CORPORATIONS OUTLINE – WEINBERGER
Jamie Rehmann

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Part I – Background

I. Agency
   A. Proponent of the agency relationship bears burden of proving 2 elements to hold principal liable for actions of the agent
      1. The establishment of an agency relationship w/ a principal
      2. Authority from the principal for the agent to bind the principal.
   B. Establishment of an Agency Relationship
      1. Test - Look to the totality of circumstances to see if principal had control over agent.
         a. Specific examples
            i. Rebuttable presumption that driver of a vehicle is agent of the owner
            ii. Husband and wife ARE NOT automatically agents for each other.
      2. Effect of a Written K – Ct. will ignore K describing relationship as something other than agency, if totality of circumstances establish control over agent.
   C. Authority for the agent to bind the principal
      1. Rule: Principals are only liable to the extent the agent has authority to bind them.
      2. Actual Authority
         a. Express – express authorization to act for the principal
         b. Implied – authority to take the steps necessary to carry out express instructions/authorization
      3. Apparent Authority
         a. Used by 3d pty to prove agency when there was not actual authority
         b. Elements
            i. Principal holds out the agent (manifestation) to the 3d pty
               a. Key fact – needs to be some sort of communication or express holding out b/t the principal and a 3d pty
               ii. It is reasonable for the 3d pty to rely on the agents apparent authority.
                  a. If the agent is too high up or too low in the organization to be doing that kind of act, then probably not reasonable to rely.
                  b. The act must be something that is reasonable (an offer can’t be too high)
            c. This inquiry focuses on the communications b/t principal and 3d pty.
               i. From the principal’s holding out, was it reasonable for the 3d pty to believe the principal had given the agent authority.
      4. Inherent Authority
         a. Elements
            i. Agent violated or acts contrary to express instructions given by principle
            ii. Causes loss to 3d pty
            iii. 3d pty is an innocent (blameless)
         b. Reasoning – Even through principal is blameless too, more fair to place blame on him rather than innocent 3d pty, because principal benefits from agency relationship.
5. **Ratification** – A subsequent affirmation by the principle of promises made by the agent that the agent lacked authority to make.

### D. Consequences of Agency for Principal

1. **Principal’s Liability in Tort**
   - a. Gen’l Rule – Principal is strictly liable for actions of the agent
   - b. Three defenses
     - i. Independent contractor/ Franchisee
       - a. Factors:
         - i. Amount of control IC has over day to day activities
         - ii. Intent of the ptys in forming the relationship
         - iii. Was IC hired to produce a particular result or integral part of principals business
     - b. Exception where defense not allowed:
       - i. Principal retains ultimate decision making control over day to day activities of IC
       - ii. If IC is financially dependant on principal
       - iii. Where IC incompetent
       - iv. Inherently dangerous activities – principal liable for IC’s neg’l
       - v. Ultra hazardous activities – principal strictly liable
     - c. Note – Prof. says the exceptions swallow this defense. You should almost always be able to find an exception to the defense
     - ii. Agent outside scope of employment – Factors:
       - a. Foreseeability of agent’s action in questions – the act must not be any foreseeable more foreseeable than what the public might do
         - i. Known attributes of the agent are relevant here
       - b. Nature of the Act - Agent’s action of the same gen’l nature of that authorized?
       - c. Motivation - Agent’s motivation to serve employer or personal motivation?
       - d. Time/place dimension – frolic and detour
       - e. Note – even if act forbidden, principal still liable unless prove act was outside scope of employment (Restatement § 230)
     - iii. Borrowed Servant – If agent of gen’l employer being borrowed by a special employer, special employer is liable but not gen’l employer.
       - a. Two principals can’t both be liable
       - b. But must be abandonment of agent’s allegiance to gen’l employer.
   - c. Ratification
     - d. Note – Ct.’s more likely to hold large employer liable b/c ec. efficiency

### E. Consequence of Agency for of Agent

1. **Agent’s Liability in K**
   - a. To escape personal liability agent must disclose to 3d pty:
     - i. He is acting in a representative capacity AND
     - ii. The identity of the principal
     - iii. This is objective test from view of 3d pty
   - 2. Agent owes principal fiduciary duty of loyalty
a. Duty to subsume his own interests and act solely for benefit of principal in all matters connected w/ the agency (moral duty)
   i. This is so even in the absence of a contractual relationship – the inquiry is simply whether an agency relationship is shown
b. Specific breaches of the duty:
   i. Corporate Opportunity Doctrine
      a. See under duties to officer/directors to shareholders
   ii. Grabbing and Leaving – Can’t leave employer and take trade secrets (includes client list) or all key employees.
   iii. Other prohibited activities
      a. Deceit – lying about leaving if asked
      b. Disparagement of former employer
      c. Competing with employer
         i. But can make preparations to compete if do it on own time and don’t start competing until after you leave.
            a. ex. of permissible planning – lease, financing, purchasing, brainstorming
            b. ex. of impermissible competing – soliciting clients, staff
            c. gray area – disclosure to clients/staff about plans is okay so long as not disparaging and not done on employer’s time
c. Fiduciary duty lasts even after agency ends
d. **Remedy** for breach of fiduciary duty is punitive damages!!!!
   i. Remedy for corp. opp. doct. is disgorgement
Part II – Forms of Business Organizations

I. General Partnership – UPA (Uniform Partnership Act – adopted by most states)
   A. Formation
      1. Rule: Partnership is the default organization of two or more ppl. carrying on business for profit (6)
         a. This is so, regardless of their intent
      2. Determining whether pty is a partner or not (e.g., employee/lender)
         a. Totality of Circumstances Test (7) – look at pty’s actions
            i. Proponent of partnership has burden of proof.
            ii. Presumption of partnership if pty receives share of profits
                a. unless:
                   i. payment was wages for employment, debt, rent, ect.
                   ii. share of profits are just icing on the cake
                   iii. putting cap on amount of entitled profits is evid. of no partnership b/c partners split profits 50/50
            iii. Overcoming the presumption – evid. not partners (totality of circumstances)
                a. control – participating v. just following orders
                   i. exercising negative veto rights is evid. of not partners
                b. contribution – contributing property/$ to the partnership v. not contributing anything
                c. loss sharing – express agreement to share losses v. no loss sharing
                   i. but not dispositive b/c UPA provides for default loss sharing
                d. self labeling - what the parties hold themselves out as partners or something else (employee, lender, etc.)
         b. Partnership by Estoppel – when a person represents himself, or permits others to represent him, to anyone as a partner he is bound
            i. Two elements (16):
               a. Alleged partner must give credit to the partnership by his words or conduct or allow another person to represent him as a partner
               b. Proponent of the partnership relied on the alleged partner’s representation
   B. Gen’l Rules of Partnership (absent a contrary agreement)
      1. Partnership Interests - Every Partner has equal interest in partnership profits only (18(a))
         a. Liable for losses only proportionate to his contribution.
         b. Interest in partnership assets in possessory only, no property rights (26)
            i. This means that creditors of an individual partners can only attach that partner’s share of profits – not partnership assets and must get a charging order to get access to profits (28)
      2. Control - All partners have equal rights in management (majority rules in making business decisions) (18(e))
         a. But must be unanimous vote in “extraordinary” decisions.
            “Extraordinary” = decisions that will incur joint liability under 15.
3. Liability - Partners are joint and severally liable for everything that the other partner does → they bind each other (15)

C. Fiduciary Duties of Partners

1. Duties Owed (common law and 404):
   a. Loyalty – can’t act contrary to the interests of the partnership
      i. Two standards – trending away from Meinhard
         a. Meinhard v. Salmon standard - Must put interests of your partners above your own, thought of self should be renounced!
         b. Other ct’s/UPA – Can put yourself first, so long as it doesn’t disadvantage the partnership.
      ii. Specific applications of (trending away from Meinhard)
         a. Can’t compete w/ partnership b/f leave, but can start making preparations. (Meehan v. Shaughnessy)
         b. No duty to render information, unless on demand – can’t lie!!(Day v. Sidley)
         c. Can’t dissolve in bad faith (for purpose of asserting a partnership asset for yourself)
         d. Can’t take partnership assets w/ you when you leave
            i. business opportunities which come your way solely because of your interest in the partnership are considered partnership assets (see “business opportunity doctrine” at pg.)
   b. Care – limited to refraining from grossly neg’l conduct, intentional self dealing, knowing violations of the law
      i. Business Judgment Rule applies

D. Partnership Agreements

1. All of the UPA rules, including fiduciary duties, are default and can be contracted around (UPA preamble)
   a. Examples (all would be a breach of loyalty if not contracted around)
      i. Contracting around dissolution
         a. Guillotine method of expelling a pty for specified conduct is okay if written into partnership agreement.
            i. But never okay if SOLE purpose of expulsion was to increase partnership profitability.
      ii. Contracting around partnership assets
         a. Instead of clients of a partnership being firm assets, partners can agree that each client is an asset of the individual partner.
      iii. Contracting around equal control
         a. Each partner has control equal to pro rata share of investment in partnership

E. Dissolution

1. UPA rules
   a. Causes for dissolution (31)
      i. Express term of partnership in a K
      ii. Partner chooses to leave
         a. But if term stated in partnership K, partner that leaves would be in breach
iii. Death of a partner (absent an agreement to continue)
iv. Judicial dissolution for specified reasons (32)
   a. Partner uses this when leaving the partnership when leaving on
      there own would put them in breach of K
   b. Feuding partners IS NOT a cause for judicial dissolution
b. Procedure of dissolution (38)
   i. Dissolution w/out fault → winding up → liquidation → termination
      a. Absent an agreement, withdrawing partner can demand assets be
         liquidated and proceeds distributed (38(1))
   ii. Wrongful dissolution (partner breaches partnership K) → ct. may
      proceed as above OR continue partnership w/out the wrongful partner
         (38(2))
      a. Partners who have breached K must pay non-breaching partners
         damages.
      b. If non-breaching partners going to continue partnership, must pay
         breaching partner his share of partnership interests.
iii. UPA procedure for dissolution IS NOT DEFAULT. This is one of the
     few UPA provisions that is not stated in conditional language.
     a. Point – if ptsy specify in K how to dissolve the partnership, ct. can
        ignore (ex. if partnership continues, leaving partner can’t take a
        partnership asset w/ him)
     c. Even after partnership dissolved, it is not terminated until “winding up” of
        business affairs is completed (30)
        i. This means partners, even after dissolution, have right to income from
           partnership assets (e.g., fees from firm clients)
2. Ct’s exercise broad equitable discretion to ignore default rules, or express K,
   to provide fair relief (judicial activism)
   a. Examples:
      i. Implied term of partnership, if a partner owes the partnership money,
         until loan repaid.
      ii. Allow partnership to continue even if no fault b/c partner buy-out
        more economically efficient then liquidating assets.
      iii. Where partner’s contribution is labor instead of money, not liable to
        pay proportionate share of losses.

II. Limited Partnerships (UPA applies)
   A. Formation
      1. Gen’l Partnership is default – same as above
      2. Limited Partnership formed by (not sure where this is in UPA)
         a. Filing certificate of limited partnership w/ Secretary of State setting out
            identify of gen’l partners and limited partners.
      3. Purpose – bring together those w/ money w/ those w/ knowledge
   B. Gen’l Rules of LP
      1. Control (centralized)
         a. GP exercises broad control
         b. LP MUST NOT exercise control
2. Liability
   a. GP is fully liable just like in a normal partnership because they have control
      i. This is for protection of creditors
      ii. BUT CAN MAKE GP A CORPORATION TO LIMIT LIABILITY
   b. LP are only liable for their contribution to partnership unless they start exercising control, in which case they will be liable like a GP

C. Fiduciary Duties
   1. Gen’l Partners owe LP’s same fiduciary duties that GP’s owe each other in a gen’l partnership

D. What Makes it Unique
   1. LP’s get tax benefit of a partnership but limited liability benefit of a corporation.
   2. This is a trade off between no control = no liability

III. Corporations (Model Business Corporation Act)
A. Formation
   1. Must file Art. of Incorporation w/ Secretary of State (2.01)
      a. Must set forth name, address of corp., name, address of each incorporator, number of share (2.02)
      b. If don’t state corp. purpose, default is “any lawful purpose” (3.01)
   2. Rule of thumb is to put only mandatory info in art. of incorporation and include rest in corp. bylaws.

B. What makes a Corp. Different?
   1. Limited Liability
   2. Centralized Mngr.
   3. Perpetual Existence
   4. Free transferability

C. Extent of Limited Liability
   1. Liability during the incorporation process
      a. Rule – Promoter (office of a corp. pre-incorporation) is personally liable for pre-incorporation contracts, unless he makes clear to contracting pty that when corp. comes into existence, pty should look solely to corp. for performance
         i. Corp. still not liable for the K unless they adopt or accept the benefits of the K.
         ii. Just a promoter is liable, so too can promoter enforce performance even if corp. never comes into existence
   2. Piercing the Corp. Veil – losing liability after incorporation
      a. How to pierce
         i. Failure to pay att’n to corporate formalities (all ct.’s require this)
            a. Annual meetings of shareholders
            b. Annual minutes of meetings of directors
            c. Commingling assets and affairs (THIS IS THE BIGGIE)
               i. Failing to keep separate books/records
ii. Failure to keep separate accounts/titles
   ii. Failure to pierce would sanction fraud or injustice (some ct.’s require this as a second prong)
      a. Must show corp. formed just to escape debts that never intended to pay
      b. Must show deception to creditors
   iii. Inadequacy of insurance, corp. assets is never enough to pierce veil
      a. reason is b/c respect legis. decision in setting ins. minimums
      b. Some evid. to suggest easier to piece for torts than for breach of K
      c. Policy for allowing veil piercing
         i. We allow ppl. to incorporate to avoid personal liability (that is okay) but if owner commingles personal identity w/ that of corp. then we should not give him the benefit of limited liability.
         d. Remedy – shareholders/officers personally liable for their entire net worth

IV. Limited Liability Corporations (LLC) (Uniform LLC Act)
   A. Formation
      1. Must file articles of organization w/ secretary of state (202)
         a. Must set forth name, registered agent, duration, principal office
         b. One person can form an LLC
      2. Name must contain “Limited Liability Company” or “LLC”
   B. What makes an LLC different?
      1. Limited Liability (like a limited partnership)
         a. Except no gen’l partner to remain liable
      2. Pass through on taxes (like a partnership)
      3. Control can be centralized or diffused – just state whichever in art. of org.
         a. Solves problem of limited partnership, with limited partners crossing the line
      4. Why would anybody still do a limited partnership?
         a. Managers (GP) like limited partnership b/c keeps investors from exercising too much control
   C. Other Similarities
      1. Voting can be pro rata based on percentage each member gets or can be one vote per member (like partnership)
      2. Promoters or principal can be liable for K made b/f LLC incorporated (like corporation)
      3. Must be represented in court by a lawyer, not a member (like corporation)
      4. Subject to corporate veil piercing (like corporation)
      5. Courts tend to just be importing corporate law for LLC
         a. Same fiduciary duties
            i. but can be waived like a partnership
         b. Veil piercing
         c. BJR applies if centrally managed
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<th>Formation</th>
<th>Cost</th>
<th>Liability</th>
<th>Transferability</th>
<th>Continuity</th>
<th>Management</th>
<th>Taxation</th>
<th>Losses</th>
<th>Benefit</th>
<th>Downside</th>
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<td>General Partnership</td>
<td>Default – look to actions</td>
<td>None</td>
<td>Joint &amp; Several</td>
<td>None – need unanimous consent</td>
<td>At will</td>
<td>Diffused, every P is agent of others</td>
<td>Pass through</td>
<td>Pass through to Ps – can use to offset personal income</td>
<td>Pass through on taxes/losses</td>
<td>- All joint severally liable – Fragility of form</td>
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<td>Limited Partnership</td>
<td>Filing cert. of LP w/ Secretary of State</td>
<td>Filing fee</td>
<td>Limited to investment for LP - GP fully liable</td>
<td>- LP interest is freely transferable - GP can’t transfer interest unless all agree</td>
<td>At will</td>
<td>Centralized (GP exercises ALL control)</td>
<td>Pass through</td>
<td>Pass through</td>
<td>Pass through on taxes/losses - Ltd. Liability for LPs only</td>
<td>LPs liable if exercise any control</td>
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<tr>
<td>Corp.</td>
<td>Filing Art. of Incorp.</td>
<td>Filing fee, annual fee, mtg. minutes</td>
<td>Limited to your investment</td>
<td>Freely transferable</td>
<td>Perpetual Existence – lasts forever</td>
<td>Centralized (Board, Officers)</td>
<td>Double – pay taxes on income</td>
<td>Must carry over losses</td>
<td>Limited Liability</td>
<td>- Double taxes – Poss. of veil pierced</td>
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<tr>
<td>Limited Liability Corp.</td>
<td>Filing art. of org.</td>
<td>Filing fee</td>
<td>Limited to investment</td>
<td>Requires consents</td>
<td>Choice of term or perpetual</td>
<td>Choice of Centralized or diffused</td>
<td>Pass through</td>
<td>Pass through</td>
<td>- All benefits from above</td>
<td>- Poss. of veil pierced</td>
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Part III – Duties of the Corp.

I. Duties of Corp to Shareholders
   A. Purpose – The corporation exists for the primary purpose of making profit for its shareholders. Managers must operate to accomplish that end.
   B. The Business Judgment Rule (BJR)
      1. Decisions of corporate managers (officers/directors) on how to best accomplish the goals of the corp. are reviewed under the business judgment rule.
      2. BJR – Decisions will not be second guess by courts unless P proves mngr:
         a. Breached duty of care (see below)
         b. Acted in bad faith (this is a breach of duty of loyalty)
            i. fraud, illegality, self dealing, conflict of interest
         c. Waste – not rationally motivated for purpose of making profits
            i. Mnger can easily overcome this by making up any way the decision was “rationally” motivated to make corp. more profitable.
               a. Ex. “Good will” (Wrigley case), saving money for long term profits, employee moral, pursuing lit. would be distraction, ect.
               b. But “Benefit to society” is not enough to deprive shareholders of their profits (Dodge v. Ford)
            ii. Exceptions where no biz. reason needed – Charitable donations
               a. DE – Corp. has discretion to make donations if receive a benefit (i.e., tax break, “good will” – but unclear if donation anonymous)
               b. PA – Corp. can make donations without a direct benefit so long as in best interest of the corp.
               c. CA, NY – Corp. can make donations that benefits others regardless of benefit to corp.
               d. Policy – a healthy society = healthy economy
      3. Rationale for the rule
         a. Judges are ill equipped to second guess the business decisions of managers
            i. Can’t sit as a “super directors”
            ii. But are equipped to look into the from of the decision, just not substance
         b. Reward follows risk – mngrs. need to have freedom to make risky decisions that could pay off big for the corp.
         c. Shareholders can just liquidate their stock of don’t like what mngt decisions are being made

II. Fiduciary Duties of Officers, Directors, Insiders
   A. Background
      1. Who owes the duties?
         a. Directors, Officers, Controlling Shareholders (this is distinct from majority shareholder)
      2. To whom do they owe duties?
         a. Minority Shareholders, Shareholders who do not have the ability to exercise control
      3. Why do they owe a duty?
a. Agency relationship (see first section)
b. They are in a position of financial power and informational advantage over the minority shareholders.

4. But BJR grants broad immunity for mistakes made by officers/directors/controlling shareholders.

B. Fiduciary Duty of Care
1. Mngrs. owe shareholder a duty of care in making their decisions in order to be entitled to the protections of the BJR.
2. How to satisfy the duty
   a. Follow corporate formalities
      i. Hold a meeting – schedule the meeting enough in advance to give board members adequate notice
      ii. Keep minutes, discuss the decision at the meeting
   b. Avoid gross negligence
      i. Managers must inform themselves and deliberate before making a decision
         a. Relying on an expert is okay (Brehm v. Eisner)
         ii. If the decision requires shareholder votes – need to properly inform/make recommendations to the shareholders
         iii. Managers be at least familiar w/ the nature of the business and keep themselves informed of the financial status of the business
             a. Can be held liable for misconduct (stealing) of other directors if you fall asleep at the wheel.
   c. Ensure corporation has adequate compliance program to ensure employees are complying w/ applicable criminal laws (Caremark case)
      i. Compliance program needs to be communicated by the director in a meaningful way (education) to employees
      ii. Needs to be a reporting mechanism for employees to report violations to a disinterested source
      iii. If don’t do this – not protected by BJR b/c not a “rational” decision
   d. If discover wrong doing of other directors → there may be an affirmative duty to object, resign, threaten legal action against the wrongdoers or seek outside counsel

C. Fiduciary Duty of Loyalty
1. Managers owe shareholders a duty of loyalty in making their decisions in order to be entitled to the BJR
2. Specific examples of conduct that constitutes a breach of the duty (if P pleads these, they are outside the BJR)
   a. Self dealing/conflict of interests in the deal
      i. P bears burden of proof that mngr. had a personal interest in the dec.
      ii. D can still escape liability by proving the transaction was fair
         a. There can still be transactions where directors/officers will have a self interest but is still fair to shareholders.
         b. If mngr. benefits from the transaction, it will still be fair if the corp. benefits too b/c then benefits passed to shareholders
b. Corporate Opportunity Doctrine – An agent can not profit from an opportunity which came to them solely by virtue of their employment
   i. Test is whether the agency relationship is the sole cause that afforded the opportunity (Reading v. Regem)
   ii. Other relevant factors:
      a. Whether the opportunity harms, competes with, or brings shame on the principal is also relevant
      b. Corp. reasonable expectancy to have this opportunity brought to their attention.
   iii. Defenses of agent against principal that claims corp. opportunity doct.
      a. Disclosure of the opportunity to the principal (even informally)
      b. Financial incapacity – employer did not have the financial resources to take advantage of the opportunity
         i. hardly ever a winner b/c always ways a corp. can raise money
      c. Outside line of business – corp. must be in same line of business as the opportunity
         i. hardly ever a winner b/c corp. can always expand line of biz.
      d. Opportunity presented itself outside the agent’s scope of employment
         i. agent must show opportunity came on his own time, using own resources, not related to employment, ect.
      e. Legal incapacity – employer could not legally take advantage of the opportunity (e.g., would be an antitrust violation, required a license employer couldn’t get, not allowed in art. of incorporation)
         i. hardly ever a winner b/c can amend art. of incorporation but the antitrust arg. could win

D. Remedy for breaches of fiduciary duties
   1. If director/officer breached duty of care, then personally liable for the damages that flow from his decision
   2. Breaches of fiduciary duties = punitive damages!!!

III. Duties of Officers, Directors, Insiders w/ Respect to Securities
A. Consequences of being labeled a security
   1. Federal Securities law regulation
      a. Includes registration b/f sales
      b. Liability for material misstatement, fraud, insider trading, short swing profits
      c. Expense, disclosure
   2. But there are benefits: prestige, raise capital, acquisitions by swapping stock

B. Threshold Question – Is it a security?
   1. This is basically just asking the question of whether the investors needs the protection of the fed. securities laws
   2. Look to plain language first – 33 Act §2(a)(1) broad definition of security
      a. if characterized as “note” or “stock” look to specific tests below
      b. if not characterized as instrument that falls under plain language of §2(a)(1) then look to ec. realities and apply “investment K” catch all
3. **Investment Contract** – gen’l catch all used if instrument not specifically enumerated in §2(a)(1)
   a. **Invests money**
      i. Test: Gives up valuable consideration in exchange for separable financial interest in something characteristic of a security
         a. IBT v. Daniel – pension fund held not be an invest K b/c workers giving up work for their salary not for their pension payment
      ii. Factors
         a. **Economic realities** – what is investor really giving up consideration for, an investment or something else (e.g. house to live in, gambling for fun)?
         b. Congressional Intent
            i. is there another pervasive regulatory system governing the investment
            ii. does the investment have an impact on capitol mkts?
            iii. similarity to enumerated securities under §2(a)(1)
   b. **Common Enterprise** – 3 ways to show
      i. Horizontal commonality – pooling of interests b/t investors so that investors either succeed together or fail together
      ii. Vertical commonality – split whether this is “common enterprise”
         a. Broad VC – investor success linked to promoter’s efforts
            i. promoter’s effort effect all boats equally
         b. Narrow VC – promoter and investor’s success is interwoven and dependant upon each other
            i. promoter’s boat rises and falls w/ investor
   c. “Led” to Expect Profits
      i. Key is whether investor “led” – how would a reasonable investor perceive the situation (objective test)
      ii. **Economic Realities** – regardless of what the instrument is labeled (e.g. “stock”) look to substance of K over form.
         a. Foreman – Co-op City K weren’t securities even though labeled “stock” b/c ec. realities
            i. Name of the instrument is only impt. if leads investor to believe that it is protected by securities reg.
         ii. **For “stock” label to apply, must possess some common characteristics of stock**
            a. dividends based on profits, negotiability, ability to pledge, proportionate voting rights, ability to appreciate in value
            iii. No expectation of profits if true motivation was consumption
   d. “Solely” from Efforts of Others
      i. Solely doesn’t mean solely – if it did then promoters get around sec. reg. by giving investors minimal amount of control
         a. Investor can still have some control but not meaningful enough to fall outside of need for protection
      b. **Look at whether control so significant that investor couldn’t have had reasonable expectation of profits solely from other**
e. Specific Applications

i. Real Property? No, other regulatory scheme, actual expectation is for consumption not profit, if there is profit its not from efforts of others

ii. Time Shares? SEC said look to following factors:
   a. expect profits from promoters efforts, income from property being pooled by promoter w/ other properties, mandatory rental period, mandatory agent?

iii. Partnership?
   a. Limited Partnership –Presumption of security unless limited partner has some control
   b. Gen’l Partnership –Presumption not a security. P can only rebut by show GP not able to exercise that control
      i. but choosing to remain passive does not rebut presumption or else it would provide a perverse incentive

iv. Franchise? Are franchisor’s efforts undeniably significant in determining profitability of the venture. Most franchises not securities b/c amount of control franchisor would have to exercise would make widespread operations inefficient

4. Stock – 2 tests
   a. Sale of business vs. sale of stock in business
      i. Sale of assets of business – does not fall under plain language of §2(a)(1) and fails Howey test
      ii. Sale of all stock in business – not a security b/c “sale of biz. doctrine”
      iii. Sale of some/almost all stock in business
         a. Landreth – held owner transferring 85% of shares to new owner was sale of stock b/c stock had usual characteristics and purchase motivated by expectation of profits (see next test)
   b. If characterized as “stock” then falls under plain language of statute but still must see if possess usual characteristics (Foreman Rule)
      i. usual characteristics
         a. dividends based on profit, negotiability, ability to pledge, proportional voting rights
         ii. must not have all the usual characteristics, but if it doesn’t look to policy of sec. reg. (do the investors need to be protected b/c info asymmetry) to see if should be covered
         iii. other considerations
            a. motivated by expectation of profits
            b. promoter still exercised some control (didn’t transfer 100% of biz)

C. Registration

1. 33 Act §5 – Gen’l rule: Must register a security b/f can offer or sell it.
2. §3(11) Exception for securities sold solely w/in state of incorporation
3. §4(2) Exception for transactions by an issuer not through a “public offering”
   a. What does “public offering mean”?
      i. Test (Duran): whether the particular class of investors needs protection
         a. Determinative factor: Does the person have access to the kind of information that would normally be included in a 33 Act RS.
b. Access Means:
   i. Actual access to the information (disclosure) OR
   ii. The kind of relationship w/ the issuer that would give you the possibility of getting the information AND bargaining power that would force the issuer to give it to you.
      a. Bargaining power = close relationship or the level of sophistication so know what questions to ask.

4. Reg D – Safe Harbor for §4(2)
   a. Allows small businesses to do public offerings where the cost of registration would be prohibitive
   b. Rule 504 – Issuer can offer up to $1mil. offering to unlimited purchasers
   c. Rule 505 – Issuer can offer up to $5mil. to no more than 35 purchasers
      i. Accredited purchasers and live in relatives don’t count as purchasers
   d. Rule 506 – Issuer can offer an unlimited amount to no more than 35 “sophisticated purchasers”
      i. Accredited purchasers and live in relatives don’t count as purchasers
   e. Note: There is a prohibition on gen’l solicitations w/ these offerings and re-sales are restricted. Must also file Form D.

D. Causes of Action/Liability
   1. §12(a)(1) – If violate §5 (selling an unregistered security) then purchaser entitled to strict rescission
   2. §12(a)(2) – If material misstatement in prospectus (written document) then purchaser entitled to strict rescission
   3. §11 – If material misstatement in RS then all statutory defendants are liable to purchaser.
      a. Statutory D’s:
         i. Those who signed the RS (includes issuer, CEO, CFO)
         ii. Directors, or named as soon to be directors, or performs similar functions
         iii. Experts who prepared or certified a part of RS
         iv. UW
         v. Control Persons of any of the above
      b. Remedy – Damages and all Ds jointly and severally liable
   c. §11(b)(3) Due Diligence – for everybody but issuers
      i. Two distinctions
         a. Experts v. non experts – experts are the accountants doing audit, non-experts are all the other Ds
         b. Expertised portion of RS v. non expertised – expertised portion is only the audited financial info certified by auditor (Worldcom)
            i. Includes 10-Ks if incorporated by reference b/c require audit
            ii. Does not include 10-Qs or other info even w/ a comfort ltr b/c no independent audit done.
      ii. Experts DD requirements
         a. Expertised portion - Reasonable investigation AND reasonable grounds to believe AND did believe the truth
            i. Can’t just rely on mngt integrity (Worldcom)
ii. Must comply w/ GAAS when doing audit
b. Non-expertised portion – no liability (§11(a)(4)

iii. Non-Experts
a. Expertised portion - Reasonable grounds to believe AND did believe the truth
i. But does not have to make separate investigation
b. Non-expertised portion - Reasonable investigation AND reasonable grounds to believe AND did believe the truth

iv. §11(c) Reasonable Investigation Standard - that required by a prudent man in management of his own property (Escott v. BarChris)
a. Bar Chris Factors to take into account:
   i. How high up in the org. D was
   ii. How much D participated in preparing the RS
   iii. D’s background education/knowledge

v. Point – DD defense is hard to win!!
a. Want to incentivize mgmt/underwriter gatekeeping

4. 34 Act Rule 10b-5: Unlawful for any person to use a device/scheme/act to defraud or make a material misstatement/omission in connection w/ purchase or sale of securities
a. Elements
   i. Standing - P must be a purchaser or seller of a sec (Blue Chips Stamps)
      a. 3 classes of P’s who have no standing
         i. Potential purchaser who didn’t buy
         ii. Potential seller who didn’t sell
         iii. Shareholder/creditors who suffered harm b/c of fraudulent purchase/sales of insiders (insider trading)
            a. But shareholders of the issuer in these last 2 classes can bring a derivative suit if the issuer was a purchaser or seller.
   ii. Conduct by D – 2 choices
      a. manipulative or deceptive scheme or practice which operates to defraud
         i. Sante Fe Industries – breach of fid. duty not enough w/out it being manipulative or deceptive b/c plain breach of fid. duty is state law claim – don’t want to expand into state law.
      b. material misstatement or omissions
         i. Test for materiality (Basic) - “substantial likelihood” the info would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of info made available”
            a. Forward looking info can be material – judged under a probability/magnitude test
            b. But no affirmative duty to disclose everything
   iii. Scienter – must prove a specific intent to deceive/defraud
      a. For insider trading must prove:
         i. D knew info was non-public AND
ii. D knew the info was material
iv. Reliance – 2 Tests
   a. Omissions - where there is a duty to disclose, and D makes an omission, P’s reliance is PRESUMED (Affiliated Ute)
   b. Misrepresentations – If P not a recipient of the info, can prove reliance through FOM (in efficient mkt stock price reflects all info, including D’s misrepresentation and investor relies on mkt price)
v. Loss Causation – must prove drop in price came from D’s misrepresentation

b. Remedies
   i. Typical remedy is out of pocket expenses
   ii. Can also be disgorgement if D’s profits are greater than P’s losses
   iii. Rescission, or benefit of the bargain
   iv. §20A(d) – employers can be vicariously liable (another incentive to institute a compliance program)

E. Insider Trading Rules
1. Policy
   a. Prohibition for insiders to trade on material non-public information b/c of fiduciary relationship.
      i. Agent’s can’t profit at the expense of the principal (shareholders)
   b. Two statutes under 34 Act to enforce
2. §10(b) and R. 10b-5 – same elements as above but w/ the following modifications (all revolves around D owing a fiduciary duty)
   a. Abstain or Disclose Rule (TGS)
      i. Standing – P must be a contemporaneous trader (this is b/c there needs to be a breach of fid. duty – D didn’t disclose)
      ii. Conduct by D that meets the “deceptive” requirement: 3 types
         a. If D is the trader:
            i. He must be an insider, or constructive insider (lawyer, accountant, IC) of the corp. whose shares he is trading
               a. Chiarella: no fid. duty owed to shareholders of another corp.
            b. If D is the tipper (the one who makes the tip):
               i. He must be breaching a fiduciary duty in making the tip.
                  a. He must be motivated by some personal or financial gain
            c. If D is the tippee,
               i. The tipper must be breaching a fiduciary duty in making the tip AND the tippee must be aware of the breach
      iii. Materiality Rule: If the information is material, the person with the fiduciary duty must abstain from trading or disclose it
     iv. Scienter – D must know:
       a. The info is non-public and
       b. The info is material
   b. Misappropriation Theory – R. 14(e)-3
i. D is prohibited from trading on information that would constitute a breach of fiduciary duty to ANYBODY, not just the shareholder of the corp. whose shares he traded.
   a. ex. O’Hagan – Atty liable for trading in stock of company who his firm’s client was merging with b/c breach of fid. duty to his client.
   b. This is b/c the breach of fid. duty satisfies the “deceptive device” element of §10(b)

3. §16(b) – Officers, directors, and 10% shareholders must pay to the corp. any profits they make w/in a 6mo. period from buying/selling the corp.’s equity stock.
   a. Elements
      i. The company must be a 34 Act reporting co.
      ii. Standing – The action must be brought as a derivative suit on behalf of corp. b/c profits of the D’s go back to the corp.
         a. P must made demand, but can still bring suit if demand refused
         b. None of the other procedural requirements for derivative suits enforced (including BJR protection for refusing demand)
      iii. Statutory Ds
         a. Officers, directors, or anybody that holds similar policy making function
            i. Test they would likely have access to type of info that Act designed to prohibit trading on.
            ii. Deputization – If an officer of one corp. A is sitting as an outside director for corp. B. Corp. A can be named as a D“director” for profits off corp. B’s stock.
            iii. Trades taking place b/f becoming mngr. are not covered, but §16(b) still applies for 6 mo. after ceasing to be mngr.
         b. 10% beneficial shareholders
            i. Each class of sec. considered separately – still covered if own more than 10% in one class but less in another class or total outstanding sec. of the corp.
            ii. If own convertible securities, look to % D would own if converted.
            iii. Must be a 10% shareholder both before the purchase and at time of sale for §16(b) to apply
               a. The first transaction is where D becomes a 10% shareholder is not matchable (Foremost-McKesson)
               b. Once drop below 10%, subsequent transactions not matchable (Reliance v. Emerson)
      iv. Prohibited trading
         a. Strict liability for any D who makes a profit off trading in company’s equity securities w/in 6 mo. period.
            i. Applies only to equity securities, or convertible equity sec.
         v. Strict Liability
   b. Remedy - Disgorgement to the corp., atty fees
c. Calculation of damages - Purchases and sales w/in a 6 mo. period are matched up in whatever way maximizes profit – regardless of what net profit was.
   i. Lowest price buys matched w/ highest price sales OR
   ii. Highest price sales matched w/ lowest price buys
   iii. Order of purchase/sale combos is ignored – whatever makes most profit
   iv. Leftover purchase/sale combos that result in a loss are ignored

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Summary of Insider Trading Actions

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<tr>
<th>Attribute</th>
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<th>§16(b)</th>
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<tr>
<td>Potential D’s</td>
<td>Insider traders, constructive insiders, tippers, tippees, misappropriaters</td>
<td>Officers, Directors, 10% shareholders</td>
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<td>Conduct</td>
<td>Using inside info in connection w/ purchase or sale</td>
<td>Purchase or sale for profit w/in 6 mo.</td>
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<td>Mental State</td>
<td>Scienter (know info is non-public AND material)</td>
<td>None – strict liability</td>
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<tr>
<td>Enforcement</td>
<td>DOJ, SEC, Contemporaneous trader</td>
<td>By corp. or derivatively by shareholder</td>
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<tr>
<td>Liability</td>
<td>Criminal, Civil, Treble Damages</td>
<td>Disgorgement of “profits”, atty fees</td>
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<tr>
<td>Disclosure</td>
<td>No</td>
<td>Must file when become 10% shareholder, officers/directors must file when change holdings</td>
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<tr>
<td>Subject Securities</td>
<td>All</td>
<td>Equity securities of a 34 Act registrant</td>
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IV. Indemnification for Director/Officer’s Misconduct

A. Mandatory Indemnification

1. DE §145(e) – Corp. SHALL indemnify present/former officer/director for expenses (including atty fees) if:
   a. Actions brought against them because of their corporate position AND
   b. Successful on the merits
      i. This includes suit being dismissed, but not a settlement (vindication does not necessarily mean success on the merits)

B. Permissive Indemnification

1. DE §145 makes permits indemnification in certain circumstances if officer/director acted in good faith
   a. (a) If suit brought by 3 pty, may indemnify for expenses, judgments, fines, settlement costs
   b. (b) If suit brought by corp. or derivately, may indemnify for expenses but only w/ judicial approval if found guilty
c. (e) Advancement of legal fees

2. DE §145(f) – Corp. and officer/director can enter K to make the permissive indemnifications mandatory
   a. Limits
      i. The mandatory K rights can’t be contrary to the §145, i.e., the officer/director still must act in good faith to be entitled to indemnification
      ii. Corp. must adopt the indemnification into the art. of incorporation
      iii. Indemnify for monetary damages only, not injunctive relief
      iv. Can not indemnify against creditors
      v. Does not indemnify for intentional misconduct (breach of duty of loyalty)
Part IV – Shareholder Participation/Control

I. Derivative Suits (Model Business Corporation Act)

A. Background
1. Corporation is a legal person → can sue and be sued
2. Derivative suit = shareholder realizes that the corp. has a legal claim against somebody but is not filing suit
   a. Corp. probably not filing suit b/c wrongdoer is one or more managers who don’t want to make the decision to have suit filed against themselves
3. Mngt business rationale for corp. not filing suit
   a. Suit could be a distraction for corporation
   b. Law suit is bad business
   c. If mng is the D, may be indemnified by the corp.
4. Shareholder disagrees w/ mngt decision and brings suit on corp.’s behalf
   a. This is distinguishable from a direct suit which shareholder files on her own behalf

B. Procedural Obstacles – Complaint dismissed if these aren’t overcome
1. Standing (7.41)
   a. Contemporaneity - Shareholder must have been a shareholder at time breach took place (but not necessarily at inception)
   b. Rationale
      i. Prevents manufacture of diversity – share being transferred to person in another state to get diversity of citizenship for fed. jurisdiction
      ii. Prevents lawyers buying claims ex post
2. Demand Required (7.42)
   a. Shareholders must make a written demand upon the corporation to file suit 90 days b/f the shareholder is allowed to file suit on corp.’s behalf
      i. 90 day waiting period waived if:
         a. Shareholder earlier notified that demand was rejected
         b. Corp. would suffer irreparable harm if shareholder waited 90 days
   b. Consequences of making demand
      i. Estopped from later claiming demand was excused
      ii. Concede that board has authority to refuse demand and their decision is protected by the BJR.
      iii. Point – If want to win MUST NOT MAKE DEMAND AND PLEAD DEMAND IS EXCUSED
   c. Demand excused under state law if P can plead why demand would be futile. P must show either:
      i. A majority of the board has a material financial interest in the claim (DE, NY)
      ii. A majority of the board is incapable of acting independently, i.e., controlled by the wrongdoers (DE only, not NY)
         a. The chairman being the wrongdoer does not alone est. domination
      iii. The underlying transaction wasn’t the product of a valid business judgment (DE, NY)
a. E.g., Board did not follow business formalities (having a meeting, keeping minutes, discussing the dec., etc) in making the decision
d. If demand excused, claim can still be refused if recommendation comes from Special Litigation Committee (SLC)
i. Ct.’s take 2 approaches in evaluating SLC decision:
   a. Delaware – SLC dec. reviewed under two part test
      i. Rule: Prong 1) Were proper procedures followed (same as BJR) 2) Ct. reviews de novo the substance of the dec.
         a. Rat. – thwarts attempts to follow procedures but counter to the spirit
         ii. P must prove – SLC not independent, acted in bad faith, or came to wrong dec.
   b. New York – SLC dec. reviewed only under BJR.
      i. Rule: Only inquiry is into the procedures/methods used not make the dec., not substance (if hires indep. outside directors to make an inquiry, that will satisfy the test)
         a. Rat. – ct.’s aren’t equipped to probe into business dec.
      ii. What P must prove – SLC not independent or acted in bad faith

3. Security for Expenses (state law)
a. Minority of states have statute which states P has to post expenses of the litigation for the corp. b/f can bring derivative suit. Corp. must first ask the judge to invoke the statute
   i. Basis – litigation is expensive, this keeps P’s from bringing frivolous claims
b. But most states (including DE) don’t have this b/c most corp. don’t invoke their right.
   i. If they did, then P also gets access to corp. records and can solicit other shareholders to join the suit or make tender offers (could be beginning of takeover)

4. Remedy
a. P must show the benefits of the relief sought flow to the corp., not the individual shareholder
   i. Examples of remedies the benefit the shareholder (no derivative)
      a. Suing b/c voting rights infringed (Eisenberg v. Flying Tiger)
      b. Suing for dividends (Dodge v. Ford)
   ii. Example of remedy that benefits the corp. (derivative)
      a. Having lights installed at stadium to increase profitability (Wrigley)

C. Competing Policy Concerns (Work this in on Final!!)
1. Corp. Board View – derivative suits are a nuisance brought for the benefit of a few shareholders and plaintiffs lawyers
   versus
2. Agency costs – derivative suits keep down agency costs by holding mngr. accountable
3. Collective action problem – derivative suit provides incentive where otherwise small shareholder would not have incentive to bring suit
II. Proxy Contests (Fed. Securities Law) – Note to self, maybe combine this with shareholder proposals section.

A. Background

1. The Process
   a. Proxy solicitation - Corporate management solicits shareholder proxies to get the votes they need to reappoint incumbent directors
      i. Proxy – shareholder appoints an agent (usually an officer) to vote on their behalf at shareholder meetings
   b. Proxy contest – When insurgents solicit proxies to appoint their own directors

2. Incumbent mngt. has huge advantage in proxy solicitations because:
   a. If shareholder didn’t like the incumbent’s they probably would have sold their stock already
   b. Incumbents have access to corporate finances to pay for proxy solicitations

3. 34 Act §14(a) Federal Securities Laws step in to regulate to level the playing field - ONLY APPLIES TO 34 ACT REGISTERED COMPANIES

B. Access to Corporate Funds (State Law Issue)

1. Mngt has broad right to use corp. assets to solicit proxies so long as:
   a. The contest is over policy issues – not soliciting proxies purely for personal gain/personality issues
      i. This is an easy standard to meet
   b. The expenses were reasonable
   c. The expenses were legal (no bribery, gifts, ext.)

2. Insurgents have right to be reimbursed for expenses spend so long as they win.
   a. As a practical matter, nobody tries to take over through proxy contests anymore b/c expense is huge if you loose

C. Federal Regulation of Proxy Solicitations – 34 Act §14(a)

1. Must include proxy statement w/ proxy solicitations (R. 14a-3,4,5,11)
   a. Disclose info such as conflicts of interest, issues expected to be raised at shareholder meeting, ect.
   b. Must file the proxy statement w/ SEC (R.14a-6)

2. Insurgents have a right to get their solicitations out to shareholders.
   a. Mgt has two options to get insurgent info out (R. 14a-7)
      i. Mail the insurgents info to shareholders and charge insurgents for costs OR
      ii. Give insurgents access to shareholder list to mail themselves
   b. Mgt. never wants to give insurgents access to the list
      i. Access = power, insurgents can focus in on major shareholders
      ii. Mgt. wants to see what info insurgents are providing so they can counter

3. Liability
   a. Proxy statements can not contain material misstatements or omissions (R 14a-9)
i. Materiality – “Would” (as opposed to could) the misstatement have altered the “total mix” of info shareholders deem “significant” in making their decision
ii. Scienter – neg’l preparing a proxy statement is enough (Seinfeld case)
iii. Causation
   a. If votes were necessary for the decision, then a misstatement in the proxy statement = causation
   b. If votes not necessary for the decision, then misstatement in proxy statement can not cause the harm from the decision
b. There is an implied right of private and derivative action for violations of these rules (S. Ct. in J.I. Case)
c. Remedy – whatever relief is necessary
   i. Injunctive relief – If P files suit b/f decision is carried out
   ii. Rescission – Undoing the decision (merger)
   iii. Money Damages
   iv. Atty fees (if bring suit on behalf of other – derivative)

III. Shareholder Proposals (Fed. Securities Law)
A. Background
   1. If shareholders want to bring an issue to other shareholder’s attention at the annual meeting they do it by submitting a proposal in the proxy statement
   2. Also covered by 34 Act §14(a) and Rules thereunder
B. Distribution of Shareholder Proposals
   1. Mgt. has choice on how to distribute
      a. Same as proxy contests (R. 14a-7)
         i. Give insurgent access to shareholders list OR
         ii. Mail insurgent’s material to shareholders and charge OR
      b. Include in the mgt.’s proxy statement a short resolution (500 words) of the shareholder’s proposal (R. 14a-8)
C. Grounds for Refusing Distribution (R. 14a-8)
   1. Note – Typically mgt. will write ltr. to SEC stating grounds for exclusion and requesting a no-action ltr. b/f they exclude the proposal
   2. Threshold Issue – Shareholder’s eligible to submit proposals (R. 14a-8(b))
      a. Hold at least $2,000 in mkt value or 1% of registrant’s voting securities
      b. For at least 1 yr. by date of proposal submission
      c. Continue to hold the securities at date of vote
   3. Procedural grounds for exclusion
      a. Each shareholder can only submit 1 proposal for each meeting (R. 14a-8(c))
      b. If fail to appear at a meeting where your proposal is being considered, can’t submit another proposal for 2 yrs. (R. 14a-8(h)(3))
      c. Can’t re-submit a proposal on the same matter w/in 5 yrs. if (R.14a-8(i)(12)
         i. It has been up for vote once and not received at least 3% support
         ii. It has been up for vote twice and not received at least 6% support on most recent submission
iii. It has been up for vote three times or more and not received 10% support on last submission.

4. Content grounds for exclusion under R. 14a-8(i)
   a. (1) Proposal is improper under state law
      i. resolutions that would be binding on the board are usually improper
      ii. requests or recommendations of the board are usually not improper
   b. (4) Proposal relates to a personal grievance or seeks personal benefit
   c. (5) Proposal is not “significantly related to company’s business”
      i. but just b/c something doesn’t effect sales doesn’t mean its not significantly related
   d. (6) Co. doesn’t have the power to effectuate the proposal
      i. If proposal just calling for a study, that is within power to effecuate
   e. (7) Proposal deals with a matter that relates to ordinary business operations
      i. But not excluded if deals w/ strategic or policy choices

5. POINT- Hard to refuse on content grounds, best bet is to argue threshold or procedural grounds for refusal

6. BJR Application – Mgt. has authority under the BJR to spend $ fighting shareholder proposals b/c superfluous proposals detract from shareholders meeting.

D. Liability – If mgt. improperly refuses, they would be liable under R. 14a-9 for a misleading proxy statement
   1. Rationale: When mgt. sends out proxy solicitation, they are telling shareholders how they are going to vote. If they know a shareholder plans to raise an issue but don’t tell the proxies how they are going to vote → that is misleading.

E. Voting Rights – If mgt. goes overboard w/ selective proxy solicitations and rearranging structure of meetings to intentionally disadvantage voting on a shareholders proposal → may be a breach of fiduciary duty (Peerless Case)

IV. Inspection Rights (State Law)
   A. Power to Inspect = Power to destroy
      1. Shareholders could be gaining access to detriment of corp.
         a. Could be competitor wanting trade secrets
         b. Proxy contest insurgents want shareholder list
         c. First step in a tender offer
         d. Junk mailing initiative
         e. Fishing expedition to file a derivative suit
      2. Thus ct.s have to draw a distinction when shareholders should get access
   B. How to gain access
      1. Must show a “proper purpose” for wanting to inspect records
         a. Always a proper purpose – desire to inspect to assess investment, any economic concern for value of corp.
         b. Never a proper purpose – competitor trying to access trade secrets, junk mailing
         c. Gray area
i. Tender offer – Need to phrase in a way that would positively effect value of corp, not just a “take over” (Crane Case)
ii. Social activism – Pilsbury says not okay b/c not motivated by economic interest, but today social concerns do effect value

2. NY only – shareholder must have owned at least 5% of any class for 6 mo.

C. Remedy (MBCA §16.04)
   1. P must bring derivative suit to compel access and costs
      a. P entitled to atty fees
   2. Affirmative defense to costs – refused inspection in good faith

V. Control in a Close Corporation
   A. Structural Features of a Closely Held Corp.
      1. Small no. of shareholders (usually less than 30)
         a. Public corp. usually has large no. of shareholders
      2. No ready mkt. to liquidate stock – no mkt. to sell stock b/c no way to value them AND usually entered shareholder agreement limiting ability to sell
         a. Public corp. has “wallstreet option” (ability to liquidate is primary rationale for BJR)
      3. Substantial shareholder participation in mgt.
         a. Public corp. usually has separation of ownership from control

4. POINT – Closely held corp. more like a partnership than a corp.
   a. usually have a term of existence, centralized mgt., and no transferability

B. K Methods of Protecting Minority Shareholder (If you are entering a close corp. this is what you want to negotiate for to protect your rights)
   1. Shareholder Voting Agreements
      a. Supermajority Voting Rights – Minority can veto majority vote.
      b. Cumulative Voting – Number of votes = number of shares X number of directors to be elected
         i. This allows minority to put all your votes on one director to ensure he’ll get elected an give you some representation on the board.
         ii. Majority can counter this by having staggered elections (only elect one or two directors at a time so they will always outvote you)
      c. Vote Pooling Agreements – Minority shareholders can enter K to vote their shares together (otherwise they would always be outvoted by majority)
         i. K is binding even if later change mind on how to vote (Ringling Bros.)
      d. Other points on shareholder voting agreements
         i. Minorities can also agree to vote each other in as directors
            a. Voting directors is something inherently in shareholder rights and majority shareholder doesn’t need to be privy to the K (in contrast to mgt. K which all shareholders have to be privy to).
         ii. Majority can’t remove a director voted in by cumulative or pooling agreements – only the minority holders can remove him (MBCA §8.08)
   2. Management Agreements - Negotiate appointment to corporate office and salary (preferably treasurer)
a. Limits on the agreement – there are limits or else binding ability of
directors to make decisions would violate their fiduciary duty of loyalty to
shareholder, creditors (McQuade, Clark v. Dodge)
i. All shareholders must be a party to the agreement – best to put it in art.
of incorp.
   a. This is basically an agreement to waive directors fid. duty of
      loyalty
   b. If shareholder comes in later, must give him notice
   c. Creditors, non-pty shareholders pose a problem (sympathetic P)
b/c they have not agreed to the waive of fid. duty and could be
harmed by sterilization of the board
ii. The term of office should not be unconditional – making it contingent
on serving “faithfully and competently” is good
iii. Salary should not be unconditional – making it contingent on
profitability of corp. is good
b. Note – if one term of the K is void, the whole K is void b/c not severable
3. Interest Transferability Agreements: Prevents Freeze-outs
a. Right of first refusal – Majority must first offer shares to minority if
selling, if minority refuses can’t sell to 3d pty for a lower price.
b. Call options – Majority must sell you some shares at a specified time if
you demand it.
c. Put options – Majority must buy your shares from you at a specified time
if you demand it.
d. Restrict free transferability to 3d pty – Don’t want to get stuck as a
minority shareholder w/ a majority who you don’t know.
e. Mandatory buy/sell K – One side must buy out the other upon the
occurrence of a specified event (e.g., death)
f. Valuation – Agree in advance for some method of valuing the shares if
you buy/sell out.

C. Judicial Methods of Protecting Minority Shareholder
1. Fiduciary Review
   a. Shareholders in close corp. owe each other fiduciary duty of loyalty like
Partnership
      i. Judged by strictest standard of good faith
      ii. Rationale
         a. Minority has no liquidity to get out if unhappy w/ majority
decisions
         b. Minority subject to freeze-outs and majority in a position to offer
buy-out for unfair price.
         c. More likely interest in close corp. is shareholders livelihood rather
than investment
      iii. Typically the minority is the one seeking protection, but if minority
has veto rights, the majority can seek protection for oppressive
behavior
   b. The fiduciary duty owed gives rise to the Equal Opportunity Rule – In the
absence of a contract to the otherwise, majority can not arbitrarily afford
themselves benefits (management positions, salary, and dividends, buy-outs) and not minority
i. Problem – easy for majority to overcome this argument by claiming BJR
ii. Solution – Doctrinal situations where BJR doesn’t apply
   a. Selective Redemption – If corp. is purchasing back shares from one shareholder (majority), must extend the offer to all shareholders
   b. Freeze-outs – A low ball buy out offer after a pattern of unfair treatment of minority that would normally be protected by BJR constitutes a freeze-out, which is a breach of fiduciary duty of loyalty (no need to actually sell)
   c. Unfair buy-out: Majority owes minority a duty to disclose all material facts surrounding the transaction (b/c they are the ones w/access to the facts) when offering minority price to buy out.
      i. No cause of action on this unless minority actually sells the stock (b/c this is a kind of 10b-5 claim)
      ii. This duty to disclose can not be K around or waived
d. Buy-sell K provides for unfair method of valuation
e. Any other equal behavior where a business purpose can not be articulated could give rise to a cause of action
iii. Remedies – all direct b/c benefits flow directly to the minority
   a. Order the same opportunity that was afforded majority to be extended to minority
      i. If opportunity has passes → damages
      ii. Only if the opportunity was an offer to purchase majorities stock will ct. order buy-out of minorities stock
   b. If corp. has already purchased minority’s stock at unfair price remedy is fair value of stock less price paid
2. Statutory Dissolution
   a. **(MBCA §14.30)** Dissolution may be requested by a shareholder if:
      i. Directors/Shareholders deadlocked
         a. DE articulates this as “not reasonable practicable to carry on business)
      ii. Acts of directors are illegal, oppressive, fraudulent OR
      iii. Corp. assets being wasted
   b. But this is an extreme remedy (b/c ptys chose corp. form which is perpetual existence) and ct. will use broad equitable power to grant other remedies if possible
      i. Grant buyout rather than dissolve corp. (usually only if majority has received buy-out offer too)
      ii. Entitled the minority to the benefits majority was receiving unfairly
         a. In some cases may also grant atty fees and lost wages (Pedro)
c. Example where ct. granted statutory dissolution:
i. Even if granted buy-out, the bought out party would still be bound to a mortgage of the corp. which he has personally signed for (Haley v. Talcott)

ii. Also evid. that ct.’s trending towards allowing dissolution b/c they realized that it is just a bargaining chip for minority to get bought out and business will likely continue on anyway.

3. Effect of an express K (or lack thereof) given these judicial remedies

a. Factors ct. considers in determining whether to honor an express K entered by the ptys.
   i. Management decision contracts:
      a. Ct’s more sympathetic if all the pty’s start biz. together (Wilkes)
      b. Ct’s less sympathetic if majority took all the risks in starting the biz. first, then minority joined later (Ingle)
      c. If the K was overreaching (Smith – minorities ability to veto all decisions was overreaching and not honored)
   d. Note: Unless there is an express K, minority has no right to demand dividends, demand employment, or demand a salary b/c all these decisions protected by BJR.
      i. Exceptions:
         ii. Freeze-out claim if majority follows this behavior w/ a low ball offer.
         iii. Bad faith decisions (for personal reasons) not protected by BJR (this includes firing minority for opportunistic reasons)

   ii. Buy-out contracts:
      a. If K provides for unfair method of valuing shares in buy-out
      b. Can not K around duty to disclose material info when majority is making offer to buy out minority b/c covered by securities laws
      c. Will the departing pty be held harmless for debts of the corp.
      d. K needs to state that ptys intend to use the provisions over statutory rights

D. Summary

1. 4 Circumstances in which aggrieved shareholder can force buy-out
   a. Private exit agreement (buy/sell agreements above)
   b. Breach of Selective Redemption Doctrine
      i. But there must be offers to buy back majority stock before minority can invoke this
   c. In connection with a fundamental change in the corporation (merger)
      i. Dissenting shareholder entitled to appraisal remedy (have shares bought by corp. at fair mkt. value)
   d. Statutory Dissolution!! Extreme remedy b/c ptys have chosen corporate form which provides for perpetual existence and creditors depend on that
      i. Only appropriate where:
         a. Acts of directors are illegal, oppressive, fraudulent OR
         b. Corp. assets being wasted
ii. Even then ct. has broad equitable power to grant buyout rather than
dissolve corp. or grant other remedies (like entitled the minority to the
benefits majority was receiving unfairly)
Part V – Takeovers

I. 3 Ways to Take Over
A. Hostile Takeovers
   1. Proxy Contests (see previous section – maybe move down)
      a. This is an appeal to stockholders hearts and mind.
   2. Tender Offers
      a. This is an appeal to stockholder wallet

B. Friendly Takeover
   1. Transfer of Control
      a. This is the only friendly method b/c it requires current controlling person’s approval (they are the ones selling it to you)

II. Tender Offers (Fed. Securities Law)
A. Background
   1. Outsider puts out to shareholders that he wants to acquire a certain percentage of stock to gain control
      a. Gets shareholder att’n by advertising the offer for stock at a premium above mkt. value
   2. Conditions the offers on
      a. A period of time AND
      b. Only goes through if outsider gets percentage of shares it needs
   3. Outsiders prefer this method over proxy contests b/c
      a. Used to be able to do “creeping tender offers”
      b. Even if you loose:
         i. Aren’t out a lot of money
            a. In proxy contests, if you loose you are out all the money spent on solicitations
         ii. Greenmail option

B. Federal Regulation of Tender Offers – The Williams Act
   1. Purpose – to protect shareholders from abuses of “creeping tender offers”
   2. Requirements
      a. Early Warning – When an outsider acquires more than 5% of a target’s equity securities they must register w/ SEC
         i. Prevents “creeping tender offers” by alerting the market
         ii. Registration required for ppl. acting in concert who acquire an aggregate share of more than 5%
      b. Disclosure - Registration requires extensive disclosure of outsiders finances, other entities own interest in, any other material info. ect.
         i. Helps mnt. evaluate whether the outsider poses a threat
      c. Mandates how tender offers must be carried out
         i. Offer must be left open for at least 20 days
         ii. Shareholders can withdraw their shares anytime while the offer is still open
         iii. Offer must be open to all shareholders of the same class
         iv. All shareholders must be paid the best price paid to any other shareholder
v. If a greater percentage of shares are tendered than outsider was seeking, outsider must purchase pro rata from each tendering shareholder the percentage of shares he was seeking.

d. Implied right of private action - §14(e)
   i. Ct’s have interpreted an implied right of private action for violations of the Williams Act
   ii. Standing – Shareholders of the target (regardless of whether they tendered) and mgt. who purports to be representing shareholder interests may bring suit.
   iii. Other elements – materiality, reliance, causation, damages
   iv. Damages – Same as 10b-5

e. Defensive tactics are explicitly allowed
   i. Greenmail, golden parachute, poison pills, ect.

C. Defensive Tactics

1. Shareholders challenge – shareholders often challenge mgt. defensive tactics to a tender offer b/c tender offers are a win, win situation for shareholders
   a. Ex. If shareholder tenders – they get a premium for shares, If don’t tender – either tender offer still goes through and presumably new mgt. will increase profitability or tender offer doesn’t go through and nothing changes

2. Types of Defensive Tactics
   a. Greenmail - When outsider gains a toehold in the corp. mgt uses authority under MBCA §6.31 to use corporate funds to re-purchase the outsider’s stock at a premium
   b. Poison Pill – Rights are attached to companies stock which allow the shareholders to purchase new shares of the company at ½ price upon a “triggering event” (usually a tender acquisition or merger).
      i. Usually there is a provision that allows the board to redeem the purchase rights for a small fee to shareholders
      ii. Effect – this dilutes the companies stock price thus making it unprofitable for a tender offer w/out consulting mgt. first.
   c. Golden Parachute – Mgt. has K w/ corp. that if they are fired for any reason they get a huge severance package.
      i. Effect – Keeps outsiders from coming in and firing them b/c drains corp. funds and wastes money.

3. Judicial Review of Defensive Tactics
   a. Rule: Mgt. has a duty to protect the corporate enterprise and their choice of defensive tactics are entitled to BJR if pass 2 part test
      i. Substantive Test
         a. Defensive tactics must be based on a “good faith belief” after a “reasonable investigation” that the outsider poses a treat.
            i. This could be a direct threat (such as bad rep. of being a looter) OR policy differences (like the standard for proxy solicitation reimbursements
         b. The defensive measure must be in proportion to treat posed
ii. Procedural Test – The defensive measure must have been approved by majority of board after following proper formalities (meetings, etc.)

III. Transfer of Control (Common Law)

E. Background
1. The shareholder who owns the largest block of shares (doesn’t have to be 51%) is granted the right to control the corp. b/c they can elect directors
2. Thus, investors will pay a premium (more than mkt. value) to purchase the controlling block of shares b/c with it comes control of the corp.

F. Who is entitled to the premium paid for a controlling block?
1. Two theories
   a. The premium belongs to the seller of the shares because there is nothing inherently unfair about selling a controlling block
   b. Control of the corporation is a corporate asset, therefore the premium paid should be distributed to the shareholders on pro rata basis.
      i. This is a type of “equal opportunity” rule
      ii. Rejected by most courts – but make the argument anyway
2. The Gen’l Rule - If the sale is for control and nothing more than the seller is entitled to keep the premium.
   a. Nothing inherently unfair about fetching whatever price you can for your shares.
3. Exceptions were sale of control block is considered a corporate asset (seller not entitled to keep premium
   a. If selling to a purchaser who plans on looting the corporation
      i. This includes if the purchaser is planning on taking advantage of an opportunity for personal benefit which belongs to the corporation.
      a. Note – can probably get around this bad fact if don’t sell for a huge premium and include right to stay on the board (presumably to keep purchaser from stealing the corporate opportunity)
   b. If selling a corporate office
      i. But it is okay to sell immediate resignations from the board b/c the purchaser would get spots on the board eventually anyway by virtue of their controlling block.

G. Remedy
1. Derivative suit and premium dived amongst shareholders on pro rata basis
   a. Note – In Pearlman v. Feldman ct. allowed minority to recover individually in a derivative suit b/c if damages went to the corp. the wrongful majority seller would have been able to recoup his proportionate share.
Part VI – Mergers

IV. Mergers

A. Ways to Accomplish a Merger

1. Asset Acquisitions – A acquires all the assets of B in exchange for either cash or stock in A. B then dissolves and distributes the cash or shares in A to its shareholders.

2. Statutory Mergers – Directors and majority of shareholders must vote to approve a merger b/t A and B. The two companies would then become a new company and the old companies would dissolve. The shareholder of the old companies get pro rata shares in the new company.
   a. Dissenting shareholders are entitled to appraisal rights – FMV of their shares

B. De Facto Merger Doctrine

1. Farris v. Glen Alden – Ct. held that when companies “merge” through an assets acquisition (which does not involve shareholder vote or appraisal rights) if the effect is the same as a statutory merger, then dissenting shareholders are entitled to appraisal rights
   a. Look at substance over form

2. DE and PA have since abolished the De Facto Merger Doctrine
   a. There must be different ways of combining companies w/out the effect always being the same as a de facto merger
      i. De Facto Merger drains cash (paying out appraisal rights), expensive, time consuming to resolve, involves litigation, etc.
   b. Legislature has left sale of assets law separate from merger law

C. Judicial Review of Mergers (if challenged by a dissenting shareholder)

1. MA Test – Two Prong
   a. First must determine if Business Purpose (got from DE)
      i. Mergers (even if approved by directors and shareholders) must be for a business purpose, otherwise dissenting shareholders can challenge as breach of fiduciary duty.
         a. This keeps w/ the corporate doctrines of fiduciary duties of majority/directors to minority
      ii. The prong is satisfied only if there is some goal or interest of the business that is furthered by the merger
         a. A personal purpose, or business reason (like bank requiring it) is not sufficient
   b. Second, Merger must be fair

2. DE Test – Only look to fairness of the merger
   a. Must be specific acts of fraud, misrepresentation, or other misconduct
      i. Can meet this by showing that D did not reveal all material facts about the merger when majority of shareholders voted for it.

D. Remedy

1. MA
   a. Typical remedy is rescission of merger
   b. If rescission too impractical (b/c merger took place long ago and too hard to round up all shareholders) then remedy is “rescissory damages”
c. Valuation
   i. Basically the same as appraisal rights but articulated differently
      a. Value is determined as of day of adjudication (not value as of day of merger as is typical valuation for appraisal rights)
      b. Puts harmed shareholder back on place he would have been if merger not take place.

2. DE
   a. Appraisal Rights
   b. Valuation
      i. Used to be “Block Method”
         a. Add together three different valuations
            i. Price of assets X assigned weight (usually the lowest b/c of depreciation)
            ii. Mkt price X assigned weight (mkt price alone not enough b/c mkt. may be undervaluing shares)
            iii. Most recent earnings X assigned weight (look to sale of comparable business to see what weight other ppl. are giving this factor)
      ii. Current Method – Appraisal based on elements of future value of share
         a. But Only consider future values that are known or susceptible to proof.
         b. This is pretty much the same thing as MA’s “rescissory damages” looking to future value.