degree of diligence, care and skill which ordinarily prudent person would exercise under similar circumstances in like positions

1. Bates v. Dresser p. 143-147: (Duty to supervise): Appellant bank president and directors and appellee bank receiver appealed the circuit court's judgment in favor of appellant directors but against appellant bank president on appellee's bill in equity charging appellants with the loss of the bank's assets though a bank employee's theft during their tenure. Although there were warning signs that the thieving employee was living the fast life and another employee raised the issue of possible theft, the theft was not ascertainable on the face of the bank's ledgers and semi-annual audits revealed no fraud. The Supreme Court affirmed the circuit court's entry of judgment in favor of appellant directors since there was no indication that they should have been on notice of the bank employee's theft; it also affirmed the judgment upholding appellant bank president's liability since he assumed responsibility for losses to the bank which were chargeable to his failure to act on the warning signs.

Note: obligation greater for full time President than for members of the board who are episodically there

   o Corporate boards of directors have a duty to supervise, not always demanding but when something puts them on notice they have a duty to inquire

      a. One bite rule: If you have notice then you have a duty to take action (one bite rule), you have no duty to investigate until you are given notice that something is wrong.

2. Barnes v. Andrews p. 147-151: Plaintiff filed suit against defendant with respect to the latter's role as director of a corporation. The action centered upon general liability for the collapse of the enterprise; his specific liability for overpayments made to an individual, and his specific liability for the expenses of printing pamphlets and circulars used in selling the corporate shares. The court dismissed the suit, holding that there was no evidence that the defendant's neglect caused any losses to the company, and that, if there were, that loss could not be ascertained.

Note: business judgment rule NOT a defense to monitoring

   a. Duty to perform with skill of person in like position (i.e. the D must be judged based on the duties of a director); duty to keep reasonably well informed, only occasionally asked CEO how things were going

   b. Causation: “The Plaintiff must accept the burden of showing that the performance of the defendant's duties would have avoided loss, and what loss it would have avoided”; reminded that this is a negligence claim, so must not only show a violation of the duty but also that the violation caused the damage (i.e. how much could have been saved by specific actions)

3. Francis v. United Jersey Bank p. 157-166: Defendants argued that the corporate directors whom defendants represented were not liable for fellow directors' conversion of trust funds because they were not aware of it. Plaintiffs argued that the directors were negligent in not noticing or trying to prevent the misappropriation, and that their negligence proximately caused the resulting harm. The court held that the directors
did have a duty to exercise ordinary care in managing the corporation. The court noted that ordinary care included becoming familiar with corporate business, staying informed about activities, becoming familiar with corporate financial status, and objecting to or taking means to prevent illegal activity when it was discovered. The court then found that the directors had breached their duty by failing to do those things, and that such negligence proximately caused plaintiffs harm.

a. Basic Standard Amplified: “As a general rule, a director should acquire at least a rudimentary understanding of the business of the corporation. Accordingly, a director should become familiar with the fundamentals of the business in which the corporation is engaged. Because directors are bound to exercise ordinary care, they cannot set up as a defense lack of the knowledge needed to exercise the requisite degree of care.”

b. Proximate Cause Modified: “Determination of the liability of Mrs. Prtichard requires findings that she had a duty to the clients of Pritchard & Baird, that she breached that duty and that her breach was a proximate cause of their losses.”

4. Caremark Handout p. 28-31: The director’s duties include the duty to attempt in good faith to ensure that an adequate corporation information and reporting system operates.

<<The derivative action alleged that members of the corporation's board of directors breached their fiduciary duty of care to the corporation in connection with alleged violations by the corporation's employees of federal and state laws and regulations applicable to health care providers. The suit purported to seek recovery of losses from individual defendants who constituted the board of directors of the corporation. The parties proposed that the suit be settled. The court stated that the record did not support the conclusion that defendants either lacked good faith in the exercise of their monitoring responsibilities or conscientiously permitted a known violation of law by the corporation to occur, and that the claims asserted against them had to be viewed as very weak. Despite the weakness of plaintiffs' claims, the court concluded that the proposed...
settlement appeared to be an adequate, reasonable, and had a beneficial outcome for all parties, and thus approved the settlement.

Note: Duty to maintain reporting and information system >>

B. **Business Judgment Rule:** When a corporate director or officer makes a business judgment in good faith, he or she will not be held liable for any losses that ensue as long as the director or officer is (1) not interest in the transaction, (2) is reasonably informed with respect to the subject of the business judgment, and (3) reasonably believes that the business judgment is in the best interest of the corporation.

1. **Smith v. Van Gorkom** p. 170-204: Plaintiffs argued that defendant directors' decision to approve a cash-out merger of their corporation into another violated Del. Code Ann. tit. 8, § 251, and did not warrant business judgment rule protection. The court agreed, finding that defendant directors based their decision on one person's representations, which did not constitute a report on which they could reasonably rely under Del. Code Ann. tit. 8, § 141(e), and that they did not seek documentation of either the merger terms or the adequacy of the proposed price per share. The court also found defendant directors were grossly negligent in permitting the agreement to be amended in a way they had not authorized. Finally, the court found that the stockholders' vote did not ratify the action, because the stockholders weren't aware of the lack of valuation information, and because defendant directors' statements were misleading.
   - BJR will provide a defense to directors to who do not have a conflict of interest have made a reasonable investigation, and breach is not entirely irrational;
   - Mr. VanGorkom could not accurately describe the terms and did not have a valuation study and periodically tried to cure defects and never cured them as far as he thought he had;
   - D corp was unable to produce copy of; BJR not available to them; one consequence of this case was that boards were better prepped for decisions

   a. Informed basis: The BJR is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Thus, the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one.
      1) no conflict of interest
      2) not entirely irrational
   b. Informed: all material info available to them
   c. gross negligence

<<Leverage buyout - management buys all the public share holdings (i.e. the non-controlled group)

Very common for directors to have directors and officers’ insurance. Allows them to buy an insurance policy to protect them from duty of care violations.

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

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

SECTION 102(b)(7): Section 102(b)(7), Delaware corporate law’s exculpation statute that allows corporations to limit a director’s personal liability. Section 102(b)(7) of the Delaware General Corporation Law allows companies to adopt charter provisions limiting their directors’ liability for breaches of fiduciary duty. It was enacted in 1986, after the ruling in *Smith v. Van Gorkom* spotlighted the inadequacy of D&O liability insurance. Significantly, the statute expressly bars exculpation for breaches of the duty of loyalty, actions not taken in good faith, and situations where a director derives an improper personal benefit.

- gave corporate shareholders the right to opt out of monetary damages for a pure negligence violation

UNLIKELIHOOD OF A DUTY OF CARE SUIT SUCCEEDING:
- Plaintiff has the burden of proof.
- In Delaware a gross negligent standard applies.
- Section 102(b)(7) opt out provision.
- Business judgment rule defense.

Cf. FEDERAL SECURITIES LAW FRAUD CLAIMS:
- No business judgment defense.
- Mandatory disclosure system produces detailed published evidence.
- Possibility of a prior SEC investigation.

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

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

3) IN SUPERVISION CASES: The plaintiff must show that a director knew or should have known of facts which would prompt an ordinarily prudent person to investigate or change corporate practices. Cf. *Caremark*. 
4) CAUSATION: The plaintiff must prove that a failure of a director to satisfy a standard of care caused a specific harm. Modern development illustrated by Francis: Cause is shown if failure was a substantial factor; need not satisfy Barnes v. Andrews.

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

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

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

- Encourage risktaking.
- Shareholders voluntarily invest; shareholders assume directors engage in risktaking.
- Rational shareholders can diversify away firm-specific risk through a portfolio.

IV. DUTY OF LOYALTY

Does business and ask was it at a fair price?

A. Globe Woolen p. 418-423: Influence exerted in ways other than a vote: The company, which operated mills, brought this action against the electric company to compel the specific performance of contracts to supply electricity to the mills. The electric company argued that the contracts were made under the dominating influence of a common director and that their terms were unfair and oppressive. The trial court held in favor of the electric company and annulled the contracts, and the appellate court affirmed. In affirming this judgment, the court held that the common director's refusal to vote on the contracts did not nullify the influence and predominance that he had exerted in arranging the contracts. The court found that as a result of the contracts, the electric company was losing large amounts of money and that such consequence was foreseeable to the common director who stood by and said nothing while the contracts were presented to the other directors of the electric company as a mere formality.

- At the time transactions were voidable if they were not approved by a disinterested majority.
- IN this interest Mr. Manard did not vote but caused by his dominated presence to vote for Bay; influence may be shown in ways other than vote, should have recused himself and probably not even renegotiated contract;
- if you do have a contract then you have duty to warn;
- today: contracts are no longer voidable but under what circumstances does the the P or the D under a arm’s length transaction

B. Gries Sportscenter v. Cleveland Browns p. 423-431: Shareholders of a corporation brought a derivative action challenging the acquisition of another corporation
by the directors. The directors invoked the protection of the business judgment rule and claimed that this rule shielded them from having to prove that their decision was fair to the minority shareholders. The court found that the rule did not apply in this case. The directors voting for the acquisition were considered interested parties because they held stock in both the acquiring and the acquired corporations, and they profited from the challenged transaction. They did not meet the definition of disinterested parties required by the business judgment rule. Also the majority of them were dominated by or beholden to the person who was the majority stockholder in both corporations. They were not independent, as required by the business judgment rule. The court concluded that the transaction was intrinsically unfair to the corporation and to the minority stockholders because its effect was to benefit the majority stockholder, and that the protection of the business judgment rule was not applicable in this case.

- Substance: arm’s length transaction: A transaction between two unrelated and unaffiliated parties; a transaction between two parties, however closely related they may be, conducted as if the parties were strangers, so that no conflict of interest arises.
  - arm’s length transaction: burden of persuasion normally on the board to show that the price was equally to the market or what experts will testify that the markets will produce and normally fail the burden
- Procedure: burden of persuasion normally on board: A transaction not given protection by the business judgment rule is subject to strict scrutiny, and the directors have the burden of showing the transaction was fair.
- Burden of persuasion on plaintiff to determine it is fake
  - Exception: If you have a transaction which involves a conflict of interest, if there is full disclosure of all material information and the transaction is approved by all the disinterested directors, then the burden of persuasion to show the transaction is unfair shifts back to the plaintiff.

C. Marciano v. Nakash p. 435-439: Both parties had entered into a joint venture to market designer jeans. Stock ownership and the composition of the board were shared equally by the parties. Ultimately the board deadlocked over policy issues and a court-approved plan of liquidation followed. Appellees had made loans to the corporation upon which they asserted claims at liquidation. Appellants argued that the debt was voidable under Del. Code Ann. tit. 8, § 144 because it originated in self-dealing transactions. On appeal, appellants argued that the chancery court applied the wrong standard of review for self-dealing transactions and thus its finding of full fairness was erroneous. The court held that relationship alone was not the only factor to determine if an interested director transaction was void. Since the loans were made on favorable terms, the loans were not automatically void under the intrinsic fairness test. The court affirmed the decision of the chancery court, because although appellees' loans originated in self-dealing transactions, the test of intrinsic fairness supported the validity of the loans in light of the financial circumstances of the corporation.

1. Majority of disinterested stockholders
2. Shifts burden of persuasion to plaintiff
Courts take it very seriously.

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

- Provides a safe harbor for conflict of interest transactions;
- When a majority of the disinterested board, or a majority of the disinterested shareholders approve a transaction then the burden of persuasion switches back to the P;
- P has the burden to show that (1) the transaction violated a standard of gross negligence and was the proximate cause of injury (i.e. if the market would have produced 100 units for a particular transaction it may be the range under a duty of loyalty is between 95-105)
- The common law rule, as Marsh earlier informed us, see pp. 415-417, was that a contract or transaction was per se voidable when an interested transaction was initiated in the absence of shareholder ratification, or statutory or bylaw authorization. See p. 437 3d full par.
- **DGCL §144** significantly "ameliorated" the common law rule. See p. 438, 1st full par.

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

### Duty of Loyalty

- Burden of persuasion is on plaintiff
- Plaintiff must prove a violation of duty
- Burden of persuasion is on the plaintiff to show a conflict of interest

#### D. Corporate Opportunity Doctrine

1. **Guth v. Loft** p. 440-443: In this case, Guth was chief executive officer of Loft, a manufacturer of candies. Guth decided not to continue to buy Coca-Cola syrup after an opportunity to buy Pepsi Cola was offered to him. He personally bought shares in Pepsi and sold Pepsi syrup to Loft. **HELD**: Loft had an interest or expectancy in Pepsi. **REMEDY**: Constructive trust.
The court affirmed the lower court's judgment, holding that the business opportunity presented to the officer was one which the corporation was financially able to undertake and was in the line of the corporation's business, and, by embracing the opportunity, the self-interest of the officer was brought into conflict with that of the corporation.

- The court stated that the officer could not receive a benefit from his breach of his fiduciary duty.

- Stand for a tripartied DL standard to determine whether an opportunity belongs to a director or an employee requires first to ask whether a corporation has an interest or expectancy

2. Interest or expectancy **Broz** (handout 45-55): Broz personally owns RFB Cellular. He also serves on the Board of Cellular Information Systems (CIS). This case involves the purchase by Broz of the so-called Michigan-2 cellular license.

- The court also held that the trial court erred in its application of the corporate opportunity doctrine under the facts of the case, where appellee had no interest or financial ability to acquire the opportunity.

- Line of business is narrower and refers to history

- Brought back to life whether the offer was made to the individual as an executive or as an individual
  - If an offer is made in his or her business office, then it is made as an executive
  - When made at your home and you are involved in many corps, then the court has struggled

3. Distinction between line of business and interest in expectancy (handout p. 51-52): For an opportunity to be deemed to belong to the fiduciary’s corporation, the corporation must have an interest or expectancy in that opportunity. “For the corporation to have an actual or expectant interest in any specific property there must be some tie between that property and the nature of the corporate business.

4. Offer to executive or individual

5. Financial ability to undertake - If the opportunity belongs to the corporation then the corporation has to be financial able to undertake
   - When in doubt offer to corp and see if they can undertake
   - If an interest or expectancy should deliver to board; if it is an interest or expectancy cuts against the financial ability to undertake

E. Close Corporations - A corporation whose stock is not freely traded and is held by only a few shareholders (often within the same family).

1. **Donahue v. Rodd** p. 530-541: The controlling shareholder sold his stock to defendants; however, defendants refused to purchase plaintiff's stock. The trial court dismissed plaintiff's suit, because the initial transaction had been carried out in good faith. On appeal, the court held that in a close corporation, all shareholders owed one another a strict duty of utmost good faith and loyalty. Further, the court held that a
controlling shareholder could not utilize its position to create an exclusive market for its shares. In this case, defendants had created a market for the controlling shareholder but refused to extend that market to plaintiff, thereby excluding her. Therefore, the court reversed and held that either the initial sale had to be rescinded or defendants had to offer to purchase plaintiff's stock at the same price agreed upon in the initial sale. (offered a deal to their father)

- In MA, the fiduciary duty of close corporation is equivalent to partnership; when corporation repurchases shares it does not have to meet the \( \text{make an equal offer to all potential shareholders} \)
  a. Fiduciary duty = partnership
  b. because stock in close corporation illiquid, equal offer when repurchase of shares

2. Wilkes v. Springside Nursing Home p. 541-546: Plaintiff and individual defendants entered into a partnership agreement. Plaintiff filed a bill in equity for declaratory judgment and damages in the amount of salary he would have received under the agreement had he continued as a director of the business, a nursing home. The judge of the probate court referred the matter to a master who, after lengthy hearing, issued his final report. Plaintiff argued that he should recover damages for breach of the alleged partnership agreement or should recover damages because defendants, as majority stockholders, breached their fiduciary duty to him, as a minority stockholder. The court concluded that the master's findings were warranted by the record and the final report was properly confirmed. However, the court reversed that portion of the judgment that dismissed plaintiff's complaint and then remanded the case to the probate court for entry of judgment against defendants for breach of fiduciary duty with respect to the freeze-out of plaintiff.

- Donahue v. Rodd rule made operational (i.e. if you fire someone must meet the following test):
  1) Two part test
     a) Business Purpose
     b) Least harmful means
  - applies when you deprive someone of employment or cut off dividends was the decision made for legitimate business purpose and were there less harmful means

3. Kemp & Beaty p. 583-589: Appellants, corporation and majority shareholders, sought review of appellate court decision affirming the lower court's decisions to grant petitioners' application for dissolution of appellant corporation unless the corporation or any shareholder elected to purchase petitioners' shares at fair value within 45 days. The court affirmed, holding there was sufficient evidence supporting the lower court's conclusion that majority shareholders had altered a long-standing policy to distribute corporate earnings on the basis of stock ownership, as against petitioners only. Furthermore, the court reasonably determined this change in policy amounted to an attempt to exclude petitioners from gaining any return on their investment and no error occurred in determining that this conduct constituted "oppressive action." Moreover, no abuse of discretion occurred in concluding that dissolution was the only means by which
petitioners could gain a fair return on their investment. The court merely modified judgment by permitting additional 30-day extension for exercising option to purchase petitioners' shares.

- Two stockholders owning 20.33 percent of the corporation’s stock were informed that they would not receive "extra compensation bonuses," a "known incident to stock ownership in this firm" shortly before or after their employment ended. After this decision, bonuses were only paid to employees.
- The plaintiffs brought suit to dissolve the firm under §1104(a) of N.Y. Bus. Corp. Act, which permits dissolution for "oppressive actions."
- Corp was one where more than the statutory minimum of (20%) corp felt the y were being treated unfairly, they were being oppressed due to reasonable expectation;
- in structure of close corporation one can understand the decision; the duty of loyalty is even more demanding because of the seller of stock
  
a. Oppressive action will justify dissolution at request of minority
b. Oppressive measured by reasonable expectations of minority stockholders (i.e. to job, or dividends)

F. Interested Mergers: where there are common relationships

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

- **Appraisal remedy** – a shareholder who objected to the consolidation of his company with another was held to have a right in the absence of statute to treat the consolidation as a dissolution of his company and to receive the value of his shares upon their surrender
- **De facto merger** – an acquiring corporation A will typically acquire the assets of corporation B in exchange for A’s stock; Corporation B will distribute A’s stock to its shareholders and dissolve>>

**Weinberger** p. 1097-1111: Action was brought by plaintiff class challenging the elimination of defendant corporation's minority shareholders by a cash-out merger between defendant corporation and its majority owner. The lower court held that the terms of the merger were fair to plaintiff and the other minority shareholders of defendant corporation. On appeal, the court held that the record did not establish that the transaction satisfied any reasonable concept of fair dealing, as the matter of disclosure to the defendant's directors was wholly flawed by conflicts of interest raised in feasibility study, and the minority shareholders were denied critical information; thus, the vote of the minority shareholders was not an informed one. The court further held that the standard "Delaware block" or weighted average method of valuation, should not control. Rather, the court endorsed a more liberal approach requiring consideration of all relevant factors pursuant to Del. Code Ann. tit. 8, § 262(h).

Crawford is the president of a firm that is about to not exist.

Note; This is the key Delaware merger case and a leading duty of loyalty case.

1. Duty of Loyalty requires both fair dealing and fair price
2. Appraisal exclusive absent fraud, duty of loyalty, waste
3. Appraisal remedy: DL block approach broadened by Weinberger p. 1111-1115; appraisal remedy was broadened beyond market value, asset value, etc but also take into account other valuation techniques used at the time; as a shareholder you always want a TRO to give you the capacity to renegotiate for a higher price
   o Rights of shareholders to bring lawsuits are not really personal rights but derived from breach of fiduciary duty

_The appraisal remedy we approve may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved._

Interested merger – controlling shareholder and its director nominees, “since they stand on both sides of the transaction…bear the burden of establishing its entire fairness and it must pass the test of careful scrutiny by the courts.”

<<In the traditional Delaware block approach, the object is to give the shareholders the value of the stock at the moment before the merger, the so-called "going concern" value.

All factors and elements which reasonably might enter into the fixing of value must be taken into account. These typically include:
   (1) Market value
   (2) Asset value – look for current value of the assets
   (3) Dividends
   (4) Earnings value – average of earnings during the pervious five years taking out extraordinary occurrences
   o Experts would come forward with competing visions
   o Look at discounted cash flow and look at what earnings will be; use prior year’s earnings to predict; also use terminal value to determine how long the firm will last
   (5) "Any other facts which throw light on future prospects of the firm that was merged."

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

>>

V. DERIVATIVE LITIGATION
   <<Derivative action - a suit asserted by a shareholder on the corporation's behalf against a third party (usu. a corporate officer) because of the corporation's failure to take some action against the third party.
**business-judgment rule** - The presumption that in making business decisions not involving direct self-interest or self-dealing, corporate directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation's best interest. • The rule shields directors and officers from liability for unprofitable or harmful corporate transactions if the transactions were made in good faith, with due care, and within the directors' or officers' authority

- “The business judgment rule is a presumption protecting conduct by directors that can be attributed to any rational business purpose. In order to plead and prove a claim, a plaintiff must plead and prove facts overcoming this presumption. Where the presumption is overcome, directors bear the burden of proving the fairness of the challenged conduct. The difference between these two levels of judicial scrutiny -- a presumption in favor of directors that protects conduct that is rational, versus a burden of proving fairness -- frequently is outcome determinative.”

A. Zapata v. Maldonado p. 623-633: The stockholder brought derivative actions in state and federal court, alleging that the corporation's officers and directors had breached their fiduciary duty. The stockholder did not first demand that the board members bring the action, alleging that such a demand would have been futile as all of the directors were defendants. After replacement of some board members, the new board created an investigation committee. The committee determined that each action against the corporation should be dismissed. The chancery court denied the corporation's motion for summary judgment or dismissal, holding that the "business judgment" rule was not appropriate for dismissal of a stockholder's derivative suit. On an interlocutory appeal, the court reversed and remanded, holding that a court should inqire into the independence and good faith of an independent committee and the bases supporting its conclusions. The chancery court was then directed to determine, applying its own independent business judgment, whether the motion should be granted.

1. Demand on the board is require except when demand would be futile (in the sense that a majority or more of the board has a conflict of interest) or there otherwise is a wrongful decision not to sue
2. When demand is futile the board may delegate authority to seek termination of a derivative suit to a disinterested minority of the board
3. In reviewing a Special Litigation Committee conclusion to dismiss, the DL SC requires:
   - The court first inquires into the independence and the good faith of the committee and whether there was a reasonable investigation
   - The court second may apply its own business judgment to determine whether the suit should go forward. Here the court analyzes: Is the suit in the corporation’s best interest?
     - Virtually ever subsequent DL case has not applied it
     - When you go through a analysis where you are attempting to show that the financial probable recovery to the corporation exceeds the out of pocket expense of litigation then that would not be in the best interest of the corporation
• No matter how much P’s dislike Zapata because it lengthens litigation, Ds hate it even more because limited discovery is available

B. In Aronson v. Lewis p. 644-658, the DL SC concluded that demand is only excused when facts are alleged with particularity which create a reasonable doubt that the directors’ action was otherwise the product of a valid exercise of business judgment rule
  o Defendants, Meyers parking system (Meyers) DL corporation and its ten directors
  o the DL SC concluded that demand is only excused when facts are alleged with particularity which create a reasonable doubt that the directors’ action was otherwise the product of a valid exercise of business judgment rule
  o Plaintiff shareholder alleged that certain transactions conducted by defendant directors in connection with a subsidiary corporation violated the business judgment rule. Specifically, plaintiff asserted that defendants involved the corporation in providing unjustified benefits to a financial consultant. Defendants responded by moving to dismiss the claim in its entirety. The chancery court denied the motion and held that under Del. Ch. Ct. R. 23.1, plaintiff successfully alleged demand futility in that he allowed defendants to correct the alleged wrong. The court reversed and remanded, holding that plaintiff’s failure to allege facts implicating director bias, lack of independence, or involvement in activities contrary to corporate interest acted as a bar to meeting the requirement of demand futility. Accordingly, plaintiff was granted an opportunity to amend his complaint.
  o There was enough pleading to show that the CEO probably dominated the board, but there was not enough to show that there was a reasonable doubt
    • The fact that he appointed directors or may have had a role in their appointment was not far enough; had to show financial connection

C. Oracle Corp. Deriv. Litig. p. 56-75: To determine whether a board member is independent, the Special Litigation Committee has the burden to prove that there is no material issue calling into doubt its independence. Independence “turns on whether a directors is, for any substantial reason, incapable of making a decision with only the best interest of the corporation in mind.” This can go beyond financial or familial relationships. (case involved Stanford ties)

D. Beam v. Stewart (Handout p. 76-82: In a non-special litigation committee context, the court declined to find that personal friendship would give rise to a reasonable doubt that a director’s decision was otherwise than the product of a valid exercise of business judgment. The case followed Aronson and was limited to its facts.
VI. WASTE DOCTRINE
A. Roger’s v. Hill p. 474-476: P has burden to prove payment has no relation to value of services for which it was given and in reality is a gift:
   - Plaintiff alleged that the bylaw, which authorized payments of specified percentages of profits to officers as compensation in addition to their salaries, was invalid and that amounts paid were unreasonably large. The Court held that stockholders were authorized to adopt the bylaw. The Court also rejected plaintiff's argument that directors were required to apply all profits to acquisition of property and payment of dividends, holding that profits included sums to be paid to officers. The Court also held that although percentages were not per se unreasonable, the payments had become large enough to warrant investigation.
   - Decision will considered unprotected by the BJR when a payment has no correlation to the service which was given and in reality is a gift

B. Walt Disney Co. Derivative Litigation Handout p. 94-106: Defendants could be held personally liable to the corporation for directors knowing or intentional lack of due care regarding an executive’s employment contract and termination agreement:
   - The allegations included that the CEO negotiated the president's hiring and that the compensation committee and the old directors knowingly or intentionally abdicated their responsibility to exercise business judgment and to make a good faith attempt to fulfill their fiduciary duties to the corporation and its shareholders to review the hiring. Similar allegations were made for the termination against the new board. The hiring and termination allegedly awarded the president in excess of $140,000,000 for barely one year of allegedly ineffective service. The president's employment arrangement involved, in part, a large salary, stock options back-dated to be in the money, discretionary bonuses (both vested unless he was fired for cause), and an arranged no-fault termination so vesting would take place.
     - Decision which is entirely consistent with Smith v. Van Gorham (i.e. BJR)

VII. SHAREHOLDER SUFFARAGE: Involves state law and federal securities law
State law level: there is an annual meeting, there is no requirement that every share have every vote, cumulative voting is permitted but not required, classification fo board where only 1/3 is up for re-election

A. Cumulative Voting p. 489-491: technique to attempt to ensure that minority shareholders or shareholder blocs could elect at least some representatives to the corporate board
B. Proxy Expenses
   1. Rosenfeld Rules p. 499-508 – if you are an incumbent you are entitled to full reimbursement of your expenses; the campaign expense of the incumbents’ slate of candidates is paid by the corporation; but, unless victorious, outside challengers’ expenses almost invariably are not paid
Appellant brought a stockholder's derivative action where he sought to compel the return of funds paid out of the corporate treasury to reimburse both sides in a proxy contest for their expenses. The lower courts affirmed the judgment of the official referee that dismissed appellant's complaint. The court affirmed the dismissal. The court noted that appellant did not argue that the funds were fraudulently extracted from the corporation, but instead admitted that the charges were fair and reasonable. The court held that since appellees acted in good faith in a contest over policy, they had the right to incur reasonable and proper expenses for the solicitation of proxies and in defense of their corporate policies, and were not obliged to sit idly by. The court also noted that stockholders had the right to reimburse successful contestants for reasonable and bona fide expenses incurred by them in any such policy contest, subject to court scrutiny. Thus, the dismissal of appellant's complaint was proper.

2. Policy: Why does corporate law perpetuate an election financing rule that generally deters elector challenges?

3. Reasonable in amount – reimbursed when reasonable in amount

Whether or not there should be some method

C. SEC Rule 14a-8: helps shareholder with proposals for action (i.e. issues other than directors’ nominations that are considered a proper subject action)

- Rule 14a-8 is applicable only to covered corporations under §12 and Rule 12g-1 of the SEC Act (securities listed on a national securities exchange or traded in the over the counter market with 500 or more holders of a class of stock (“equity”) and $10M in total assets).

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

- The most common grounds are for it to be improper under state law

D. Judicial Review of Voting Rights Changes

- Staff no action letters are not rules that create legal rights under the Administrative Procedure Act. NY City Employees Retirement Inc. v. SEC. p. 767-775

  - [no-action letter] - A letter from the staff of a governmental agency stating that if the facts are as represented in a person's request for an agency ruling, the staff will advise the agency not to take action against the person. Typically, a no-action letter is requested from the SEC on such matters as shareholder proposals, resales of stock, and marketing techniques.

- In MM Co., Inc. v. Liquid Audio, Inc. Handout 107-116, as attempt by a board to add two additional directors to frustrate a rival group from taking control was struck down. When the primary purpose of a board bylaw
amendment or other action is to prevent the effectiveness of shareholder vote, the board “bears the heavy burden of demonstrating a compelling justification for such action”

- Bitterly contested tender offer; one was certainly going to win the proxy fight and before that could occur the incumbents added two directors
- “compelling justification” Seligman feels comes close to saying that you are not allowed to do it; when you have a voting contest going on you cannot change the rules unless you can show a compelling justification

VIII. TENDER OFFERS

A. Chief v. Mathes (not assigned)
   1. Defendant burden to show threat to corporation
   2. Threat included threat to business policy

B. Unocal p. 193-1204
   o The lower court granted a preliminary injunction to plaintiffs, enjoining an exchange offer of the defendant for its own stock, concluding that such an offer was legally impermissible. The court on appeal was faced with the issue of whether defendant board of directors had the power and duty to oppose a takeover threat it reasonably perceived as being harmful to the corporate enterprise, and, if so, whether the action taken was entitled to protection of business judgment rule. The court held that there was directorial power to oppose plaintiffs' tender offer and to undertake a selective stock exchange made in good faith and upon a reasonable investigation pursuant to a clear duty to protect the corporate enterprise. The court further held that the repurchase plan chosen by defendant was reasonable in relation to the perceived threat and was entitled to be measured by business judgment rule.
   1. Business Judgment balancing element
   2. Risk of threat broadened to include risk of non-consummation; illegality; securities (look at list)
   3. When you adopt a defense you have to show it was proportional to the offense

C. Revlon p. 1206-1229: limited to where break up/shift in control is inevitable
   o Plaintiff shareholders brought an action against defendant directors due to irregularities of a corporate auction. Essentially, plaintiffs moved for an injunction to bar a third-party corporation from engaging in deals with defendants in the form of options, the sale of assets, and exclusive dealing provisions. The trial court granted the injunction on the grounds that defendants had breached their duty of care by entering into such transactions, thus ending an active auction for the company. Essentially, the breach occurred because defendants made concessions to the third-
party corporation, rather than maximizing the sale price of the company for the stockholders' benefit. On appeal, defendants claimed that they did not breach the business judgment rule. The supreme court affirmed the trial court, holding that defendants allowed considerations other than maximizing shareholder profit to affect their judgment. Accordingly, the injunction was upheld.

1. must run a good faith auction
2. burden on D shifted when sale of firm is inevitable
3. lock-ups only ok if do not end auction
If not inevitable:
   was there a reasonable investigation in good faith
   can the P carry the burden absent of showing a threat
   was the break up inevitable in which all defenses were available

D. Omincare, Inc. v. NCS Healthcare, Inc. Handout p. 117-146
1. Majority: Agreement of board to present merger agreement to shareholders for a vote under DL §251 (c) even if board no longer recommended the merger, coupled with agreement of majority stockholders to vote in favor of the merger in the absence of an effective fiduciary out clause, was both preclusive and coercive and therefore unenforceable. Analysis under UNOCAL not REVON
   - Even if they don’t have obviously financial commitment they have interest if the board is going to change the corp for which they work

2. Veaey dissent: Given the facts of this case, the better rule is that the business judgment rule should apply, but even under UNOCAL the proportionality inquiry should take into account that the contractual measures protecting this merger agreement were necessary to obtain this deal

IX. FEDERAL PROXY FRAUD
Rule 14a-9 considers whether a particular statement or omission is false and misleading and whether the statement or omission is material

A. J.I. Case v. Boark (p. 785-789): A private cause of action can be implied under Rule 14a-9. Under the circumstances here, it was the duty of the courts to be alert to provide such remedies as were necessary to make effective the congressional purpose, namely, to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation. Accordingly, federal courts had the power to grant all necessary remedial relief. The judgment was affirmed because a federal cause of action was authorized for rescission or damages to a corporate stockholder. Here, respondent had suffered from petitioner's consummated merger, which was allegedly effected pursuant to the use of a proxy statement containing false and misleading statements.
   - A private cause of action can be implied under Rule 14a-9.;
   - significant because same theory extended to 10b5;
   - SEC can enforce all these cases; intended to provide investment protection
B. *Causation: Mills v. Electric Auto-Lite* p. 791-796: *No causation in omission case when shareholder votes essential link:*

- Petitioners asserted that respondent distributed a misleading proxy solicitation informing petitioners that the board of directors recommended approval of the merger, without also informing them about a conflict of interest of the directors with the merging third company, in violation of § 14(a) of the Securities Exchange Act of 1934 (Act), 15 U.S.C.S. § 78n(a), and SEC Rule 14a-9. Petitioners filed a motion for summary judgment, which was granted but reversed on appeal. Petitioners were granted certiorari to review the issue of causation for a private right of action. The Court vacated judgment for petitioners and remanded the case, because the conflict of interest was a materially misleading aspect of the proxy solicitation. The Court held that where there was a finding of materiality, petitioners made a sufficient showing of causal relationship between the violation and injury to seek redress, so long as it was proven that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in accomplishment of the transaction.

- causation is required under 10b5

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Materiality: When a fact is misrepresented or omitted, it can only violate Rule 14a-9 (or Rule 10b05) if it is material.

C. *Materiality: TSC Ind. V. Northway* p. 801-807: *“An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”:*

- Genuine issues of fact existed as to whether the acquisition of certain shareholder interests in the target had resulted in a change of control. Therefore, summary judgment was inappropriate under 17 C.F.R. § 240.14a-3. Certain omissions of fact were material as a matter of law under 17 C.F.R. § 240.14a-9. The Court reversed the partial summary judgment granted to respondent since the proxy statement prominently displayed the fact that the acquiring company owned a percentage of the outstanding shares in the target company.

- Rule: An omitted fact if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.

- Test: Showing of a substantial likelihood that, under all the circumstance, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. (i.e. there must a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the “total mix” of information made available.

- See FN15: Failure to disclose conflict is material as a matter of law

- Applies to omitted facts and material misrepresentation, applies to vote and deciding how to purchase or sell securities

- In analyzing whether a pre-merger material is significant; look at probability that
You can be held liable for making a false statement; but you are allowed to say no comment

D. Basic v. Levinson p. 810-817
   1. Predictive info: probability and magnitude test
   2. No comment OK
The Supreme Court granted certiorari to resolve a split among the courts of appeals as to the standard of materiality applicable to premerger discussions and to determine whether the courts properly imposed a presumption of reliance in certifying class members in an action alleging violations of § 10(b) of the Securities and Exchange Act, 15 U.S.C.S. § 78A et seq., and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1987). The Court held that an omitted fact was material if a reasonable shareholder would consider it important in making his or her vote and this standard should be applied to all § 10(b) and Rule 10b-5 actions. The Court also held that materiality required a case by case review of the facts and that a rebuttable presumption existed that stockholders relied on available information when buying or selling securities. The judgment of the court of appeals was accordingly reversed and remanded.

E. VA Bankshares p. 819-827: Statement of reasons, opinions, or beliefs can both be misrepresented and material:
   o Respondent minority shareholders filed suit against petitioners, banks and directors, after petitioners solicited proxies for voting on a merger proposal. In their solicitation, petitioners urged the proposal's adoption and stated respondents would earn a "high" value and a "fair" price for their stock. Respondents withheld their proxies and after approval of the merger sought damages alleging violations of the Securities Exchange Act of 1934, 15 U.S.C.S. § 78n(a), and 17 C.F.R. § 240.14a-9 (1990). The trial court found in favor of respondents and awarded damages. The appellate court affirmed holding that certain statements in the proxy solicitation were materially misleading. The United States Supreme Court reversed holding that the knowingly false statements might have been actionable even though conclusory in form, but that respondents failed to demonstrate the equitable basis required to extend the private action pursuant to 15 U.S.C.S. § 78n(a) to them.
   o MF: VBI owned 85 percent of FABI; 15 percent was owned by 2,000 minority shareholders. In recommending a merger, the FABI directors stated that the price offered per share was "high" and "fair." The case makes one clear holding: Statements of reasons, opinion, or belief can be misrepresented and material.
   o "Bespaks Caution Doctrine": Cf. the above statement in Virginia Bankshares with the bespeaks caution doctrine. Under the doctrine, see especially pp. 831-833, a false statement is not considered material, if it is accompanied by cautionary language in the relevant corporate document.
      o Two limitations
(1) the bespeaks caution doctrine is limited to forward looking statements; and
(2) vague or boilerplate disclosures do not suffice to mitigate the effect of a false statement. See p. 833.

F. SAB No. 99 Handout 148-151: Both quantitative and qualitative measures of materiality can be used. There are numerous circumstances in which misstatements below 5% (quantitative) could well be material (See handout 150)

  o Whether the misstatement arises from an item capable of precise measurement or wither it arises from an estimate and, if so, the degree of imprecision inherent in the estimate
  o Whether the misestimate makes a change in earnings or other trends
  o Whether the misstatement hides a failure to meet analysts consensus expectations for the enterprise
  o Whether the misstatement changes a loss into income or vice versa
  o Etc. See handout p. 150
  o presumption when more than 5% occurs then that will be material
  o when there is less than 5% there can still be qualitatively material facts (subject to earning estimate that it is not going to meet, criminal charges)

XI. Rule 10b-5: The "manipulative and deceptive devices" prohibited by Section 10(b) of the Act and Rule 10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.

  o Definition of "on the basis of." Subject to the affirmative defenses in paragraph (c) of this section, a purchase or sale of a security of an issuer is "on the basis of" material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.
  o Applies to any purchase or sell

Two basic types of cases:
  1. “insider trading”
  2. false corporate statements

A. Standing – Blue Chip Stamps p. 915-928: Respondent did not purchase any stock, but later sued the corporation and its shareholders under § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, 17 C.F.R. § 240.10b-5, alleging it had not purchased stock due to a prospectus that was misleading as it was overly pessimistic regarding the corporation's status. The district court dismissed respondent's complaint, which the court of appeals reversed. The court reversed and concluded respondent was
not entitled to sue for a violation of Rule 10b-5, and held that a plaintiff class, for purposes of a private action under § 10(b) and Rule 10b-5, was limited to actual purchasers and sellers of securities. Moreover, the court declined to create an exception to that rule, as the court of appeals had, that would permit an offeree of securities pursuant to a consent decree, such as respondent, to sue under Rule 10b-5 regardless of whether it had purchased securities, at least in the absence of a contractual right or duty to purchase.

- Have to be an actual purchaser or seller

B. **Scienter** – *Ernst & Ernst* p. 930-938: Petitioner, an accounting firm, had been retained by a small brokerage firm for 21 years to perform periodic audits of the brokerage firm's books and records. Respondents were customers of the brokerage firm who had invested in a fraudulent securities scheme perpetrated by the president of the brokerage firm. The Supreme Court reviewed the Act and concluded that the language of § 10(b) clearly connoted intentional misconduct. The Court stated that the language of a statute controls when it is sufficiently clear in context. The Court held there could be no private cause of action for damages under § 10(b) of Act and Rule 10b-5 without an allegation of scienter, i.e., intent to deceive, manipulate, or defraud.

- If you had an intent to fraud or deceive then you satisfy scienter, recklessness will suffice; negligence not enough
  - Key issue – recklessness
  - Cf. SEC Exch. Act §21E(c)(1) in forward looking statements

C. **Reliance** – *Basic v. Levinson* p. 951-955: The Supreme Court granted certiorari to resolve a split among the courts of appeals as to the standard of materiality applicable to premerger discussions and to determine whether the courts properly imposed a presumption of reliance in certifying class members in an action alleging violations of § 10(b) of the Securities and Exchange Act, 15 U.S.C.S. § 78A et seq., and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1987). The Court held that an omitted fact was material if a reasonable shareholder would consider it important in making his or her vote and this standard should be applied to all § 10(b) and Rule 10b-5 actions. The Court also held that materiality required a case by case review of the facts and that a reputable presumption existed that stockholders relied on available information when buying or selling securities.

- usually can be satisfied by fraud on the market presumption; shareholders are indirectly relying on the false statement
- Fraud on the market presumption
  - shareholders are indirectly relying on the false statement

D. **Duty** – Omission Cases

1. *Chiarella* p. 962-972: Petitioner printer was indicted and convicted of violating § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C.S. § 78j, and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5. While working for a financial printer, petitioner handled announcements of corporate takeover bids. Without disclosing his knowledge, petitioner purchased the targeted companies stock, selling the shares immediately after the takeover attempts were made public. Reversing petitioner's conviction, the Court held that petitioner had not violated the duty to
disclose material information where no relationship of trust or confidence existed between petitioner and the shareholders. While noting that silence in connection with the purchase or sale of securities could have been fraud under § 10(b), the Court held that petitioner had not violated § 10(b) where he was under no affirmative duty to disclose the information before trading. Because petitioner was not an agent or fiduciary of the sellers, the Court found that he had no duty to the sellers.

- must be a duty demonstrated by a P to recover; must show the person has the information had a duty to disclose; didn’t violate 10b5
- C.f. 2nd circuit holding that “anyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose”
- C.f. SEC v. Texas Gulf Sulphur Co. “The essence of the Rule is anyone who, trading for his own account in information intended to be available only for a corporate purpose and not for the personal benefit of anyone’ may not take advantage of such information knowing it is unavailable to those with whom he is dealing, i.e. the investing public.”
  a. must be a duty
  b. duty to employer reserved
  c. misappropriation duty reserved; ; exists in a narrower form than discussed in dissent

2. Dirks p. 973-981: Petitioner was an officer of a broker-dealer firm and specialized in investment analysis of insurance company securities to investors. Petitioner received information that a corporation had vastly overstated assets. Petitioner discussed this information with clients, and some of those clients sold holdings in the corporation. When respondent learned of petitioner's actions, respondent found that petitioner aided and abetted violations of § 17(a) of the Securities Act of 1933, 15 U.S.C.S. § 77q(a), and § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C.S. § 78j(b), by repeating the allegations to members of the investment community. In a divided opinion, the appellate court found against petitioner and he sought the Court's review. The U.S. Supreme Court held there was no actionable insider-trading violation by petitioner where petitioner was a stranger to the corporation, had no fiduciary duty to corporation's shareholders, did not try to gain corporate shareholder's confidence, and did not illegally obtain the information about the corporation. Therefore, petitioner had no duty to abstain from the use of the inside information, and the lower court's judgment was reversed.
- government lost, but amazing victory

  a. Footnote 14 insiders: The case adopted the constructive insider theory in Footnote 14 — when outsiders have "entered into a special confidential relationship . . . and are given access to information solely for corporate purposes . . . See pp. 981-983, Notes 1-2.
outsiders will also have the same kind of duty as insiders if there is an expectation of confidentiality and if there is equivalent to a contract either express or implied

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

  - Tippers can be liable even if they do not personally trade; violation of fiduciary duty will typically require a quid pro quo; tippee will be held liable only if the tipper has violated the fiduciary duty and the tippee had scienter of it.

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

  - See p. 976 fn 14 “Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, account, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders.”

3. O’Hagan Handout p. 152-167: classic form of 10b5 violations which includes both those with a duty (O&D) and those who from fn14 potential D with expectations of confidentiality (accounts, lawyers, etc) and says there is a new and special misappropriation duty available in criminal cases that applies when there is deception on the source of the information.

  - Respondent was a partner in a law firm which represented a company regarding a potential tender offer for the common stock of another company. During the representation, respondent purchased call options for the other company's stock and sold them for a significant profit. After the Securities Exchange Commission initiated an investigation into respondent's transactions, a jury convicted respondent of securities fraud. On writ of certiorari, the Court held that criminal liability under § 10(b) of the Securities Exchange Act of 1934 (15 U.S.C.S. § 78j(b)) may be predicated on the misappropriation theory. The court also held that Securities Exchange Commission Rule 14e-3(a) was the proper exercise of the Commission's prophylactic powers under § 14e of the Securities Exchange Act of 1934, 15 U.S.C.S. § 78n(e), regarding the prevention of the misappropriation charged against respondent. The Court reversed the judgment of the court of appeals holding that criminal liability under the Securities Exchange Act of 1934 may be predicated on the misappropriation theory.

  - Grand Met retained O’Hagen’s firm (though he was not directly involved) and was aware there would be a tender offer and chose
to buy stock and options before the offer was public knowledge, made $4.3M

- Is a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, guilty of violating §10(b) and Rule 10(b)(5)?
  - Owes a duty of some sort to his employer the law firm and he owes a duty
- Classical: corporate insider trades in the securities of his corporation on the basis of material nonpublic information
  - The classical theory applies no only to officers, directors, and other permanent insiders of a corporation, but also to attorneys accountants, consultants, and others who temporarily become fiduciaries of a corporation

a. *misappropriation adopted in criminal cases*: “a person commits fraud “in connection with” a securities transaction, and thereby violates 10b and rule 10b-5 when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.

b. *deception on source of information*: “In lieu of premising liability on a fiduciary relationship between company insider and purchaser or self of the company’s stock, the misappropriation theory premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information

c. *theory protect integrity of securities markets from abuses by “outsiders”*

d. also held that rule 14e3 is says you don’t have to show a duty under 14e3

E. Fraud must be “in connection with” securities trade: “in connection with the purchase or sale of any security” intended only that the device employed, whatever it might be, be of sort that would cause reasonable investors to rely thereon, and in connection thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation’s securities.

- The mere fact that an insider did not engage in securities in securities transactions does not negate the possibility of wrongful purpose; perhaps the market did not react to the misleading statement as much as was anticipated or perhaps the wrongful purpose was something other than the desire to buy at a low price or sell at a high price.

  1. *Texas Gulf Sulphur* p. 911-912: affirmation of disclose or abstain rule (must abstain from trading in a security unless he or she discloses any material nonpublic information about that security to the investing public
  - if a corporation makes a false statement while outsiders are buying a false stock then it is “in connection”
o Does not allow delays in disclosure of material nonpublic information if it will serve a “valuable corporate purpose” such as acquisition of mining rights.”

2. O’Hagan: “a person commits fraud “in connection with” a securities transaction, and thereby violates 10b and rule 10b-5 when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.”