I. Basic Business Organization Concepts

A. *The Role of Economics & Government-* a number of governmental and economic factors play a role in if and how organizations decide to do business.

1. **Ordering of Organizations-** organizations structures are established by three different forces-

   a) *Private Ordering*- this is organizing through contract. The terms are *determined by the parties*.

   b) *Market Forces*- these are forces such a supply and demand. Specifically the ability of any actor to sell/buy services/products from/to another source. As the relationship becomes less elastic, these forces act less on the parties.

   c) *Government Regulation*- the government has created corporate law that govern business relationships-

      1) **Default Rules-** these rules are used where the parties failed to contract different terms. These rules may be designed to *reduce transaction costs* by allowing parties not to have to contract every aspect of their relationship. Alternatively, these rules may serve as a *penalty* to encourage parties to contemplate these terms in their agreement.

      2) **Immutable Rules-** some rules set by government are in place for public policy reasons and parties will not be allowed to contract around or change them.

      3) **Taxation-** organizational structure may be based on optimal taxation (mainly avoiding double taxation) by the government.

2. **Business Decisions-** when deciding how to organize an enterprise, business decisions are made based on following factors:

   a) *Opportunism*- opportunism occurs where a person, through the possession of better information or positioning than the other party can further their own interest at the expense of the other party. The risk of this behavior is of primary concern.

   b) *Team-Specific Activities*- where an organization makes an investment that is team specific (tailored to a specific customer) the risk of opportunistic behavior is increased.

   c) *Contracting*- in an effort to avoid opportunism for team specific activity, parties may contract. However, the contract itself may give rise to an opportunity for opportunistic behavior by

      1) **Discrete-** a discrete contract will be for a specific transaction and will have a definite termination.

      2) **Relational –** these contracts are often more general in terms and for a long period of time. They may contain terms governing re-negotiation of the relationship.

3. **Relationships of the Organization-** when considering a business form, parties look a principally three different types of relationships-

   a) *With Each Other*- these concerns include control and management of the business

   b) *With Outsiders*- specifically the liability to outside parties

   c) *With Government*- the tax and legal consequences of the actions of the business.

B. *Sole Proprietorship –* the most simple form of business organization is the sole proprietorship. The proprietor is the business entity; he is responsible for all financial and tort liability incurred by the business. Issues pertaining to liability arise when other persons are hired by the proprietor to work for the enterprise-

1. **Agency- Fiduciary Duty-** when a person works as an agent for a sole proprietor, he has *a duty to prefer the interest of the principal to his own*. This duty is triggered by his employment by law, not as a result of private or market ordering. (CCS v. Reilly)

   a) *Regardless of Notice Quit*- even where the employee has given notice of his intent to no longer work for the principal. The duty continues as long as the agent is employed.

   b) *Duty May Extend Beyond Employment*- a duty may be created beyond discharge where the principal has a protectable interest (client info, etc.)

2. **Limits on Discharge-** *employment will generally be considered to be at will*, meaning the sole proprietor can terminate an agents at anytime and the agent can do the same. This is because the agent is considered to be protected by market forces. However, sometimes a principal's ability to discharge an agent will be limited where it would otherwise seem to be at will, in any case, liability for discharge will be limited to contract remedies (no tort). (Foley v. Interactive, 22).

   a) *Public Policy*- discharge is not allowed on discriminatory (racial, sexual) grounds, refusal to perform criminal acts, etc.

   b) *Implicit Contract*- an implicit contract may be determined to exist where there are published guidelines for dismissal, assurances of continued employment, etc.

   c) *Bad Faith*- where the person is discharged to avoid paying a commission, bonus, etc.

3. **Agency Liability-** agency law allows the agent to bind the principal to creditors – either tort or contract, by their actions. This liability is necessary in order for the agent to have actual authority (otherwise no one would deal with agents if they thought it would impair the validity of the contract, etc.) This authority must stem from one of the following:

   a) *Actual Authority*- where a principal has directed manifested his consent to the agent's authority. The agent will be able to bind the principal *regardless of the 3rd party's knowledge of such authority*.

b) *Inherent Authority*- this is gap-filling authority that an agent will be deemed to have based on his position/office with the principal, regardless of if he had been specifically granted the authority by the principal.

c) *Apparent Authority*- or ostensible authority, is created where the agent acts *outside his actual authority* but the 3rd party *reasonably believes* the agent to be acting *within* his authority. (Blackburn v. Witter)

d) *Ratification*- if the principle is aware of the agents use of a power with a 3rd party and *fails to disavow or acts in compliance* of the decision- the principal may be bound.

II. Joint Ownership Organizations- because of the inherent limits of sole proprietorship (capital and operational capacity), most business organizations take some form of joint ownership where the venture has more than one stakeholder. This sharing of profits and losses creates considerations that are not present in sole proprietor situations.

A. *Considerations in Joint Ownership-* when considering a choice of joint ownership organizations, investors primary concerns stem from the following issues:

1. **Decision Making-** This determination will stem on the *method of decision making* (voting v. board of directors) as well as *who will make decisions* (passive investors, board, etc.). This is a choice between *equal v. centralized control.*

2. **Liability Limits-** corporate forms are often chosen for the purposes of limiting liability for the actions of the business venture.

a) *Contract/Tort Creditors*- will an investor be personally liable for the torts/contracts of the venture or will it be limited to their investment?

b) *Taxes*- will the income from the venture be subject to taxation both as income to the venture and to the investors or will their be pass-through taxing.

3. **Exit-** the investors must balance the ability to withdraw their assets while at the same time inhibiting the ease of withdrawal enough prevent opportunistic withdrawal. Specifically, it must be determined if the withdrawal of an investor will terminate the organization.

B. *Partnerships-* the oldest and most traditional form of joint ownership.

1. **General Partnerships-** the default form of joint ownership is defined as “an association of two or more persons to carry on as co-owners of a business for profit” is governed in most states by the Uniform Partnership Act (UPA). This form of organization is used typically in a *small firm* where the investors are *active in day-to-day operations.*

a) *Formation*- a general partnership can be formed in two distinct ways:

1) **Operation of Law-** a partnership may be formed by a simple contract between parties. Nothing need to be filed with the state regarding the formation of the partnership.

2) **Implicit Creation-** a partnership may be deemed to have been implicitly created between parties where they represent to the outside world that they are partners in enterprise. They will be estopped from claiming they were not a partnership- §16 for creditors. This can be avoided typically be labeling the relationship "employer/employee" etc.

b) *Liability*- a general partnership provides no shelter of liability. Each partner is *completely* liable for all debts and torts of the partnership.

1) **All partners are agents-** of the partnership and may bind the other partners *unless otherwise agreed.*

2) **May Have Apparent Authority-** if outsiders are unaware of a partner's agreement limiting the ability of a partner to bind the others, the agreement will prevent the binding of the partnership by apparent authority. (See I.B.3.c)

c) *Management*- all partners have *equal* voice in decisions which are conducted by simple *majority* rule. Unless agreed otherwise by the partners.

d) *Continuity*- general partnerships are dissolved by *death* of a partner, *withdrawal* of a partner, or *bankruptcy*. At dissolution, the assets/liabilities are divided equally between all partners. New partners can only be added with the approval of all existing partners. *Withdrawal rights are favored over continuity*.

e) *Transferability*- a general partnership is essentially *not transferable* unless all partners agree to allow the transfer.

f) *Complexity of Operation*- partnerships work best where there are a *small number* of interest holders; there is no outside reports that have to made by the partners (i.e. state filings).

g) *Tax Consequences*- a partnership does not create a taxable entity. All tax liability *flows through to partners*.

2. **Limited Partnerships-** exist where there are some investors who wish to remain passive or be only partially involved in the firms operations; they trade off control for limited liability. This is accomplished by having two grades of partnership **general partners** and **limited partners**. The limited partnership *must have at least one of each.*

a) *Formation*- unlike a general partnership, limited partnerships must file with the state in which they are considered to be formed.

b) *Liability*- general partners are fully liable for all debts/torts of the partnership. Limited partners have limited liability and are only liable for the amount they have invested in the partnership.

c) *Management*- limited partners **cannot** participate in the management of the firm except for certain exceptions (voting for managers and other major issues). Doing so will subject them to eliminate their limited liability protection.

d) *Continuity*- a limited partnership is **not** dissolved by the death or withdrawal of a *limited* partner. *Continuity is favored over withdrawal rights.* Limited partners must give a six month notice of withdrawal generally. General partners may withdraw at will without dissolution so long as one general partner remains.

e) *Transferability*- a limited partner may allow the limited interest to be freely assigned by the limited partner without the approval of all partners. A general partner can still not transfer his interest unless all agree.

f) *Complexity of Operation*- a limited partnership must be filed with state, but need not make reports/or pay fees for its continued existence.

g) *Tax Consequences*- pass through taxation applies to income from a limited partnership. Unless the limited partnership is structured as a corporation by agreement of the partners with the following four characteristics:

1) **Continuity of Life**

2) Centralized Management

3) Debt liability limited to corporate property

4) Free transferability of interest.

3. **Joint Ventures-** a joint venture has many of the characteristics of a general partnership with the primary difference that the agreement is *limited in scope and duration*, generally *defined close-ended objective*.

C. *Corporations-* the formation of a corporations of differs significantly from a partnership; this is because a *separate legal entity* is considered to be formed by incorporation. The is the organization of choice for *limited liability* as well a venture with a large number investors, particularly where the investor has no direct interest in the day-to-day operations of the enterprise.

1. **Formation-** varies significantly from partnerships, must file with the state of incorporation, including articles of incorporation, officers of the corporation and the board of directors.

2. **Liability-** the principle advantage of the corporate form is its limited liability. Liability for all investors and managers is limited to their investment in the corporation.

    a) *Illusion of Protection*- may small corporations will be unable to get credit from lenders without a personal guarantee of the investor, circumventing the corporate protection.

    b) *"Piercing the Corporate Veil"*- certain fraudulent by corporation owners/shareholders may render them susceptible to personal liability. (See IV….)

3. **Management-** corporations have a *centralized management* structure. Shareholders (owners) select a board of directors who chooses officers to oversee day-to-day operations of the enterprise.

4. **Continuity-** corporations have potentially *perpetual existence* as a separate entity and are not dissolved by the death or withdrawal of any shareholder.

5. **Transferability-** shares of corporate ownership are *freely alienable*. However this may be restricted in some corporations at the request of some stockholders. (see V….)

6. **Complexity of Operation-** forming a corporation involves filing with the state and often the annual payment of a franchise fee.

7. **Tax Consequences-** since a corporation is its own legal entity- it has to pay taxes on its profits before they are distributed to investors. Such distributions are referred to as dividends and are also subject to tax when received by the investor. This is the issue of **double taxation**.

    a) *Profits Distribution Without "Dividends"*- to avoid double taxation, corporations may *pay salaries or fringe benefits* to investors that are exempt from being taxed as corporate profit, but are still subject to personal income taxation.

    b) *Subchapter-S Corporations*- a corporation may also elect to become a pass-through entity for taxation much like a partnership under subchapter S. This is only available to corporation of *limited size* (under 75 shareholders).

D. ***Modern Limited Liability Entities-*** states have recently added a number of business organizations that allow investors to have the protection of limited liability while keeping the flexibility associated with partnerships.

1. **Limited Liability Companies (LLC)-** similar to a partnership, the LLC is a hybrid of partnerships & corporations and has been adopted in most jurisdictions under the MLLCA. Investors are referred to as members rather than partners.

   a) *Formation*- an LLC must file with the state to come into existence.

   b) *Liability*- liability for members is limited to their investment in the firm.

   c) *Management*- Membership control over management decisions is proportional to their capital investment in the firm. However, members may elect to have *centralized management*, similar to a corporation.

   d) *Continuity*- like a partnership, an LLC dissolves on the death or withdrawal of any member. However, these withdrawal rights may be restricted by an agreement between members. Members may only be added with the consent of all other members.

   e) *Transferability*- a members interest in a LLC is not transferable without the consent of all other members.

   f) *Tax Consequences*- treated as a partnership, as long as two of the four tests for limited partnerships are not present (see II.B.2.g.1-4)

2. **Limited Liability Partnerships (LLP)-** limited liability partnerships are essentially structured the same as general partnerships, but are allowed the protection of from the liability for the actions of other general partners. This a is typical from professional organizations. (Dentists, doctors, lawyers) They are also subject to a solvency requirement, like a corporation before it can distribute assets.

E. ***Fiduciary Duty in Joint Ownership-*** partners in ownership owe each other a duty of loyalty and honesty that is stricter than the morals of the market place. The must favor the interests of the common venture over their own. This duty arises from law to fill in the void left by contracts. They have a duty of "the finest loyalty"…"the punctilio of an honor the most sensitive" to each other. (Meinhard v. Salmon, 72)

III. Roles in the Corporate Form – Shareholders v. Managers-

the corporate form of business has unique roles that carry a variety of duties and obligations. Key to the efficiency of the cooperate form is the allocation of control from the vast number literal owners of the corporation, the shareholders, to those who run the corporation, the directors. A balance must be struck between the ability of the directors to effectively manage and the stockholder's ability to hold director's accountable for their decisions.

A. ***Characteristics of the Corporate Form-*** in considering the role of directors and shareholders in corporations the following features of the form itself, they are each different than the structure of a general partnership

1. **Separation of Function-** corporate statutes set out separate and unique roles for the directors, officers, and shareholders of a corporation. Specifically the separation of ownership and management functions.

2. **Centralized Management –** key to the form is also that decision making for the group is made by the board of directors. They have broad discretion and all corporate power.

3. **Perpetual Entity-** the corporation is an enduring entity with a potentially limitless life span; a fictional legal person capable of asserting rights and owning assets.

4. **Freely Transferable Interests-** key to corporate governance is that a shareholder may transfer his interest at anytime he feels his money could be put to better use elsewhere without affecting the interest of others.

5. **Limited Liability—**the premise that an investor may only be liable for his investment.

B. Players in the Game-

the rules of the corporation are determined by statutes that require corporations to have articles of incorporation/bylaws that establish the basic relationship and role of the three corporate actors – directors, officers, and shareholders.

1. **Principles of Corporate Governance-** the traditional statutory scheme establishes the powers of the board, officers and shareholders of a corporation. These statutory norms are modified and/or augmented by the articles of incorporation and bylaws of a company.

   a) *Articles of Incorporation*- must be on file with the state of incorporation. Typically these can only be modified by the approval of at least a simple majority of shareholders. They are public records available to anyone.

   b) *By-laws*- these may often be modified by the board of directors on its own authority or by a majority of shareholders. These are not a part of the public record of a corporation.

2. **Directors-** of a corporation are given *all corporate power*, (MBCA 8.01) they are the principle managers that are chosen by and accountable to the shareholders. The board of directors exercises this power based on majority rule (unless modified, see VI…)

   a) *Oversight Function*- the directors do not run day-to-day operations or decision making. (although they may if they are also officers) There principle function is the oversight of the officer

   b) *Determine Basic Policy & Direction*- the board will as part of its function determine the underling policies of the corporation with the goal of maximizing shareholder value. They also make basic decisions, such as shareholder meeting locations, dividend allocation, etc.

   c) *Don't Share in Profits Directly*- the directors are not residual claimants of the corporation (all though they might as shareholders). They are paid an independent salary (which may be based on corporate performance).

   d) *Inside v. Outside Directors*- directors who are also stockholder and/or officers in the corporation will be referred to as inside directors. Those whose only attachment to the corporation is their job as director are termed outside directors. A typical board will have both inside and outside directors.

3. **Officers-** run the day-to-day operations of the corporation. They are not residual claimants (don't share in profits) of the corporation. They are subject to dismissal by the board. They generally lack the vast agency power of partners.

4. **Shareholders-** are the *owners* and residual claimants of the corporation and are *entitled to all profits*. Distribution of the profits however is controlled by the board of directors.

   a) *Limited Control*- shareholders have limited control over the management of the corporation, but still have important powers in the basic determinations of the enterprise. (See III.D.1)

   b) *Limited Liability*- shareholders are limited in their liability to the amount they have invested in the corporation.

   c) *Different Classes*- their may be different classes of stockholder who may have different voting privileges or claims to profits/residuals. Such distinctions must be made in the articles of incorporation.

C. *Role of Markets-* the characteristic of free alienability of corporate interests is illustrated in the trading of such interest in markets, such as the NYSE and NASDAQ markets. These markets exert force on the corporation and provide essential governance over their activities.

1. **Liquidity-** market provide liquidity allowing investors to *almost no cost to enter/exit the firm* if they are not happy with the management. As such, the liquidity allows investors to freely enter into ownership without fear they will be unable to exit. Inability to exit = more desire for control (wall street rule)

2. **Valuation-** the market serves the function of providing a value of an investor's investment. If the market is *perfectly efficient* all relevant information regarding the performance of a company will be *instantly* reflected in the price of its stock.

3. **Monitoring Function-** the market also serves as an *implicit check on directors*. If investors are unhappy with the actions of director they may exit the firm en mass. The market therefore provides incentives for directors to behave themselves.

   a) *Institutional & "Active" Investors*- large stake investors will have a proportionally larger interest in the management of the corporation. Such investors are much more likely to monitor company information and the behavior of directors.

   b) *Rational apathy - "Passive" Investors*- smaller investors will not spend the time to become informed on company matters or monitor the directors as they are aware that other active investors will perform this function and it is not worth their effort for the small investment.

4. **"Beating the Market"-** an investor is able to beat the market where he is aware of information that is not yet reflected in the stock price. (i.e. the market is

wrong) This is a breakdown in efficiency in the market that is normally quickly corrected.

D. *Role of the Shareholder-* while the shareholder does not participate directly in the day to day operations of the corporation or the policy and management decisions; they still have important powers to protect their investment based on their rights as owners.

1. **Shareholder Control-** shareholders can exercise direct control over the corporation in three important ways. These rights are limited, but are *guaranteed by statute*, they can be modified by the shareholders:

   a) *Composition of the Board of Directors*- most direct control by shareholders comes from their power to elect the member of the board of directors and to remove them from office. (7.01 et seq. MBCA)

   b) *Articles of Incorporation/Bylaws*- shareholders must approve all changes in the articles of incorporation and bylaws that establish the power relationships in the corporation.

   c) *Fundamental & Conflict of Interest Transactions*- transactions that are fundamental to the corporation must be approved by shareholders (merger, dissolution) as well as conflict of interest transactions that can voided by disapproval (self-dealing of directors/corporation).

2. **Shareholder Meetings-** shareholders exercise their corporate power at stockholder meetings where they are allowed to vote (either in person or by proxy). The statutory requirements of the meeting are established to assure the shareholders the right of *informed suffrage*.

   a) *Annual Meeting*- corporations are required to hold at least one stockholder's meeting annually. This meeting may be compelled by a shareholder suit where a meeting has not been held within 15 month of the past meeting. (§7.03) the primary purpose of the meeting is the *election of directors*. *Agenda of the meeting is Controlled by Directors*

      1) **Failure to Hold Doesn't Invalidate-** if a corporation fails to hold the required meeting – actions it takes are still valid, however a shareholder may sue to compel a meeting.

   b) *Special Meetings*- can be called for specific issues. These meeting may be called by persons given the power in the *bylaws* or depending on the jurisdiction. The board is always given the ability to call a special meeting

      1) **Delaware-** no shareholder is given the power to call a special meeting – only the board of directors and those authorized by the bylaws.

      2) **MBCA-** the MBCA allows a special meeting to be called by a shareholders who own at least 10% of the company to call a meeting. (immutable rule) This makes a corporation more susceptible to a hostile replacement of the board by a takeover raider.

c) *"Record Date"*- shareholder as of a certain date will be entitled to vote. This record date is set by the board of directors but may not be more than 70 days before the meeting. (§7.05)

d) *Notice Requirement*- (§7.05) shareholders are entitled to receive notice of the time/date/location of the meeting. Notice must be given at least 10 days prior to the meeting but not more than 50 days.

1) **Special Meetings -** Special meeting notice must include an *agenda* of what will be addressed at the meeting.

2) **Effect of defective notice-** If notice is defective and not waived at the meeting, the decisions reached at the meeting may be subsequently voided.

e) *Quorum Requirement*- for an action at meeting to be valid, it must typically be *voted on by a majority of voting shares*.

1) **May be lowered-** some state allow for lowering the quorum to 1/3 of voting shares. (Del. 216) or may be set as low as the bylaws/articles state (MBCA 7.25)

2) **May be raised-** may be set by articles or bylaws at any percentage. This may be used in close corporations to create an effective veto for minority shareholders.

3. **Controlling Composition of the Board of Directors-** perhaps the most important power of shareholders is the ability to control the composition of the board of directors.

a) *Election of Directors*- shareholders elect directors annually for a *one year team* (unless modified see III.D.3.d) at the annual meeting.

1) **Slate established by Board-** the slate of directors to be elected is determined by the board of directors.

2) **Plurality Necessary-** in order to win a seat, a person must gain a plurality of voted shares.

b) *Strait v. Cumulative voting*- corporations may hold their elections based on cumulative or strait voting. This is determined generally by the corporate certificate. However, some states may require or not permit cumulative voting.

1) **Strait Voting-** *allows are shareholder to cast votes for **each seat individually***. This system of voting allows a majority shareholder to be able to elect *every member of the board.*

2) **Cumulative Voting-** this voting system provides *greater representation to minority shareholders*. In this system, the board is ***elected as an aggregate*** each shareholder is given [(number of shares) x (number of seats) = number of votes.] This allows a minority shareholder to pool her votes to elect a director.

⇒ Determining minimum number of votes to elect- use the following formula: ((S*X)/(D+1))

⇒ S = Number of Directors to elect, X = Number of Shares, D = Number of seats on the board to be elected.

c) *Removal of Directors*- shareholders may also act to remove board member *by a plurality of votes cast* at a special meeting called for that purpose (often may be by a raider). Removal is governed by MBCA §8.08 and Delaware §141(k). (in *Delaware* any restrictions on removal are a default that may be opted out of)

1) **Without Cause Alright-** unless otherwise restricted (classified board, cumulative voting, etc.) a director may be removed without cause by the shareholders. This may be restricted by bylaws/articles.

⇒ So long as not done for "inappropriate & inequitable" aims. (Dolgoff v. Projectovison)

2) **Cumulative Voting Restriction-** in order to protect minority rights, in a cumulative voting system, a director can only be removed *without cause* by a vote where the shares voted against removing her would have been sufficient to elect her. (Delaware- Unless the entire board is being removed)

3) **Classified Boards-** in order to preserve take-over protection, board members of a classified may only be removed for cause.

4) **Class Elections-** where board members were elected by certain classes of stock, they may only be removed by a vote of the same class of stock that elected them.

5) **Amending Bylaw/Articles to Allow Removal**- where removal of directors may be restricted, the stockholder may act to remove the restrictions, such actions may include

⇒ Declassifying the board (amend. Bylaws or Articles)

⇒ Amend to Allow Removal W/O Cause (Roven v. Cotter)

⇒ Amend to Remove Cumulative Voting

d) *Filling Vacancies*- as a default, vacancies that occur in the board may be filled by either the *board or a vote of shareholders* (often done by consent see III.D.3.g). The rule will require the director to stand for reelection at the next meeting (even if on a staggered board).

e) *Changing Number of Directors*- the number of directors is set by the bylaws/articles and may be changed generally (depending on art. or bylaws) with the approval of board or shareholders. MBCA §8.03(a) restricts board modifications to a 30% increase w/o shareholder approval.

f) *Classified Boards*- a corporation may split it board into up to 3 classes. Each class would serve a term of years equal to the number of classes. At each election only one class is elected. This is used to limit a raiders ability to completely take-over a board

1) **Eliminates Removal Power in Delaware jurisdiction-** in order to assure the take-over protection provided by a classified board, the power to remove members is restricted to w/cause.

2) **Reduces effectiveness of Cumulative Voting-** where the number of seats available in election is reduced (i.e. class voting) the increased power given to minority shareholders by cumulative voting is proportionately reduced.

g) *Elections by Consent (w/o Meeting)* – unless provided otherwise in the certificate of incorporation, shareholders may act by written consent to elect directors. In Del. §212 the procedures are set out. This rule is written to protect the minorities right to be heard.

1) **If Unanimous-** may elect a single direct to fill a vacancy

2) **If Less than Unanimous-** may only elect by consent if all seats that would be up for election are being decided (entire board or entire class).

E. *Shareholder Communications-* another right and role for shareholders is communication with other shareholders regarding the future disposition and decisions of the corporation. Most often, these communication *request a proxy of voting rights* for a pending vote. These communication are *subject to regulation by the SEC* (Securities Exchange Commission).

1. **Who Pays for Communication-** essentially there are two forms of communication. Costs of the communication may be required to be paid by the corporation, or the expense may be footed by the corporation or by the soliciting shareholder.

a) *Shareholder Cost -SEC 14a-7* – This rule provides that the corporation must either *mail the proxy at shareholder expense* or *give a list of shareholders* to the solicitor so he can mail the proxy himself.

b) *Corporation Cost – SEC 14a-8*- this rule requires the corporation to *include the shareholder request in their proxy materials* in certain circumstances.

2. **SEC 14a-8 - Shareholder Access to Corporate Proxies-** This rule allows “shareholder proposals” to be included on the corporate proxy at essentially no

expense to the shareholder. This is often used by *small holders* who which to influence a corporation's *social or political* interest. This access is restricted by the following regulations:

a) *Must be 'Qualified Shareholder'*- in order to be eligible, the shareholder must have owned at least 1% or $1,000 value in stock for longer than one year.

b) *Length Restriction*- the proposal may not be longer than 500 words.

c) *Must be a 'Request'*- any proposal to director must be in the form of a request, otherwise it would violate state law (giving directors all corporate power) by diluting corporate power, which is in contradiction to 14c-2 of the rules.

d) *'Ordinary Business Operations' Excluded*- proposal that would effect the ordinary business operations of the corporation are excluded based on that day to day operations are properly determined by officers and directors by rule 14(c)(7). Issues of senior executive compensation are not considered to be 'ordinary business' operations.

e) *'Not Significantly Related to Company Business' Excluded* – resolutions that are do not bear on a substantial percentage of the corporate business. (c)(5)

f) *'Socially Significant' issues may be allowed*- in the past proposal regarding significant social issues have excluded on either ordinary business or non-significance grounds. The SEC has a trend of *allowing socially significant proposals*. (Lovenhenn v. Iroquois Brands)

3. **SEC 14a-7 Independent Solicitation of Proxies-** where the shareholders proposal would be excluded under the (c) provisions for including the request in corporate materials. Most importantly this method is *not subject to any length or content restrictions.*

a) *Restriction on Solicitation- any solicitation outside the proscribed means of the SEC is prohibited.* This specifically includes newspaper and other media adds directed at shareholders.

1) **Broad Definition of Solicit –** solicitation of proxies is broadly defined by the SEC to be "*Any communication 'reasonably calculated' to influence shareholders*"

2) **Oral Prohibitions-** corporate management is prohibited from any oral solicitations of proxies. Non-management may solicit orally (yeah baby!) in front of less than 10 people.

3) **Statement of Intent to Vote = OK –** where a shareholder merely states his intent to vote in a certain way on a matter, as long as it is in a public newspaper/press release and is not intended to solicit others.

4) **Request not Execute Prohibited-** for purposes of solicitation- requests to revoke or not to exercise a proxy is also a form of solicitation.

b) *Access to Corporate Information*- the corporation has the option of either performing the mailing for the stockholder (at his expense) or giving a list of shareholders for the mailing, where the corporation believes the list *will not be used for proper purposes* it may have the ability to with hold the into.

c) *Discretionary Authority Proxy*- directors have a limited right to solicit proxies for their use with discretionary authority to be exercised against independent stockholder proposals. So long as the following are met:

1) **Unsure of Exact Proposal-** where the directors are aware a proposal is to be made, but aren't aware of its exact nature.

2) **Opt Out Proxies Issued-** if the proposal becomes definite, a proxy allowing the shareholder to opt out of the proposal will be sufficient for the directors to retain discretion. (UNITE v. May Co.)

IV. Directors Responsibilities & Remedies- with power comes responsibility and are friends the directors are not free from liability with all corporate power. When it hits the fan, someone has gotta pay! *This chapter deals with a director's liability to stockholders for her actions or failure to act.*

A. *Fiduciary Duty of Directors-* directors as the controller of the corporation have a duty *to make responsible decisions* for the corporation, additionally as agents of the corporation, they owe a duty to *prefer the interests of the corporation to their own*. These duties together are termed the fiduciary duties of the director. These duties are *ascribed from case law* rather than any statute, however the MBCA does have a general provision governing director conduct. §8.03

1. **Duty of Care-** the duty of care is the corporate duty to assure that decisions are made properly within the corporation. This is more of a *procedural* duty and is governed by the business judgment rule.

2. **Duty of Loyalty-** the duty of loyalty is the duty to assure fair and candid dealings between the corporation and the director. This is concern where the director is on both sides of a transaction (*self dealing)* or the determination of a 'corporate opportunity'. It's limits are set by case law determinations of fairness.

3. **Business Judgement Rule-** this court is committed to non-interference in corporate decisions. The rule creates a *rebutable presumption* that the directors *acted in good faith for the best interests of the corporation.* Essentially, *absent evidence of fraud or misconduct* the court will **not** second guess business decisions. (Shlensky v. Wrigley)

   a) *Shareholder Assumed Risk*- investors are adequately aware of the risk of a bad call and the effect on the business.

   b) *Discourage Corporate Conservatism*- as a matter of policies, courts don't want directors worrying about subjecting themselves to possible liability.

4. **Broad Duty –may extend to 'Stakeholders' –** modern interpretations of fiduciary duty expand the duty beyond the corporate shareholders. More than 30 states have 'other constituency' statutes the purport to create duty to employees, bondholders, and host communities. Such provisions don't exist in the MBCA or Delaware codes.

5. **Legislative Limits of Liability-** legislatures have acted to shape and limit director liability for breaches of fiduciary duty in the following manners:

   a) *Allow Exculpatory Provisions in Articles*

   b) *Regulation of Maximum & Minimum Indemnity of Directors*

   c) *Conflict of Interest Guides*

   d) *Regulation of Derivative Suits*

B. *Duty of Care- Negligent Decision Making-* while directors are generally protected from liability for their actions under the business judgment rule, it doesn't provide blanket indemnity for the directors.

1. **Decision Making-** directors are required to make decisions with the diligence and care of a reasonably prudent person. These decisions are *protected by the business judgment rule* and therefore breaches of the duty must often be an egregious breach of duty- essentially *gross negligence or recklessness*. The liability in decision making is based on the violation of two duties of due care:

    a) *Substantive Due Care- Bad Decision*- this sort of liability arises when the decision to proceed with a transaction was *clearly outrageously risky* or a *no-win situation* that no prudent director would have reached the decision. (Litwin v. Allen)

    b) *Procedural Due Care- Bad Process (Smith v. Van Gorkum)*- where the directors are responsible a decision that was clearly *grossly unintelligent or uninformed.*

        1) **Good Faith Irrelevant-** the fact the directors believed they were acting in the best interests of the corporation is irrelevant where the action was without procedural due care.

        2) **Shareholder Approval Irrelevant-** shareholders were also uninformed, so their approval of an uniformed decision is irrelevant.

2. **Duty to be Informed-** ignorance of corporate actions is never an excuse for directors, the inability to perform this duty does **not** excuse its violation. (Francis v. NJ) Directors as part of their duties have to be actively managing the corporate entity.

    a) *Duty to Monitor*- directors have a duty to be familiar with financial statements and other relevant materials. Where such material demonstrate need, *a duty to investigate may be created.*

    b) *Duty to Prevent Misconduct*- directors have **no** direct duty to discover/ferret out wrong doing. (Graham v. Allis-Chalmers)

        1) **Reasonable Reliance-** directors are entitled to trust the employees that they are performing/reporting below them.

        2) **Suspicion = Duty to Investigate-** however where wrongdoing by an employee is *witnessed or should have been reasonably suspected*, directors will have a duty to investigate/cease such conduct.

C. *Limits on Director Liability-* partially as a response to the court's ruling in Smith v. Van Gorkum, the legislature in Delaware acted to create statutory limits on director liability for business decisions. These limits may be placed in a corporations articles of incorporation in order to be effective.

1. **Statutory Exculpation Provisions-** Director liability may also be limited by corporate charter where allowed by statute, almost 40 states have such statutes. Delaware statute (§102) (proposed MBCA 8.30-1) allows a corporations to *limit or eliminate but not expand* director liability for any actions except for:

   a) *Actions in Bad Faith*

   b) *"Duty of Loyalty" Breaches*

   c) *Where the director received improper personal benefit.*

2. **Indemnification-** based on agency principles, the corporation may be considered to indemnify the director for any liability incurred as a result of his actions as a director as long as they were in good faith. MBCA 8.50-59, Del. 102(b)(1), 145.

3. **Insurance-** corporations may carry insurance that covers director and officers for liability for decision made in their corporate capacities. Often has same limits of provisions above.

D. *Duty of Loyalty- Conflicts of Interest-* a directors second fiduciary duty arises from his agency based duty to favor the interest of the corporation over his own. This is essentially a concern in 3 areas, where the director is involved on both sides of a transaction, where the director and the corporation are in conflict for a business opportunity, or where the director uses sells/gives corporate assets.

1. **Corporate Opportunity-** directors may not compete with the corporation for business opportunities.

   a) *Factors in Determining*- in determining if the opportunity was in fact corporate, the court will look at the following factors:

      1) **Scope of business-** where the opportunity is within the scope of the operations of the corporation.

      2) **Reasonable Expectation of Parties-** where a board member is an 'outside' member- or only limited involvement in the enterprise the opportunity is less likely to be considered corporate.

      3) **Affect the Interest of the Corporation- "corporate expectancy-** where the opportunity would affect the interests of the corporation (either beneficially of adversely).

      4) **Who Received Opportunity-** if the director utilized information he received *in his capacity as a director* for a personal gain instead of a corporate one, that would constitute misuse of a corporate asset. (CIS v. Broz)

5) **Ability to Act-** whether the corporation had the ability act to take advantage of the opportunity will be considered by the

b) *Director Action Acceptable*- a director's taking of business opportunity will not be considered taking a corporate opportunity where:

1) **Disclosure & Approval-** where the director has *fully disclosed* the opportunity to the corporate and his decision to take the opportunity is accepted by the board.

2) **Rejected by Corporation-** where the corporation has considered and rejected the opportunity, the director's use of it may be alright- disclosure to corporation may be required.

3) **Fair to Corporation-** where a directors action is subsequently determined to be fair by a court if will also be allowed to stand. (this is a last resort, preference for private ordering resolution)

2. **Misuse of Corporate Assets-** *Waste of Assets*- the derivation of corporate assets for an improper purpose or *Gift of Assets*- the transfer of corporate assets for an insufficient consideration- are both violations of a directors fiduciary duty.

a) *Determined by Business Judgement Rule*- whether a transaction is in fact a waste of assets or a gift will be determined by the BJR where the directors are not interested.

b) *Ultra Vires Act*- **these acts are void** where determined to have occurred regardless of any subsequent determination by stockholders to cleanse the transaction.

3. **Executive Compensation-** is a special form of self dealing since is directors receive compensation. Problems arise where compensation can be considered greatly excessive consideration. Compensation is treated like other self-interested transactions. (Cohen v. Ayers)

a) *Where no self-dealing = subject to BJR*

b) *Where Validated = Subject to BJR*- like other self-dealing problems, where the compensation package was approved by a majority of disinterested directors or the shareholders, it will be considered valid.

c) *If Gift – cleansing ineffective*- a gift of compensation will not be cleansed by shareholder approval.

4. **Director Self Dealing-** where a director is on both sides of the transaction, specifically where the interest of the director is *greater on the non-corporate side*.

a) *Delaware- Remedying Conflict Transactions*- under Delaware statute §144, conflict transactions *are not presumptively void*. The transaction may be preserved if one of two cleansing actions is taken or if the transaction was fair to the corporation

1) **Cleansing Actions-** is where the transaction is approved *after it occurred*. Where disinterested, court give considerable deference to cleansing actions

(preference of private ordering to ex post judging.) The Delaware statute allows this in two forms:

⇒ Approved Disinterest Board Members- if the transaction is approved by a majority of disinterested board members, if a substantial portion of the board is interested in the transaction, the court may still look at intrinsic fairness.

⇒ Approved Shareholders in Good Faith- if the transaction is approved by shareholder vote in good faith. Good faith comes into question where the interested party is a majority shareholder (and therefore approval was assured) a court will still look to intrinsic fairness.

2) **Intrinsic Fairness-** where the transaction *fails to be subject to cleansing, fails the cleansing determination, or cannot be cleansed* (because of pervasive interest) the court will look at the fairness of the transaction to the corporation *at the time it was transacted*, and not in retrospect.

b) *MBCA- Remedying conflict Transactions*- Subsection F, §8.61 is essentially equivalent to Delaware standards for approval providing the interested transaction:

1) **Disclosed and approved by a majority (>2) of disinterested directors**

2) **Disclosed and approved by a majority of stockholders**

3) **Shown to be fair to the corporation**

c) *Difference Between MBCA and Delaware*- note that Delaware statute says that the transaction is *not void solely because* there is a conflict of interest where the test is meet (i.e. could be voided by court anyway), where the MBCA states the transaction *is valid* where the statute is met.

5. **Parent/Subsidiary Dealing-** another concern of self dealing transactions occurs with transaction between the parent corporation and the subsidiary in which the parent is a majority stockholder. (Sinclair v. Levien)

a) *No Exclusion of Minority Shareholders = BJR*- where nothing is received by the parent 'to the detriment or exclusion of minority shareholders'- there is no unfairness and the BJR will be applied.

b) *Minority Treated Different = Fairness*- where the majority receives benefits not confirmed on the minority the intrinsic fairness test will be used.

c) *Cleansing By Minority*- if a transaction is approved by the majority of disinterested shareholders (majority of the minority.)

E. *Derivative Litigation-* occurs when a stockholder brings a suit *in the name of the corporation* against the directors of the corporation for a breach of fiduciary duty. The allowing of these suits must balance the *risk of a strike suit* by an unhappy investor with the *conflict of interests* that are present in interested board members appearing on both sides of the lawsuit. This creates a dilemma of *shareholder rights v. director control* and *judicial oversight v. private ordering*.

1. **Universal Demand Requirement – MBCA §7.42-** in an effort to prevent frivolous strike suits, the MBCA requires that a stockholder make a demand on the board to bring a derivative action. The purpose of demand is to *assure that intra-corporate remedies have been exhausted.*

a) *Demand Accepted*- the board may accept the demand and proceed with a derivative action (yeah, right, what a good idea! Sue ourselves, why didn't we think of that!)

b) *Demand Refused*- where a parties demand for a lawsuit is rejected by the board the stockholder is the shareholder may still have a lawsuit where the board can be shown to be interested

1) **Non-Interested Board = BJR-** where there is a non-interested board, the decision not to proceed with the lawsuit will be judged by the business judgment rule.

2) **Interested Board = Fairness-** where the board is shown to be interested, the decision not to proceed with the action will be judged by the court based on intrinsic fairness.

2. Excuse of the Demand Requirement – Delaware – Arronson v. Lewis
Delaware is different from the MBCA in that is *allows demand to be excused* in the presence of two factors where the shareholder *alleges facts that create a reasonable doubt that director decision was disinterested* ***and*** *the decision would be protected by the BJR.* This is based on Delaware belief that the directors should have control unless shown to be disabled.

a) *Judicial determination of Interest =level of review* - the determination of board interest is key because it *determines level of review.*

1) **Interested Board = Intrinsic Fairness** (favored by shareholders)

2) **Non-Interest Board = Business Judgment Rule** (favored by board)

b) *Making Demand May Concedes Board as Disinterest*- making a demand on the board by a shareholder may prevent them from later claiming that the board was interested in the transaction. The decision of the board not to pursue the action will then be judged by the BJR.

c) *Determining Board Interest*- several factors play in the court's decision of whether the board is in fact interested excusing demand. In general *excuse of demand is rare in Delaware Cases.*

1) **Director Greater Benefit Than Shareholder = Interested-** a general rule, is that where a director can be shown to have profited by a transaction more than a

2) **Approval By Disinterested = Not Interested-** where the majority of the board can be shown to be disinterested, and approved the decision *either in advance or subsequent* to transaction will make the court determine that demand would not have futile.

3) **Named as Defendant Doesn't = Interested-** simply because a director is named as a defendant in the suit will not necessarily make him interested for determining excuse of demand.

4) **Non-interested Directors Beholden to Interested Director-** where disinterested directors can be shown to be undue influence of interested directors (hand picked by) etc. may be considered influenced.

d) *Board Inaction on Transaction (Rales v. Blasband)*- where the current board was not involved in the decision that the suit is being brought in regards to, they will only be considered to be disabled *when they can be shown to be interested*, since they did not make the decision is cannot be shown to be outside the BJR to excuse demand. Examples of where the board will be considered not to have acted include:

1) **Majority of Directors Subsequently Replaced**

2) **Subject Transaction was not voted on by Board**

3) **Subject Transaction was voted on by a different board (subsidiary)**

3. **Independent Litigation Committees (ILC)-** in the 1970s, an effort to design a protection for shareholders that would still allow the directors to control derivative litigation, some states allowed the formation of ILC – comprised of some/all of the disinterest members of the board. Standards of review of the committee decision to proceed or dismiss vary with jurisdiction

a) *Full Business Judgment Rule Protection (NY)*- some states find the decision of the committee, like most director acts, to be reviewable only under the business judgment standard of review.

b) *No Deferral – Structural Bias Concern (IA)*- some states will not give any deference to decisions of such a committee citing the structural bias of having other directors judge the actions of other board members. There will be no protection under the Business Judgment Rule.

c) *Delaware Standard – (Zapata v. Maldonado)- Two Step Test*- Delaware will give deference to decisions made by such committee where the meet a two part test and must be made up of at least two directors. *This test is only applied where demand was determined to be excused.*

1) **Determine Independence of Committee-** the court will look at the committee decision process and determine if it was made in *Good Faith after reasonable investigation*, by looking at if the committee is in fact disinterested. Plaintiff shareholder has burden of proof (DE loves those directors).

2) **Apply Court's "Independent Business Judgment"-** the court will use its own business judgment to determine if the decision of an independent committee was justified. This means the decision of the committee *does not receive the full protection of the business judgment rule.*

d) *MBCA Treatment (7.40-47)*- the MBCA allows for the appointment of a committee by the disinterest directors. The MBCA only requires the first step of the Zapata test, regarding interest, good faith and procedures, but would replace the second part of the test with the BJR.

V. Close Corporations-

not all corporations are giants. Many are closely held by a *small number of shareholders who participate actively in the corporation*. These are often owned by family members who often fail to contemplate a falling out of relations in the business. This combined with several features unique to a small number of shareholders create problems that are unique to this type of businesses and courts have created *exceptions to general corporate principles*.

A. Overview- Special Concerns in Close Corporations-

the strongest concern in a close corporation is the *protection of minority rights* since may of the checks against majority opportunism that are present in large corporate structures lose their effectiveness in smaller structures.

1. **Partnership Analogy-** many small close corporations would have been set up as partnerships, however, in order to enjoy corporate benefits (mainly limited liability) they were set up as corporations. As a result courts that treat close corporations different will often analogize to partnership law.

2. **Often Majority Controlled-** most close corporations have a majority shareholder, who is often therefore a board member, and since most close

corporate shareholders participate actively in the business, he may be an officer. As a result the *separation of function protections are annulled.*

3. **No Liquidity- Cannot Exit-** the greatest factor in majority opportunism is the fact that a minority shareholder *has no market for his investment* in the corporation and therefore will not be able to exit where he is unhappy with the corporate (majority) management.

4. **Fiduciary Duty – Not as Effective-** because a director is a majority shareholders, they don't fear reprisals for their actions or have to worry about reelection.

5. **Special Rules Developed-** many states, including Delaware & MBCA have developed special statutes that may be invoked by declaring a corporation to be a 'close' corporation (must have less than 30 shareholders) that allow limiting of majority powers. MBCA §7.32 allows the following alterations to board discretion in close corporations (w/unanimous adoption, for 10 years, in bylaws/articles):

    a) *May Fetter Discretion of Board*

    b) *Eliminate Board Entirely*

    c) *Alter Allocation of Profit*

    d) *Manner of Board Election/Removal*

    e) *Dissolution Provisions*

B. *Contractual Limits on Shareholder Discretion-* shareholders may attempt to limit the possibility of majority opportunism by attempting to form *ex ante agreements to assure minority representation*. While modern statute have had a more liberal view of such agreements. However, statutes still will allow agreements that limit actions as *shareholders* but will **not** allow *restriction as directors*.

1. **Shareholder Agreements Restricting Board Discretion-** these agreement purport to restrict the discretion of shareholder *as a director*, they often include guarantees to keep minority shareholders as corporate officers.

    a) *Historically Invalid or Limited*- historically, the enforcement of these agreements has been enjoined on the basis that they *sterilize the discretion of the board* in conflict with the statutory edict that directors shall possess all corporate power.

    b) *Modern Trend – Allow Some Limitation*- modern state statutes allow some restrictions to be placed on director discretion. Delaware and MBCA statutes and some others allow these restriction *only where the corporation is designated a close corporation*. To be effective these provisions must meet with the following:

        1) **Unanimous Adoption**

        2) **Amend/Written in Bylaws/Articles**

        3) **May have time limit-** (MBCA limits to 10 years)

2. **Super-majority Restrictions (Veto Power)-** another restriction that was not available in the past but has gained modern acceptance is veto power. This a scheme where the percentage of votes necessary to adopt any measure is set high enough that a sole/two shareholder(s) can prevent adoption. (i.e. A, B & C all own 1/3 of X, and the super-majority percentage is set at 70%).

   a) *Related Restriction- Quorum Requirement*- this may also be done by setting a quorum requirement of 70%, so a *veto may be exercised by not casting a vote.*

   b) *Generally Allowed*- (MBCA §8.24, §216) - the MBCA and Delaware allows this sort of restriction.

   c) *Receding Provision*- the protection of a super majority provision for certain transactions may be easily circumvented where the articles or bylaws may themselves be amended by simple majority.

      1) **Must Adopt Super Majority for Bylaws/Articles-** in order to protect the super-majority requirement, a separate provision must be including limiting the modification of all or that specific provisions of the bylaws/articles. (Blount v. Taft)

      2) **May be Automatically Protected-** the MBCA §7.27(b) has an automatic provision requiring the same super-majority requirement to amend the provision.

3. **Voting Agreements-** this tactic required a group of shareholders to vote in a certain manner on issues presented- they are often referred to a 'pooling agreement'

   a) *Historically Allowed*- because these restrictions restrict shareholders *as shareholders* and not in a director capacity they have always been allowed in some form.

   b) *May Allow Minority to control*- 'agreements to agree'- these agreements may create a 'majority' by having several minority members band together and agree to cast their votes in the same manner.

   c) *Enforcement of Voting Agreements*- a complication arises in the attempt enforce such agreements, the court is reluctant order a shareholder to cast his votes in a certain manner.

      1) **Use of Arbitration-** the court may order an arbitrator to determined and invoke the shares.

      2) **Other Votes Withheld –** the court many enjoin the casting of the votes outside of the voting agreement (Ringling Bros.)

      3) **Other Contractual Remedy-** the court may enforce other ex ante remedies in the agreement, such as a mandatory buy-out provision. (Ramos v. Estrada)

      4) **May Allow Specific Enforcement-** the MBCA (§7.31(b)) makes these agreements specifically enforceable.

C. ***Cures for Close Corporation Conflicts-*** (4 pts. for alliteration) where conflict occurs between the shareholders in a close corporation, it can be particularly devastating because of the high involvement of the shareholders in the corporation. Three remedies are used by the court in these disputes in checking opportunistic behavior in majority shareholders:

1. Overview of Remedies-

a) *Derivative Suits*- the same remedy of a stockholder against a director that is present in large corporations is used here, however, the nature of a lack of separation of functions limits its effectiveness in close corporations.

b) *Direct Suits*- a unique feature to close corporations is to allow suit *directly against other directors/shareholders* which is not in accordance with corporate norms. This is often termed a *freeze out* action. However often it will **not** be allowed where it would be unfair to creditors, etc.

c) *Involuntary Dissolution*- the court may also elect to use the *equitable remedy* of dissolution or may fashion some other form of unique relief.

2. Breaches of Fiduciary Duty-

breaches of fiduciary duty are handled different that in other corporate suits. Specifically, close corporation directors are held to an *enhanced fiduciary duty*, a duty of the *'utmost good faith and loyalty'.* (Donahue v. Rodd Electric) This is based on the an analogy to *partnership law.* Standards for review of decisions in close corporations include:

a) *Plaintiff Must Demonstrate Bad Faith*- actions of directors will still be protected by the business judgment rule unless the plaintiff can demonstrate that they were taken in bad faith. (Zidell v. Zidell)

b) *'Legitimate Business' Purpose = Defer to BJR*- if there is a legitimate business purpose for the action against the shareholder. The plaintiff can rebut this presumption by demonstrating a *less harmful alternative* to the decision made by the board. (Wilkes v. Springside)

3. Involuntary Dissolution-

this equitable remedy is based on an analogy to partnership law allowing any partner to dissolve the firm. This is still considered by the courts to be an *extreme remedy*. Many statutes allow a shareholder to petition for this remedy.

a) *Standard for Dissolution - Oppressive Conduct*- courts may order dissolution where a shareholder can demonstrate illegality, fraud or *oppressive conduct*. The definition of oppressive conduct is the only serious debate:

1) **Reasonable Expectation Test-** courts hold that where conduct by the majority has *substantially defeated the minority's reasonable business expectations* that will be considered to be oppressive conduct. (Kemp v. Beatley)

⇒ May Be Inappropriate- where far removed from original owner (i.e. 3rd generation in family business didn't have 'reasonable expectations' of his granddad.) (Gimble v. Bolstein)

2) **Exclusion From Management Insufficient-** the removal of a person from a directorship/management position will not be in and of itself sufficient to constitute 'oppressive conduct'. (Gimble v. Bolstein)

b) *Willing to 'Taylor' Relief*- because dissolution is such an extreme remedy, the court will often be willing to fashion other forms of relief. *where other than dissolution is advocated,* the majority shareholder must demonstrate that the solution is reasonable.

c) *Essentially a forced buyout- corporate reorganization*- since the corporation will often reform without the minority shareholder, this is the essentially the equivalent of a court-ordered buyout.

d) *May Be Avoided by Mandatory Buyout*- the MBCA §14.30-37, allows a corporate majority to avoid involuntary dissolution by repurchasing the shares of the minority for fair value. *Minority shareholder must sell rather than proceed with dissolution action.*

4. **Stock Repurchase Agreements-** these are contingent contracts that specify of the occurrence that will require a corporation/other shareholders to purchase shares and will require the other shareholders to sell them.

a) *Generally Enforceable at Ex Ante Price*- these agreements are excitable at the ex ante price *even where unfair* because both parties are assumed to have contemplated the possibility of increase or decrease in price and *assumed mutual risk*. (Concord Auto v. Rustin)

b) *Fair Price Triggered by Breach of Fiduciary Duty*- where parties can show the buyout was triggered by a party's breach of fiduciary duty, the court will determine a fair price for the shares if the ex ante price is not fair. (Failure to have fair dealing- Pedro v. Pedro) (Gallagher v. Lambert – if discharge to avoid price increase, etc.)

1) **ESOP Repurchase Common-** a required repurchase of a close corporation with discharge (regardless of circumstances) is typical, and allowed in order to preserve the nature of a close corporation.

2) **Termination is Not De Facto Breach-** the mere termination of an employee, without a separate illustration of a breach of fiduciary duty will not be enough. This is based on recognition of at will employment (*regulating as employee, not stockholder)* and respecting ex ante contracting. (Gallagher v. Lambert.)

c) *Restrictions on Alienation- (MBCA 6.27, Del 202)* shares may be restricted in the ability to be transferred where, in accordance with the statutes, so long as it's *physically noted* on the shares and the shareholder must have *actual knowledge.* These may be in the form of first refusal, or other purchase options.

d) *No 'Right to Liquidity'*- corporations may be selective in who they grant required repurchase agreements to. (i.e. ESOP repurchase, but no general employee repurchase). Such buyout provisions are not construed to create a right of liquidity.

VI. Corporate Risk Allocation- one of the most important relations

between the corporation is the regulation of risk between the corporation and outsiders. A primary consideration in adopting a cooperate form is the avoidance of personal liability. This chapter analyzes how that risk is determined through contract, when the corporate protection from liability will be disregarded, and the effect of invalid attempts to allocate risk to a corporate entity.

A. Equity Cushion- is the permanent capital of the corporation. When shares are purchased for "par value" (a base value for shares determined by the corporate articles) this money must be kept on hand by the corporation, it served to assure creditors that the corporation would be able to pay it debts. *Modern statutory schemes* allowing par value of shares to be set at pennies or fractions their of, has *eliminated any protection* this provided. Today these protections are provided from market sources.

1. **Cash Restriction-** as part of this protection, historically, cash is required for the par value of shares or services already rendered. The MBCA now allows future consideration and promissory notes to be used. Delaware still follows the cash requirement.

2. **Limits on Dividends-** The equity cushion's modern relevance is tied to the limits it places on the distribution of corporate dividends.

   a) *Delaware Scheme*- (§170) Delaware does not allow dividend to be paid out of the capital of a company (equity cushion) but only out of surplus (assets > liabilities – capital) . However, there is no minimum par value to stock, so the cushion can be effectively eliminated.

   b) *MBCA Scheme*- (§6.40) the MBCA does not require an equity cushion. Dividends are allowable so long as:

      1) Can Pay Debts in normal course of business

      2) Solvency Test Passes (Assets > Liabilities)

c) *In Effect- No Difference Between MBCA & Del.-* the Delaware and MBCA have no significant difference in the effect of statutory regulations imposed on the distribution of dividends.

d) *Some State Have Increased Requirement-* California has actually increased the requirement to a %125 solvency test.

e) *Invalid Distribution may be Voided-* the court may void distributions that are invalid.

f) *Deference to Good Faith Valuations-* the court, on the basis of the business judgment rule will not overrule a corporation's determination of a surplus where made in good faith. (Klang v. Smith Foods)

g) *Nimble Dividends May be Allowed-*where a corporation has been historically unprofitable (i.e. may be well below ability to distribute dividends) but is recently profitable, it may be allowed to distribute 'nimple dividends' out of current profits.

B. *Piercing the Corporate Veil-*

the purpose of forming a corporation is to limit personal liability. However, in certain circumstance, where the *corporate shield is abused*. In these situations, the court will *piece the protective corporate veil* and *hold the shareholder liable* for the actions of the corporate form.

1. **Overview of Piercing Factors-** courts are likely to pierce to the shareholder behind a corporation based on a number of macro-factors:

a) *More Likely in Tort v. Contract-* a court is *less* likely to allow piercing in a contract setting on the basis that a contract is rests on a *voluntary assumption of risk*, (i.e. creditor charged higher rate for higher risk loan). A court is more likely to allow piercing in a tort setting where there was *no choice of tortfeasors* and *no assent to risk*.

b) *More Likely to Pierce to Another Corporation v. a Person-* the court is more likely to piece a corporation to another one (parent as shareholder of a subsidiary) than to a person.

c) *Closely Held v. Publicly Held-* a court will essentially only piece the corporate veil of a closely held corporation (by individuals or a subsidiary) and will not pierce to a widely held public corporation.

2. **Piercing to a Real Person-** many corporations may be set up a single individual person in order to protect them from liability of their personal business operations, this is allowed unless the following factors are violated:

a) *Fraud-* if the corporation is used as a *shell* to perpetrate fraud or *injustice* (by deceiving creditors) it is more likely to be pierced.

b) *Pervasive Control-* the shareholder need to dominate the corporation, such that it is a *shell for personal activities*.

c) *Commingling of Assets-* the failure to keep the assets of the corporation from personal assets will contribute the assumption that it is just a shell.

d) *Failure to Observe Corporate Formalities*- where a corporation fails to observe corporate formalities (holding meeting, keeping corporate records, holiday party) it will weigh against respecting the corporation's status as a separate entity.

e) *Undercapitalization*- where the corporation has no assets of value, especially if they are purposely siphoned of limited. (i.e. leases everything from another corporation having the same owner)

3. **Piercing v. Personal Liability-** sometime piecing cases don't require piercing at all. For, *torts* a *tortfeasor will be personally liable for his torts*, regardless of the existence of a corporate entity (i.e. it won't insulate liability). Additionally, many corporate *debts* have a *personal guarantee* by the director/shareholder, thus no piercing is necessary.

4. **Piercing to a Corporation-** a court will piece a corporate veil to reach a parent holder of a subsidiary where the following factors are met. The goal of allowing corporate piercing is to *prevent excessively risky behavior.*

a) *Dominate Control over Subsidiary*- where parent control is 'so dominates the subsidiary has no separate existence—it is a mere conduit' the court will be more willing to pierce.

1) **Control of Board Not Dispositive-** control of the board by a parent will not be enough to assume 'domination'. (Best Foods)

2) **Allow Muti-board Directors to have Separate Hats-** when a director sits on both the parent and the subsidiary board, he will have the presumption to be acting under the guise of which ever board he is acting for, unless evidence of disloyalty is produced. (Best Foods)

b) *Use in way that result in Fraud/Injustice*- where the subsidiary is horribly undercaptialized, commingled assets, used for siphoning assets to the parent, or as a liability shell, it is likely to be pierced by the court.

c) *Proximate Cause of Injury*- in all piecing cases, plaintiff must show that the corporate act or omission was the cause of his injury.

d) *Creditors weary of Multi-level corporations*- creditors are alert to the problems inherent in multi-level corporations, specifically- the concerns of undercapitalization, commingling of subsidiary assets, and the impairment of profit motive.

C. *Legally Void Allocations of Risk-* this section deals with times where attempts to impute liability onto a corporate entity fail and who is left holding the bag.

1. **Overview-** void allocations of risk can occur in three situations:

a) *No Valid Corporation*- where the corporation that the risk is attempted to be allotted to doesn't in fact exist. This is often as a result of a *failed attempt to create* a new corporation or where the corporate *existence has been suspended* by the state (failure to pay franchise fee).

b) *Acted under Apparent Authority but w/o Approval*- where an agent acts without the authority of the principal. Decisions of who will bear liability base on the good faith reliance of the contracting party.

c) *Corporation Didn't Have Power to Act*- the final, and most rare, is where the corporation attempts to perform an action it cannot perform because it doesn't have the power to do it by law or its own articles/bylaws. The opportunistic enforcement of the Ultra Vives doctrine has left it with limited application.

2. **No Valid Corporation-** a person cannot act as an agent for a non-existent principal. This leaves the 'agent' without the protections of agency law, such actions will result in *personal liability*, this is a policy decision based on *strong penalty defaults* for failure to follow corporate procedures.

a) *Ambiguous Allocations of Risk*- where a party's attempt to allocate risk to a non-existent corporation is ambiguous, it will be construed against the party attempting to organize the corporation and impute *personal liability*. Again this is based on strong penalty defaults. (RKO v. Graziano)

b) *De Facto Doctrine Abandoned*- the doctrine of corporation of estoppel has been abandoned. No corporation will be considered to exist unless it is on file with the state, again this is based on strong penalty defaults.

c) *"Assume to act with corporate authority" = Liable*- where no corporation in fact exists, *personal liability will* ***not*** *be extended to all those who are investors* in the non-existent corporation, ***but only*** *to those who 'assume to act with corporate authority'* **regardless** of if they did in the challenged transaction. (Timberline v. Davenport) MBCA §2.04

3. **Acting Without Corporate Authority-** corporation have agents that are created by the board/bylaws. Agents can bind the principal based on *actual, implied, and apparent authority* (see I.B.3). Additionally, where the action is outside the

authority of the agent, but later ratified by the corporation, it will also be binding. The only instances of contenting authority to bind principal arise under *apparent authority*. This is where the agent appeared to have the authority in a given situation, but did not.

a) *Must be Good Faith*- in order to bind the principal, the other party must show that its reliance on the agent's authority was made in good faith.

b) *Suspicious = Duty to Investigate*- good faith of the belief will be invalidated where the authority of the agent to conduct the transaction is suspect, creating a duty in the other party to *investigate the agents authority* and he fails to do so. Especially where the factors below are present:

1) **Inconsistent Information-** where the party receives inconsistent information regarding the agents authority.

2) **Odd Transaction-** where the transaction is *outside the normal course of business* of the agent.

4. **Ultra Vives Acts – No Corporate Power-** this doctrine allows the voiding of corporate acts that are outside the power granted to the corporation by the statutes of the state or the articles/bylaws of the corporation.

a) *Historically - Used Opportunistically*- this doctrine has a history of only being invoked where the corporation makes a decision it has later regretted and attempted to invalidate it.

b) *Modern – Limited Uses Allowed*- as a result, modern statute have greatly limited the use of this doctrine. (MBCA §3.04, Del. §124) Under the MBCA is can only be used in two instances:

1) **Shareholder suit to enjoin act-** where a shareholder sues to prevent a ultra vives act. (charitable giving, etc.)

2) **Derivative/Direct Suit against perpetrator-** a suit against the corporate officer/director who performed a ultra vives.

VII. Friendly Control Transfers- Mergers- a corporation may decided to join with another corporation. This decision may be based on a belief new management can do better, a decision by the selling corporation to invest in another venue, or even a synergistic belief the two operating together would greater than the sum of its parts. These transactions are more complicated because they *fundamentally change the corporation*, indeed it may disappear, therefore, *shareholders are afforded more rights than in ordinary transactions.*

A. *Types of Mergers-* modern mergers are effected in any number of methods. These different methods are selected based on the variation the allow in *who must approve the transaction*, as well as *the resulting corporation(s)*, and perhaps most importantly the *possible effect of dissenting shareholders*.

1. **Statutory Mergers-** in this traditional form, two previously separate corporations combine to form one ('surviving corporation') that has *all the assets and liabilities of the two prior entities*. Terms of the merger are obviously binding on all shareholders of both corporations. The following steps are necessary:

    a) *Both Boards Approve Merger Plans*- both board of directors must approve a plan of merger.

    b) *Both Corporation Shareholder Must Approve*- the shareholders of both the acquiring and the selling corporation must approve the transaction. The percentage of approving shareholder required may vary (super-majority requirements).

    c) *Typically- Receive Shares in Surviving Corporation*- in a traditional merger, the shareholders of the acquired corporation would receive stock in the surviving corporation. However, the statutes don't require this, and shareholders in the acquired corporation may receive other types of consideration (junk bonds, cash, a shinny yellow bicycle).

    d) *Dissenters Can Claim Appraisal Rights*- dissenters who vote against a merger may claim the right to have their shares appraised for their 'fair value' if they believe they received a raw deal (which apparently they do, cause they didn't vote for it). See VII.B for discussion on appraisal.

2. **Sale of Assets-** in this form of merger a corporation may sell all or a part of its assets to another corporation, this has the equivalent effect of combining the forces of the two corporations.

    a) *Must Be Approved by Seller's Shareholders Only*- these transactions must be approved by a selling corporation where they constitute *all or substantially all* of the corporations assets. (MBCA 12.01, Del. 271) This transaction **does not** have to be approved *by the acquiring* shareholders.

    b) *Delaware- No Appraisal Rights for Seller-*

    c) *Doesn't Necessarily Dissolve Seller*- unlike a merger, the selling corporation is not necessarily dissolved as part of the transaction.

    d) *Don't Need to Transfer All Assets*- the transaction may only be for party of the corporation (a division, etc.) or the entire thing.

e) *Don't Need to Pass Liabilities*- the liabilities of the corporation will often not be passed as part of the transaction.

3. **Triangular Mergers-** these mergers get their name from the fact they involve 3 parties, the normal two, plus a *wholly owned subsidiary* created by the acquirer specifically for the transaction. The subsidiary is *capitalized with stock of the parent*.

a) *Forward Triangular Mergers*- in this merger, the subsidiary merges with the target, the target receives the stock in the parent. The result is the equivalent of a stock exchange. The subsidiary (formerly the acquired corp.) has stock in the parent, and the parent owns all shares of the subsidiary.

b) *Reverse Triangular Mergers*- this is essentially the same, *except the subsidiary is acquired*, and disappears at the end of the transaction. The effect still leave the target as a wholly owned subsidiary. This is used where the *target survival is desired*.

c) *Acquiring Shareholder Approval Not Required*- the approval of the acquiring corporations shareholders in not required in either of the triangular mergers (Board has full control over subsidiary w/o shareholder vote). No appraisal rights exist for the acquiring corporation.

4. **Compulsory Share Exchanges-** this form requires that the shareholders of the target exchange their shares for shares in the acquiring corporation.

a) *Leaves Target in Existence*- this leaves the target in existence as a *wholly owned subsidiary*.

b) *Acquiring corporation shareholder don't get to approve*- while the acquired corporation must have a majority approve the transaction, the acquiring corporation again doesn't get to approve the deal.

5. **Short Mergers-** these are mergers that occur *between a subsidiary and a parent*, as a result of the already close nature of the corporations, the codes allow for abbreviated approval. (MBCA 11.04, Del. 253) These mergers, where parent has requisite majority (90%, etc), can be conducted without a shareholder meeting, and without appraisal rights.

B. Dissenter's Right To Appraisal- where a merger occurs, a shareholder has an interest in a completely different entity that what she had when the interest was purchased. As a result, the law will generally afford a shareholder who *dissents* from a merger the option to exit the investment for fair value. This is in the form of appraisal rights.

1. **When Available-** appraisal rights are typically *tied to voting rights* in that whenever a transaction has to be voted on to be approved, the *dissenting* shareholder will have judicial appraisal rights after attempts to resolve the conflict internally are exhausted. Statutes view on the measure of relief differ greatly:

a) *Delaware §262*- where a shareholder seeks determination of *fair value* by a court, he will receive whatever fair value is determined to be, whether it is *higher or lower* than what the shareholder received. Additionally, the shareholder may be liable for appraisal costs. *Delaware limits this right to mergers*.

b) *MBCA §13.02*- the MBCA allows a *broader remedy*. Shareholders will receive the difference between 'fair value' and what they received. (only can go up) the corporation have to pay for the appraisal (unless dissenters acted in bad faith or arbitrarily.) *MBCA allows for actions with the effect of merger*.

c) *Market Exception*- Delaware will **not** provide appraisal rights where the shares are publicly traded. (on the basis that the market already provides 'fair value') the MBCA has no market exception.

2. **De Facto Merger Doctrine-** what about when something looks like a merger, smells like a merger, and tastes like a merger but it's called something else (see VII.A.2-4). The De Facto Merger doctrine allows for "substance over form" providing shareholders the ability to seek a declaration by the court that a transaction was in fact a merger.

a) *Creates Voting and Appraisal Rights*- the court's decision that the transaction was in fact a merger creates the requirement of shareholder approval and appraisal rights associated with a statutory merger.

b) *Factors in Determining*- where accepted courts look to two factors in determining if a de facto merger has occurred:

1) **Actual merger must take place soon after initial transaction**

2) **Selling corporation must quick cease to exist**

c) *Rejected by Majority of Jurisdictions – Including Delaware*- a majority of states, including Corporate Deity Delaware- have rejected the de facto doctrine, either by cases or by statute.

d) *Modern Statutes (MBCA) Reduce Role*- modern statutes that provide voting and appraisal rights for transactions that are similar to mergers (stock exchanges, etc.) that have reduced the need for a de facto doctrine.

C. *Fiduciary Duty Remedies for Merger-* the merger decision like any other will always leave open the possibility of suits against director for breaching their fiduciary duty as directors, this is particularly a *concern* where the merger transaction is *dominated by a majority shareholder*. This suits often stem from *freeze-out* mergers where the minority interest is *eliminated in the transaction.* Most importantly, *where a violation of Fiduciary Duties is shown, a party is entitled to more than fair price appraisal damages.*

1. **Freeze Out Mergers-** or ‘cash out’ mergers were developed after statutory changes in the 1970 allowed *different consideration to be paid to different shareholders* in mergers; this allowed majority holders to give minority holders cash instead of equity in a new corporation- eliminating their interest. *As a result statutes were enacted banning mergers for the sole purpose of eliminating minority interests.*

2. **Legitimate Business Purposes Test-** some courts have adopted a legitimate business purpose test for determining if a merger was in fact a freeze out by the majority. *Defendant has the burden* of proving the merger was performed for a legitimate business purpose.

   a) *Entitle to More Than Fair Price*- if the test is failed, the prevailing party is eligible for recissory damages or the equitable recission of the merger if possible. If not possible party is to receive *present value* damages.

   b) *Rejected by Delaware*- note that Delaware uses the entire fairness standard discussed below and does not recognize the LBP Test.

3. **Delaware – Weisberger v. UOP-** Delaware Supreme court departed from appraisal as a sole form of relief for minority shareholders. The suit brought by minority shareholders must allege frausd misrepresentation, or other misconduct- specifically a *violation of fiduciary duty*. This will often be based on a charge of *self-dealing* and a breach of the duty of loyalty.

   a) *Appraisal = Ineffective Remedy*- Delaware recognized that appraisal was not an effective remedy where a fair price was the remedy. Essentially since the only remedy for appraisal was fair value – a company had every incentive to low ball and original offer since worst case scenario they have to pay a fair price as settlement.

   b) *Entire Fairness Review*- where the directors are unable to demonstrate that a cleansing transaction, the defendants will *have burden to prove entire fairness* of the transaction based on the following two-part test:

      1) **Fair Dealing-** key to fair dealing is *disclosure* of all relevant information (specifically the interests of the directors). And that consideration by the board and the shareholders was obtained in good faith.

2) **Fair Price-** all relevant factors must be considered in the determination of a fair price. This includes the *future prospects* of the stock of the company. Specifically, this represented an *abandonment of the block method* of valuation typically associated with appraisal.

c) *Cleansing Transaction*- the burden of proving the transaction was fair will be from switched to the defendant shareholder to the plaintiff minority to prove the transaction unfair where the defendant can show any of the following:

1) **Informed Majority of Minority Approval-** where the defendant can show that the minority *was adequately informed* and that a *majority of minority shareholders approved* the transaction.

2) **Independent Directors-** where the directors approving the transaction avoid interest through appointing an independent negotiation panel. (Getty)

4. **Appraisal as Exclusive Remedy – MBCA §13.02-** the MBCA provides that appraisal shall be the sole remedy for a dissenting shareholder *unless* the transaction is alleged by the shareholder to be *fraudulent or unlawful* with respect to the shareholders (i.e. violation of fiduciary duty) or the corporation. *No other remedy where only disagreement is price.*

D. Fiduciary Duty in 3rd Party Mergers- unlike prior discussions, 3rd party mergers (arm's length mergers) often do not involve self-dealing. As a result fiduciary duty breach are often based on a claim of a breach of due care rather than of loyalty. (Smith v. VanGorkom). Where no violation of fiduciary duty is alleged, the transaction will be *protected by the business judgment rule*.

1. **Appraisal as Exclusive Remedy** Under a due care context, directors are ***only*** *obligated that a fair price be paid* for the corporation, not necessarily the best possible deal, as a result *appraisal for fair value* is often the only remedy. Only expectancy damages required for remedy for a bad deal.

2. **Delaware- Entire Fairness Review –** *where a violation of the business judgment rule* is proved by the plaintiff, the transaction will be reviewed under the entire fairness test established under *Weisberger*. See above.

3. **Del. - Recissory Damages only where loyalty breach-** Delaware will allow recissory damages *only where there is a breach of the duty of loyalty by a director*. Since a breach of due care only doesn't result in shareholders losing to the benefit of directors, no recissory damages will be awarded. (Cinerama v. Technicolor)

E. Control Premiums- where a shareholder is transferring a controlling interest in a corporation, he will often to be able to charge a higher than market value for the shares because of the added power/benefits of having control (ability to elect directors, etc.). This is referred to as a *control premium*. Conflict may arise because a control premium is by not given to minority shareholders. As a general rule, *shareholders are allowed to charge a control premium* but a *director may* ***not*** *sell control of the corporation (i.e. a corporate office or asset).* This determination is obviously at issue where the director is the seller of the premium shares.

1. **Shareholder Role- Free to Negotiate-** where a director is 'wearing his shareholder hat', he may freely negotiate for the sale of his shares at premium

without informing minority shareholders. This based on the fact that there is *no fiduciary duty between shareholders*. (Tyron v. Smith)

a) *Must Act in Good Faith*- director do not have to inform minority shareholders, but the cannot commit fraud or misrepresentation as part of the sale of control.

b) *Unreasonably High Premium May = Bad Faith*- where the premium is unreasonably high- director may have duty not to sell or investigate on the basis that the purchaser may intend to commit fraud on the corporation (looting).

2. **Director Role- Must Not Sell Corporate Assets-** the director may sell his shares, however the direct selling of corporate power other than the powers inherent as a majority shareholder. If a corporate power or opportunity is transferred with the shares for a premium (i.e. director receives disproportionate proceeds), the director may be deemed to be wearing his 'director hat' rather than shareholder- making the sale invalid. (Perlman v. Feldman)

3. **Cannot Sell Offices-** the selling of a corporate director seat or office directly is prohibited.

a) *Resign Linked Purchase – OK*- however, if an agreement to resign from an office is included as part of a transfer of control has withstood legal challenges.

b) *Concern Where Controlling Interest is Not Transferred*- this mainly a concern where a large block is transferred at a premium but is not enough to create a controlling interest in the purchaser.

VIII. Hostile Control Transfers- Takeovers-

mergers take place where the board of a corporation decides to sellout/combine with another corporation. However, were the board decides it doesn't want to sell- the hostile takeover is born. Takeovers may be motivated by a raiders belief he can manage a company more effectively or simply belief that its current assets are under valued and wants to sell them in itty bitty peices.

A. *Overview -*

These takeovers are de facto mergers executed through the approval of shareholders rather than the board but shareholders 'vote' by selling their shares. The board may act to prevent the sale where it is in the best interests of the corporation, but may not act solely to keep in control of the corporation (entrenchment). The main area of dispute in the area is between the raiding party and the target board. Specifically, the raiding party will challenge actions of the board in preventing the takeover as an entrenchment action and breach of fiduciary duty.

1. **Direct Dealing with Shareholders-** unlike traditional mergers, takeovers are often executed through direct dealing with the shareholders and circumventing the board of directors. This area is typically *more regulated by federal rather than state law*. This is done in one of two ways:

a) *Tender Offer*- a raider may offer to *purchase the shares* of the shareholders a premium over market value in order to replace the board of directors. In order to be in accord with federal law, tender offers must:

1) **Be Disclosed-** the terms of the offer must be disclosed as to give the opposing board an opportunity to react

2) **Must be Open for 20 days-** this is to prevent coercion by offering a 'limited time only' offer.

3) **Must pay everyone same price-** to prevent the coercion of front-end loaded offers, all persons offering share under the tender offer must be paid the same compensation per share. (pro rata offer for 2 tiers)

b) *Proxy Fight*- the raider may seek to *control the votes* of majority of the shareholders. In order to take control by a proxy fight a raider may seek to use a majority of votes to *Replace Directors* or *Cause a Merger* with the raider corporation. Proxy fights may also be difficult-

1) **Shareholder Passivity-** dissatisfied shareholders typically sell their shares, rather than waiting for proxy contest- as a result most shareholders probably favor current management.

2) **No Reimbursement-** where management gets to use the corporate treasury, the raider must bankroll his own show.

2. **Prisoner Dilemmas-** these occur where a shareholder may be tempted to take the front end of a loaded tender offer to avoid the back end by not accepting the tender offer. These are often considered coercive and a reason for not allowing front loaded offers.

3. **Winner's Curse-** the winner's curse is that a company cost almost always costs more to acquire than it is really worth because the bidding war.

4. **Terms of Hostile Takeovers-** the world of hostile takeovers is replete with quaint medieval terms to describe, awe ain't it cute:

a) *Bust-Up Merger*- a bust up merger is one where the raider is seeking to dissect the target in juicy morsels to be sold off to the highest bidder.

b) *Raider v. Target*- the raider is the party seeking to acquire the target.

c) *Arbitrageurs* – are persons who don't make anything and suck the life out of others—they have no friends and are generally arrogant bastards.

d) *Front-end Loaded Offers*- these offers give more money to shareholders who sell there shares first to a raiders. They are very coercive because shareholders may sell to avoid being screwed by the back end.

e) *Golden Parachutes* – these are lucrative compensation packages paid to directors of the target to shut their pie-holes and allow/accept a hostile takeover. Tin parachutes are the same thing paid to high level management.

B. Defensive Measures- the board either acting unilaterally or acting with shareholders may adopt a number of tactics to attempt to prevent the acquisition of control by a raider:

1. **Friendly Raider- White Knight-** is a 3rd party who is friendly to management who may step in and attempt to acquire a controlling interest rather than the

raider. A white squire is a person who attempts to do this without a controlling interest.

2. **Board Defensive Provisions-** the following are defensive tactics that may be adopted by the board to defend against a hostile takeover threat. There use is subject to judicial review. (XIII.B-C)

a) *Lock-ups/Termination Fees*- these are agreements that may be entered into with a white knight in order to prevent a merger. They generally grant favorable terms (stock options, asset sale) to white night that would have to be honored by an acquiring raider as to dissuade interest.

b) *Poison Pills*- these are established by boards to allow existing shareholders to purchase newly issued shares for a bargain price upon the occurrence of an event. They are structured to avoid allowing the raider to be part of the purchase-effectively doubling or tripling the cost of the merger.

1) **Flip-in Plans-** this allows for the bargain purchase of the existing companies shares.

2) **Flip-over Plans-** this type allows for the bargain purchase in any corporation the target is merger with—i.e. the surviving corporation of the raider. (plan is a liability of target that is transferred in merger)

3) **Dead Hand Poison Pill-** this plan may be used to prevent take-over by merger through proxy fight by allowing *only continuing directors* the option of redeeming the pill.

c) *Stock Repurchase-(Self Tender Offer)*- the board may enact a repurchase plan whereby the corporation requires its own shares preventing their purchase by the raider. Del. §160 allow repurchase.

1) **Greenmail-** derived from blackmail, this is were a raider sells shares in a target back to the target for a premium price to make the bad man stop!

2) **Selective Repurchase Agreements-** the corporation may also only offer to repurchase the shares of parties other than the raider (preventing greenmail) (questionably legal)

3. **Shark Repellant/Porcupine Provisions-** these are provisions that are put in place to prevent attempts by a raider through shareholder review rather than board action.

   a) *Super-majority Amendments*- this would require mergers, etc. to be approved by more than simple majority (i.e. 2/3 vote).

   b) *Fair Price Amendments*- a provision may allow for waiving of the super-majority provision where the offer of merger is cash and 'fair' according to values/formulas established by the clause.

   c) *Staggered Board Amendments*- creating a classified board to limit the number of directors that could be elected by a raider is also a popular tactic.

   d) *Dual Class Capitalization*- agreement were formally adopted that shifted the number of votes that each share could have (some would have more than one, others less), this has been banned by the SEC rules.

C. ***Judicial Review of Tender Offers & Defenses-*** where the board of the target corporation takes defensive action in an attempt to prevent acquisition by raider, such actions must be taken out of a good faith believe that the raider will do harm to the corporation and not for the purpose of entrenching the current board in the control positions. These suits often arise from the raider (or another shareholder who wants the raider to win) brings action as a shareholder against the target for breach of fiduciary duty based on a claim of entrenchment.

1. **Dominate Motive Test-** defensive action would be allowed where board could point to a *"reasonable investigation" and good faith belief* that a plausible business purpose for the defense to rebut claims of entrenchment. Where the test is met, the decision will be subject to the business judgement rule for review. This test has since met with disfavor since it all but removes defensive strategies from review on the basis of fiduciary duty. (Cheff v. Mathes)

2. **Enhanced Scrutiny – *Unocal* Doctrine-** Delaware developed a intermediate level of scrutiny based on a worry of board self-interest leading to entrenchment. It is combination of the dominate purpose test but requiring the *proportionality* of the defensive measure. (Unocal v. Mesa Petroleum)

   a) *Two-Part Test*- where the defensive tactic is adopted by the board in order to be subject to the business judgment rule, the board must prove the following:

      1) **Reasonable Perception of Threat-** based on the dominate purpose test the board must have a belief that bid poses a threat to the value of the company (i.e. would harm shareholders).

      2) **Reasonable Response to Threat-** that the action taken was a reasonable response to the posed threat. This is the *proportionality test.*

   b) *Refining the* Unocal *Doctrine* (now how's that for a Levin Pun)- subsequent decisions of the court clarified these duties:

      1) **May Defend Deal-** *absent a triggering of Revlon duties*, discussed infra, there is no requirement that the directors take the best deal- as a result, they may

undertake defensive measures (lock-ups, cancellation fees, etc.) *to protect a proposed merger in accordance with the* Unocal *test* once it has begun. (here there was no break-up of company-only a merger) (Paramount v. Time)

2) **May Take Long-term Over Short Term-** while director's goal should be to maximize shareholder value- their decision to follow a long term plan rather than realize short term gains will not be disturbed by the court-subject to the business judgment rule. (Paramount v. Time).

c) *Rejected By Some States*- some states have rejected the notion of heightened scrutiny and continued to apply the predominate purpose test.

3. **Poison Pills-** this defensive tactic significantly increases the potential cost of takeover bid and may be adopted before any bid begins (shark repellant). The pill effectively makes any take-over without the board's approval. The plan involves questionable board powers, but where ever a state has held the plan was outside of the board's a statute was enacted by the state to allow the plan.

a) *How it works-* the board issues a *right* (pursuant to Del. §157) that allows the shareholder to exercise the right. The right is essentially worthless (allows purchase of preferred share for way above market), however on the occurrence of some event (i.e. corporation merges with corporation that owns 20% or more of it), the *right* allows for the *bargain* purchase of shares either in the target (further diluting ownership; *flip-in*) or surviving corporation (*flip-over*) to *everyone but the raider*. Before the occurrence of the event, the board can *redeem* the option for *nominal consideration*.

b) *Requires Negotiation With Board*- The pill's primary effect is making up for law short fall- *allows director approval* of 'de facto' merger that is take over. Because the *board has the discretion to* ***redeem*** *the poison pill* making it possible for a raider to purchase without triggering the pill.

c) *Pass Unocal Test*- the court has upheld these rights under the Unocal test (1. reasonable reaction to 2. potential threat) because of the low impact on the target corporation, *even where no raider threat is identified.* (Moran v. Household Int'l.)

d) *Passing Revlon Test*- where directors become subject to the *Revlon* rule (infra) they may be compelled to redeem the poison pill for any possible purchaser (cannot tell one suitor it will redeem and not another).

4. **Auctioning Duty – The *Revlon* Rule-** while take-over defenses are normally governed by the Unocal test, however *once directors* ***offer*** *the company for sale, or recognize that sale is* ***inevitable*** *they must endeavor to get the* ***best price*** for shareholders. Essentially, this means a director must treat all bids equally and cannot employ defensive measures against any bidder (lock-ups, cancellation fees, etc). (Revlon v. MacAndrews).

a) *Triggering the* Revlon *Duty*- in *Paramount v. Time*, the court refined the triggering of Revlon duties to two distinct circumstances:

1) **Company Decides to Sell Self-** (unilateral trigger)

2) **Alternative Break-Up Transaction Sought-** where a corporation “abandons its long-term strategy and seeks an alternative transaction also involving he breakup of the company”, Revlon duties will also attach. (hostile trigger).

b) *Control Transfer = Trigger* Revlon *Duties*- where the purposed merger would constitute a transfer of control (here from at large to single corp. [as opposed to Time Warner were in market on both sides of transaction])- entitling the shareholders to a control premium they cannot receive from a later transaction. (Paramount v. QVC)

D. *Judicial Review of Voting Contests Defenses- "Proxy Fights"-* a fight for control of a company may also be waged by proxy fight instead of by tender offer. Different standards of review apply in this situation since the change in management is effected the *exercise of franchise rights* rather than purchase of shares. This is based on a deep reverence for the shareholder franchise right a key to concept of corporate governance.

1. **Cannot Subvert Franchise Rights-** management will not be allowed to use corporate machinery (control of meeting date, location) to entrench itself in its office. If power that are normally at discretion of the board are used *with the intent to inhibit the franchise power* they will be invalid. (Schnell v. Chris-Craft).

2. **Good Faith Motive Irrelevant-** even if such an action is taken in the good faith that protection from the shareholder is in the best interests of the corporation, if the board acted with *primary purpose* of interfering with franchise rights, the action will be invalid. (court stops short of a per se invalidity rule) (Blasius v. Atlas)

3. **Unocal Standard of Review- Viability of Proxy Contest-** under the Unocal test, Delaware *may allow some dilution of the franchise rights through defensive measures* under as a 'reasonable response' to threat posed. (Unitrin v. American General)

   a) *Subversion of Franchise = disproportionate*- as concluded in Schnell and Blasius, the purposeful subversion of the franchise will not be allowed.

   b) *Proxy Fight Viable = reasonable*- even where a defensive measure has the effect of diluting the voting rights of a shareholder (ie super-majority measure or poison pill share issuance) as long as the shareholders may still exercise control of the corporation through a proxy fight, the measure may be allowed. (here AG can still theoretically achieve control through proxy fight)

   c) *Unocal Test Seems Easily Meet*- defensive measures seem to easily meet the test of Unocal (reasonable response to threat) in all but the most extreme circumstances.

IX. Federal Regulation of Corporations- Disclosure- up to this point, we have been dealing exclusively with state regulation of corporations. Recent years have seen the federal government become more involved in the regulation of corporations. The federal government has specifically attempted to *leave aspects of corporate governance to the states*, all federal regulation is based on a desire for *complete **disclosure** of information to insure the informed exercise of franchise rights by shareholders*. If the court views the rule as infringing to much on state governance over corporations, rather than regulating the disclosure of information, it may invalidate the rule. (Business Roundtable v. SEC)

A. *Rule 14(a)9- False or Misleading Proxy Statements-* SEC rule 14(a) regulates the manner in which the proxies of shareholders may be sought, as you may imagine in naturally contains a general anti-fraud provision (14(a)9) prohibiting material misrepresentations or omissions. Federalism concerns exist the extent that violation of the rule also violate state laws (fiduciary duty).

1. **Express Federal Cause of Action-** the rule also contains an express cause of action for the federal government against offending statements for both civil and criminal penalties.

2. **Implied Individual Cause of Action-** the court has also determined that an individual cause of action *for damages* was implied in the adoption of the rule. This action was seen as necessary to achieve the statutes goals and may be brought directly or in a derivative suit against the corporation (where it is the defendant). (Case v. Borak)

3. **Necessary Elements-** in order to maintain a claim under 14(a)9 a party must allege the following elements in order to prove *defendants action harmed plaintiff*:

    a) *Materiality*- a misrepresentation or omission will be considered to be material where *a reasonable shareholder would have considered it important in determining how to vote.* A threshold lower than this would encourage to many frivolous claims.

    b) *Causation*- a court will have a rebutable presumption that plaintiff shareholder relied on the misstatement, see infra IX.A.4.

    c) *Scienter*- the Supreme court has not ruled on an intent requirement for 14(a)9. However some courts seem to establish that mere negligence is enough.

    d) *Damages*- a successful claim may be entitle to damages, injunctive relief and even in extreme cases the recission of a transaction.

4. **Causal Requirements- Presumption of Affect-** the plaintiff may have difficulty proving *reliance on the statement/omission in voting* by himself or others. Additionally, the requirement of personal reliance would render class actions all but impossible. As a result the court has adopted a plaintiff friendly *presumption* that the misrepresentation affected the outcome.

    a) *Don't Need to 'Have Been Duped' Personally*- even if the plaintiff shareholder did not tender his proxy on the basis of the misrepresentation, he will still have standing to sue on the basis that *other shareholders may have been misled*. (Mills v. Auto-Lite)

    b) *Don't Need to Show Vote Actually Affected*- because of this difficulty a material defect will be ***presumed to have affected the outcome*** of the vote where proxies were necessary to the completion of the transaction (*essentail link)*. (Mills v. Auto-Lite)

    c) *Not Available Where Majority Interest = Assured Approval* - however, where the majority can show that *the majority vote* ***alone*** *was sufficient for approval* (ie no other proxies were needed = *no essential link*). This is based on the minorities inability to affect the outcome regardless of any misrepresentation = would allow to many frivolous suits. (Virginia Bankshares)

    d) *Allowed Regardless of Majority Where State Remedy Lost*- the second circuit quickly qualified the ruling in VA Bank by allowing a cause of action where the approval of by minority shareholders based on the misrepresentation *precluded state remedies.* (appraisal rights, approval = cleansing, etc.) (Wilson v. Great American).

B. ***Rule 10(b)5-*** this rule serves as a *catch-all fraud provision* for securities transactions. The language prohibits "any act…which operates or would operate as a fraud or deceit upon any person, *in connection with the purchase or sale of any security*." (sub. C). It is also presumed to have created an *implied private cause of action*. As long as federal cause of action is based on fraud in transactions, the availability of a state remedy will **not** necessarily preclude a federal remedy.

1. **Standing Requirements-** in order to be able to bring a cause of action under 10(b)5 the plaintiff must allege fraud *in connection with the purchase or sale of securities.*

a) *Must Actually Have a Transaction*- the most stringent requirement of 10(b)5 is that the plaintiff <u>actually purchased or sold securities</u>, a breach of fiduciary duty alone will be insufficient (leave to state law remedy) (Birnbaum v. Newport Steel, Blue Chip v. Manor Drug) Specifically, this restriction *would exclude the following 3 groups* who may have valid claims of harm:

1) **Would Have Bought-** persons who claim absent the misrepresentation, they would have bought shares (too speculative, unreliable evidence of intent).

2) **Who Didn't Sell-** persons who claim that they would have sold their shares, except for the misrepresentation. (would have state remedy for Fiduciary Breech anyway)

3) **Current Shareholders-** current shareholders who suffered a loss in value as a result of the misrepresentation. (They have a state remedy for fiduciary breach anyway, allowing them a federal action would completely supplant state role.)

b) *Broad Definition of 'In Connection with'*- the fraud must be connected with the transaction of securities. However, this does require that the fraud be by one party of transaction against another, but the security transaction may be part of a bigger scheme (here agent commits fraud on principle through transaction with 3rd party). (Banker's Life)

c) *Must Have Deception*- in order to have a claim of fraud an allegation of an omission or misrepresentation must be made. *A violation of fiduciary duty alone is* ***insufficient*** to maintain a 10b-5 cause of action. Again, this is based on a deference to state laws on internal governance matters. (Santa Fe v. Green)

1) **Where Misrepresentation & Internal Management may have 10b-5 action-** the existence of state remedy doesn't necessarily preclude federal. Where corporate mismanagement is alleged along with a misrepresentation associated with a securities transaction a 10b-5 action may be created. (Goldberg v. Meridor)

2. **Common Law Fraud Elements-** the burden of proof for 10(b)5 draws from the elements of common law fraud from which the statute itself is derived. In order to maintain an action the following elements must be present and are explained in detail subsequently:

   a) *Misrepresentation/Omission*- a party must make an actual misrepresentation or omission, violation of a fiduciary alone is insufficent.

   b) *Material Fact*- the fact involved must be material- meaning one *that a reasonable investor would want to be aware of in deciding to trade*.

   c) *Scienter*- some level of intent of action must be required, often a standard of *recklessness* is applied, although the Supreme Court has not spoken with definite force.

   d) *Reliance*- the plaintiff must show reliance on the misrepresentation or omission, this burden is eased by a *presumption of reliance*.

   e) *Causation*- this is associated strongly with reliance, essentially the plaintiff must demonstrate that the misrepresentation affected the value of the stock.

   f) *Measure of Recovery*- the plaintiff should be recover the value difference between the misevaluation of the stock caused by the misrepresentation and the true value.

3. **Material Fact/Omission-** a plaintiff must illustrate that the omission or misrepresentation was material. Material is considered to be present where *substantial likelihood a reasonable shareholder would consider it important in deciding how to vote (buy/sell).* It can roughly be determined by a pseudo-math formula of (probability * magnitude). (Basic v. Levinson)

   a) *Effect of Silence*- except as noted below, silence or a 'no comment' response by a corporation will *not* be considered fraud under 10b-5 because there is no misrepresentation.

   b) *Silence Where Duty to Speak*- however, where a duty to speak is created, failure to disclose will result in an omission that will be considered fraud.

      1) **Material Information-** once information is considered to be material, there is duty to disclose the information.

      2) **Where Past Statements Become Misleading-** where past statements that were true when they were made *become misleading* because of subsequent events, an affirmative duty to *correct the statements* may be created. Statements that are *merely false are not enough* to constitute fraud, *must become misleading* (in re Time Warner).

c) *Safe Harbor Rule*- in certain situations where a corporation issues statements *in good faith* (dividend & revenue forecasts) a corporation can insulate itself from potential 10b-5 liability by also *issuing cautionary language*. This has the effect of rendering the 'misstatements' immaterial and therefore unactionable under 10b-5.

4. **Scienter-** no clear standard exists as to what mental state is necessary in to incur liability under 10b-5. However, the Supreme Court made clear that *more than negligence is required*. The circuits have been spilt as to if that means *intentional* conduct alone is prohibited, though most allow that *recklessness* alone would be suffice to incur liability. (Ernst & Ernst v. Hochfelder).

5. **Reliance & Causation-** as in common law fraud, the plaintiff must show a causal link between the action of the defendant and his injury. In fraud, that link is based on reliance on the fraudulent act. In part because of the difficulties involved in showing personal reliance on the misstatement (also would effectively bar class action), the courts have adopted a *rebuttable presumption of reliance* on fraud. (Basic v. Levinson, again).

a) *Presumption of Reliance-fraud on the market theory*- the presumption of reliance was established by Supreme Court in *Basic*, and is based on a *fraud on the market theory* – that is any fraud committed by the defendants should be *reflected in the market valuation* of the stock and plaintiff is *assumed to rely on the integrity of the market price*.

1) **Based on Perfect Info Market-** the fraud on the market theory is based on a belief that *any available information is essentially instantaneously reflected in the market valuation* of the stock.

2) **Refutable by Showing-** the presumption of reliance may be refuted by the defendant by showing that either:

⇒ Would Have Traded Anyway- that absent the misrepresentation or omission that the plaintiff would have transacted anyway. (i.e. no reliance)

⇒ Did not affect market price- the defendant may also show that the misrepresentation cause no noticeable effect on the market price of the security. (i.e. no causation)

b) *Questionably Good Law*- the decision in *Basic* may be somewhat shaky in light of the current composition of the court. 3 of the 4 majority members are no longer on the court; also Rehnquist, Scalia, and Kennedy all recussed themselves from consideration of *Basic*.

c) *Concurrence*- the concurrence in *Basis* (White & O'Connor), wouldn't have adopted the fraud on the market theory, specifically because they claim it had a poor basis (they think most people trade because they believe market price is incorrect rather than correct) and that such a theory amounts to a policy change implemented by the court rather than Congress (hello Lockner).

6. **Measure of Recovery-** A plaintiff's proper recovery is the difference between the true value of the stock and the valuation caused as a result of the misrepresentation. This becomes difficult where significant time passes between

the misrepresentation and its discovery- i.e. determining what change in price was due to extrinsic events and what was due to fraud. (Green v. Occidental)

a) *Out of Pocket v. Recissory*- an issue exists as to whether out out-of-pocket measure should be used or a recission measure. Out of pocket is based on the damages incurred by the plaintiff, while recission is based on the 'undoing' of the transaction.

1) **Recissory Inappropriate-** recession may be inappropriate because such a remedy is based on *unjust enrichment to the defendant*, most cases, the plaintiff transacted with market and the defendant corporation never received any unjust enrichment from the fraud.

2) **Where Kept Stock - Ideal Measure = Difference Between Market Price and Value @ time of misstatement -** the ideal form of recover in out-of-pocket terms- i.e. true damages of the plaintiff would be the difference in price paid and actual value at the time of the fraudulent statement or omission.

3) **Where Sold Stock Before Disclosure = No Recovery** – they sold before the disclosure they did not suffer any damage as result of the misrepresentation and would not recover under out of pocket.

4) **Longer Time Before Disclosure = Hazards-** if the difference between actual price at the time of the misrepresentation and when it is revealed is used, the longer the period between the events, the *more likely price was influenced by extrinsic factors.*

⇒ As a result, plaintiff may be compensated for all loses rather than just those that are from the fraud of the defendant.

b) *Frequently Combined by Court*- unfortunately, these damages are frequently combined in a confusing fashion by the court, all though recission may be used where the transaction actually occurred between the plaintiff and the defendant.

c) *Congressional Limits* – recently limits were enacted regarding recovery for 10b-5 fraud

1) **Limits on Attorneys Fees-** frequently the main beneficiaries in 10b-5 actions are the attorneys in class actions rather the individual investors who may have suffered small losses. As a result, in order to reduce the number of nuisance suits filed by opportunistic attorneys limits were placed on who may represent and for how much. (led may req. by largest stakeholder, fee limits)

2) **Limits on Damages-** damages for a 10b-5 action for fraud may not exceed the difference between the purchase or sale price and the mean trading price of the security during the 90 day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated.

X. Federal Regulation - Insider Trading-

insider trading occurs where a person is privy to material information before the general public, and uses that information to transact in the security and gain a profit when the information is disclosed and incorporated by the market (i.e. beating the market). Issue arise over *when the use of information constitutes fraud*. Specifically because fraud is generally based on a *fiduciary duty* and issues concerning *where duties are owed and what constitutes a breach*. Also, these duties are based on *state law*, which raises issues of *federalism*.

A. Overview of Insider Trading- insider trading constitutes a unique form of fraud because there is often no direct 'victim' of the fraudulent transaction. Liability is often based of a violation of a *fiduciary duty* resulting in *unjust enrichment* of the defendant. The federalization of such offences is based on the *goal of security regulation to **equal access** to information.*

1. **Common Law Basis-** insider trading prohibitions is base on the common law prohibition against a fiduciary using information privy to her as a fiduciary for her own personal gain. Essentially the action was to *punish* the fiduciary as much as to compensate the principal.

2. **Federalism Concerns-** insider trading often walks the line of interference in the state realm of governing fiduciary duty because fraud as it is defined in most instances based on a violation of fiduciary duty.

3. **Harms of Insider Trading-** while like speeding, insider trading might seem like a victimless crime, there are concerns of the harms that might occur if inside trading was not regulated:

   a) *Delay Disclosure*- if insiders were allowed to hold back information and to trade on it, they would have every incentive to delay disclosure of the material information.

   b) *Corporate Injury*- the price of mergers and take-over of companies could be adversely affected by insiders trading in advance of a bid.

   c) *Erode Confidence in Markets*- perhaps most importantly, the delay of information would erode confidence in the market price as an accurate valuation of the stocks value- leading to market instability.

4. **Types of Insider Trading-** Insider trading may be classified into different categories based on the relationship of the trader to the company of the traded shares.

   a) *Traditional*- this is the standard insider action where the corporate insider uses material information to gain an advantage in trading shares *of the company where he is an insider.*

   b) *Misappropriation*- this is a theory of insider trading where the insider *uses information from his role as a insider* in one corporation to gain an advantage trading shares *of another corporation*.

   c) *Tippee Liability*- this is where a person *receives material information from an insider* to gain an advantage in trading shares of a corporation.

   d) *Constructive/Temporary Insiders*- these are persons who are not technical insiders in a corporation but become insider because they are trusted with material information as party of there duties and are therefore bound by a fiduciary duty. (lawyers, accountants, consultants, analysts)

e) *14e-3- Tender Offers*- this rule provides are blanket prohibition based on trading based on any material knowledge of a tender offer.

5. **Private Cause of Action-** as in other actions under 10b-5, there has been to determined to be a implied private cause of action for contemporaneous traders.

B. *10B-5 as a Regulation of Insider Trading-* it slices, dices and purees! what doesn't 10b-5 do! This blanket anti-fraud provision is also used to regulate insider trading.

1. **Traditional Liability- SEC v. Texas Gulf Sulfur-** the 2nd circuit created broad liability for insider trading. The case adopted a sweeping duty of any person in possession of material information was under a duty to *disclose information to the public* or *abstain from trading* in the security.

a) *Material Information*- material information was again defined as information "to which a reasonable man would attach importance in determining his choice of action." (probability * magnitude)

b) *Disclose or Abstain Rule*- the case adopted the disclose or abstain rule from *Cady*, the rule requires that a person in possession of material inside information must either <u>disclose</u> it to the investing public or if he <u>is disable from disclosing by a duty</u> or <u>chooses not to </u>he *must abstain from trading*.

c) *Insiders Can Act After Dissemination*- insider may trade on information once it has been effectively disseminated. This is not necessarily after a press conference, must appear over widely circulated media.

2. **Limiting Liability- Duty to Disclose- Chiarella v. US-** the court limited liability for insider trading under the rule. Specifically, *liability would not arise* where a person traded on material information the was not available to the public, but the person had *no duty to disclose the information* and failed ot disclose prior to trading. This greatly narrowed the potential liability for insider trading.

a) *No Duty to Speak = No Fraud*- here the defendant had no conceivable duty to the target corporations whose securities he traded in, as a result, he had no duty to *disclose or abstain*.

b) *Decided Different Today*- note that Chiarella could probably be held liable today certainly under the ex post facto rule 14e-3, and probably under the misappropriation theory adopted by *O'Haggen, infra*.

3. **Tipper/Tippee Liability- Dirks v. SEC-** tippee liability is based on where the insider himself does not trade (the tipper) but disclose information to another individual who acts on it (the tippee). The courts have held in some situations hold a tippee liable *derivative from the duty of the tipper*.

a) *Tippee-Assumes Duty of Insider Where Aware of Duty*- the court imposes a standard of tippee liability *derivative from the tipper* where a person receives information and the following are met

1) **Insider Breached Fiduciary Duty-** where the disclosure of the information was in fact a breach of the insider's fiduciary duty. (see infra)

2) **Knew or Should Have Known of Breach-** the tippee had constructive or actual knowledge that the disclosure of the information was in fact a breach of the tipper's duty.

b) *Tipper Expect Personal Benefit = Breach of Duty*- a tippor has breach his fiduciary duty where he expected to receive some personal benefit either indirectly or directly from the transmission of the information to a tippee. The definition of benefit is very broad.

4. **Misappropriation- US v. O'Haggen-** the Supreme court upheld a misappropriation theory of insider trading. This is where a person *uses inside information from one source to trade in the securities of another*.

a) *Based on Duty to Source*- this liability is base on a violation of the fiduciary duty of the source of the information—specifically the fact that had the source known that the trader would have acted on the information, it would not have be disclosed him. Fiduciary-turned-trader - *Liability is based on failure to disclose an intent to trade to the source.*

b) *Broadened Potential Liability*- the potential here is for much broader applications of insider liability- essentially liability could be extended to anyone who is *entrusted with information*.

C. 14e-3 – Tender Offers- after the Court's decision in *Chiarella*, the SEC acted to prevent future such actions by adopting a blanket rule the prevent trading based on *undisclosed material information of a pending tender offer*.

1. **Valid Regulation of SEC-** the rule has been held valid by the court as a legal use of the SEC's power. The court noted that such a rule was consistent with Congress's desire to insure equal access to information.

2. **Creates New Duty-** Most importantly, the rule imposes its own duty. No fiduciary duty is required, a party is regulated based on its possession of the information and not based on a duty to any corporation.

3. **Disclose or Abstain Rule-** the rule is interpreted to have the same disclose or abstain rule that regulates 10b-5.