Corporations Outline

I. Agency and Partnership

A. Agency (27-33)

Definition

Agency definition: The manifestation of consent of one person that another shall act on his or her behalf and subject to his or her control. Restatement (Second) of Agency §1(1), at 27.

This is a hierarchical relationship. This is what control means.

Agency is also volitional. It can only be created by mutual consent. An agency relationship does not require a contract. It can be proven by circumstantial evidence (but the principal must be shown to have consented to the agency).

The pivotal concept often is control. We will also explore this concept in the partnership (see pp. 70-71) context.

Gay Jenson v. Cargill 28 (Minn. 1981)

Inadvertent agency relationship. A Farmer sold grain to Warren Seed & Grain Co. (a grain elevator). When it went bankrupt, the farmer sued Cargill as the principal on Warren's contracts. Cargill had exerted massive control over Warren’s day-to-day activities as a condition of continued financing. The court found the three characteristics of implied agency (see pp. 31-2):

1. Consent of one party to act in an agency capacity to the other,
2. Action on behalf of the agent to the benefit of the principal company, and
3. Exercise of control over the agent by the principal company.

These were substantiated by the court’s list of nine activities indicating managerial control.

Agency Authority (33-41)

Grant to a party allowing that party to enter into third party contracts binding upon the principal.

i. Actual authority

Created one of three ways:

A. EXPRESS:
Typically written in a statute, certificate of incorporation, bylaw, or board resolution. Express authority can be oral. Occasionally there will be litigation concerning extravagant language, or mistakenly given or fraudulently procured express authority.

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

ii. Apparent authority

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

1. Manifestation of authority by principal.
2. Reasonable reliance on that manifestation by a third party.

According to the Lee court, apparent authority is a question of fact that relegated a binding agreement to things falling within boundaries of normality for usual business dealings in any given situation.

iii. Ratification

Authority after the fact. A principal can ratify authority contract either expressly or by course of conduct.
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Lee 35 (2d Cir. 1959)
Apparent authority. Yardley, agent of Jenkins, offered pension rights to Lee orally (never formalized in writing) as inducement for his employment. When the agreement was not executed as promised, Lee sued Jenkins. Lee did not offer any proof of actual authority vested in Yardley by Jenkins, so the court looked to apparent authority. Court held that Yardley had apparent authority to extend the oral contract because it lied within the “ordinary course of business” for his job, although the court would have disallowed relief if the offered contract had been so “extraordinary” as to fall outside of apparent authority.

B. Partnership (41-57, 70-73)

With the growing ascendancy of the limited liability company and limited liability partnership, the partnership (and to a lesser extent, the limited partnership) are forms of business organization that are of declining significance as the noncorporate alternative form of choice. Even as the limited liability company has become the alternative form of choice, inadvertent partnerships will continue to be formed.

It is worth emphasizing at the beginning of these materials that the Achilles heel of partnership law is unlimited personal liability. In a partnership, all partners' personal assets can be subject to suit. In a limited partnership at least one general partner's assets are similarly vulnerable. In contrast in a limited liability company and a corporation, all investors (including managers) are usually subject only to limited liability (meaning that they can only be sued for the amounts they invest).

Three basic policies for partnership:

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

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

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

i. Formation
It is always preferable to draft a partnership agreement. In that way, normally through nonadjudicatory means, the parties ex ante can define their rights and duties in various foreseeable circumstances, see p. 48.

Partnership law is notable for the frequency of instances in which partnerships are formed through oral agreements or inadvertence.

A partnership is an association of two or more persons to carry on as co-owners a business for profit. UPA §6, p. 42. “Co-owners” refers to control.

UPA §7(4) does not address issues such as significance of control in the definition in §6 or in the intent of the parties.

Martin 43 (1927)
The broker-dealer firm K.N. & K. received a bailout loan of $2.5 million from P.P. & F. P.P. & F. were to receive (1) 40 percent of K.N. & K. until the loan was repaid; (2) the right to inspect the books and receive any information they thought important; and (3) “they may veto any business they think highly speculative or injurious.” The court saw these moves as collateral insurance, and not so unusual to be considered overt acts of implied partnership. However, that was only because the nature of the original relationship was essentially created for a mortgage.

Partnership may be created by estoppel if a person represents partnership in words or conduct to a third party who engages in business upon that reliance.
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Limited Partnership - at pp. 70-73. One or more general partners with unlimited liability, but limited liability for each limited partner. In order to secure limited liability for each limited partner: (1) a written certificate of limited partnership must be filed. See RULPA §201, at p. 70. (2) Limited partners lose their limited liability shield if they participate in the control of business.

ii. Partnership finances
1. No minimum capital is required - no investment is necessary.
2. Each partner owns two types of interest:
   a. Co-owner of partnership property: UPA §25. Partnership property may only be used for partnership purposes and is not subject to individual property attachment.
   b. Partnership interest: UPA §26, like a share of stock. Partnership interests are freely transferable and may be assigned. UPA §27. However, the transfer of a partnership interest does not usually create a new partner absent accord by other partners. UPA §18(g).
3. The key Section regarding finances is UPA §18.

Absent agreement:
- All profits are shared equally
- Losses shared the same as profits
- Partners receive no salary but are entitled to reimbursement of expenses

Each aspect of UPA §18 is subject to variation by agreement. This is a key role of lawyers in partnership formation: Raising issues for potential partners to include in their agreement before operations begin.

iii. Governance
Implicit in the UPA is the notion of collective decision-making. See, e.g., UPA §18(e): "All partners have equal rights in the management and conduct of the partnership business," discussed at p. 50. Concommitant with this power are fiduciary duties. We will devote considerable attention in the corporate law context to analyzing the duty of care, (September 10 and 12) and duty of loyalty (September 24 and 26).

Meinhard 51 (1928)
Joint venture "subject to fiduciary duties akin to those of partners." Salmon, while a partner with Meinhard, in the operations of a hotel property leased until April 1922, secretly in January 1922 entered into an arrangement with Gerry for a 20-year extension of the lease and other agreements. Cardozo held this as impermissible because joint partners “owe to one another ... the duty of the finest loyalty. Many forms of conduct permissible [operating as an independent businessperson] are forbidden to those bound by fiduciary ties.”

iv. Liability (54-55)
Partnership law is based on the theory of collective responsibility:
1. UPA §9: A partner usually may bind a partnership and ultimately create personal liability for other partners.
2. UPA §13: In the ordinary course of business, partners may bind the partnership for torts.
3. UPA §14: Partners now bind the partnership for breaches of trust.

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

LIMITED LIABILITY COMPANIES
Handout pp. 1-8 introduces the limited liability company (LLC). Consider this background reading now. On October 10, we will compare the LLC with the close corporation by focusing on the Uniform Limited Liability Company Act (1996).

II. Incorporation
Corporations Outline

A. Choice of form: Partnership v. Corporation (75-79)
   1. **Tax considerations:** Pp. 75-76. This is usually the straw that stirs the drink, as Reggie Jackson put it. To do an appropriate tax analysis requires up-to-date tax information on each potential investor.

   2. **Limited liability:** Pp. 76-77. We will address this topic in detail (See pp. 83-93); Handout 9-11.

   3. **Ease of Formation:** P. 77. A partnership requires no filing fees, no annual reports, and no written document.

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

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

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

   A corporation usually has perpetual existence.

   6. **Established Interpretative Law:** See pp. 78-79.

B. Mechanics of incorporation (79-83)

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

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

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

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

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

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

There are also several practical questions including:
1. **One corporation or many:** This is a limited liability issue. There are no longer tax advantages to multiple incorporations.
2. **Where to incorporate.** Out-of-state incorporation also involves qualification to do business in any state in which business is conducted.
3. **Can the incorporator (or promoter) enter contracts before the corporation is formed?** Pp. 82-83. The promoter often signs preincorporation contracts. He or she is normally liable unless the contract disclaims liability.

A corporation cannot be liable because an agent may not bind nonexistent principal.

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

C. Defective incorporation (83-87)

Cranson 84 (1964)
IBM dealt with Cranson under the assumption of his status as corporate entity.

1. De jure  Real corporation
2. De facto  Good faith intent to incorporate under existing law
3. Estoppel  Requires third party to have dealt with defective corporation under the belief that corporation was legitimate

D. Piercing the corporate veil (87-93; 98-105; Handout 9-11)

Three basic applications
i. Alter Ego or Instrumentality Doctrine
ii. Undercapitalization
iii. Fraud

These materials address the first two applications - the third application is implicitly covered later in the course when we address securities fraud. See October 29 - November 19.

There are three ways that the veil can be pierced. Each requires similar facts to justify veil piercing:
1. Individual Owner ----- Corporation
2. Parent Corporation -- Subsidiary
3. Enterprise Liability

i. Alter ego or instrumentality doctrine (88-98)

Walkovszky 88 (1966)
Plaintiff (P) was run over by a taxicab owned by Sean Cab Corp. Sean Cab Corp. was 100 percent owned by Carlton who similarly owned 10 other taxi cab corporations. Court held that conducting business to further personal goals, using the corporation simply as a shield from personal liability, will allow courts to pierce the veil.

Laya 101 (1986)
List of facts that allow piercing:
1. Commingling corporate and individual shareholder funds
2. Diversion of corporate funds for non-corporate use
3. failure to maintain the corporate formalities necessary for issuing stock
4. Individual shareholders representing official capacity as corporation to outsiders
5. Bad minutes
6. Incidental equitable ownership in two companies
7. Etc.

ii. Inadequate capitalization (98-100)

Minton 98 (1961)
Inadequate capitalization will allow piercing when the funding available for corporate purposes is trifling compared to the corporation’s current liabilities. No minimum bar for actual capitalization, so review is fact-based.
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Radaswekski HANDOUT 9 (8th Cir. 1992)
Missouri law evolved a distinctive test for piercing the corporate veil. Must show:
1. Parent corporation must have complete control (complete domination) where the subsidiary had no independent will,
2. The control must be intentionally used to commit fraud or statutory wrong toward plaintiff, and
3. The control and breach of duty must be the proximate cause of injury

E. Corporate powers, corporate purposes, and Ultra Vires (106-125)

Purposes of a corporation are usually generally defined in their articles of incorporation. It is more precise to think of the doctrine of ultra vires as being dormant rather than dead. The DGCL does permit shareholders to draft corporate certificates with restrictive purposes and power clauses. If this is done, restrictions on corporate action outside of those purposes can be enforced.

Small corporations still have some responsibility to stay within the strictures of their incorporation.

Ultra Vires: An action is ultra vires if it contradicts a terms of the corporation’s charter or one necessarily implied by it. Normally when a corporation violates a law, it performs an illegal act, but not one that contradicts something in the charter. Thus for a firm to disobey clean water standards is illegal, but not ultra vires. Or when a corporate executive exceeds his or her personal authority but does an act the corporate charter would permit the firm to do if an officer were properly delegated the authority, it is not ultra vires. But where it has been fully executed, neither party may seek rescission because it was ultra vires.

Ultra Vires and torts: Modern cases consistently hold that a corporation may not escape liability for a tort by pleading ultra vires.

Dodge v. Ford 109 (1919)
Plaintiffs were minority shareholders of Ford who objected to termination of special dividends and also sought to enjoin the construction of a large factory at River Rouge. Ford had massive cash on hand but decided to forego a dividend to throw money into expansion under Henry’s dictatorial desires. Dodge brothers were shareholders that filed suit to enjoin the expansion and reap a dividend instead. Ford argued expansion and cash reserves were reasons within management’s powers to cancel the dividend; court disagreed. Didn’t enforce the enjoinder, because expansion is in the interest of shareholders, but did mandate a dividend.

➔ Primary duty is to shareholders. Does not rule out charitable contributions, but limits managerial impunity to make sweeping decisions at shareholder expense. Not a black-and-white rule, so look for facts about cash position, costs, etc.

A.P. Smith 115 (1953)
Corporate charitableness. Water and gas supply business contributed to Princeton for a maintenance fund. Shareholder sued as ultra vires charity. Court said no because charitable donations are permitted if:
1. There is some benefit to the corporation
2. The donation is some reasonable amount
3. The recipient is not a “pet” charity

III. Corporate Governance

A. Duty of Care (133-167; Del. Gen. Corp. L. §141)
Can be applied to two types of fact patterns:
1. Negligence—specific decisions
2. Failure to Board to adequately supervise operations of corporation

STATUTORY EXCEPTIONS:
Corporations Outline

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

2. DGCL §141(c): Committees may exercise the power of the board except in specified cases such as:
   - amendment of the certificate of incorporation.
   - adoption of a merger agreement.
   - recommendation of sale of all or substantially all assets.
   - recommendation of dissolution.
   - amendment of bylaws.

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

It frequently has been argued that the board in a large corporation is unequal to the task of managing a corporation because of such reasons as:
   - Information constraints. See pp. 136-137.
   - Board composition; e.g., selection of inside directors or passive outside directors. Pp. 137-138.


In 1971 Harvard Business School Professor Myles Mace, in Directors: Myth and Reality, concluded:
   1. Directors do not establish policies of the firm.
   2. Directors rarely choose chief executive officers.
   3. Directors rubber-stamp compensation decisions.
   4. Directors rarely ask tough questions.

Yet if the board is supposed to be an auditor of a monitor of managers, a type of check and balance, it is not the only one:
   1. In small firms, active outside shareholders may carefully review management.
   2. In large firms, institutional owners and lenders perform a monitoring rule.
   3. Stock market price may trigger a more active board.
   4. Product market competition.
   5. SEC Disclosure and Fraud Rules.

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

How well the board performs a monitoring rule has varied over time. Mace’s work, the 1970s corporate bribery scandals, and the takeovers of the 1980s prompted reforms:
   - Audit committees.
   - More information available to directors.
   - More outside directors.
   - Greater director involvement in such fundamental decisions as evaluating tender offers or chief executive officer succession.

Suits against Boards are generally shareholder derivatives. Judgment awards are paid directly to the corporation, not to shareholders.

Law is leading to determinations based on the influence of the Board of Directors: duty to manage risks and liability reduction. Two classes of Board decisions reachable with litigation:
   1. Duty to supervise
   2. Specific business judgments
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**Bates 143 (1920)**

**Duty to investigate.** Tiny bank sued for losses due to theft under liability theory. Issue was whether bank directors were liable for failure of duty when they relied on statements by the cashier charged with balancing the books. US held that they weren’t liable because they had properly relied on the cashier (thief) having faithfully and accurately dispensed of his duties. However, the president was nailed because he was responsible for the employee and close enough to the harm that he should have noticed it under his normal duties.

- To second-guess the exception for good faith reliance in this case would create a policy harm.
- One bite rule: There is also no failure to investigate if all of the indicia available normally to the Board present no indication of foul play.

**Barnes 147 (1924)**

**Director ineptitude.** Stockholders sued the former director of their company for running it into the ground (albeit not illegally). Learned Hand basically called their theory of mismanagement liability bullshit. He said that directors have a duty to keep advised of the conduct of their corporate affairs. Directors may not be right for the job, but that’s a risk of business that isn’t open for liability shots.

- Directors can’t be totally passive. Always a duty to keep informed in some detail.
- Duty to investigate only starts when a red flag goes up on business conduct (one bite rule).

**Graham 151 (Del. 1963)**

No director duty to prevent harm.

**Diagram of Transaction**

- BOARD
- PRESIDENT

**INDUSTRIES GROUP**

Four other divisions

**POWER EQUIPMENT DIVISION**

/   /   /   /   /

Ten Depts.

/   /   /   /   /   /   /   /   /   /   

x

Derivative action by corporation for damages resulting from antitrust violation. Price-fixing occurred in one of the ten lowest departments, rigged by low-level employees. Suit claims directors failed to take preventative measures to learn of and/or prevent antitrust activity. Court held that absent a cause for suspicion, there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.

**Francis 157 (1981)**

Drug addict mother made director and failed to perform proper duties as director in reviewing financial statements, etc. While she was hopped up on hohane, her sons stole the company blind. Lack of duty of care wasn’t exact cause of liability, but was a proximate cause. Changes causation standard – non-action doesn’t have to be substantial factor, but as a minimum shows causal and traceable negligence to nexus of duty of care.

- Duty of Care not same for every CEO in every business. Some CEOs in similar circumstances will have greater or less activity within the business. Burden on Π to establish that failure in Duty of Care led to harm; Board’s duty is to perform with diligence, care, and skill.

**B. Business judgment rule (167-205)**

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

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

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

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

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

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

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

Smith 170 (Del. 1985)

Informed decisions as defense to breach. Van Gorkom, C.E.O. of Trans Union, meets with Pritzker on September 13, 1980, and suggests that Pritzker buy Trans Union for $55 per share. Preceding this meeting, Van Gorkom had discussed with senior Trans Union management a leveraged buyout at $55 per share. Pritzker agrees to a $55 per share price if given an option to buy 1 million shares of Trans Union at $38 per share and the deal be accepted by Trans Union within three days (from 9/18 when Pritzker agreed until 9/21). The Court held that the determination of whether a business judgment is an informed one turns on whether all directors have informed themselves ‘prior to making a business decision, of all material information reasonably available to them.’

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.

Judicial review of business decisions turn on conflicts of interest:

- Pure business decision - Defer to the business
- Board interested decision - Defer to injunction

AFTER VAN GORKOM:

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

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

UNLIKELIHOOD OF A DUTY OF CARE SUIT SUCCEEDING:

(1) Plaintiff has the burden of proof.
(2) In Delaware a gross negligent standard applies.
(3) Section 102(b)(7) opt out provision.
(4) Business judgment rule defense.
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Cf. FEDERAL SECURITIES LAW FRAUD CLAIMS:
(1) No business judgment defense.
(2) Mandatory disclosure system produces detailed published evidence.
(3) Possibility of a prior SEC investigation.

C. Capital structure and projections (125-131; Reg. S-K Items 10(b), 303(a); Securities Act §27A; Securities Act Rule 175; pp. 230-232, 258-276)

Portfolio theory: Any rational investor can eliminate firm-specific risk
Efficient market hypothesis: Publicly available information will be rapidly reflected in stock prices

The approach of the federal securities laws to corporate governance is systematically different than that of state corporate law. While the approach of state corporate law duty of care is generally to provide compensation for investors after they have been injured by a violation; the approach of the Federal Securities laws generally is to deter misconduct from occurring by enforcement of a mandatory disclosure system.

The federal mandatory disclosure system provides more than simply disclosure of historical data. Significantly the accounting data are wrapped in a considerably broader set of textual disclosures which emphasize predictive or forward looking information.

The federal mandatory disclosure system only applies to the largest business firms. See p. 231.

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

Item 303: Management’s Discussion and Analysis

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

Item 303(a) generally requires:

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

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

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

Liquidity: . . .

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

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

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

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

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

Flynn 262 (3d Cir. 1984)
Investors more likely to act in favor of corporate decision in absence of the withheld information.
Flynn addresses the issue of whether projections should be MANDATORY or PERMISSIVE.

The case for MANDATORY projections:

1. Projections, at least if prepared by management for internal use, arguably are material facts for
   investors.
2. Only if projections are mandatory will all investors receive equal information.
3. A permissive system might result in only favorable projections being disclosed.
4. The very fact that firm has difficulty making a projection tells much about the quality of its
   management.

The case for PERMISSIVE projections:

1. Business argument: Requires disclosure of competitively disadvantageous information.
2. Preparation expenses might be great.
3. A mandatory system would expose firms to risk of litigation.
4. In new firms or with firms entering new fields, there might be insufficient data with which to make
   a projection.

Wielgos 268 (7th Cir. 1989)
Safe harbor. 12/82: Commonwealth Edison [CE] nuclear power plant construction cost estimate.
12/5/83: CE stock sold at $27,625. Internal CE estimates are higher than those incorporated into the prospectus.
Prospectuses and forward-looking statements qualify for the Rule 175 safe harbor unless it is shown that such
statements were made or reaffirmed without a reasonable basis or were disclosed other than in good faith. Rule
175 assumes sophisticated readers of corporate disclosures.

Bespeaks Caution Doctrine: If a corporation makes forward-looking statements with sufficient and
meaningful cautionary statements, they are protected from liability in reliance on those statements.

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

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

1. Revenues, income (loss), earnings (loss) per share, capital expenditures, dividends, capital structure
   or other financial items.
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2. Management plans and objectives for future operations.
3. A statement of management future economic performance contained in Item 303, MD & A.
4. Underlying assumptions to any of the above.

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

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

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

Rule 175(a) provides a safe harbor for a forward looking statement which is deemed not to be fraudulent “unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith.”

SECURITIES ACT §27A

The most hotly contested provision in The 1995 Private Securities Reform Act was the new safe harbor for forward looking statements.

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

(1) An issuer that, at the time that the statement is made, is subject to the reporting requirements of section 13(a) or section 15(d) of the Securities Exchange Act of 1934;
(2) A person acting on behalf of such issuer;
(3) An outside reviewer retained by such issuer making a statement on behalf of such issuer; or
(4) An underwriter, with respect to information provided by such issuer or information derived from information provided by the issuer.

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

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

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

(3) There is then a novel safe harbor for oral forward looking statements when appropriate reference is made to a readily available written document. Sec. Act §27A(c)(2).

Underlying the complex view new safe harbors is a simple, but as yet unproven belief: “Fear that inaccurate projections will trigger the filing of securities class action lawsuit has muzzled corporate management.” 1995-1996 Fed. Sec. L. Rep. (CCH) ¶85,710 at 87,208. Whether this belief is warranted – or whether corporate management is reluctant to publicly discuss projections for other reasons is an empirical question that time will answer.
Management will only be held liable if their forward-looking statement is knowingly false (reckless).

IV. The Duty of Loyalty

(415-440; Del. Gen Corp. L. § 144)
Self-dealing can occur in a variety of circumstances:
- Individual director
- Interlock
- Parent-subsidiary

Section 8 of the Clayton Act prohibits interlocks between competitors if either firm has $1 million in assets or profits.

A. Self dealing transactions (417-440)

i. The Basic Standard (418-434)

Duty of loyalty arises in cases where there is a conflict of interest. Defendant has burden of proving fairness of deal by showing that directors stand on “both sides” of the transaction.

Globe Woolen 418 (1918)
Interested influence may be exerted in ways other than a vote. Interested director made his desires clear on a pending, interested transaction, and then abstained from the vote. Court held the transaction interested because of the dominating influence of the chairman in dictating the vote in absentia. If you stand on both sides of the fence, you must make sure the transaction was fair.

Gries Sports Enter., Inc. v. Cleveland Browns 423 (1986)
Self dealing transactions first have to fail the “disinterested” portion of the Business Judgment Rule.

ii. Safe Harbor Statutes (434-440)

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

Marciano 435 (Del. 1987)
I use this case simply to illustrate the relationship of DGCL §144 to the common law duty of loyalty.

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

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

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

Approval by fully informed, disinterested directors, makes for a purely business decision. Cannot be invoked as breach of duty of loyalty. Can be breach of duty of care under gift or waste doctrine. Burden on party attacking transaction.

B. Corporate opportunity doctrine (40-454; Handout 36-43)

Corporate Opportunity: A business opportunity which becomes known to a corporate official, particularly a director or other upper management, due to his/her position within the corporation. In essence, the opportunity or knowledge belongs to the corporation, and the officials owe a duty (a fiduciary duty) not to use that opportunity or knowledge for their own benefit. The corporation may have the right to damages (to be paid off) for such improper appropriation (use) of the opportunity on the theory that the official holds it in “constructive trust” for the corporation. The corporation may obtain an injunction (court order) to prevent someone's use of the knowledge or opportunity. In such cases angry stockholders may bring their own legal action for their benefit in what is called a derivative action. Such insider misappropriation (inappropriate use of information) may also be criminal theft, or be violative of federal or state securities laws.

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

- The opportunity presented is in the same line of business as the corporation or a line in which the corporation has an interest or expectancy, and
- The opportunity is presented to a corporate officer in a corporate rather than individual capacity, and
- The corporation is financially able to undertake the opportunity, then
- The officer is forbidden from seizing the opportunity for her or his own personal gain.

Guth 440-442

Line of business test. 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. Until it is determined who wins, court retains benefits of opportunity in trust.

Test for corporate opportunity:
1. Did corporation have interest or expectancy in opportunity,
2. Was opportunity offered to individual in personal or corporate capacity,
3. Was corporation financially able to undertake opportunity (not really important anymore – assumption of attractive opportunity present, funds will be available).

Interest normally requires a preexisting relationship. Analyzing the expectancy, focus on reasonable expectations of business. More difficult to prove than interest; concept can stretch very far.

Johnston 444 (1956)

If an opportunity is presented to an officer in their official capacity, even if the offer wouldn’t normally be considered a corporate opportunity, it becomes subject to the doctrine and must be presented to the board before any personal action may be taken.


Line of business test further defined: The real issue under the COD is whether the opportunity is so close to the normal business functions of the company as to bring the transaction into the class of cases where the actor is in competition with their corporation.

ALI test: Specifically requires full disclosure prior to taking advantage of any corporate opportunity.

V. Executive Compensation

A. The Waste Doctrine

Rogers 474 (1933)
Corporations Outline

Executive was compensated at a certain percentage of profits. When he grew profits astronomically, so did his bonus in actual dollars. Shareholders sued as waste. Waste Doctrine: Dissent held that if a bonus payment has no relation to the value of services for which it was given, it is in reality a gift in part and the majority stockholders have no power to give away corporate property of the minority.

Walt Disney Company Chairman and CEO Michael Eisner hired Michael Ovitz to be president of Disney. Ovitz got mad sick compensation when the board granted him a No-Fault termination after one year. Shareholders sued as corporate waste, moving the board outside of the protection of the Business Judgment Rule. Court held that the board made a business decision.

Three grounds for challenging executive compensation:
1. Duty of loyalty shifts burden of proof to compensation committee for showing disinterested board
2. If cannot show interested transaction, proceed under BJR and waste doctrine. Different form of BJR – not like deciding where to put a new store. More based on absurdity. Pro plaintiff standard assumed board was fully informed in establishing the amount in question as “reasonable.” Limitations on salary will come from IRS laws and security regs.
3. No true standard: How much is too much?

VI. Shareholder Voting Rights

Pp. 487-511; Rule 14a-8

A. Voting

Corporate law has three primary techniques to deter corporate dysfunction:

1. Fiduciary Duty Litigation.

Electoral rights are the weakest device to protect shareholders in the modern corporation. See data at pp. 487-488.

State corporate law today essentially is based on assumptions of nondemocratic restraints. Shareholders are protected (1) By laws against fraud and unfairness; (2) their ability to sell their shares in a stock market; and (3) by holding stock in portfolios.

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

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

Shareholder indifference can be characterized as “rational apathy.”

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

1. Minority Representation: This theory is epitomized by the cumulative voting debate. There are two questions today:
   a. Is cumulative voting permissive (like DGCL §214) or mandatory?
   b. Does it coexist with classified boards (like DGCL §141(d)) or are classified boards prohibited? See pp. 490-491.
Corporations Outline

Cumulative voting is on the decline:

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

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

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

Cumulative voting when permissive may be dropped by a simple majority of shareholders. But see Coalition to Advocate Public Utility Representation v. Engel forbidding one corporation to drop permissive cumulative voting during a proxy contest. See p. 491.


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

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

This theory has not been successfully developed in the United States:

- Labor long unenthusiastic.
- Difficulty defining who the governed are.
- Chris Stone, Where the Law Ends, alternatively proposed public directors; e.g., Comsat.
- Nader’s constituency representatives is another alternative.
- At the moment worker ownership of a few large corporations is the most interesting development in this area.

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

A. Corporate elections are different than political elections.
B. Votes should be subordinated to financial decisions of the corporation.
C. Nexus of contracts theory - managers negotiate with labor and capital suppliers.

4. Relational Investment. Focus on institutions such as CalPERS. To date, this approach is highly episodic in nature. See pp. 494-495 for relevant data.

i. Corporate Formalities (495-497)

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

ii. Proxy Election Expenses

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

**Rosenfeld 499 (1955)**

Two criteria for reimbursement:
1. Expenditures cannot be used for the personal entrenchment of the board – must be policy related
2. Expenditures for the pursuit of specific policies must be reasonable amount

Voorhis dissent: Because it is difficult to differentiate between personal and policy expenses, only such expenses as are reasonably related to informing the stockholders fully and fairly concerning the corporate affairs should be allowed.

Law changed post-Rosenfeld. Can now succeed on reasonable amount challenge. Therefore, second point of test is more important because the personal/policy determination can be so nebulous.

iii. Disenfranchisement

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

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

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

Securities Exchange Act Rule 14a-8

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

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

VII. The Close Corporation

Close corporation:
1. Small number of stockholders (<30)
2. No market for stock
3. Substantial majority stockholder participation in management of corporation

Because close corporations have no readily available market for stock, heightened fiduciary duty exists. Based on duty of loyalty.

B. Heightened fiduciary duties
Corporations Outline

Donahue 530 (1975)
Fiduciary duty equal to Cardozo’s “order of highest punctilio, utmost good faith and loyalty”.

Wilkes 541 (1976)
Test of whether good faith and loyalty are breached:
Can controlling group demonstrate legitimate business purpose for its action?
  • If yes, can minority show that an alternative less harmful to minority’s interest is also available?

C. Stock Transfer Restrictions

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

Under §342 there are three eligibility requirements:

1. Fewer than 30 shareholders.
2. Section 202 share restriction.
3. No public offering.

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

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

DGCL §202(d) provides that any restriction to maintain Subchapter S status is conclusively reasonable.

The most difficult stock transfer restriction problem is how you define the value of shares now to be transferred at a future time. There are several alternative techniques, each of which has disadvantages. These include:

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

Book value: Book value is based on original cost and may be considerably less than current fair market value.

Nonetheless original price and book value are mechanically easy to apply.

More sophisticated valuation techniques such as earnings value or capitalization of earnings, see pp. 551-552 or asset value, usually require an appraiser. On October 15 and 17, we will discuss the appraisal process for dissenters in mergers and other fundamental transactions. That discussion is relevant here.

One reason close corporation share restrictions or buy-and-sell agreements tend to be detailed is that there are a number of potentially difficult drafting choices if a sophisticated valuation technique is employed.


D. Voting agreements
Corporations Outline

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

i. Stock Pooling Agreements
Voting agreement is always OK, but it is not always easy to enforce (it can always be abandoned). A voting trust is binding.

Ringling v. Ringling Bros.-Barnum & Bailey Combined Shows, Inc. 554 (1946)
2/3 pooling agreement between sister and brothers. Votes go to an arbitrator if the parties could not agree. When the arbitrator clause was invoked, the opposing shareholder sued.

Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling 563 (1947)
Must arbitrator’s decision be followed? No. Vote is only enforceable when shareholder willingly cast votes. Arbitrator’s decision is not binding – shares cannot be voted by anyone other than the shareholder. Only binding in voting trust, not voting pool.

Cf. Note 1 at p. 567 for a more recent approach.

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

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

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

E. Deadlock avoidance and dissolution

Kemp & Beatley, Inc. 583 (1984)
Two stockholders owning 20.33 percent of the corporation’s stock were informed that they would not receive “extra compensation bonuses,” a “known incident to stock ownership in this firm” shortly before or after their employment ended. After this decision, bonuses were only paid to employees. The plaintiffs brought suit to dissolve the firm under §1104(a) of N.Y. Bus. Corp. Act, which permits dissolution for “oppressive actions.”

Section 1104(a) is available to a stockholder owning 20 percent or more of a firm whose stock is not publicly traded, and proof of either mistreatment of complaining shareholders or misappropriation of corporate assets by those in control. Used to counter illegal, fraudulent, or oppressive conduct.

Oppressive conduct: Majority shareholders acting in such a manner as to destroy the reasonable expectations of the minority holders that for the basis of their participation. Must be objectively reasonable.

CLOSE CORPORATIONS AND LIMITED LIABILITY COMPANIES
STATUTORY COMPARISONS

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<tr>
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<th>Delaware Close Corporation</th>
<th>Limited Liability Company</th>
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<tr>
<td>Formation</td>
<td>Elective: DGCL §341(a)</td>
<td>Elective: ULLC §103(a)</td>
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<tr>
<td>Eligibility</td>
<td>DGCL §342:</td>
<td>ULLC §103(b):</td>
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Corporations Outline

| Requirements          | 1. Fewer than 30 shareholders  
|                      | 2. DGCL §202 share restriction  
|                      | 3. No public offering           | Restrictions or operating agreement |
| Management           | 1. DGCL §351: Without directors  
|                      | 2. DGCL §350: Restriction of directors  
|                      | 3. DGCL §354: Operating as a partnership | ULLC §203(b)-(c) |
| Special Remedies     | 1. Custodian: DGCL §352  
|                      | 2. Provisional director DGCL §353  
|                      | 3. Shareholders option to dissolve corporation DGCL §355 |

Q. Given this pattern, why is the limited liability generally preferred today to the close corporation?

Cf. Handout 1-8

VIII. Mergers

DEL. GEN. CORP. L. §§251, 253, 262; Pp. 1063-1073, 1082-1094.

During the 19th century corporate law was characterized by Jacksonian hostility to big entities. Mergers, when permitted, both required supermajority votes and provided an appraisal remedy to protect dissenters. The appraisal remedy may have, in part, been necessary because of the general lack of stock markets to facilitate exit.

During the 20th century, this context has dramatically changed. Shareholders in public corporations are protected by ability to sell shares in a stock market. Corporate law today no longer has size constraints or discourages mergers. The availability of the appraisal remedy has been reduced. The high vote requirements generally have been eliminated.

DELAWARE MERGER LAW

DGCL §251 — General Rule:

1. Majority vote by shareholders in both firms. DGCL §251(b).
2. Appraisal rights under DGCL §262.

There are several exceptions:

1. DGCL §251(f) — unless required by its certificate — no vote of the surviving firm if:
   a. No certificate amendment.
   b. Identical stock after merger.
   c. No more than 20 percent of common stock employed. No appraisal right often for survivor’s shareholders. See DGCL §262(b)(1).

2. DGCL §253:
   a. No vote of either surviving parent or subsidiary shareholders.
Corporations Outline

b. No appraisal rights for parent when parent owns 90 percent or more of subsidiary.

3. DGCL §262(b)(1) No appraisal if shareholders in a firm listed on a national security exchange or held by 2,000 or more shareholders.

4. DGCL §271 sale of assets:
   a. There is a vote if a sale or lease of all or substantially all assets.
   b. But no appraisal.

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

5. Triangular mergers. See pp. 1067-1068.


A. The Appraisal Remedy

The right to treat a consolidation as dissolution, and as a remedy, provide correct buyout price for minority shareholders. Appraisal remedy requires several techniques (because of inherent unreliability in each individually).

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

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

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

Delaware caselaw has further established:

(1) Market value was never given more than 50 percent weight in appraisal and could be reconstructed.
(2) Asset value typically follows generally accepted accounting principles and is not based on book value, but rather a current appraisal.
(3) Dividends are only significant when not paid. "Substantial negative dividend recognition" is then recognized.
(4) Earnings value involves averaging the last five years earnings then multiplying by a multiplier. This could be fewer than five years if there were unusual years.

The multiplier was meant to equal the price to earnings ratio in the relevant industry. Today this typically is done by studying similar firms.

The traditional Delaware block approach has been criticized:

1. It is highly subjective. The trial court discretion in assigning weights is typically decisive, but rarely explained in a way that can be followed in subsequent cases.
Corporations Outline

2. The approach reflects a hostility to market value in appraisals, but at the same time creates a stock market exception.

3. There is no explicit requirement that assets be revalued, although this is usually done.

4. The remedy is technically difficult to commence. See DGCL §262(d). There must be (1) written demand before merger vote; and (2) vote against the merger or abstention.

5. The costs of an appraisal are uncertain. The court has discretion concerning interest. See DGCL §262(i) (j).

6. Brudney & Chirelstein add that the appraisal formula ignores synergical value in an interested merger because DGCL §262 provides for “fair value exclusive of any element of value arising from accomplishment of the merger.”

Valuation of Common Stock of Libby, McNeill & Libby 1082 (Me. 1979)
Valuation approach based on judicial determination of “fair value.” Illustration of Block Approach, the evaluation techniques, and weighting the results according to specific circumstances.

Weinberger v. UOP, Inc. 1097 (Del. 1983)
Five principal holdings:

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

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

3. The appraisal remedy was broadened to include the discounted cash method.

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

5. A merger can now be enjoined on a series of grounds (notably fraud, duty of loyalty violations, and waste).

Rabkin v. Philip A. Hunt Chem. Corp. 1120 (Del. 1985)
Two-step merger. Rabkin addresses the fifth principal holding in Weinberger. March 1, 1983: Olin bought 63.4 percent of Hunt common stock at $25 per share subject to a condition that if Olin bought all or substantially all of Hunt’s stock within one year it would pay $25 per share. It is clear within the one year period, Olin intended to buy the rest of Hunt. After the one year period, Olin structured a merger to purchase the remaining shares at $20 per share. Suit based on belief that $20 was on the low end of “fair price.”

The legal question: Is an appraisal the only remedy available to Hunt shareholders or are they entitled to an injunction per the Weinberger exceptions for “fraud, misrepresentation, self-dealing, waste or gross and palpable overreaching?”

Failed business purpose test (merger must be for legitimate business purpose – under circumstances, must be fair to minority). Court found that the delay by Olin was simply to disadvantage the minority by forcing the lower $20 purchase price.

IX. Tender Offers
Corporations Outline

Definitions on pp. 1133-1142, 1180-1206

A. The phenomenon

Tender offers are addressed by three categories of law: (1) The Williams Act Amendments to the Securities Exchange Act; (2) state control share statutes; and (3) state corporate law. In this course we will solely address state corporate law.

The cast of characters in a tender offer might include:

1. Bidders
2. Targets
   i. Managers
   ii. Employees
3. Shareholders
   i. Institutional Investors
   ii. Arbitrageurs
   iii. “Individual” Shareholders
4. Other Constituencies
   i. Surrounding Communities
   ii. Suppliers/Distributors
   iii. White Knights
   iv. Investment Banks

By disaggregating the target you can see why agency cost theory does not work well in harmonizing incentives of target corporation managers with incentives of its shareholders. Shareholders are delighted to receive a premium bid; corporate officers in hostile bids fear dismissal.

Why do hostile tender offers occur? There are several competing hypotheses, notably including:

1. Disciplinary
   a. Agency Costs Theory
   b. Query: Why don’t other disciplinary mechanisms work (e.g., board of directors, derivative suits)?
   c. Query: Suppose the market for control is effective, how does it influence managerial behavior?
2. Synergy
   a. Horizontal: The problem of antitrust policy.
   b. Vertical
   c. Empire Building: Managerial labor market
   d. Exploitation
   e. Two tier bids
   f. Coercion, free rider problems.

B. State corporate law

**Cheff v. Mathes 1181 (Del. 1964)**

Greenmail. Board of directors may use corporate funds to acquire stock in the corporation if motivated by a proper business purpose but not to perpetuate its own control of the corporation.

The practical effect of this case is to supplant shareholder ownership with its voting power with a managerial defense that prevented either a tender offer or a proxy contest. See Note 3, at pp. 1191-1192.

There may be very few instances in which management could not satisfy its burden of showing a reasonable investigation and a corporate policy difference. The key limit in Cheff was that an instantaneous rejection of an offer without any investigation will not suffice. Cf. Condec, at p. 1191.
Unocal Corp. 1193 (Del. 1985)

Opposite of greenmail. Board decided to offer buyout to everyone but Mesa. Mesa sued. Court held that if board’s decision not to fight a takeover bid was a valid business judgment, then court would not overrule pure business decision. Board must have reasonable perception of threat and reasonable response to that threat (proportionality test).

Element of balance: Defensive measure taken by target company must be reasonable in relation to the threat posed.

There are two further points worth noting about this case:

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


C. Tender offers
Pp. 1206-1219, 1240-1260

Revlon 1206 (Del. 1986)

Competitive bidding for Revlon, so sale was inevitable. Revlon had issued notes. In cases of inevitable sale, a director’s focus is solely on making sale beneficial shareholder. Forstmann was granted a lock-up option in exchange for a purchase offer, essentially eliminating competition. Court held that Revlon directors breached their duty when they became more concerned with their liability to note holders rather than shareholders. Lock-up options are not available when sale is inevitable.

Paramount Communications, Inc. v. QVC Network, Inc. 1240 (1994)

In 1993 Paramount and Viacom negotiated a merger. Each Paramount share would be converted into Viacom securities and $9.10 cash. Paramount instituted a poison pill with a Rights Agreement created to ward off other suitors, but was to make an exception to Viacom. Additionally, Paramount instituted three defensive provisions:

1) a No-Shop Provision, stating that Paramount would not engage in any purchase offers outside of the Viacom merger unless they were unsolicited third-party offers without any contingent financing and that such discussion would be necessary for Paramount’s fiduciary duties,
2) a Termination Fee, paying Viacom $100M if the deal was either terminated for a competing offer, not approved by shareholders, or if the Board recommended a competing action, and
3) a Stock Option Agreement, allowing Viacom to purchase almost 20% of Paramount’s outstanding common stock at $69.14 per share under highly questionable and favorable terms with a junk bond, and with a possibility of an uncapped and unreasonable provision for Viacom to force Paramount to pay a cash sum equal to the difference between the purchase price and market price of the stock to Viacom.

QVC offered $80 per share at .893 QVC stock and $30 per share conversion for up to 51% of Paramount’s outstanding stock.
QVC raised its offer to $90 per share. Paramount recommended that the offer was not in the best interests of the shareholders because it was highly conditional, but the Board would not communicate with QVC because they believed it was prohibited by the No-Shop Provision.

X. Federal Proxy Fraud [Rule 14a-9]

DOES NOT EXPLICITLY STATE A CAUSE OF ACTION. Pp. 783-796, 800-807, 810-817

A. Implied cause of action

Basic questions are:
1) Whether a particular statement is false and misleading, and
2) Whether the statement or omission is material.

Proof required as two separate elements.

Proof elements same for 10b-5

Borak 785 (1964)
Where a federal securities act has been violated, but no private right of action is specifically authorized or prohibited, a private civil action will lie, and the court is free to fashion an appropriate remedy. Implied cause of action not limited to prospective or injunctive relief, but could also include retrospective or monetary damages. Necessary as a supplement to SEC Act as a deterrent to avoid private parties seeking remedial relief in federal courts.

B. Causation

Mills 791 (1970)
Management omitted material facts in proxy statement. Management pleaded transactional fairness as reason for omission. Court held that transactional fairness is not a defense to proxy statement rule violations. Court held that as long as aggregation of all non-management interests can defeat the proxy statement, then the omission is sufficient to show fraud.

 If management is strong enough to pass proxy without shareholder consent, omission is irrelevant.

Causation is not normally an issue under 14a-9. If you can show a material omission was an essential link in the nexus, then causation is inferred.

C. Materiality

The same law of materiality applies to Rule 14a-9 and Rule 10b-5 and indeed generally in federal securities law. A fact can only violate proxy law if it is material.

i. The Basic Standard

TSC Indus., Inc 801 (1976)
Definition of materiality: An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This does not require full disclosure, as some information may do more harm than good.

The accounting standard of materiality: If there is a statement or omission of 10% or more. If less than 5%, immaterial.
 Two exceptions: criminal activity and conflict of interests.

Codified in 14a-9 (p. 818 in supplement).
ii. Contingent Events

**Basic Inc. v. Levinson 810 (1988)**

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

Court held that a misstatement by management regarding a merger negotiations is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding whether to buy or sell stock.

Any fraud committed on defendants should be reflected in market value of the stock. Fraud-on-the-market theory creates a rebuttable presumption of reliance, refutable by showing defendant would have traded anyway, or that misrepresentation did not affect market price. Takes out causation element.

In order to prevail on a 10b-5 claim, plaintiff must show that statements were misleading as to a material fact. It is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant.

Kate has something to say. Predictive information must take into account:
- Magnitude of event, and
- Probability of it occurring.

“No comment” or silence, in the absence of a duty to speak, is not equal to misleading.

Safe harbor: In situations where corporation issues statements in good faith (dividends and revenue forecasts), the corporation can insulate itself from liability by issuing cautionary language – effectively making misstatements immaterial.

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

iii. Reasons, Opinions, or Beliefs

**Virginia Bankshares, Inc 819 (1991)**

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.” Challenger believed that board agreed to the lower price as “fair” so that they could remain on the board. Minority shareholder had standing because her 14a belief was supported by objective evidence that the recommended price was not the maximum available. Board breached duty to seek best price. The case makes one clear holding: Statements of reasons, opinion, or belief can be misrepresented and material.

Materiality turns on whether the stated opinion or belief is analogous to the facts and details that the shareholder has. Must look at a reasonable shareholder standard.

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

**Note:** The “Bespeaks Caution” Doctrine

Pp. 827-834

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

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


XI. Securities Fraud and Insider Trading

A. Should trading on the basis of material nonpublic information be illegal?

Pp. 837-847

i. Arguments in Favor of Regulation

1. Equity
   Congress consistently has emphasized equity or fairness arguments in enacting insider trading legislation. That is, all investors should have equal (or roughly equal) access to new material information. See, e.g.:

   a. S. Rep. No. 792, 73d Cong., 2d Sess. 21 (1934): “The express purpose of this provision [§16(b)] is to prevent the unfair use of inside information.” See also H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934) addressing §16(b) in a Section entitled, “Control of Unfair Practices by Corporate Insiders” and stating “Men charged with the administration of other people’s money must not use inside information for their own advantage.”

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


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

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

2. Allocative Efficiency


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

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


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

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

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

3. Property Rights


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


ii. Arguments Against Regulation

1. Compensation to Insiders


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

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

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

2. Stock Price Smoothing
Corporations Outline

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

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

3. Private Ordering

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

a. Portfolio theory militates against shareholder concern with individual firms.


B. Insider trading at common law

Pp. 848-856; Sec. Ex. Act §16(b); Pp. 870-882, 886-891.

i. Before the securities exchange act of 1934

*Goodwin v. Agassiz*

283 Mass. 358, 186 N.E. 659 (1933)

Pp. 852-856

OMITTED

C. Section 16(B) of the Securities Exchange Act

Section 16(b) provides in relevant part: “Any profit realized [by any beneficial owner of 10 percent or more of any class of equity stock in a firm registered under the 1934 Act, director or officer], from any purchase and sale or any sale and purchase within any period less than six months . . . shall be recoverable by the issuer, irrespective of . . . intention . . .”

This is the original insider trading Section in the Securities Exchange Act. There are five basic elements. Any profit realized by (1) 10 percent + beneficial owners, officer, or director from (2) any purchase and sale or any sale and purchase of any equity stock (3) within any period less than six months (4) shall be recoverable by the issuer (5) irrespective of the insider’s intention.

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

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

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

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

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

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

Kern County Land Co. v. Occidental Petroleum Corp.
411 U.S. 582 (1973)
Pp. 873-882

OMITTED

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

OMITTED

D. RULE 10b-5
Pp. 894-915; Sec. Ex. Act §21A; Rule 10b5-1

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

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

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

i. The Disclosure or Abstain Rule

The Rule: If you are in possession of material facts, either have to disclose them or refrain from trading on them. If you disclose, you must use methods reasonably reliable to disseminate information. Or, you can wait until volume calms down if it is a lesser-traded stock.

Use materiality standard from 14a-9 (proxy fraud).

SEC v. Texas Gulf Sulphur Co. 896 (2d Cir. 1968)

MATERIAL FACTS:

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Alleged Violation</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/29-10/30/63</td>
<td>Initial Ground Survey</td>
<td></td>
</tr>
<tr>
<td>11/8-11/12/63</td>
<td>Initial Drill, K-55-1 and Holyk visual estimate</td>
<td>1. Defendants who purchased stock or calls between 11/12/63-3/31/64.</td>
</tr>
<tr>
<td>early December</td>
<td>Chemical assay in Utah, “remarkable” results</td>
<td>2. Their “tippees”</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3. Officers accepting options on 2/20/64.</td>
</tr>
</tbody>
</table>
### Corporations Outline

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>11/12/63-</td>
<td>Land acquisition.</td>
<td></td>
</tr>
<tr>
<td>3/27/64</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3/31</td>
<td>Drilling resumed.</td>
<td></td>
</tr>
<tr>
<td>4/13</td>
<td>Canadian journalist visits drill site; prepares article</td>
<td>5. Crawford purchases on 4/15 at 12 a.m. and on 4/16 at 8:30 a.m.</td>
</tr>
<tr>
<td></td>
<td>confirming 10 million ton ore strike.</td>
<td></td>
</tr>
<tr>
<td>4/16</td>
<td>Canadian article published.</td>
<td>6. Coates order to buy at 10:20 a.m., 4/16.</td>
</tr>
<tr>
<td></td>
<td>9:40 a.m. Canadian official announcement.</td>
<td>7. Corporation and certain officers before 4/12 press release.</td>
</tr>
<tr>
<td></td>
<td>10:00-10:15 a.m. American press briefed.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10:29 a.m. Merrill Lynch wire carries story.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10:54 a.m. Dow Jones ticker tape carries story.</td>
<td></td>
</tr>
</tbody>
</table>

**Knowing Possession test:** Must demonstrate that person trading had knowledge of relevant, nonpublic information.

See p. 905 n.12.

**Rule 10b-5 is more limited. Requires:**
- When a firm sells a security to the public or is subject to disclosure requirements of the SEC, it will be required to disclose nonpublic info at least periodically
- Duty to update and duty to correct material disclosures
- Encouraged (but not required) to release quickly any news or info which might reasonably be expected to materially affect the market for its securities and to make a frank and explicit announcement if rumors or unusual activity indicate that info on impending developments has leaked out
- SEC encourages (not requiring) prompt corporate disclosure of material business events
- A firm may not selectively disclose material info to some, but not to all

**Rule 10b-5 is not the only Rule that requires disclosure of material nonpublic information.** See Notes and Comments at pp. 912-915: (1) A corporation usually will be required to disclose material information when it sells new securities to the public or complies with the periodic disclosure requirements of the mandatory disclosure system; (2) there is a Rule 10b-5 duty to correct or update prior material statements, see pp. 912-914; and (3) the securities exchanges encourage, but do not require, disclosure of important news developments. See pp. 914-915.

**BACKGROUND**

Trading “on the basis of” or “while in possession of” material nonpublic information: Rule 10b5-1.

**Damages:** Cf. Sec. Ex. Act §21A.
ii. Standing

Blue Chip Stamps 915 (1975)
Standing to bring a 10b-5 action. Birnbaum Rule: Only actual purchases or sellers of stock are capable of bringing an action under Rule 10b-5. If you are a shareholder who didn’t sell, or you suffered a loss due to the material omission, you may bring a shareholder’s derivative suit. Policy harm against investment and business decisions if anyone is capable of bringing suit.

- If you didn’t buy stock at all, you’re SOL.

(1) It is impossible to avoid some case-by-case evisceration of Blue Chip in circumstances such as those described in Notes 1-4.

(2) The most controversial aspect of Blue Chip was not its holding but its references to “vexatious” litigation and “strike” suits. See p. 930 Note 5. This later provided support for the Private Securities Litigation Reform Act of 1995, which has enacted new procedural restrictions on securities litigation.

iii. Scienter

Pp. 930-940

Ernst & Ernst 930 (1976)
- If you plead and prove an intent to misrepresent, you have satisfied scienter
- If you plead and prove only negligence, you have not plead sufficient culpability to satisfy 10b-5
- If you plead and prove recklessness for historical information, it would suffice for scienter. If for forward looking information, recklessness will not suffice.

iv. Reliance

Basic Inc. v. Levinson 951 (1988)
Revisited: Any fraud committed on defendants should be reflected in market value of the stock. Fraud-on-the-market theory creates a rebuttable presumption of reliance, refutable by showing defendant would have traded anyway, or that misrepresentation did not affect market price. Takes out causation element.

Only an element in material misrepresentations; not omissions.

v. The duty element

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

Chiarella 962 (1980)
Rule of law: No general duty to disclose before trading on material, nonpublic information. Mere possession of material, nonpublic information does not violate 10(b), but a duty to disclose vests with the existence of a fiduciary relationship.

Would have been a cause of action for the printing company, because Chiarella had duty to them. Chiarella owed no duty to the general public because he was not an insider. Dissent argued for absolute duty of disclosure when in possession of any material nonpublic information. This is the serendipitippee argument, which segues to Dirks n. 14 constructive insiders.

Only an element in omissions; not material misrepresentations.
Corporations Outline

Dirks 973 (1983)

Dirks is important for two primary reasons:

A. The case adopted the CONSTRUCTIVE INSIDER THEORY in footnote 14 — when outsiders have "entered into a special confidential relationship . . . and are given access to information solely for corporate purposes . . ." See pp. 981-983, Notes 1-2.
   • Includes corporate outsiders, such as accountants, lawyers, law clerks, etc.

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

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

Footnote 14 – p. 976 – Constructive Insider Theory
Fiduciary duty is only for the activity you were hired to do.

Footnote 22 – p. 979 – Walton v. Morgan Stanley
In the absence of any fiduciary relationship, there is no basis for imposing tippee liability on the firm. Fiduciary duty is removed by an arms length transaction.
If there was a confidentiality agreement, then they could've been liable. The key is to look at any financial benefit. For an insider to violate 10b-5, there must be quid pro quo.


Misappropriation theory holds that a person commits fraud “in connection with” a securities transaction and therefore violates section 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.
The misappropriation theory premises liability on a fiduciary-turned-trader’s deception of those who entrust him with access to confidential information.
Rule 14e-3 applies only to tender offers. Example: If a pizza delivery guy overhears the CEO of a company disclose that they are going to merge with a target corporation, the delivery guy cannot act on that information if he’s aware that that person is the CEO. If he does trade, it would be in breach of a duty.