**Corporate Finance Outline**

1. **INTRODUCTION TO #ACCOUNTING**

**Overview of Terms**

* **Historical Value Approach (cost principle):** for accounting books, take cost at which asset was purchased. Often inaccurate, especially with particular assets (e.g. cars, stocks).
  + Why standard feature? Creates consistency and allows for standardization (facilitates comparison). If you vary 🡪 transparency is important. Also, reduces accounting costs (not perfect, but good enough and easy to produce).
  + Numbers on balance sheet will thus NOT match up to FMV.
* **Accrual Method Accounting:** Tied to obligations 🡪 when money is *earned*, NOT received. Not when cash leaves or is brought in.
  + Some manipulation occurs, but *less than* in cash method accounting. More difficult to manipulate (harder for management to move $$ around).
* **Cash Method Accounting:** Tied to actual cash flow.
  + Problem: big fear of manipulation 🡪 accounting fraud. E.g. big incentive to have cash come in at certain times to manipulate results. Messes with market signals.
* **Entity Reporting:**
  + Concern that ppl might try to hide losses by moving them to subsidiaries (p. 8 on consolidated concerns—supposed to address this problem).
* **Accounting Conservatism:** understatement will do less harm. Presumption to take the lower of two possible numbers.
  + May or not be accurate, but designed to deal with management incentives, especially in settings relating to compensation.
  + External v. internal accounting purposes 🡪 bonus calculation v. investor info.
* **Balance Sheet: *Assets = liabilities + equity***. BOTH sides have to balance. ***Static document*** 🡪 “snapshot” or moment in time.
  + Want standardization.
  + **Assets:** Things owed by a business. Generally classified as current (converted into cash within a year) or non-current.
  + **Liabilities:** obligations to provide economic benefits to a third party in the future.
* **Equity:** ownership interest. *Equity = assets – liabilities*. Can be divided in different ways (preferred v. common stock) and each may have different concerns.
  + **Par Value:** value that is assigned to the stock on issuance. Whether it has legal effect depends on the jurisdiction. In Delaware, it does.
    - There to protect creditors. Creditors and shareholders have different perception on dividends. For certain jurisdictions, corporation is prevented from issuing dividends ***below the aggregate par value***. BUT issue with valuation 🡪 stock does not need to be sold at par value.
    - Creditors and shareholders will have varying risk preferences. Creditors = low risk when business is doing poorly (creditors get paid first, so want to ensure there is enough money for themselves; if there is little leftover for shareholders, will want business will take risks to increase value).
* **Intangibles:** patents, brands, IP. Has unique accounting problems.
  + **Goodwill:**  only has an accounting value when purchasing an asset above FMV. Should be suspicious if these numbers *actually represent* current value.
* **Depreciation:** assets wearing out or just becoming obsolete. Technique of deprecation is somewhat artificial (relatively fixed, numerical process).
* **GAAP:** a variety of sources that give guidelines. Often required by law (e.g. SEC filings).
* **Income Statement:** Like historical novel—begins on first day of fiscal year and tells reader how balance sheet came to look the way it does by end of year. Link between two balance sheets.

**Cases**

* [Defer To Accountants] *Bolt v. Merrimack Pharmaceuticals* (9th Cir)(Bolt wanted shares redeemed according to GAAP accounting sheet. Articles of Inc. built GAAP into redemption rights—can redeem if “net worth” over $5m “as shown on the balance sheet.” M argued “net worth” doesn’t mean equity, but refers only to the section dealing with preferred stock [grouped separately]. Q: can Bolt redeem?)
  + **Yes**. “Net worth” should be given its well-established meaning. Court will defer to accounting professionals (here, PWC) on how to apply GAAP UNLESS they are ***clearly wrong***. Judges aren’t really in a position to second-guess accounting.
    - **Redemption Right:** under certain circumstances, you can force company to buy your shares. Not a feature in ordinary common stock, but common in preferred shares.
    - Policy concern about institutional competence, bias, and predictability.
  + And regulation S-X says PS should be separate, but it doesn’t say that it is a liability (doesn’t apply here). International accounting standards are too low in the GAAP hierarchy to be relevant. Are these shares debt? These shares are hybrid: can vote and elect board members (like equity), but have redemption rights, liquidation preference, and restrictions (like debt) 🡪 in between. Court ultimately defers (again) to PWC.
  + AG: this case is an intro to what preferred stock can look like. E.g. special voting rights to vote on one director (buys influence, allows to monitor), liquidation preference, dividend of 4%, conversion/redemption rights.
    - Can dilute someone’s economic or voting interest.
* [#Due Diligence Defense] *In re Software Tookworks, Inc.* (9th Cir) (Ps are going after underwriters. Stock issued was overvalued, and value plummeted shortly after issuance. Deloitte did accounting, and underwriters argued they reasonably relied on accountants. P argued there was a bunch of red flags. Issue: was summary judgment warranted?)
  + **Partially.** For backdated contracts, D conducted reasonable diligence. Expertised version, and followed up on red flags (court gives deference 🡪 allowed to rely on accountants). For SEC letter, question of material fact 🡪 not clear if there was reasonable investigation. Fact finder could conclude that D had access to enough info to uncover truth.
    - Lawyers *do* also have reasonable care defenses, but expected to know more than other parties. Amount of investigation ***highly dependent on context*** (e.g. if contract issues play on accounting statements).
    - **Consignment contract:** sale goods to third party, but if they don’t sale them, they don’t have to buy them. Like ability to return.
  + **Section 10-b:** covers fraud in connection with purchase/sell of securities. “Fraud” often tracks common law, but may include scienter element.
  + [From Corporations] **§ 11:** Concerns with false registration statement. **§ 12:** Concerns false statements in prospectus.
    - 11 & 12 are more plaintiff friendly 🡪 *doesn’t have to show scienter*. BUT D has **“due diligence defense.”** *“Reasonable investigation”* under 11 or *“reasonable care”* under 12 (very similar ideas). A lot of these cases come down to accounting fraud problems.
    - Can sue (1) every person who signed registration statement; (2) director of the issuer; (3) every expert whose profession gives authority to a statement and prepared/certified registration statement (usually accountant); (5) every underwriter.
    - **Due Diligence Defense:** anyone who is NOT the issuer can escape liability if person, after *reasonable investigation*, had *reasonable ground* to believe (and did believe) that registration statements were true and there was no material omission.
    - In registration statement, there is expertised version and non-expertised version.
      * *Non-expertised version (e.g. lawyer-written part):* Experts have no liability (11[a][4]). Non-experts not liable if after ***reasonable investigation*** believed statements were true 🡪 **“due diligence defense”**(11[b][3][A]).
        + Worthwhile for company conduct due diligence.
      * *Expertised version (e.g. engineer written part):* Experts after RI believed statements were true or registration statement did not *fairly represent* expert statement (11[b][3][B]). Non-expert not liable if had ***no reasonable ground***to believe statements were untrue 🡪 easier defense (11[b][3][C]).

1. **VALUING FIRM OUTPUT**

**Intro**

* Assets that trade in *thick markets* are easy to value (reliable). Unique assets with few buyers (*thin market*) make valuation difficult.
  + Sophistication of valuation hinges on what is at stake.
* [How To Value] – lots of different ways, and courts look at most credible. Have to analyze incentives/purposes.
  + **Simple way:** look and value assets. But often firms are worth more than their components.
  + **Look backwards:** Look at earnings statements. Not rare to take into account book value/share. Or average last 5 years of earnings. Draw comparison to similar businesses and look at price/earnings ratio.
    - **Problems:** Is their earnings representative? Depreciation arbitrary? What is a comparable industry/business? How similar is similar?
  + *How to handle interest?* Simple v. compound (given b/c of competitive pressure).
  + Time is money. Opportunity cost. Risk of getting payment.
  + **Discount rate:** the rate at a past payment has equal value today. Reverse interest rate. ***Crucial question:*** how to figure out this rate?
    - Higher risk = higher discount rate.
  + **Interest rate risk:** for a bond, if the opportunity costs improve, this will decline the value of the bond. Tied to the interest rates in the economy.
  + **Payment risk:** risk that the payment would be made (e.g. company goes bankrupt).
* **Annuity:** stream of payments (often limited in term). E.g. bond.
  + Can value if can figure out discount rate. It is complicated if the interest rates are floating.
  + **Perpetuity:** indefinite stream of payments. Can calculate b/c future payments too far out are worth essentially zero. Stock is technically a perpetuity (corporation has indefinite life).
    - A basic problem is being able to predict the future.
    - Also, some perpetuities may have staggered or growing payments. But growth rates *tend to go away* due to competition or saturation.
* [Valuing Common Stock]
  + **Problems:** First, what to value? Earnings per share? Dividend streams? Second, difficult to predict future earnings of firm. Third, how long will earnings last?
* [Price Of Risk]
  + Risk preferences vary for individuals, and tend to increase with age. Also, more risk averse as stakes increase 🡪 ***declining marginal utility of wealth?*** Or, could be due to ***loss aversion*** or ***endowment effect*** (overvalue something they have and undervalue something they don’t have). Generally, with more risk, people insist on higher returns.
    - **Key issue:** how to pin down an actual rate? What risks are likely to matter to investors? 🡪 **Diversification**. Reduces volatility problem 🡪 some risks you can diversify away (*un-systematic*, *unique* or *diversifiable risk*), other risks you can’t (*systematic risk*). NOT all risk will matter or is equal.
  + Greater risk = more the investor will demand

**The Capital Asset Pricing Model (CAPM); The Efficient Capital Market Hypothesis (ECMH)**

* **#CAPM**
  + *Systematic v. unsystematic risk*: former is associated with the whole economic system, and with stocks, the performance of stock market. All stocks subject to this risk. Rational investor will not demand any more $$ for *unsystematic or unique risk* (perils that face an individual company unique to the firm) 🡪 assumption is that investor is diversified (thus making unique risk irrelevant).
    - **Beta =** relationship to market movement (sensitivity to systemic risk). Not all stocks are similarly affected by market risk.
      * If stock is perfectly correlated with that of a market portfolio, beta = 1.
      * Up/down one-half as much as market, beta =.5. Returns increase/decrease twice as much as market, beta = 2.
      * Higher beta 🡪 investors will demand a higher price.
  + **Cost of Capital = Risk Free Return + (beta x equity premium)**
    - **Risk Free Return:** Instrument that has negligible risk. (E.g. U.S. Treasury Bond)
    - **Equity Premium:** Risk premium over the risk-free rate. Difference between return of class (e.g. S&P 500) and risk free instrument.
    - Professional firms provide betas, but subject to debate.
  + **Problems:** Assumption that people will diversify. CAPM is partially backward looking (e.g. beta). Other variables might impact. **Capital Market Line** (CML) has been shown to be historically high 🡪 high-beta stocks underperform. Why? Unsystematic risk still affects companies. And small cap stocks empirically don’t fit well on the CML. Problem with model?
  + *Should we every use un-levered beta?* Beta measures the volatility of returns to stock regardless of firm leverage, rather than the volatility of returns on assets employed in the business.
* **#ECMH** – Theory that information in the market is rapidly incorporated into price, so profit can be made based on trading on this information.
  + *Strong* (all info, including private) v. *semi-strong* (all public info almost instantly absorbed into price) v. *weak* (past performance completely absorbed by stock price and cannot be used to make profit).
    - Strong form disproved by data (e.g. insider trading bump).
  + **Semi-strong is center of debate** 
    - ***Wrong?*** Behavior economics (ppl are irrational 🡪 loss aversion). Cognitive biases. Buffet. Small v. long-term priorities. And no clear consensus about how info will affect price. Herd behavior (rationally following irrational behavior). Not instantaneous incorporation (takes some time). There *are* inefficiencies, but is very risky/expensive to exploit (e.g. don’t know when bubble will burst); arbitrage is risky. Or, stock market bubbles not being directly attributable to any one piece of information.
      * Not everyone needs to follow 🡪 small group of experts can get info into stock.
    - ***Right?*** Irrational behavior cancels each other out (counter: but irrational people act in similar irrational way). Empirically, very difficult to exploit supposed “inefficiencies” 🡪 suggests market is efficient.
    - Lots of courts rely on, as well as SEC in designing policy regarding disclosure.
  + Significant amount of case law and regulations *assumes* that semi-strong theory is true.
    - False information can still be absorbed efficiently. Difference between absorbing information and reflecting reality.

**#Valuation in the Courts**

* Valuations in courts and within businesses can be very different. Incentives are different.
  + *Precedents matter*. Decision in *Weinberger*, Delaware Supreme Court opening things up 🡪 don’t just have to follow bloc method, but can use any legitimate valuation method used in finance. There *isn’t one right way*.
* [Fraud-on-the-Market Not Extended to Non-Public Info] *West v. Prudential Securities* (7th Cir) (Guy spread lie about impending acquisition and bunch of ppl bought. Others bought stock during inflated pricing period and are claiming damage based on efficient market, “fraud-on-the-market doctrine” 🡪 effectively relying on integrity of the market. Issue: can these people form class?)
  + **No.** This ***non-public info*** 🡪 ***no causal link***.Even if semi-strong is true, wrong kind of info. No ***causation*** between non-public info and stock price (key failing of P’s position). Record does NOT support extension of fraud-on-the-market doctrine to *non-public statements*.
    - P’s could have shown that info was *rapidly absorbed*, but much tougher argument. True, market price did rise, but that could have been caused by other events. Lower court did not sufficiently explore alternative explanation. Simply increased trading does NOT increase price (not like widgets w/ classic supply and demand), but ***information rises/lowers stock***. (No reason to think that D is like Buffet, who by simply buying, and ppl knowing this, would cause stock to rise). And even if it worked for a moment, experts would dig in and discover truth 🡪 if the market *is efficient* (as P alleges), then stock would not have risen in the long term (ppl would have discovered lie quickly).
  + AG: Reliance puzzle under 10b creates a problem for class actions. Many members would have bought/or didn’t have info in the first instance. Counter: **“Fraud-on-market doctrine”** 🡪 ***rebuttable presumption*** that person relied. Didn’t matter if you heard b/c w/ efficient market, ppl will relying on false information that was rapidly absorbed (knowing info would be incorporated). Can break this presumption if show the person would have bought anyway or that the truth would have come out.
* [ECMH—Look To Market Price] *VFB LLC v. Campbell Soup Company* (3rd Cir) (Vlasic was spun off [separate ownership and create new entity] and sold by Campbell Soup; shareholder in Campbell received shares of new company [like-kind stock dividend]. P claimed fraudulent conveyance claim [where company looks in bad shape and then starts funneling assets/money to executives] 🡪 Company acting on behalf of creditors aided breach of directors FD by selling Vlasic at too high of price. Issue: was VFI fairly valued at $500m?)
  + **No.** Bunch of different valuations, but market price (open and informed trading) is “a *more reliable measure* of the stock’s value than the subjective estimates of one or two expert witnesses.” VFI *not* insolvent at the time. And there was an issue with inflating numbers (product loading), but when the manipulation was corrected, the stock value ***did not*** drop 🡪 fraud should have made market price unreliable, but truth came out, and still over $500m. ***If*** markets are efficient 🡪 then it makes a lot of sense to look to market value = company *still* valued above $500m.
    - AG: was information concerning fraud absorbed? Maybe not efficient? Is court over-relying on ECMH? Can you disregard fraud problem by looking at stock price after fraud? How much of this is lower court deference? Efficiency of the market ends up being the key issue. Court ignores VFI’s expert witnesses 🡪 opposite of *Technicolor*.
      * Some courts are very open to market value; other courts reject it. Considerations: does the stock have an established market? Merger scenario (control premium)?
      * What about this case suggests market price is right standard? Hard to reconstruct after the fact? And market is valuing minority share, not control premium. What market price tainted by fraud?
    - **Fraudulent conveyance:** basic idea is that company is in trouble/insolvent and starts funneling money to its ppl.
      * Issue: insolvent at time of transfer or made insolvent because of transfer? Here, claim is VFI fraudulently conveyed $500m to Campbell in exchange for something worth much less. Doctrine designed to protect creditors.
  + Why did Campbell use spin-off instead of just selling businesses? Goldman suggested spin-off for tax purposes and quicker/efficient (selling would lead to uncertainty and distract management).
* [Look To Experts—CAPM] *Cede and Cinerama v. Technicolor* (Delaware) (MAF bought Technicolor at $23 share. Stockholder dissented 🡪 appraisal suit. [Technicolor did really well post-buyout, bought at $100m and sold at $700m+, which fueled long-term litigation]. Valuation comes down to dueling experts who use discount cash flows and CAPM. Issue: who is right?)
  + **D expert is more reasonable, with some tweaks.** The pieces of each expert’s opinion are not interchangeable. Here, not obvious why expert used 5-year period. And no good comparable companies.
    - AG: Chancellor Allen is *giving incentive* to experts to come up with reasonable numbers.
    - Parties here are using the same method but ending up at radically different numbers. Why? Varied assumptions (e.g. Rappaport assumes growth rate will tail off), and what past numbers to use? Multiplier could be off. An odd year can skew numbers.
      * Rappaport is assuming a 1.3 beta. Court says measuring based on wrong time period (looked post-merger intention announcement, which led to wild price swings).
      * Court recognizes possibility of small-cap premium (Rappaport included), but court says Technicolor is NOT small-cap 🡪 old company, brand name, oligopoly player, so no special premium.
        + When ever you’re look at comparables, needs to be a good one.
      * Another problem is that the two expert valuations are impossible to compare/mix.
  + This is a series of cases, and much doesn’t survive on the appeal, e.g. battle of the experts 🡪 court said that it would pick the ***most reasonable/plausable of the valuations***, with some adjustments. Higher court said *it’s your job to come up with the right numbers* = abdication of judicial role. Court needs to make a judgment on what is **fair value**, NOT just who is *most plausible*.
* [Delaware #Bloc Method] *Piemonte v. New Boston Garden Corp* (Mass) (Court used Delaware bloc method [not likely to see in business]. Merger, and dissenters seek appraisal. Issue: how to value?)
  + Court decides early on to use Delaware bloc method. Why? Used similar statutes to Delaware, so borrowed method.
    - **Delaware Bloc Method (only used in courts):** Combination of three methods 🡪 **(i)** market value, **(ii)** valuation based on earnings: looking at earnings and multiplier (earnings in prior years, then what multiplier gives stock price [price/earnings ratio]), and **(iii)** valuation based on net asset value. Each three are weighted (court needs to determine weight for each).
      * **Strengths:** Not completely irrational to average techniques or give lower weight to some methods. Eliminates some error? Percentages will still be arbitrary.
      * **Major problems:** it’s backward looking. And *highly arbitrary* 🡪 mixing a bunch of valuation methods. Really rough and imprecise, sort of blend/average of multiple techniques. *Very subject to judgment calls*, particularly when it comes to weighting. Gives trial court a lot of power.
        + 5-year period representative? Expansion income.
        + AG: *not* the most accurate way of valuing. But courts actually have the capacity to do this valuation (basic calculation).
      * **Market value:** use trading value or look at comparable companies? Court used stock price just prior to announcement.
    - Why is Delaware bloc still popular? Easy to use, mechanical, straightforward. Simpler. Judge is not in a position to use sophisticated discounted cash-flow analysis. And flexible, allows you to tweak inputs (too much discretion?).
      * Professor Campbell: Too many courts are overwhelmed by massive amounts of complex, tedious, technical valuation evidence offered by the parties 🡪 courts to a significant extent have *failed* to base their opinions on modern finance theory (DCF analysis).

[#Control Premia and Minority Discounts]

* Statute said in valuations, party is entitle to *“fair value.”* Statutory interpretation problem. Does this include minority discounts?
  + **Appraisal suit:** statutory right, once person has been cashed out in merger, to challenge valuation (fair value).
    - **Key issue:** should there be some sort of ***minority discount?*** Should small shares be discounted in relation to controlling block shares. Different states have different answers, but Delaware says no further weighting factors at *shareholder level* 🡪 everyone gets proportional interest at going concern. *Cavalier*
    - Further twist in *Rapid-American*. Court is worried about whether it makes sense to add value based on Rapids 100% ownership of subsidiaries 🡪 say ***yes***, extra value from control can be included. Distinguishes from *Cavalier*.
* [No Minority Discount] *Cavalier Oil Corp. v. Harnett* (Delaware)
  + Delaware rejected notion of a minority discount for shares owned by a person holding a small portion of shares. You ***cannot pay minority shareholders less*** b/c they’re minority shareholders. Trying to value *the corporation itself*, as distinguished from a specific fraction of shares. Minority discount imposes a penalty for lack of control, and unfairly enriches the majority shareholders who may *reap a windfall* form the appraisal process by chasing out a dissenting shareholder, a clearly undesirable result. Supposed to value interest as a ***“going concern.”***
    - Appraisal process is NOT intended to reconstruct a pro forma sale but to assume that the shareholder was willing to maintain his investment position had the merger not occurred.
* [Premium For Control] *Rapid-American Corp v. Harris* (Delaware) (Harris, plaintiff, wants a control premium. Rapid argues that control premium should not be added at the shareholder level—isn’t part of Rapid’s “going concern” value. Rapid was 100% owner of subsidiary. Issue: how to apply Cavalier Oil?)
  + **Must consider control premium**. Distinction between corporate level discounting and shareholder level discounting (not shareholder level going on here b/c Rapid is 100%). The latter was rejected by *Cavalier*. Exclusion of control premium artificially and unrealistically treated Rapid as a *minority shareholder* 🡪 control premium required by unique facts of this case. Court needed to consider Rapid’s full ownership (reflects economic reality).
    - AG: there is a problem under *Cavalier Oil* with picking and choosing among shareholders. The issue here is not that, but where to value subsidiaries independently or take into account the fact that Rapid owns the subsidiary. Court says it should be allowed to take into account that Rapid can do whatever it wants with subsidiary, and that value of control is passed onto shareholders. NOT discount to minority shareholders, but valuation of a company and taking into account that it owns subsidiaries.
      * *Rapid-American* (corporate level valuation) shows the limits of *Cavalier* (shareholder level discounting).
    - [Get rule top of p.204]
  + AG: *Cavalier Oil* and *Rapid American* make appraisal suits more valuable. Whether this is good or bad depends on how you perceive mergers. Protecting minority shareholders?
  + **Discounted Cash Flow Analysis** 
    - (1) Initial projection of cash flows
    - (2) Discount to present value (where CAPM comes in)
  + BUT, addition of a control premium to a discounted cash flow valuation (as opposed to public company comparison methodology) is NOT appropriate. *Berger v. Pubco Corp*

1. **CAPITAL STRUCTURE**

* Capital structure is both a concern for financing, as well as an ex-post litigation concern 🡪 leads to real conflicts among various investors, e.g. shareholders v. bondholders. Also, should company change their capital structure?
* [Basic Financing Options]
  + **Warrants:** *warrants* are stock options issued by the company itself, and *call options* are issued by others. Riskier than common, but options can be a type of hedge (reduces risk).
    - Riskiest form of investment in corporations
  + **Common Stock:** (possibly) voting rights (typically one share one vote; but also ultimate repository) and *residual claimants* 🡪 get whatever is leftover. Also, often get dividends at discretion of the board, and are the beneficiary of fiduciary duties.
  + **Preferred Stock:** creatures of contract, and come in full variety of choices. Often have dividend preference at a fixed amount (protected via “cumulative preferred”, as opposed to “straight”) and *don’t* have voting rights. However, often can get voting rights if dividends are not issued for a certain amount of time. Or may have rights against company issuing more senior equity or equity with better liquidation preference, or have conversion rights.
    - Often for more sophisticated parties who can parse contracts.
    - **Blank Preferred:** corporate charter creates a class that the board can later subdivide into one or more series, and specify the rights and preferences as new series are authorized. Allows the Board to set dividend payments to reflect changing market conditions 🡪 ***planning flexibility***. Solves problem of needing to amend charter to adjust terms for preferred in light of market conditions. Because the terms can be set by a Board vote, over time blank preferred were used as *poison pill*.
    - **Participating Preferred Stock:** Fairly rare type of preferred that gives holders the right to receive *additional earnings payouts* over and above the specified dividend rate under certain conditions. Allows VCs to participate in excess profits.
    - **Floating Rate Preferred:** dividend rate that *varies* with short-term interest rates.
  + **Corporate Debt**: doesn’t *have* to include securities. Can simply just go to the bank. And may be possible to convert debt into equity. Creature of contract. Issue of default will be key 🡪 very severe sanctions, so bond/debt holders will have a lot of power. Often bonds/debentures can be long-term relationships (up to 100+ years).
    - **Debentures:** unsecured corporate debt issued by a company, sold in public market (although short-term debt may be called “notes”). Subject to SEC disclosures. Highly standardized terms to *facilitate pricing* in market. Terms are sticky 🡪 been around a long time and may have been put in at a time when economy and related concerns were very different (can be unsuited to modern conditions). Can be adjusted via agreement (*Eliasen*), but highly unusual.
      * **Trust Indenture:** contract that governs the debenture. Names a trustee to act as agent on behalf of the holders to enforce the terms of the debenture. Required for debentures sold in excess of $10m.
    - **Bonds:** promissory notes, with terms like debentures, but are secured with collateral 🡪 gives priority in bankruptcy. Risk that company may issue new debt after the fact, which changes risk (another person who gets same/better outcome at bankruptcy). Indenture covenants are often designed to protect against this, if not, price will be reflected.
    - **Structured Financing:** obtain lending by using high-quality assets (e.g. accounts receivables) and separating them from the risks of overall business. Involves sale of assets to *special-purpose vehicle*, which in turn issues securities against the pool of assets.
      * Allows borrowers to obtain a lower interest rate than they could obtain on the basis of their overall credit ratings.
* [Interpreting Investment Terms] *Eliasen v. Itel Corp* (7th Cir) (Debentures issued in 1886 when company was struggling. Plaintiffs, now after sale [which kicks in rights], claim that these debentures were really the residual claimants. Odd contract; unusual situation. Last sentence of debenture contract says “any such proceeds remaining after such payments shall be distributed to Class B debentures,” BUT defendents point to an earlier sentence, “sum of $1,000 will be payable to the bearer…” Issue: residual claimants?)
  + **No.** Debentures have never been residual claim (though this is NOT decisive), NOT convertible, and in 1886 no one thought that company would be sold to fully satisfy debenture claims (explains sentence in contract). AND would make no sense to give voting rights to common if debentures are residual claimants 🡪shareholders could easily circumvent debenture interests (evidence that right doesn’t exist). Voting rights are tied to incentives, and if common were not residual claimants, would not have any incentive to raise value of company over $10.1m. In regard to external evidence, it is strange to look to Class A to get rights for Class B, and public railroad statements were made at the time where the Class B *were* de facto claimants b/c there just not enough money.
    - AG: long-term bonds/debentures have contract terms that address current problems, but are ill-equipped to handle future difficulties
* **Modigliani and Miller Irrelevance Theory (M&M):** assuming certain conditions (no transaction/tax costs, etc.), capital structure is *irrelevant* to firm value.
  + AG: theoretically sound, but is based on assumptions do not play out in the real world. Lots of evidence that capital structure does matter. For example, the way the company is managed may be altered if you have enough leverage (agency costs concerns 🡪 bond covenants trigger default upon certain events, *tying managements’ hands* in regard to compensation, dividend policy, etc.). As leverage increases, management discretion decreases. Another huge assumption is that tax is not an issues, and this is *simply not true*.
* [Capital Structure Is Relevant] *Heckman v. Ahmanson* (California) (Suit brought by Disney stockholders over greenmail payments to Steinberg Group. Originally, Disney acquired a bunch of debt to make itself less attractive [takeover defense; restricts what cash flow can be allocated to, and ups bankruptcy risk in a LBO] 🡪 court views this as hurting firm, even though M&M theory posits otherwise. Issue: SG liable?)
  + **Yes. Aided/abetted directors in FD breach**. SG is jointly/severally liable with Disney. AG: very strange and unusual to cite *Jones*, b/c SG was NOT controlling/dominant shareholder. Court can’t quit make this fit, so turns to ***aiding and abetting*** FD breach of directors 🡪 helped Disney directors put their interests above shareholders. Court assumes that loading up on debt was harmful to company.
    - **Problem:** how would SG know if directors were breaching FD? Maybe greenmail is inherently opportunistic, so SG should know it would be a breach (shoveling millions out of company to keep directors job).
    - AG: is greenmail bad? Opportunistic blackmail w/ no added value v. creating incentives that reduces agency costs. Greenmail isn’t an issue anymore b/c of tax laws (huge disincentive). Here, not clear that SG was aiding/abetting, nor is it clear that the greenmail here was bad for the company. Subsequently, Disney did quite well 🡪 not clear that loading up on debt is bad for the company. In real world, capital structure *does* affect value 🡪 debt covenants and payments disciplines board by limiting their options.

1. **ISSUES RELATED TO EXCESSIVE DEBT**

* **Protections to Creditors**
  + Contract term protections/Good Faith and fair dealing
  + Fraudulent conveyance
  + Piercing the corporate veil – shareholder needs to dominate firm (“unity of interest”), abusing the corporate form
    - Very similar to **equitable subordination**

**#Subordination**

* [Equitable Subordination] *In re Fett Roofing and Sheet Metal Co*. (4th Cir) (Firm is severally undercapitalized, and sole shareholder wrote promissory notes from firm to himself. When Fett files bankruptcy, claims his notes [which he backdated] are superior to creditors. Issue: were the notes a capitalization or bona fide lending?)
  + **Advances were contributions in capital, NOT loans**. Court will disregard outward appearances of transaction and determine its ***actual character and effect*** 🡪 rigorous scrutiny (burden to prove good faith and inherent fairness). Court is guided by *equitable principles*, and no one fact is conclusive. If so-called loans by *dominant/controlling stockholder* (who using corp as corporate pocket), especially when capital contributions are purely nominal, achieve unfair advantage over outside creditors dealing at arms length 🡪 claims will be subordinated. NOT necessary that fraud (backdating) exists. **Standard, NOT a rule.**
    - **Factors:** undercapitalization of business, fraud, etc.
      * This is NOT the same as piercing the corporate veil. In veil piercing, shareholders end up with liability; with ES, shareholders have to move back in line.
    - AG: *should* notes be subordinated if there is no fraud? If bank knows…? Here, we are NOT dealing with veil piercing and holding Fett liable. Just his debts are subordinated 🡪 ***where you stand in line***.
      * Equitable subordination reorders the line. Here, Fett was trying to jump up in line (make himself with secured creditor with backdated documents).

**FD to Creditors**

* C. Allen in *Credit Lyonnais* suggested that FD may shift when a corporation is in the ***zone of insolvency***.
* [Do FD Shift In Zone Of Insolvency?] *NACEPF* *v. Gheewalla, Cardinale and Daly* (Delaware) (NACEPFhad contract with Clearwire for licenses. NACEPF argues that Clearwire had FD to it b/c it was within “zone of insolvency,” and filed direct claim.)
  + **FD do NOT shift in *zone of insolvency*** 🡪 directors still have duty to maximize wealth of company. If you shifted, would created CoI between creditors and shareholders. Still need to keep best interests of *the corporation* in mind. **Also,** **creditors of *insolvent corporations* have NO RIGHT** **for *direct claims* for FD breach.** No direct FD to creditors 🡪 would lead to some preference over some creditors over others (same problem of conflicting duties), BUT can bring ***derivative suits*** in insolvency (creditors can say board has harmed company, and bring suit on behalf of company against board).
    - AG: two bright line rules 🡪 (i) no ZoI, and (ii) no direct duties in insolvency. BUT can file **derivative suit** in insolvency. Court is worried about predictability and guiding directors. Also, concern about what would happen if directors owed simultaneous duties to both creditors and shareholders (can be very different in the face of insolvency). Creditors have other remedies 🡪 contract rights, good faith/fair dealing, etc. Court is basically saying that creditors don’t need FD.
    - How to tell what constitutes “zone of insolvency”? Hard for board to determine fuzzy lines. Not easily defined. Guidance worry by court. *Huge unpredictability problem*.
    - In derivative suits, remedies go to corporation. Nothing in statute that says creditors can bring derivative suit when insolvent.

**Creditor Liability**

* [#Instrumentality Doctrine] *Krivo Industrial Supply Co. v. National Distillers and Chemical Corp.* (5th Cir) (P alleges that National Distillers dominated Brad’s Machine Products [its people had some control over which creditors get paid] and thus should be liable, as a creditor, to Brad’s other creditors. Issue: ND liable?)
  + **No.** **“Instrumentality”** requires ***total domination*** of the subservient corporation to the point that separate corp has no interests of its own and functions solely to achieve purpose of the dominant corporation. “Controlling influence” is NOT enough 🡪 need actual control such that corporation has *no separate mind, will or existence of its own* and is but a business conduit for its principle. ALSO, need ***fraud or injustice proximately result*** from misuse of this control. Intent to defraud is NOT enough. Here, no active domination. ND guy only had veto power, approval was not always necessary (creditor doesn’t have control over some operating decisions).
    - But got control of which creditors gets paid? Seems like control.
    - AG: argument is that Brad’s was alter ego of ND. Different than traditional veil piercing b/c D is not shareholder, but creditor. Here, the control element is *very difficult* to satisfy under instrumentality test.

**“Deepening Insolvency” Doctrine**

* [Approved DI] *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co* (3rd Cir) (Guy running a ponzi scheme, and claim here is that providing more funds when company was insolvent was part of the fraud. Issue: deepening insolvency a valid tort claim?)
  + **Yes.** Expanding debt in **insolvency** (corp’s debt exceed FMV of assets) has real economic effects and can harm company 🡪 where there is an injury, law will provide a remedy. How does deepening insolvency cause harm? Incurrence of debt can force an insolvent corp into bankruptcy, inflicting legal/admin costs. Also creates operational limitations, which hurt corp’s ability to run business in a profitable manner. Undermines relationships with customers/suppliers/employees. Prolonging life of corp may simply cause dissipation of corporate assets. These harms can be avoided, and value salvaged, if corp is dissolved in a *timely manner*.
    - AG: saying DI is an *independent* cause of action. Harm = remedy. What would the elements be? Not clear here. In subsequent case, court said negligence wouldn’t be enough 🡪 would need fraud (which makes DI irrelevant). Elements of fraud:
      * Deceptive representation/omission of material fact.
      * Scienter (knows/should know). Mere negligence is not enough.
      * Reliance
      * Injury
* [Against DI] *Trenwick America Litigation Trust v. Ernst & Young* (Delaware) (Federal court, in a prior case, thought Delaware would apply a DI doctrine. Issue of DI comes up before Delaware.)
  + **Deepening solvency is nonsense.** Even when company is insolvent, board may pursue in good faith strategies to maximize value of the firm. If acting with *due diligence/good faith*, incurring additional debt does NOT make board guarantor of a strategy’s success 🡪 would fundamentally transform Delaware law.
    - AG: saying if DI is an issue, it is subsumed within regular FD 🡪 all business judgment concerns. To the extent creditors are being mistreated, they have a lot of protections.

1. **COMMON STOCK**

**Intro**

* [Why Limited Liability Exists]
  + **Benefits:** allows for ***diversification*** 🡪 otherwise, risks would be too high (*systemic risk*). Also more ***efficient*** 🡪 don’t have to monitor all your investment companies OR your fellow shareholders (*reduces costs*). And monitoring costs would ***prevent non-wealthy*** to invest. All this leads to ***less liquidity*** and smaller capital markets.
    - Some commenters want to distinguish between contract claims (limited liability) and tort claims (should have unlimited liability).
  + **Costs:** wrong incentives, particularly in *tort law* 🡪 make excessively risk decisions because not liable. Corporations fail to insure fully. Product costs do NOT reflect full societal costs. Voluntary creditors will impose higher costs on firms. *Tax costs* will be higher b/c the entity may be treated as separate. Also, limited liability entities are subject to extensive public disclosure (designed to provide info to potential creditors about firm’s capital where unlimited liability is not available).
    - Costs imposed on creditors depend on capital structure 🡪 secured creditors monitor assets, not firms, so limited liability does not increase their costs.
  + Common stockholders (normally) NOT liable. Only risk is value of your investment.

**Problem of #Dilution**

* **Kinds of Dilution:** ***economic v. voting***. For *economic* (residual claim affected), it’s either smaller piece of a bigger pie (if sold at ***same price***) or your relative percentage would decrease if subsequent stock is sold at a ***lower price*** 🡪 people particularly care if stock is sold at less than FMV. Voting dilution isn’t typically relevant for average investor 🡪 never had enough stock to matter anyway, BUT does matter for *closely held corporations* and *large shareholders* (context matters).
  + Dilution may be *strategic*, either intentionally self-dealing (*opportunism*), or either a **“penalty dilution”** 🡪 a way to encourage investment by issuing stock at free-market value (solves free-riding problem of earlier investors getting benefit of later investors). Or it serves as strategic **poison pills**(*takeover defense*).
* **#Preemptive Rights:** possible response to dilution. Much more common in past than today 🡪 used to be *default*,now, need to be *opted-into* to have PR.
  + Either concerned with ***sizeable voting block*** and/or worried about ***value of investment decreasing***.
  + Caselaw goes back a long way. *Gray v. Portland* held that since the power to authorize new shares resided in the shareholders, than had an equitable interest in new shares when created. Idea was that corporation “held” its authorized but unissued shares in trust for its shareholders, subject to their paying for them. Like partners (how shareholders were in early companies), care who is joining company. Not that relevant to big corporations.
    - AG: Not the way the world looks now. Pre-emptive rights are useful in some settings, but for public companies, they are *disaster* 🡪 makes it hard to finance business and impractical. Now, there is general an ***opt-in rule*** 🡪 *can* have pre-emptive rights, but need to be put in the articles of incorporation.
* [Preemptive Rights] *Stokes v. Continental Trust Company* (New York) (Shareholder demands rights to buy same percentage of newly-issued stock that he currently owns at par value. Takeover case, where Blair & Co. is trying to buy 50% control of company. Issue: does P have legal right to subscribe for and take the same number of shares in the new stock as he had in the old?)
  + **Yes. Legitimate pre-emptive rights.** P has been deprived of legal right. Share of stock is a share in the power to increase stock, and *belongs to the stockholders* the same as the stock itself. Inherent right to a proportionate share of new stock issued for money only. P had right to ***buy shares at pre-emptive price*** ($450 or so, and not the $100 he was looking for).
    - AG: looks like minority opportunism 🡪 hold-up problem (taking advantage of needs of business).
  + **Dissent:** Stokes is looking for a payoff. What is really at stake is control of company, and P is risking the entire deal to get an increased price.
* [Equitable Doctrines of Dilution In Closely Held Corporation] *Katsowitz v. Sidler* (New York) (Three guys in closed corporation. Corp owed each 2.5k. K wanted to be paid, and other two wanted to take $$ and lend it to another company they owned. Board passed resolution to pay each 2.5k, but had later secret meeting to approve purchase of new stock at lower price. K didn’t buy stock [tho could have]; others did. Corp was later liquidated and other 2 got much more $$ than K. Issue: does K get proportional interest?)
  + **Yes.** Protection afforded by stock rights is illusory in ***closed corporations***. No market or diluted price. Stockholder at total loss if no rights are offered and he does not want to invest additional funds. When price is shown to be ***markedly below book value*** in a closed corporation and other shareholders benefit 🡪 claim for judicial relief exists. Right to maintain proportional equity is right NOT to purchase additional shares *without* dilution of existing equity if no valid business justification exists for dilution. Burden is on directors to show business justification. Essentially, court says K had ***right to NOT buy***.
    - Here, no valid business justification was advanced 🡪 just trying to get K to invest more.
    - AG: Pre-emptive rights not violated under *Stokes* 🡪 K was offered to buy, had notice, and did NOT purchase. But closely held, so he can’t get value of pre-emptive rights *unless* he exercises them. What about the waiver problem (didn’t K *waive* these rights)? Court suggests K might not have known about the dilution. Looks like the court trying to address ***opportunistic behavior***. Court is concerned K is being forced to contribute money to business or substantially lose value. Court says there is room for business justification, but D did not provide any (maybe a penalty dilution-type theory would have worked).
      * Not a normal pre-emptive rights case, as it is a right not to buy.
      * Case shows that dilution can be purposeful/strategic.
    - Is book value a good measure when it can be very different than market value?
* [Dilution In VC Firms] **Conversion Rights:** Another possibility, other than pre-emptive rights, in which dilution is a problem. The anti-dilution response is an ***adjustment to conversion price*** 🡪 conversion right is adjusted so that you can get increasingly more common stock during “down rounds” financing.
  + **Full Rachet:** Conversion price is reduced to give the holders the same lower price paid by the *most recent investor* (no upward rachet if stock is sold for a higher price). Price rachets down to this price *regardless o*f how many shares are sold in a down round!
  + **Weighted Rachet:** Takes into account how many shares are issued.

[Dilution as Takeover Defense—The Poison Pill]

* **Flip In Pill:** Allows shareholders *except for acquirer* of target to purchase target’s share at huge discount when certain triggering events occur 🡪 e.g. acquirer buys 30% of outstanding stock. *Dilutes acquirer’s interest in the target*.
* **Flip Over Pill:** The subsequent merger will result in the target’s company shareholders, *except the acquirer*,the ability to acquire tock in the surviving corporation at a heavy discount. *Dilutes acquirer’s interest in the acquirers company (or surviving company’s) itself*.
  + If done w/o the flip in provision, then prevents white knights from coming in. And you can just start replacing directors.
  + Both types of pill are redeemable by the board.
* PP have NOT completely eliminated takeovers, but simply increased the value of the bids. Pill *can* be redeemed. Is this good? Hard to say. Less bids, but more valuable? Controversial form of defense b/c its successful.
* **Rights:** given to shareholders of companies. Different from just option to buy shares. Up until triggering conditions, rights need to not be exercised 🡪 set at price so no rational person would use prematurely.
  + In *Moran*, it was 1/100 of a share of preferred in order to keep within limit of approved shares without having to amend the articles.
* [Approves Poison Pill] *Moran v. Household International Inc.* (Delaware) (Household passes flip-over rights plan as a general defense measure [no specific threat] 🡪 triggers on announcement of 30% tender offer or someone acquires 20%. Moran is director and wants to do leveraged buyout. Issue: poison pills ok?)
  + **Yes.**  **Two-step analysis:** **(i)** Is PP within director’s power? (*statutory challenge*) **(ii)** If so, is it *equitable*? To **(i)**, they ***do*** have power. Statute, section 157 is ***silent***, which does NOT mean prohibited. And is there for corporate financing and rights plan technically complies (even though not what was initially intended). Law is not static, must grow and develop. What about “anti-destruction” provisions (deals with problem of conversion rights being destroyed in event of a merger; allows you to get conversion right in share of surviving corporation)? Court says flip over like “anti-destruction” provisions, which have been around forever (but admittedly, these provisions had/have nothing to do with defensive measures but relate to conversion rights). *Simply a variation*. To **(ii)**, subject to *Unocal* test (*contingent* BJR, somewhere between typical BJR and “entire fairness” test). Initial burden lies with directors 🡪 must show there was (1) ***reasonable grounds*** for believing danger to corporate policy/effectiveness existed” (duty of care type analysis). Satisfy this by showing good faith/reasonable investigation AND then (2) defensive mechanism was *reasonable in relation* to threat posed (proportionality; not hard test to meet). If (1) and (2) are met, BoP shifts to P to prove FD breach. Here, (1) general threat for takeover is threat enough (deferential) and met w/ Goldman/Wachtell (reasonable investigation); and (2) proxy battles were preserved (can buy up to 20%). For FD, no gross negligence.
    - P (i) argument: rights plan is taking away shareholders right to benefit from a TO. Court says it does NOT prevent TO 🡪 lots of ways to redeem, and rights plan is not absolute. Less likely (and more $$), but not impossible. Also, can have proxy contests.
      * Court says you cannot *arbitrarily reject offer*. Poison pill was put in place in the abstract 🡪 a specific threat could materialize, and then the board would, under FD, seriously consider offer. Cannot arbitrarily refuse to keep the pill in place (kicks in *Unocal* duties).
    - P (i) argument: this will fundamentally restrict rights to conduct proxy contest. Poison pill trigger is implicated in proxy fight. Court is skeptical 🡪 proxy contest alone won’t trigger it.
* Flip-in plans approved of in Delaware in *Stahl v. Apple Bancorp, Inc*. (Flip in ok b/c it left sufficient shares below triggering percentage to solicit proxies to remove board)
  + BUT, flip-in rights plans have been questions more closely by the courts, since they can dilute the investment of the bidder in the target, and thus deter takeover bids altogether. Several courts have applied *“heightened scrutiny”* under *Unocal* to see if PP are an overreaction to possible threats.

1. **CORPORATE #DEBT**

**Intro**

* In bonds, ***standardization*** is hugely important 🡪 stabilizes market, and courts go out of their way interpreting boilerplate covenant in a consistent manner.
  + **Bondholders face a variety of distinctive risks**—interest rate risk, currency risk, default risk, risk relating to years to maturity (uncertainty rises, inflation, default probability, etc.) issuance of new debt (seniority concerns or additional claimants or bankruptcy risks), dilution risks if you have conversion right, elimination of conversion rights (e.g. merger that destroys common stock you can convert into), pre-payment risk (company redeems bonds at its choice, often to refinance), underinvestment risk, risk-profile of business.
    - *All of these affect bond value*
    - Credit Agencies become significant
* **Junk bonds:** bonds with very low rating. ***Very risky***, either due to nature of company or subordination rights. Higher interest rates. Vehicle for LBOs. Intermediate category of risk between highly rated debt and equity.
* **Time matters.** Some holders will be focused on stream of payments, but if repayment period is short, then holders will be much more focused on repayment likelihood.
* **Bond v. shareholders tension**
  + Once *lending has occurred* 🡪 **shareholders** will prefer to engage in riskier behavior. Expected payoff will be higher for them, while **bondholders** payoff is fixed. Bondholders will be against risk, so boilerplate has formed to protect bondholders from many typical scenarios (*bond covenants*).
    - **Poison debt:** bond covenants blocking leveraged buyouts.
  + **Bondholders don’t like:** “going to Vegas,” shift in business strategy that increases risk, issuance of new debt (either dilutes, is more senior, or is secured where the older bonds are unsecured), dividends, stock repurchases, spin-offs or split-offs, underinvestment (not taking care of equipment/inventory).

**Contract Interpretation and Terms**

* [Predetermined Plan, so Aggregate] *Sharon Steel*(2nd Cir)– concerned, along with *BNY Mellon*, with the **successor obligor provision** (prevents company from selling “substantially all” of its assets). Had *piecemeal sell* of various parts of the business.
  + Look at assets at time of liquidation. If you have a ***plan of liquidation*** (pre-determined goal) 🡪 lump all subsequent transactions together. Here, ***predetermined goal*** was liquidation and thus would be inappropriate to look at isolated transaction in liquidation.
    - **Spin off:** Parent owns share of subsidiary, and dividends shares of subsidiary to shareholders.
    - **Split off:** In effect, there is purchase going on. Shares of parent company in exchange for shares of the sub. Like spin off, sub no longer belongs to parent.
  + Instead, if you have ***individual business decisions*** 🡪 don’t aggregate.
    - *Sharon* may be wrong on this point, but courts highly value predictability in this area.
* [No Integrated Pre-Established Plan] *Bank of New York Mellon Trust v. Liberty Media Corp* (Delaware) (Successor obligator prevents company from selling “all or substantially all” of its assets 🡪 risks changes dramatically if this is done, and ensures acquirer assumes debt obligations [e.g. might sell of some of its best assets, leaving only risky assets left]. Here, Liberty Media engaged in a series of transactions. BNY argues that combined, they trigger provision. Issue: “substantially all” of assets sold?)
  + **No.** Aggregation is only appropriate when a series of transactions are part of a ***“plan of piecemeal liquidation”***and “an overall scheme to liquidate” and NOT where each transaction stands on its own merits without *reference to the others*. Here, independent justification for each transaction. NOT linked.
    - **Tracking stock:** stock that is linked to particular features within company.
  + **Policy debate:** *how to read boilerplate in bond covenants?* Court will NOT look at intent of parties or matter of fact, but at the accepted common purpose of such provisions (matter of law). Standardized reading allows for ***easier valuation***. Don’t want to unsettle expectations.
    - Very different from regular contracts where intention of parties is key.
    - Court highly hesitant to diverge from *Sharon Steel*, even though its not binding precedent (from the 2nd Circuit). Assume bond language tracks *Sharon Steel*.
    - Court shows desire to avoid case-by-case analysis. BUT say practice and understanding in real world is relevant 🡪 looks like *usage* can matter. Clearly avoiding intent-based analysis, in part b/c of there is not normal negotiations around language.
    - **Basic policy idea:** markets will work better w/ consistent language.
    - Court is applying NY law; often see choice-of-law provisions in indentures 🡪 deep precedent pool = predictability.

[Interpretation of Bond Covenants]

* [Good Faith Based in Covenants, Fruits of Bargain] *Metropolitan Life Insurance Co v. RJR Nabisco* (SDNY) (Met Life had purchased some $300m+ in bonds prior to KKR buyout. Many of covenants in bonds pre-dated these massive LBO’s. Met Life’s bonds will drop below investment grade [lost 20% of value]; ML arguing RJR breached implied duty of good faith and fair dealing. No explicit covenants preventing huge amounts of new debt, and there *are* covenants allowing mergers. And, ML had previously waived restrictive covenants, and had internal memos that discussed LBO risk. Issue: breach?)
  + **No.** Silence does NOT create sufficient ambiguity to overcome parole evidence rule (especially when covenants had no debt ceiling). Implied covenant of good faith/fair dealing only works where ***explicitly bargained-for benefits*** are being deprived (losing **“fruits of agreement”**). Implied covenants will only aid and further the *explicit terms* (consistent with terms) of the agreement and will never impose an obligation that would be “inconsistent with other terms of the contractual relationship.” ONLY relevant if one part seeks to prevent contract’s performance or withhold its benefits. Here, *“fruits”* of these indentures (ensure interest payments) do NOT include “getting a good investment” and thus an ability to restrict LBO. P wants Court to *create* an additional benefit that they did not bargain for.
    - For **bond indentures**, “an implied covenant…derives its substance directly from the language…and cannot give holders of Debentures any rights inconsistent with those set out. *No breach of contractual rights = no breach of implied covenants.*
    - Unbounded and elasticity argued for by P would interfere with and destabilize the market.
    - AG: Court says no waiver/assumption of risk by ML, but highlights risk in market. Avoiding case-by-case analysis? Court doesn’t want to create precedent whether internal memos are decisive, and why would other P lose?
      * Court cites *Sharon Steel* for the proposition that boilerplate provisions do NOT depend on intent of parties and uniformity matters for functioning of capital markets. Also cite a series of cases that say avoid ***subjective understandings***and ***case-by-case analysis***. Legal, NOT factual interpretation.
      * Courts give various versions of “good faith.” Here, court says it builds on pre-existing terms. When FD don’t exist, parties try to claim good faith. Also suggest a **“hypothetical bargain”** version of good faith 🡪 would parties agree to this if their attention had been called to it? Essentially a gap filler. Does court get characterization of “fruits” correct?
      * NOT a contract of adhesion. Underwriter is negotiating terms. Is U an adequate substitute for bondholders?
      * Not clear that when bonds were initial issued, there was any risk of LBOs.
  + Also, equity claims fail.
    - **Unjust enrichment:** requires circumstances such that in equity and good conscience the D should be restitution. No explicit term has been violated and no good faith. No restitution.
    - **Frustration of Purpose:** Only relevant where contract has been rendered valueless and where event was unforeseeable. Here, ML knew it was possible, and bonds are not worthless.
    - **FD Claim:** Choice of law problem. Under Delaware, no FD to bondholders. If NY, same outcome (but less clear). No workable limits to the D’s theory 🡪 FD created in a bunch of different places.
      * AG: are good faith and FD that different? Some argue that they’re similar kinds of things. This is a matter of debate, but if you see both as filing in terms of a hypothetical bargain, then they start to look very similar.
* **Distributions**
  + Lenders are concerned with use of proceeds from public funding in both the short term (immediate diversion) and long term (diversion of cash from business to the owners). Keeping funds within corp forces debtor to employ funds on new business opportunities or maintenance/replacement of assets 🡪 helps solve underinvestment problem.
  + Restrictions in CHC may extend to salaries/bonuses to prevent *de facto* dividends. Dividends are generally set by establishing an inventory of funds from which dividends must be paid.
* **Underinvestment—Asset Management** 
  + One of the most difficult problems to deal with contractually. Trying to force company to take valuable business opportunities and also worried about proper maintenance of existing plants and equipment, and replacing these as necessary to maintain production and sales.
* **Sinking Funds:** requires a certain amount of money be set aside to repurchase the bonds 🡪 by and large this is a gradual repurchase, often by lottery (slow-motion redemption of bonds). Reduces risk of nonpayment.
  + Way for lenders to reduce risk

[Call Protection]

* **Protections for pre-payment risk:** penalty for early purchase of bonds back by company (premium tacked on); not allowing redemption for a certain number of years; conversion rights; restricting type of sources can be used to pre-pay.
  + *Why do companies redeem?* Interest rates fall, so makes sense to refinance. But re-purchase price is pushed up by transaction costs and risk that rates will rise during repurchase period 🡪 need rates to be particularly attractive.
    - In *ADM*, explicit protection is premium schedule. But company may redeem anyway. So additional protection of restricting proceeds from new debt to redeem bonds.
  + Why would a company want a conversion right? Allows them get a lower interest rate b/c it protects the borrower.
* [Direct Source And Market Certainty] *Morgan Stanley v. Archer Daniels Midland Co.* (SDNY) (ADM bought back bonds. Call protection prohibited repurchasing by issuing new debt under 16%. MS had bought the day earlier, and almost immediately lost money b/c ADM repurchased via two issuings of common stock. MS argues this is violation of express terms, contract breach. ADM had also, around the same time, issued new debt below 16%, but claimed this is unrelated to bond repurchase. MS argues this is “juggling of funds” and points to bonds trading at above price as evidence that this risk was not expected. Issue: breach of call protection?)
  + **No.** “Plain meaning” of language not clear, and should read the covenant restrictively b/c it comes after broad language. MS position is dependent on subjective interpretation and would increase uncertainty in market. This very thing was addressed in another district, *Franklin* 🡪 laid out ***strict “source” rule*** (redemption directly funded through equity financing was NOT prohibited *despite* contemporaneous borrowing by issuer).
    - MS argued for a case-by-case analysis 🡪 look at magnitude of borrowing relative to size of contemplated equity-funded redemption and its proximity in time relative to the date the redemption was to take place.
    - Bond covenant says that bonds can be repurchase “from the proceeds” of sub 16% debt. Technically, the new debt issuance $$ was not earmarked for bond repurchase, and it was the stock money that was technical directed toward the repurchase. Is this enough? Bond also says “anticipation of”, so it seems like if the debt issuances freed up cash elsewhere…
    - MS market argument? Maybe market was just betting ADM wouldn’t call, notwithstanding the ADM reading?
    - Why not create stricter covenants for redemption? Some company’s really value flexibility and is willing to pay higher interest rates to obtain this.
  + AG: Court is very skeptical to add new provisions to these contracts. Doesn’t mean good faith/fair dealing is meaningless, but usually applies when court is filling in details of express provision. Typically *relatively stingy* application of the doctrine.

[Amendments]

* **Amendment Requirements:** Breach of indenture covenants treated as *event of default*, and allows creditors to accelerate entire indebtedness or foreclose on collateral. Would also allow trustee to file an involuntary petition in bankruptcy against debtor. However, these remedies are ***draconian*** 🡪 may be more expense and delay than bondholders want. Thus, remedies become negotiations to secure arrangements that would allow *waivers* of covenant breach.
  + **Trust Indenture Act** provides different bars for different types of amendments.
* [Interaction Of Provisions And Coercion] *Katz v. Oak Industries* (Delaware) (In order to obtain new funding, Oak Industries offers its bondholders equity or payment for redemption. Payment offer requires that certain amount of notes be tendered [voluntary], but for this to work, certain legal provisions would need to be deleted. Why tender? If you don’t, and 85% do, then remaining holders face significant risk [prisoner’s dilemma]. K argues this is coercion. Issue: allowed?)
  + **Yes.** First, no FD to bondholders. Second, **coercion** (providing incentives/inducements) is NOT necessarily bad. Question is whether coercion is wrongful or inappropriate. Thus, turn to *contract law good faith* 🡪 is it clear that what was expressly agreed was that the parties would consider this as breach of good faith had they thought of it? Here, no veto power (wholly inconsistent with strictly commercial nature of relationship), and vote restriction on treasury securities does not apply (K argues that Oak is trying to “force vote”, affectively voting securities). Not the same CoI (would only apply if *some bondholders* were offered different deal). K also argues that this is an effective redemption at terms ***less than*** price of stated redemption. Court says that offer depends on its attractiveness and is ***voluntary***, so hardly the functional equivalent of unilateral redemption. Not technically a redemption, but an exchange offer.
    - Not as simple as just finding “coercion.” Instead, need to look to contract (purely matter of contract law b/c FD do not apply) 🡪 covenant of good faith/fair dealing.
    - AG: Court is willing to be formalistic here. *Form over substance*. Transaction between sophisticated parties. Real advantage to predictability.
      * Some amendments are easier to make than others. Space where the federal law intrudes (p.442).
* **Covenants interacting:** conversion rights can be a significant protection, but in some circumstances, can tie into transactions and force bondholders into the deal.

**The Indenture Trustee and the Trust Indenture Act**

* **Indenture Trustee:** Heavily regulated as to *who* can be trustee. Often have pre-existing relationships with debtor (CoI problems), and may be trustees in more than one setting. Centralizes the monitoring and enforcement role, eliminating the collective action problems facing bondholders.
  + **“Event of Default”** is a pivot point that shifts duties for trustee 🡪 *role changes*. **Pre-default**, Trustee plays a monitoring role. **Post-default**, some FD responsibilities kick in. Conflicting interests become significant issues once default, and ***“prudent person”*** standard becomes active.
* [Indenture Trustee And Fiduciary Duties Pre-Default] *Elliot Associates v. J. Henry Schroder Bank & Trust* (2nd Cir) (Provision that requires 50-day notice to trustee, but trustee can waive. Another section requires 15-day, but not more than 60, notice to bondholders. Trustee waives 50 day, said it only needs a week b/c it is complete redemption [in contrast to partial]. 42 days prior to redemption, notify trustee. Cleared with SEC; redeemed on May 16. If redeemed a few days later, another interest payment would be due AND the bondholders could still convert. All holders converted b/c of high stock price. Technical requirements of bonds were met, but P argued Trustee breached obligation to bondholders by waiving 50-day notice. Issue: breach of duty?)
  + **No.** No duty to *weigh financial interests* of bondholders. As long as trustee ***fulfills its obligations under express indenture terms*** 🡪 no additional, implicit pre-default duties/obligations except to avoid conflict of interests. Just need to follow what is explicitly set out in indenture. Duties of indenture are strictly defined and limited to the terms of the indenture (BUT no CoI). **No pre-default FD.**
    - Trustee more like stakeholder and NOT fiduciary. 50-day notice is for *trustee’s benefit* 🡪 gives them time to handle complicated redemptions. Waived in this case; all technical requirements satisfied. And in pre-default area, no FD to bondholders.
    - AG: is this problematic? Bondholder has notice of trustee role so can negotiate contract? There are also a limited number of parties than can serve as trustee, so if impose FD, might shrink market. Might drop business (loss b/c of built up expertise). But if trust needs minimal oversight pre-default, won’t market produce trustees?
  + Here, two characterizations of the Trustee’s position: (1) *mere stakeholder*, w/ duties limited to those spelled out in indenture; and (2) a *trustee* w/ duties of loyalty to bondholders.
    - Other courts have also characterized trustee as (3) a *full trustee*, w/ full duties to act as a “prudent man”; and (4) an *agent for bondholder*, w/ some FD.

[Trustee Duties in Default]

* [#Private Rights Of Action]
  + Often federal regs *do not* fully cover who/when individuals have **private right of action**. SCOTUS view has evolved on this issue (p.462-63). Effectively during 1970’s and later, SCOTUS made it harder to find private right of action. Early precedents from lower courts saying implied right of action (SDNY), but not clear that they’re following SCOTUS. *This area is a mess*.
    - Decades of SCOTUS decisions under securities laws where sometimes a private right action existed, and others in which there is no right. Variety of theories. Factors? Legislative intent? In *LNC*, court looks to broad purpose provision (*Borak*).
  + [Implied Right] *LNC Investments v. First Fidelity Bank, National Association* (SDNY) (P suing Trustee for violation under TIA of prudent person standard. Discussion here: does P have private right of action under TIA [suing in federal court under federal law]?)
    - **Yes.** Both text and legislative history support this. Private right of action helps to achieve ***declared purpose*** of TIA. TIA implies in various sections duties, and SEC is NOT authorized to enforce them, so obviously clear that *someone* needs to enforce 🡪 private right of action. If not, law would say “you ought to X, but no on can make you do it.”
      * The purpose argument wouldn’t work under modern SCOTUS precedent. Purpose provision is NOT enough on its own.
      * AG: different claim than bringing right of action under state law for contract breach. Why bring claim under TIA? Prefer federal judges. Litigation strategy.
      * As practical matter, there is private right of action in lower courts, but not clear what would happen if went to SCOTUS.
* [Duties Post-Default] *Gresser v. Wells Fargo Bank* (D.Md) (After default, Notes held trustee to “prudent man” standard. Trustee had SEC notice of default, but did not notify bondholders and did not extend lease to secure bonds. Also did not accelerate notes. These look like contract breaches. Issue: implied covenants and obligations?)
  + **Yes.** During event of default, implied covenants and obligations ***can be read into*** the indenture. Court is willing to find ***fiduciary relationship***. Plausibly states three contract claims. In regard to “good faith,” court says not ready to apply good faith defense.
    - AG: very different from what we’ve seen elsewhere. Court willing to imply duties. Different use of good faith. Built into contract as a defense.

1. **#PREFERRED STOCK**

**Intro**

* **Preferred:** Hybrid form of financing. Features of *deb*t (set periodic dividend payouts, like interest payments on bonds [but board often gets discretion; and no repayment of principle]) and *common stock* (often no voting rights, but it *can* have voting rights; and if no dividends are issues, voting rights can kick in [designed to protect preferred]). Conversion rights are another protection for PS. FD may or may not be applicable. Traditionally, preference over common for dividends—but often no binding obligation to do so, only when *declared*. All sorts of contract interpretation problems.
  + Preferred must be part of the authorized shares of a corporation, expressed in AoI.
  + *Why would companies issue PS?* No problem of acceleration. No facing powerful remedies creditors have. And no big payout looming down the road 🡪 “permanent capital” that *never has to be redeemed*. Also tax law implications (e.g. interest payment deductions, dividend deductions).
  + **Protections:** often see dividend preference. What happens to preference if dividends are not issues for a long time? Non-cumulative v. cumulative.
  + **Blank Preferred:** Articles of Incorporation authorized preferred stock, but leave details to board to fill in. Provides flexibility to move quickly with changing market. To amend articles is time-consuming. Later, allowed boards to adapt PS to poison pill use.
  + **Basic issue:** non-cumulative or cumulative. Non-cumulative not popular. Easily abused, and common (typically) have greater voting rights than preferred, so abuse likely to happen.
  + Preferred are mostly ***creatures of contract***. Dominant form of VC investment.

**#Dividends**

* [Right in Articles] *Arizona Western Insurance Co v. L.L. Constantin* (3rd Cir) (Arizona suing to get dividends, where certificate of incorporation stated, “The holders of preferred stock shall be entitled to receive…a fixed yearly dividend…” Constantin argued that if court compelled dividends, absent fraud/bad faith by Board, it would interfere with management/internal affairs of corp and that Arizona would go from shareholder to creditor. Issue: Arizona have rights to dividend?)
  + **Yes.** Articles of Incorporation is ***clear*** 🡪 P is entitled to dividends. Acknowledge that courts are reluctant to force Boards to declare dividends (in discretion of directors absent *improper refusal*), but P has right to have contract enforced. Court refuses to hold that words were merely bait to prospective purchasers of preferred.
* [Overridden by Public Policy] *LL Constantin v. R.P. Holding Corp* (2) (N.J. Super) (The above case at the N.J. Supreme Court)
  + **Dividends NOT mandatory.** Need to look at all applicable provisions 🡪 by-laws suggest Board discretion to declare dividends. Legislative history demonstrates strong public policy that ***Board may determine*** what, if any, dividends are declared 🡪 *best interests of the corporation*. Statute is clear that corporate business is to be managed by directors.
    - AG: odd case. Looks like by-laws are trumping AoI. Court may be saying that they want a really clear statement. Reading Articles in light of legislative policy. Garbage!!
* [Common Judicial Approach To Contract Interpretation] *Guttmann v. Illinois Central R. Co.* (2nd Cir) (Non-cumulative preferred shareholders want back dividends that were earned in in prior years, but not paid. P argued that as long as net profits were not needed for capital outlays, then Board abuses its discretion by not issuing dividends. Issue: entitled to dividends?)
  + **No.** Directors did NOT abuse their discretion in withholding dividends. (a) No right survived to have dividend declared, and (b) directions have no discretion to declare dividends subsequently. No intelligible difference between tangibles and non-tangibles. Nothing in wording of contract that suggests existence of contingent or inchoate right to arrears of dividends. P’s claim is *lawyer-made*, dependent on notions of fairness/policy.
    - AG: very much a ***contractual analysis***. If you want certain rights, put it in the contract. Maybe court views preferred as sophisticated persons, and would rather protect common shareholders.
    - NJ Approach: Preferred have inchoate interest, some kind expectancy, and for those years that profits exist, you are entitled to dividends. Use fairness analysis. There is an *expectation* that you won’t be treated this way.

[Property Rights in Dividends]

* [Formal Understanding] *Hay v. Hay* (Washington) (AoI state that in event of liquidation, dissolution or winding up of Corp, preferred shall be paid “all accrued unpaid dividends.” P argues that dividends should come out of assets. And D argues that phrase means only dividends out of surplus profits, and since none existed, right to dividends never accrued on preferred stock. Issue: dividends due?)
  + **Yes.** Here, no worry about dividending out $$ owed to creditors. At liquidation, no longer a going concern. D’s position is based on failure to recognize valid distinction between a corporation that is a *going concern* and one that is in liquidation. Forbidding declaration of dividends except from net profits shall NOT be construed to prevent distribution of assets upon a dissolution after payment of corporate debts.
    - AG: Some formalism here. Terms become standardized to mean certain things 🡪 phrases become terms of art once precedent has been decided.
    - **Dissent:** “accrued” only means dividends declared, but *never issued*.
  + Shows impact on cumulative preferred in ***liquidation v. going concern***. Used to be splits between the courts, now, more of a contract drafting issue
* [Daily v. Annual Accrual] *Smith v. Nu-West Industries* (Delaware) (Issue: do dividends accrue on a daily basis or only on the day in which dividend is due [annual basis]?)
  + **Daily basis**. When look at contract as a whole, “reasonable person in the position of parties” would intend this result. Other provisions state that dividends will “*cease to accrue*”, which suggest they have been accruing up until that date. “Payable”, “accumulation” and “accrual” are different concepts. Payability is linked to profit (dependent on profits). If you can’t pay, AoI still states dividends cumulate. And separate question of when shareholders rights accrue (rights vest at a certain time).
    - AG: Court states they’re using standard contract rules of interpretation 🡪 intent of parties. Different than *Sharon Steel* and bonds, where the Court disregarded intent. Here, Court wants to reconcile ALL provisions of contract.
      * Many of these cases are simply drafting error.
    - **Problem:** how should we understand this language about accrual? Court treats the document as a contract, and looks at it as a whole. Just looking at word “accrual,” not obvious, but clear to court if take broad view.
* Historical backdrop: in aftermath of great depression, companies didn’t issue dividends for years. Now, issuing dividends and common putting pressure on company to get some of the $$.

**Altering the Preferred Contract**

[Voting Rules and Voting Rights]

* **Doctrine of Independent Legal Significance:** Elevation of form over substance. For a variety of transactions, multiple levers that can be pulled under Delaware law. Allows you do one provision of the Delaware code that would be ***impossible*** to do another Delaware code 🡪 EVEN when it results in the same substantive outcome. Huge hurtle for one approach, but minimal for another. Delaware says *no problem* 🡪 each transaction is ***independent of one another***. Each provision is distinct. Very formalistic.
  + Allowed companies to clear out preferred stock dividends in merger if appropriate merger laws were followed. Sole purpose of merger may be to change articles to destroy preferred dividends, but ok. More than one pathway to a transactional result.
  + Good? Line drawing problem. Allows for ***predictability*** 🡪 parties can draft around and predict. Also, allows corporations ***flexibility*** and ***creativity/innovation*** to use a variety of provisions in various settings 🡪 multiple pathways to a given result, and some pathways may be better than others. BUT this may cut against investor expectations. Allows opportunistic behavior. Also, legislative intent argument 🡪 want to allow a variety of transactions that legislature intended.
  + In modern era, board uses this doctrine to get around preferred rights to help the common.
* **Theme in #preferred conversation:** problem of interpretation. Bond covenants intent is often ignored. For preferred, less uniformity but nevertheless, the cases show *fairly strict reading* of preferred rights 🡪 instinct to protect common(*Warner* discussed in *Avatex*)
* [Contract Language, Looking at Whole] *Elliott Associates v. Avatex Corporation* (Delaware) (Planned merger that would eliminate Avatex’s AoI, and along with it, the preferred’s rights. Issue: whether the “amendment, alteration or repeal” of the certificate of incorporation is caused “by merger, consolidation or otherwise”, thereby requiring preferred vote?)
  + **Yes.** Backdrop is *Warner* (stingy reading of contract), which had slightly different language (just said preferred get vote if rights were altered/changed). Here, added words “merger, consolidation or otherwise.” The fact that they mention “consolidation” is influencing court 🡪 contemplates a *repeal* of preferred rights (through transactions) rather than just amendment of rights. Court is trying to make all the contract language have meaning (reconcile all provisions) 🡪 D’s reading were render consolidation “*mere surplusage*.” ***Technical reading*** of contract language.
    - Contrary result would create an anomaly and could risk erosion of uniformity in corporate law. Courts should avoid creating enduring uncertainties around boilerplate.
    - AG: Takeaways 🡪 courts look closely at language. Slightly different in wording gets court protection. Also, reminder that preferred don’t always lose. If contract clear 🡪 courts will give preferred their plan. Also, issue of preferred voting rights as a class (extremely important protection, if applied). One way to amend rights is to amend articles, or through merger statute 🡪 kicks in independent legal significance doctrine. P can’t rely on statute, so need to turn to contract [check this].
      * Good example of how contracts evolve based on prior case law
* [Workaround Preferred Terms—Indiana Law] *Corre Opportunities Fund v. Emmis Communications Corp* (Indiana) (E is trying to amend preferred rights, so engages in elaborate process to secure voting rights of preferred 🡪 uses return swaps [leaving record ownership] and voting agreements to avoid being forced to retire any bought shares. P argues that swaps were sales in all but name and shares should be retired; “sham” to strip away preferred voting rights. Issue: permissible under Indiana law?)
  + **Yes.** Record ownership remains with the preferred 🡪 NOT a complete exchange of entire bundle of rights of ownership. IBCL says definition of “shareholder” is “the person in whose name shares are registered in the records of a corporation.” Voting agreements are allowed (straight forward corporate law). And Indiana law *expressly permits* an Indianan corporation to vote its own shares. In regard to the Retention Plan Trust, Indiana does not follow Maryland’s “primary purpose test,” and Indiana is declining to follow stricter scrutiny (like *Unocal*). **Business judgment rule *applies***. And balance of harm argument fails.
    - Preferred’s director votes for the initial swaps, but seems like he did not know what is going on. AG: when all is said and done, his influence doesn’t do much. But other cases where directors are extremely powerful 🡪 certain rights allow preferred to take over the board.
    - Board is explicit that it is trying to benefit the common.
    - AG: example of ***highly formalistic reading*** and creative lawyering. Delaware statute says “indirectly”, so likely wouldn’t work there.

[Dealing with Class Veto Power]

* **Veto power** can be a protection against opportunism, but at the same time, risk that veto power will be misused 🡪 issue is whether there is *enough flexibility* to get around it.
* [Leading Delaware Case on #Vote Buying] *Schreiber v. Carney* (Texas wanted to create reorganization plan. Jet Capital was a large preferred shareholder that did not want to vote for transaction b/c of tax concerns. Texas gave JC a cheap loan to buy vote for transaction. Shreiber brought suit arguing tainted vote buying and therefore void. Issue: loan ok?)
  + **Yes.** Vote buying is NOT ***illegal per se***. Used to be in some cases, but rationale for this thinking is outdated. Each arrangement must be examined in light of its object or purpose. To hold otherwise would be to exalt *form over substance*. More than mere form of agreement should be considered, and voting agreements are NOT illegal per se UNLESS the object or purpose is to ***defraud*** or in some way ***disenfranchise other stockholders***. Voidable and test is **intrinsic fairness** (high level of scrutiny) 🡪 do NOT get benefit of BJR. Burden shifted (court recognizes potential area of abuse). Here, purpose was to *further interest of stockholders*.
    - Caselaw has two strands: (i) vote buying is illegal per se as matter of public policy; and (ii) voting buying is illegal per se if its object or purpose is to defraud or disenfranchise the other stockholders.
      * Court rejected (i) 🡪 necessary result of an evolving corporate environment. Delaware law permits stockholders wide latitude in decisions affecting the restriction or transfer of voting rights.
    - Voting agreements and voting trusts are allowable in Delaware.
    - AG: Court’s basic concern is that in the modern era a per se rule will be unwieldy, and in some cases, vote buying would be appropriate. Here, preferred not opportunistic, just looking out for the bottom line. Vote buying to push a transaction through that would be profitable for the company; approved by shareholders.
* [For Preferred Against Common] *Orban v. Field* (Delaware) (Stock for stock merger between Staples and Office Mart. Staples wanted 90% common approval, and one common shareholder—Orban—threatened to block transaction [has effective veto power]. Board took a series of steps to dilute Orban’s voting power. Preferred preferences would zero out common’s value. O argues board breached FD of loyalty. Issue: decision allowed?)
  + **Yes.** Board may deploy corporate power *against* the common—the ***greater good*** justifying the action—but when it does, required to demonstrate that it acted both in ***good faith*** and ***reasonably*** 🡪 heightened scrutiny and BoP on D. Board does NOT have a duty to breach its contract obligations to the preferred.
    - AG: Limit on duty of loyalty. Court is likely very aware that O is acting opportunistically.
      * Interesting case on how contract and fiduciary law interact. Court hesitant to say duty to breach contract rights in order to help common 🡪 contract rights here justify board.

**Board Duties**

* [Implicit FD?] *Mary G. Dalton v. American Investment Company* (Delaware) (Preferred shareholders argued breach of FD by merger which cashed out common, but just transferred preferred rights into merged company. Unique b/c preferred typically upset by being cashed out. Here, missing out on cash. Initially, there was a merger offer where both classes got cashed out [and preferred got $$$], but anti-trust shut it down. Brockmann, a director, then solicited offers with book value as floor [left no $ for preferred]. AIC offer cashed out common, but argued preferred got increased dividend rate, sinking fund, and are ignoring economic realities. Issue: breach of FD?)
  + **No,** BUT ***depends on facts***. Here, Leucadia’s offer was NOT made in response to Brockmann solicitation, but made by knowledgeable/experienced businessmen responding to interest rate realities (good business sense to lock preferred in). Keeping preferred as it were was equivalent to cheap debt.
    - Some language in opinion (“in between two positions” and D’s says only contract) to suggest there ***is***some FD to the preferred, BUT no explicit language suggesting a FD. But analysis suggests if casual link was established, there *would* have been some FD breach 🡪 giving guiding to future boards?
    - Defendants see this as contract rights problem; Plaintiffs argue FD issue. Court says it’s *somewhere in between* 🡪 here, causation problem. NOT just a contract problem.
    - Brockmann using book value of common as floor effectively left no $$ left for preferred.
    - AG: Opinion *is* suggesting that there can a FD breach in a situation like this, but causation is simply missing here. Jedwab, and other cases, also suggest a FD can exist
* [General Rule] Where you have a contract term ***on point*** 🡪 purely contractual issue. But when no relevant contract language 🡪 duty of ***“fair sharing.”*** *Jedwab*
  + AG: multiple possible solutions. Strict FD for both common and preferred, or just contract. Courts have taken *middle ground* 🡪 contract law if contract address issue, and FD if areas where preferred and common *“in the same boat.”*
    - Is this a good standard? Always will be litigation. Hardly ever clear cut instances. Courts are nervous about pushing it too far 🡪 want to prevent egregious behavior, but limiting the scope the FD preferred gets.
    - Use implied covenant of good faith instead, like bondholders?
* [Duties of Preferred-Controlled Board] *In re Trados Inc. Shareholder Litigation* (Delaware) (VC preferred shareholders put in a management incentive plan to sell company. Company sells at price where preferred get most of there expected price, and common get zero value. Issue: breach of FD?)
  + **No.** “Entire fairness” standard b/c CoI Here, unfair process, BUT fair price 🡪 common had *no economic value* before merger, so fair for common to receive equivalent after. Board does NOT owe FD to preferred when considering actions that trigger/circumvent contractual rights, but *does* (and *only*) when they does not invoke special contractual rights and rely on a right shared equally with common.
    - Standard of conduct (what directors supposed to be doing) v. standards of review (what court uses to figure out if directors are acting well)
    - **#Standard of Review:** Three tests
      * **(i)** If board disinterested and independent 🡪 ***business judgment rule*** = liable *only* when decisions lacks *any rationally conceivable basis*
      * **(ii)** if board faces potential conflicts of interests b/c of decisional dynamics present in particular recurring and recognizable situtations 🡪 ***enhanced scrutiny*** = D has burden to show *motivations were proper/not selfish* and that actions were *reasonable in relation* to their legitimate objective
      * **(iii)** if board confronted actual conflicts of interests such that board NOT disinterested/independent 🡪 ***entire fairness*** = defendants must show transaction was product of *fair dealing* AND *fair price*. Needs to be objectively fair, not just belief of fairness.
    - Independence goes to under influence/beholden to someone else. Different than interested 🡪 conflict of interest
    - AG: Often, VC arrangement set up so that preferred get directors, but here, they get actual control. Ends up in merger transaction when common get nothing (board looking out after preferred, not common). Court says question of independence is whether person is beholden to someone else. Here, 6/7 conflicted. For review test (fair dealing and fair price), no one component is supposed to be dispositive (but here, looks like price was).
      * Double lawsuit: FD claim and appraisal claim. Knocked both out b/c common was worth zero.
      * Any reason to doubt that the common is worth zero? Perhaps, imaginable that company could be turned around. But market says no? Court says it wasn’t foreseeable that profitability could overcome dividend and preference rate. Essentially making a prediction.
    - AG: why is there so much discussion of fair process, when fair price is determinative? Perhaps chastising the Board, but may be *guidance function/warning* 🡪 providing a road map to future boards to make it easier to avoid these problems.
  + Situation in which risk preferences very different for common/preferred. Common are underwater, so want high risk. Preferred want to preserve liquidation preferences. Especially in VC world, there is opportunity cost for tying money up 🡪 will kill mediocre businesses that are profitable (“zombie investments”) in order to deploy capital somewhere else. Leads to very conflicting responsibilities for directors.
  + In another case, court held that board had “a fiduciary duty to see that the preferred dividends [which were in arrears] are brought up to date as soon as possible in keeping with prudent business management.” Could be read to say board owed FD to common to return board control to common stockholders by *eliminating dividend arrears* that triggered preferred voting rights. *Baron v. Allied Artists Pictures Corp* (Board controlled by preferred b/c dividends haven’t been paid in long time)
    - AG: BUT, prudent business management gives a lot of deference to the board 🡪 board doesn’t have to pay dividends the *instant* the $$ is available in order to give control back to common. Middle ground type position.

**Share Redemptions and Repurchases**

* [No Right to Status Quo] *Gradient OC Master v. NBC Universal* (Delaware) (Complicated offer to preferred that includes elevation clause of certain stocks. Big part of deal structure is to induce preferred to participate. Plaintiffs argue offer is coercive—don’t have real choice; if don’t exercise, bad things happens, and if do exercise, bad things happen. Issue: wrongful?)
  + **No.**As a general rule, preferred’s rights are contractual in nature. However, share right with common to be free of *wrongful* coercion 🡪 strong-armed tender for reasons ***unrelated to economic merit of the decision***. Here, P merely alleges the *risk* of being “put out of the money.” Such a risk is inherent in the bargain a preferred shareholder makes, which generally includes the possibility that the company later can issue more senior debt or other securities w/o the preferred’s consent. Basically, P is arguing that a stockholder should have a *right* to maintain the status quo 🡪 have cake and eat it too. This is *not* supported by case law.
    - Shareholder does not have right to have status set in stone 🡪 world is dynamic, and arguably, this transaction could leave preferred in roughly the same place, but just with different details.
    - **Strong-arm:** if you’re being rational, you have no choice at all
      * AG: what makes this case tough is that it’s not clear that there was a meaningful choice here…
    - AG: like *Katz v. Oak*, but with preferred, not debt. In *Katz*, if it was wrongful, must needs be wrongful on contractual grounds. Here, FD comes into play. Tough question on whether decision is made on economic merits or strong-arm tactics. Also, issue of contract v. FD coming up. D wants to say only contract.
      * These are hard cases. Here, court says that transaction was designed to help the business. Overall, if the plan works, preferred could be better off! Not clear that economic merits are bad for the preferred. And court says P gets specific contract rights by getting 2 directors. Shows harshness in which court treats FD towards preferred 🡪 if you have contract provision on point, even if it is lame, is enough.
      * Court here seems to think that a rational shareholder could make a decision on the economic merits 🡪 didn’t *have* to tender.
    - AG: In *AC Acquisitions*, the strong-arm was to fend off another corporation. Here, arguably two choices that *could* benefit them. But really, not a very bright line in between these cases. Court seems to be struggling to meaningfully distinguish.
    - AG: If the transaction is supported, but not by 90%, the NBC U and Citi gets huge windfall 🡪 transaction penalizes preferred AND give NBC/Citi a windfall. Power move by big shareholder?
  + AG: wrongful coercion cases are always transactional. *Eisenberg* is clear example of where fiduciary theory is used.
  + AG: this is not an impossible theory, but in front of this judge, it’s a tough claim to make stick
    - **Two aspects here:** covenant stripping, like *Kats*. Court seems ok with this in the abstract. We also see the reaffirmation of the idea that sometimes all the preferred gets are contract rights, depending if any language covers the issue.

1. **#OPTIONS AND CONVERTIBLE SECURITIES**

**Introduction to Options**

* **Option:** contract giving the holder the right to buy or sell an asset at (or before) a future date a ta specified price
  + **Derivative:** security or community that derives its value from something else. Option is a *type of derivative*.
  + Entirely possible for a third party to entirely create an option for a company’s stock. But, a company can create its own options as well 🡪 *see* “Warrant”
  + **Call Option:** contractual right to buy an asset at a specified price on/before a specified date
  + **Put Option:** contractual right to *sell* an asset at a specified price on/before a specified date.
  + **American Option:** contract that allows holder to buy/sell an asset *on or before* the Expiration Date.
  + **European Option:** contract that allows holder to buy/sell asset *only on* the Expiration Date.
  + **Warrant:** call option issued by a company with respect to *its own securities*
* *Why use options?*
  + Allows you to hedge risk 🡪 e.g. futures/forwards contracts in agro industry.
  + Form of compensation 🡪 e.g. stock options for executives. Provides incentives for executives. Risk though of executive manipulating stock price through operation or shady accounting or option backdating (type of fraud), e.g. Enron scandal.
  + Use as convertible security
  + Use as warrants. Leads to dilution.
  + Allows players to bet on the market
* **Real Options Theory:** Ppl often have options even though they haven’t bought/contracted for them (many economic arrangements that are the equivalent of options, and useful to think of them as such). Economic theory to evaluate financial decisions.

**Operation and Valuation of Options**

* [Use of Options—Indiana] *Brane v. Roth* (Indiana) (Action brought against directors of co-op for breach of FD b/c they did not buy options to hedge against risk of grain prices. Issue: breach?)
  + **Yes.** Hired manager who wasn’t familiar w/ options, and failed to adequately supervise. Evidence shows that directors made *no meaningful attempts* to be informed.
    - AG: very undiversified business. Risks of not hedging are substantial. Two ways to read case: either (i) breach b/c of failure to be informed; or (ii) breach simply b/c didn’t hedge 🡪 duty to limit risk. If (ii), then in conflict with lots of corporate law—NOT standard corporate law. (i) is standard corporate law 🡪 duty to monitor (*Caremark*).
    - At this time, Indiana standard NOT *gross negligence*. Legislature adjusted standard hereafter.
* **Valuation of Options**
  + *What affects value of call option?* Exercise price; dividend policy 🡪 could affect the stock of the price as $$ is dividended out of corp; current stock price; duration of put option contract 🡪 increases chance that you get “in the money”; anything that affect price of underlying asset (e.g. M&A activity); variance 🡪 if stock moves in wide band, then chances that stock will go up is greater; interest rates 🡪 affects what you can do with money otherwise.
    - When we get to convertible securities, substantial risk that M&A activity destroys right to convert.

**Convertible Securities and Deal Protection**

[Destruction of the Option]

* There are a number of corporate actions that can destroy the value of options/conversion rights 🡪 e.g. mergers which causes common to disappear or replaced.
  + Additionally, the term of conversion rights may be *uncertain* by the ability of the issuing corporation to call the underlying securities for redemption.
* [Option Depends on Contractual Rights] *John Parkinson v. West End Street Railway Company* (Mass) (Bondholders that want to convert into preferred of new company. Statute that says that new company is “subject to all the duties, restrictions, and liabilities” to which the old one was subject. Issue: option preserved?)
  + **No.** Depends on your ***contractual rights*** 🡪 don’t get benefit of stockholder under you’re recognized as such. Subject matter just isn’t there in the new company. The contract said holder could buy stock in the old company. Option gave P merely a hope, NOT an undertaking the corp will continue for the purpose of making it good. Here, contract is not void, just makes a particular piece is *now useless*.
    - Contract had no bar on M&A activity, nor does it bar issuance of new stock, nor does it prevent dissolution of the company (these things also would have destroyed the value of the option). Bondholder simply ***realized a risk***.
      * “A consolidation which makes no arrangement for furnishing stock in the new company, and which ends the existence of the old ones, as a general rule may be presumed to *put an end* to the right of bondholders to call for stock…”
    - All that your really have prior to conversion *is a hope!* This proposition is still good today.
* [Contract Rights, and No FD Until Conversion] *Simon v. Cogan* (Delaware) (Merger transaction set up so bondholders don’t have conversion into stock that they’d like to have. Debate about whether they’re getting an equivalent. Instead of being bought out in the merger, they get similar cash value [here, $12/share]. Unsatisfying for bondholders b/c bonds were trading at $86. P argues FD breach, contractual breach, and common law fraud. Issue: FD breach?)
  + **No.** Elementary that rights of bondholders are ordinarily fixed and determinable from the ***language of documents*** that create/regulate the security. In the absence of fraud, insolvency or a statutory violation (or limited instance of implied *terms* due to good faith/fair dealing), a debenture holder’s rights are defined by the terms of the indenture. AND doesn’t matter if bondholder has option 🡪 NO FD duty owed ***until they’ve been exercised***.
    - Bondholder has legal answer 🡪 ***protect yourself through contract***
    - AG: This approach is more economic in the sense that bondholders and equity have different interests 🡪 would pull board often in opposite direction
      * If the bondholder thought that merger would create a lot of value, then ability to convert into common could be extremely common. This also relates to the issue we saw earlier as to whether $12 is fair value for the common.
      * Strong contracts rights, but courts are generally reluctant to find implied term. Not impossible to make this argument, but tough.
    - AG: a component of the court’s reasoning is that the underwriters are reliable negotiators for the bondholders. Is this convincing? Maybe, trying to sell it to the eventual purchaser. But even if they aren’t negotiating well, then won’t it be reflected into the price?
      * Court also discusses the risk of uncertainty, and the contract provisions can be included to protect against this risk
  + AG: *Simon* seems to be the dominant view, but *some* judges occasionally disagree. NOT 100% unanimity here (see case notes). However, law is pretty clear in this area = pre-exercise, bondholders do NOT get FD, but get them post-exercise.
* [No Right of Appraisal for Option Holders] *Andaloro v. PFPC Worldwide Inc* (Delaware) (Issue: can the petitioners seek appraisal under Sec. 262 to receive the “fair value” of the options they were forced to give up in the merger in exchange for certain other considerations?)
  + **No.** Language in statute refers to *stock*, NOT options. And under *Lichtman* (which tracks language of statute), the right of appraisal is NOT available to option holders.
    - Here, P is trying to use equity rationale 🡪 they *would* have been able to use their options BUT for the misconduct of Ds. Strine replies that shoehorning P’s claims into Sec. 262 would distort the statute’s intended focus as a *limited and efficient remedy* focused solely on the fair value of the stock. If there is a contract breach, *go for it!* But contract claim is different than using Sec. 262. Can’t use equity to rewrite the text.
      * AG: court is cabining the reach of statute appraisal claims. Appraisal suit is NOT about whether or not you’ve been wronged. If equity theories may be working their way into appraisal suits, would be a very type of litigation. May have a floodgate problem w/ ripple effects in other areas of corporate law.
        + Court is unwilling to use equities to stretch language of the statute. Says either you are a shareholder or your not. Here, not shareholders, so don’t get to use appraisal suit. Reins in the scope of section 262.
      * Contract claim may be harder to prove?

[#Dilution of Option Rights]

* Global concern of investors in options and convertible securities is issuance of new shares at “too low” a price. But “too low” is hard to define, particularly in closely held corps where valuation is difficult 🡪 **anti-dilution** protection thus typically limited to structural changes in common stock (e.g. stock split). Come in a few forms:
  + (i) Formula reduction in the purchase price;
  + (ii) Flat prohibition;
  + (iii) Requiring prior notice to holders of options/convertibles (so that they can convert); or
  + (iv) Participation feature giving holders an amount equal if they converted immediately prior to distribution.
* Anti-Destruction v. Anti-Dilution
  + **Anti-destruction:** prevents an event where you rights no longer exists, e.g., a conversion right being destroyed in the event of a merger.
  + **Anti-dilution:** Not that the asset not longer exists, but risk related to asset that makes conversion less attractive. E.g., restricts the issuing of additional shares to dilute the value, or restricting the divestment of assets (spin offs, stock split, dividends, etc.).
    - **Stock split:** e.g., making one share of common worth $10 into 2 shares of common worth $5 each. Doesn’t bother common, but hurts convertible preferred/bonds.
      * Roughly equivalent to a very large dividend.
    - **Reverse stock-split:** 2 shares into one. Technique to eliminate small shareholders by forcing shareholders that only own a fraction of a share to take cash.
    - For anti-dilution clauses, bargaining power matters. Companies often resist, but in a tough market, may not have a choice.
* [Anti-Dilution and Implied Terms for Preferred Stock] *HB Korenvaes Investments v. Marriot Corporation* (Delaware) (Preferred/bondholders upset b/c valuable and profit-making assets being placed into new corporation, Marriott International. Capital intensive and debt remained in old corporation. Preferred shareholders were sophisticated and hedged their stock against movement of common 🡪 isolated value related to dividend/liquidation preference [taken conversion right out of picture]. Dividend *helps* the preferred, but b/c of hedge, cannot benefit. And left with heavy debt load, so dividends to preferred less common. Here, not that the ability to convert is loss, but anti-dilution issue. Section 5(e)(iv) guarantees that certain amount of value will be left to protect rights of preferred by adjusting conversion right through complicated formula (as amount of assets leaving increases, the price of conversion drops). But problem: if 95% of assets spun off, then provision no longer works. Issue: does contract rights prevent this transaction?)
  + **No.** *Implied* in contract [anti-dilution provision] is obligation to keep a minimal amount of value in company. Here, enough value has remained. (AND court says this doesn’t interfere with prior cases that say contract should be strictly construed). BUT value remains to satisfy their remaining rights 🡪 range of values does not suggest probability of plaintiff success. For valuation, Board can make decisions with information that exists ***at the time*** (planning concern). Contract builds in deference to Board.
    - Cannot just show a *mere possibility* of harm to get preliminary injunction. No particular reason to think the far low end of bell curve is more likely.
    - Ultimately, this is contract issue. But court says the key issue happening ***at the time*** of corporate action. Board is not in a position to anticipate everything for valuation. Also, built into contract is broad discretion for board to determine value.
    - AG: We’ve seen many cases where implied term theory does not work. But here, could say “fruits of bargain” are being protected. And valuable to note that ***implied term theory*** CAN work. One of only a few cases where court implies terms for preferred shares. But court is very stingy in applying it 🡪 need ***“necessary implication”*** for term. Very tough bar to meet. But what room is left in “strict scrutiny”? Is this akin to absurdity doctrine? Here, provision is designed to deal with this precise transaction, but extreme circumstances make it not function.
    - AG: Court also found that no FD was owed. Clear contract language on point, so preferred doesn’t get FD. Consistent with pattern we’ve seen.
* [No Distributing Benefits = No Dividend] *Stephenson v. Plastics Corp* (Minn) (Plastics spun off stock in another company, United, in order to split control over the business [conflict between directors]. As part of this transaction, all stock of United was dividended to common. Issue: is this a dividend or capital reorganization?)
  + **Not dividend.** Context (facts of particular case) was necessary to split business; not about distributing benefits to shareholders 🡪 not ***“fruits of corporate operation.”*** Different *purpose* here. **Possibly a capital reorganization.** Plaintiffs should be allowed to present evidence on the issue. **Who knows about sale of all/substantially all of assets**. Not enough evidence.
    - AG: dividend or reorg? Both apply? Sale of all/substantially all of assets? Significant that this court was willing to look to extrinsic evidence 🡪 different than cases about corporate bonds, or tendency in Delaware when looking at preferred (has a more ordinary contractual analysis, but like *Wood*, find ways not to look at evidence).
    - AG: Not sure Delaware would go same way on dividend issue.
* [Whether Dividend Depends on Contract] *Wood v. Coastal States Gas Corp* (Delaware) (Gas company with tough contract disputes wants to spin off assets and distribute stock to common. Huge extraordinary dividend, and preferred complaining b/c they don’t get to participate in it. Anti-dilution provision addresses recapitalization. Issue: is this recapitalization?)
  + **No.** Settlement plan does NOT include an exchange of the common and, given the added circumstances that the *dividend or liquidated preference* of the preferred is NOT threatened and earned surplus is ample to support distribution of Valero shares 🡪 NOT recapitalization within meaning of clause. Language is classic **anti-destruction** language. Here, no merger/consolidation. Just surplus distributed to common.
    - Most purposes, preferred rights are fixed by contractual terms 🡪 duty of the court to construe contract, looking at entire instrument and reconcile all provisions
    - Stock dividend language doesn’t apply b/c it’s dealing with subsidiary stock, not Coastal stock
    - AG: in other instances, this may well be considered a recapitalization. Here, court did NOT look at extrinsic evidence, only ***within contract*** 🡪 reading all the clauses together. Probably a drafting error.
* [Make Clauses Meaningful—Implied Terms and Intent] *Coffman v. Acton Corp* (1st Cir) (Settlement agreement that gave P an additional amount in stock price rose over $7. Acton did reverse stock split, which ballooned stock price, and prior to which contract had said $7 should be multiplied by 5 [same ratio as stock split]. P argued that settlement agreement rights should be triggered. Issue: entitled to payment?)
  + **No.** P’s position would make clause meaningless b/c right could be eviscerated by stock split. Fundamental principle that a contract is to be construed as ***meaningful and not illusory*** 🡪 should be construed in reference to all its language and to its general structure and purpose and in *light of all circumstances*. These factors may qualify and control the literal signification of particular terms/phrases as effectually as if express qualifying words were found in the instrument. *P’s position is wooden*.
    - True that contracts cannot be rewritten simply to “rescue a firm from a sinkhole of its own design.” Adding new provision only permissible when additional terms are “*essential to a determination*.” Here, every reason to presume P did NOT intend to acquire nothing, and saving from unenforceability ranks as a necessity.
    - AG: not calling it good faith/fair dealing, but court’s language looks a lot like hypothetical bargaining.
      * Different case then a lot of other cases. ***Implies understanding.*** Different kinds of parties than typical and doesn’t implicate bigger market effect (concern with bond covenants). Here, small scale negotiation between two parties. And court takes this into account 🡪 intent of particular parties. Finds an *implied term* that would prevent a regular stock split (due to dilution), so only fair to have reverse stock split.
      * More inclined here to find *implied terms* 🡪 less impact on markets. Just between two parties.
  + Court provided adjustment clause, stating that it was an *essential term* that court could apply (court refuses to “disregard common sense and slavishly bow to the to the written word when doing so would plainly ignore the true intentions of the parties making the contract.”) *Reiss v. Financial Performance* (New York)
* [Implied Term Default Rules]
  + **Penalty Default Rule:** NOT coming up with what parties want/intended, but designed to provide correct incentives, e.g., to be more specific
  + **Majority Default Rule:** Imply term that the majority of parties would prefer
  + **Tailored Default Rule:** Imply terms that the specific parties wanted/intended
* [Context of Contractual Clauses] *CL Investments v. Advanced Radio Telecom Corp* (Delaware) (Warrant issued with conversion adjustments upon merger or specified dilutive transactions. Here, ART acquired Telecom via reverse triangular merger [Telecom technically survives], and *then* did dilutive transactions. Issue: is ART the “company” that assumes the anti-dilutive warrant obligations?)
  + **Yes.** ART did *not* assume the warrants via statute or contract, but the ***“context…otherwise requires”*** that ART be deemed “the Company.” If not, contract provision would be superfluous. Both legally and equitably, this outcome is required.
    - AG: Involves both anti-destruction (clearly applies) and anti-dilution clauses (controversy). Key issue: what is “company”? Statutory argument fails. But does contract requires succession of obligation? Doesn’t work. But other clause is key 🡪 if don’t rule this way, contract would be both sword (can force P to accept stock upon exercising warrant) and shield (prevent enforcing anti-dilution provisions) for ART. Idea is that ***all provisions should have meaning*** 🡪 opposite result would make clause meaningless.
    - AG: Doctrine of independent legal significance can’t really be applied here to contract b/c paragraphs reference each other (hard to argue should operate independently).

**Last Period Financing: Death Spirals**

* Of particular concern in thin markets 🡪 short selling is more likely to have an impact. Leads to a pretty dramatic effect in stock price, and allows preferred to gain control of company
* [Death Spiral Allegation] *Internet Law Library v. Southridge Capital Management* (SDNY) (ITIS needed capital and agreement with D, who represented during negotiations that wouldn’t engage selling ITIS stock for a year. In contract, no short-sell period for six months. Shortly thereafter, triggered “death spiral.” Securities fraud case.)
  + **Death spiral:** party provides financing to a target company and then proceeds to aggressively short-sell its stock in the hope that short sells will drive down its price. This price drop, in turn, enables the party to obtain more shares of common stock upon conversion by virtue of an arrangement known as a **“toxic convertible”** that allows the company’s preferred stock to be converted *at a discount* to present market value of common issuable upon conversion. Then use additional share to cover their short position 🡪 big profits.
    - AG: much stronger case against security fraud here than in *Colkitt*
    - AG: anti-dilution provision that focuses on change in market price. Not commonly issued by company that’s doing well. But if financing is tough, then might.
* [Mere #Short Selling is Not Enough] *GFL Advantage Fund v. Colkitt* (3rd Cir) (Majority shareholder in two companies. Gets financing through convertible securities to GFL. GFL starts short-selling and converting; Colkitt refuses to issue shares upon conversion request, and GFL sues. C argues GFL is trying to depress market to gain additional shares. GFL argues they were simply hedging. Issue: is this manipulative practice? Issue 2: securities fraud?)
  + **Not manipulative practice—lack of evidence (no wrongful conduct).** Short selling is NOT inherently bad 🡪 need to distinguish legitimate trading strategies intended to anticipate/respond to market forces and those designed to manipulate prices and deceive. Need to know if GFL ***injected false information*** into market (e.g. scheme to present false demand 🡪 causes someone to buy based on false appearance).
    - To establish a Section 29(b) affirmative defense of market manipulation in violation of Sec. 10(b) and Rule 10b-5, C must present evidence that:
      * **(i)** in connection with the purchase/sale of securities;
      * **(ii)** GFL engaged in deceptive or manipulative conduct by *injecting innacurate information* into marketplace or creating false impression of supply/demand for the security
      * **(iii)** for the purpose of *artificially depressing/inflating* the price of the security.
    - SCOTUS has said “manipulation” is a term of art. *Santa Fe* (merger transaction at low price, but no issue of deceitful conduct 🡪 not enough for manipulation). Simply depressing price through short selling is natural consequences of a lawful and carefully regulated trading practice. And just having convertible securities (bad incentives) is not enough for liability.
    - AG: Simply showing that someone knew of a price effect is NOT enough. Conveying negative information is NOT market manipulation UNLESS the ***information is untruthful***. Court says a lot of C’s arguments are just general criticisms of short selling.
    - AG: Typical securities fraud we’re talking about false statements. Market manipulation, in contrast, is ***conduct-based*** *🡪 effort to trick market through buying/selling*. But also often involve false statements.
      * Court says you *still* need deceitful conduct, even if false statements not required. Negative info not enough. Here, just typical short selling.
  + **No securities fraud.** Elements: **(i)** misstatements or omissions of material fact; **(ii)** with scienter; **(iii)** in connection with purchase or sale of securities; **(iv)** upon which plaintiffs relied; and **(v)** that plaintiffs’ reliance was the proximate cause of their injury. Here, C can’t point to fraudulent statements that defrauded him 🡪 has to rely on omissions, which requires *duty to disclose*, which arises *only* when one party to a transaction has material information that the other party is entitled to have b/c of *some relationship of trust/confidence* between parties (e.g. fiduciary, corporate insider, or “tippee”). Or, may have duty to disclose based on half-truths and context when highly misleading. And GFL had no duty to disclose its intentions to C.
    - AG: court rejects C’s view that short selling inherently “taints market price” 🡪 C is arguing GFL gave an implicit guarantee. Court says for this to work, we’d need to believe short-selling inherently taints market.
    - AG: in *Internet Library*, there are misstatements (allegedly). And to a degree, this can be address ex-ante in contract 🡪 room to negotiate added protection.
  + *Wharf v. United Holdings*: Option contract *can* be a security in certain settings. Interaction between contract and securities fraud? Not all breach of contract claims linked to securities are securities fraud cases. Here, Wharf sold option while secretly intending not to honor option 🡪 fraud, and makes it different from not honoring option down the road.

1. **#DIVIDENDS AND DISTRIBUTIONS**

**Introduction**

* *Given M&M theory, why might investors care about dividend policy?* Differences in tax treatments. Transaction costs. Steady source of income in retirement 🡪 cash flow, and touches on transaction costs. Dividends might reduce agency costs 🡪 provides accountability via regularly going to capital markets (Judge Easterbrook theory—sophisticated investors scrutinize/monitor each time capital markets are accessed) and relates to decision as to *who* get to reinvest earnings. Sends various signals into market (e.g. dividends = no better investment opportunities).
  + AG: separate question as to whether investors are rational? Could have impact on some of their preference.
* Board gets *discretion* on when to issue dividends, with some limits
  + **Fraudulent transfer:** around bankruptcy, cannot transfer.
  + **Legal Capital Requirements under Statute:** dividends only allowed out of **“surplus”** 🡪 above par value. In certain circumstances, can still issue dividends if have been profitable in this year and last (**“nimble dividend”**).
    - But par value can be altered via shareholder vote. So is “surplus” meaningful? Par value historically provided meaningful cushion for creditors. Over time, began to see low par or no par stock 🡪 far less protective than originally thought.
  + Issue in *Klang*.
* *How well do these legal capital protections work for creditors?*
  + Keep in mind fraudulent conveyance 🡪 duplicated in some ways in legal capital protections. But some differences: technical differences in the tests, and ***damages*** 🡪 recession of the transaction (fraudulent conveyance) v. director liability (legal capital protection). Also, to a degree, protections in legal capital stem from contracts 🡪 form of freeriding (if certain covenants in place, any other creditor will benefit).
  + Delaware is one of the few remaining jurisdictions that takes par value seriously (*Klang*) 🡪 dividends must be coming from **surplus**. Aggregate par value sets a floor.
    - *Klang* shows there are real limits to this protection 🡪 do NOT just have rely on balance sheet

**Restrictions on Dividends and Other Distributions to Shareholders**

* [Looking Past Balance Sheet] *Klang v. Smith’s Food & Drug Centers* (Delaware) (Merger. P argued repurchase of shares violated statuary prohibition against the impairment of capital. Also, argued FD breach b/c failure to disclose material facts. Why impaired? P argues balance sheet test—Smith had negative net worth. Also, even if allowed to go behind the balance sheet, S had valuation error. Issue: impairment?)
  + **No.** Company should be allowed to look ***past the balance sheet*** to actual market value. Books do not necessarily reflect current value of assetsliabilities. This comports with *purpose* of statute. The balance sheet might tell us something, but not going to tell us everything relevant to creditors claims. Need to focus on whether creditors will be paid. And statute doesn’t tell you *how* to value assets, only that they all have to be taken into account. As long as valuations is legitimate 🡪 deference. In ***absence of bad faith/constructive fraud*** on part of board, courts will NOT substitute its wisdom for that of directors.
    - Outside bank did valuation, and Board relied. Valuation reliable? **Yes.** Can use *multiple processes* and NOT one specific way to do this. Need to take into account *all assets*, and statute does not demand one particular method. Here, nothing wrong with data.
      * Repurchase **impairs capital** if funds used in repurchase exceed “surplus,” defined as excess of net assets over par value.
    - AG: Looks very much like business judgment rule. Key issue after saying you can look past balance sheet: how much deference does board get? Court says you can revalue assets, *within broad limits*, and court will defer 🡪 makes it very easy to get around par value and statutory requirement.
  + AG: another way to get around par value is to ***amend AoI*** 🡪 NOT HARD because *shareholder, who vote, are the ones getting dividends!!* But maybe company won’t do this b/c it could harm reputation and long-term relationships with creditors. Market disincentive, not legal disincentive.
    - Real limits on how much par value protects
* *MBCA Response*
  + Effectively get rids of par value—abandoned the Legal Capital approach. In their view, it is not protective and may mislead creditors.
    - As technical matter, can still have par value, but doesn’t do anything (no statutory protections)
  + Two different insolvency tests (main protection; don’t worry about par value)
    - **Equity Insolvency:** company isn’t able to pay its debts as they become due in ordinary course of business (liquidity concern)
      * Get this in Delaware via cases, not statutes
    - **Balance Sheet/Bankruptcy Insolvency:** looking at assets and liabilities. Determined on the basis of either financial statements prepared under reasonable account practices OR a fair valuation or other method that is reasonable in the circumstances.
      * Somewhat similar to what you get in Delaware with capital impairment
    - Creditor might care about both types
  + *Delaware v. MBCA*
    - Similar results, but just through different pathways
    - Lots of loopholes – flexibility to value assets. *Klang*. Possibility to lower par value after the fact. Nimble dividends (issue dividends despite issue of comparing your capital).
    - Creditors find protection via contract.
      * Other protections: Fraudulent conveyance. Piercing the corporate veil.
* [Equity Solvency Test in Delaware?] *SV Investment Partners v. Thoughtworks* (Delaware) (PE investment in Thoughtworks that redeems SV’s preferred stock out of “legally available funds.” Invested $26m, and 5 years later, SV argues stock is worth $40m+. TW says it can pay $500k. Issue: what does this phrase mean, and has SV shown enough to win case?)
  + **Not enough money either way (BoP not met), so not ruling on what “funds legally available” means.**
    - AG: Court ducks issue, but language in the lower court indicates worry about company as going concern 🡪 has some **equity solvency test** in mind. Problem if share repurchase makes it you can’t pay bills on times (destroys company)🡪 limitation on ability to repurchase the shares. “Funds legally available” would then ***go beyond*** “surplus.” **Equity solvency test** built into common law. Court doesn’t say lower court is wrong, but doesn’t have to answer this question.
      * Strict statutory limits may not be the only limits in Delaware cases 🡪 common law limitation. However, Supreme court doesn’t *actually resolve this issue*
    - **Trial court issue:** suggesting a equity insolvency test as matter of common law (statute doesn’t explicitly describe one)
* [No Creditor Complaint Exception to Insolvency Defense] *Hullender v. Acts II* (Georgia) (Couple got divorced and jointly owned insolvent company. Agreed to redeem wife’s shares. Wife seeks to redeem, and husband refuses arguing company is insolvent. Wife argues that insolvency defense should not be available b/c NO creditors involved. Issue: forced to redeem?)
  + **No—insolvency defense available.** Some foreign authorities recognize that corp. is estopped to assert its own insolvency as a defense to its obligations where no complaints by creditors are involved, but statute contains absolute prohibition and does NOT provided exceptions.
    - AG: But what about estoppel? Equity is not overriding codes (statue controls). Formalistic reading (“hands are tied”).
      * Shows that statutes can be applies quite strictly; relevant when players trying to work around statute.

**Board Discretion and Duties in Declaring Dividends**

* [Record Date to Receive Dividend] *Caleb v. E.I. Dupont de Nemours* (SDNY) (Dupont, as party of merger attempt, acquired stock in Conoco. Conoco declared dividends prior to Dupont’s ownership, but paid dividend *after* Dupont took shares. Issue: declaration date or record date for dividends?)
  + **Record date.** Owner as of the ***record date*** but NOT the declaration date is the beneficiary of the dividend. A sale between the declaration and record dates causes the dividend to inure to the benefit of the purchaser. And debtor-creditor relationship between the corp and stock owner arising at the time of declaration of the dividend was NOT ultimately controlling.
    - AG: one key issue is predictability 🡪 need to know answer is important, even if arbitrary. Possible that court could go the other way 🡪 not all rights transfer upon ownership (Williston).
    - Shareholders as a general matter are not creditors. But when dividend is declared 🡪 are creditors in respect to dividend.
* [Deference for Dividend Policy] *Berwarld v. Mission Development Company* (Delaware) (Mission is a holding company with sole asset of shares in Tidewater Oil. Tidewater ceases issuing dividends. J. Paul Getty is controlling shareholder in Mission and thus controls Tidewater [doesn’t want dividends b/c of taxes; also says for “corporate expansion and modernization”]. Plaintiffs bring suit to force liquidation of Mission. Issue: forced to liquidate mission?)
  + **No.** The extreme relief of receivership to wind up a solvent going business is rarely granted. To obtain it there must be a showing of ***imminent danger of great loss*** resulting from fraud or mismanagement. Similar caution applies in compelling a corporation to make a partial distribution.
    - Here, legitimate business purpose. No great hardship on minority. No drop in prices coincident with announcement of cessation of dividends 🡪 shareholder is “buying for growth and not for income.”
    - Also, not convinced that Getty is artificially depressing price
    - AG: Like BJR. Court is reluctant to say how business should spend its money. Courts *very rarely* interferes with dividend policy, especially with public companies. **General rule:** courts defer; very hard to force dividend.
      * Not impossible though 🡪 *Dodge v. Ford Motor Co* (huge stockpile of cash, and no obvious business reasons to keep it; responsibility is to shareholders to issue dividend) or privately held corporations conflict, *Smith v. Atlantic*.
  + Need ***fraud or gross abuse of discretion*** before courts will interfere with dividend decision. *Gabelli v. Liggett Group*
  + Dividend claim dismissed b/c all shareholders were treated alike. *Sinclair Oil v. Levien*
  + Some courts will order dividends. In *Miller v. Magline*, court order dividend when sole officer-director siphoned profits into his own compensation.
* In **Massachusetts**, there are partnership-type fiduciary duties in closely-held corporations 🡪 ***“utmost good faith and loyalty.”*** *Donahue v. Rodd Electrotype*
  + Softened in *Wilkes* 🡪 there must be a ***weighing a business interests*** advanced as reasons for major action.
* [FD Between Shareholders in Closely-Held Corp] *Smith v. Atlantic* (Mass) (Wolfson and three others invest in property [industrial real estate firm]. W wants to take income and redirect to repairs; others want dividends. Agreement gives any shareholder veto power [need 80% of director vote]. IRS penalizes for excess cash holdings [accumulated earnings tax] 🡪 large marginal tax brackets so ppl kept $$ in corporations. Issue: does corp have to pay dividends?)
  + **Yes.** W is being unreasonable (“recklessly ran serious and unjustified risks”), and stockholders in close corporation owe one another FD duty 🡪 “stockholders may not act out of ***avarice, expediency or self-interest***in derogation of their duty of loyalty.” Breached duty of *utmost good faith and loyalty* 🡪 refused to act and caused loss.
    - Do NOT have to be a majority shareholder to trigger this test
    - AG: Wolfson got protection b/c of **freeze-out problem** (salary cut; fired; unable to dissolve corporation)🡪 central problem b/c of lack of exit options. Not widely traded and difficult to sell (share transfer restrictions or risk of freeze out reduces price). Court concerned about majority abusing the minority.
      * Problem with Wolfson’s contract is raises risk of minority opportunism. Solve? Arbitration or limit scope or ***contractual provision*** that forces company to buyout minority share at pre-determined price (e.g. buy/sell agreement).
    - AG: is the problem of deadlock (here) as large as freeze-out? Should the court here extended the doctrine to minority shareholders?
    - AG: also, are the others just as in fault as W? Court seems to think that W is doing this out of spite—no real business reasons, just wants to avoid taxes and stick it to the other partners. Facts slightly altered could have changed the outcome 🡪 lower court found that W was at fault (business plan was not developed).
  + Delaware approach is the encourage parties to contract around these issues ex-ante, and for self-dealing by majority group 🡪 **“entire fairness”** kicks in or *Sinclair* FD to minority

**Stock Dividends and Stock Splits**

* **Stock split:** subdividing existing shares. Might be a way to announce a permanent dividend increase. Trying to hit a “sweet spot” in stock price range.
* **Reverse stock split:** consolidating outstanding shares. Reduce administrative costs and brokerage fees. Reduce liquidity and the proportion of stock held by retail customers (individual investors). Avoid being “penny stock” (harsh treatment by Congress, SEC, and public) or face delisting issues. Also can be a way to cash out shareholders.
* [Reverse Stock Split OK] *Applebaum v. Avaya* (Delaware) (Reverse stock split follow by stock split. Plan was to consolidate shareholder membership [reduce admin costs]. Plaintiff argues unequal treatment between shareholders. Issue: allowed to do transaction?)
  + **Yes.** Statute says discrimination based on shares. Here, discrimination based on fractional interests. AND, equity does NOT require equal treatment. What *is* required is ***fair treatment*** 🡪 sometimes does not require equal treatment. As to pricing, 10-day average is ok. Degree of discretion to board, and appraisal statute
    - Corp can validly initiate a reverse stock split and selectively dispose of the fractional interests held by stockholders who longer hold whole shares
    - For valuation, two things going on: (i) aggregation; and (ii) paying fractional shares based on 10-day average. Market price is fair *if* there is liquid market. 10 day is enough. If NOT actively traded (stale information) 🡪 court will not defer to market. **Very contextual.** Market also might be inappropriate if have majority shareholder abusing the process.
      * Plaintiff’s argue “fair value” should be “going concern” like it is in appraisal statute (two statutes with identical phrase), and market price does NOT reflect as going concern. Court says different meaning. Passed in different years w/ dissimilar purpose. Valuation of stockholder’s interest as a “going concern” is ***necessary only*** when the board’s proposal will alter the nature of the corporation through a merger.
    - AG: very possible that reverse stock split can be opportunistic.
    - AG: very *technical* reading of statute to make it flexible. Leave themselves room to go after troubling fact patterns/opportunistic deals. But flexible reading allows for broad transactional freedom.
      * Here, doesn’t look like freeze-out problem where majority trying to take control. At least in theory, this is about transaction costs.

**Stock Repurchases**

[Targeted Repurchases]

* Stock repurchases can either be general (very much like a dividend) or targeted (only available to some shareholders)
* *Grobow v. Perot* (GM bought company, EDS, founded and owned by Ross Perot. Perot got GM stock and put on board, but shortly had deep and public disagreements about how EDS should be run. Perot negotiated for GM to repurchase his GM stock at premium. Plaintiffs argue that it was board entrenchment [worried about jobs and didn’t like being criticized] and corporate waste. Issue: repurchase breach of FD?)
  + **No.** Business judgment rule case. Plaintiffs wanted *Unocal* test to apply (heightened scrutiny), but no exterior threat (extinguishable). Here, *Aronson* test for **derivative suits** (heightened pleading requirements applies) 🡪 no well-pleaded facts that indicate (i) directors had financial self-interest, entrenchment, or lack of due care and (ii) decision goes business judgment. ***Burden not met***, and public embarrassment argument is just speculative. Perot only had .08% 🡪 not enough to threatened board. And no such thing a **substantive due care** 🡪 only *process* due care. P also argues corporate waste—board bought worthless Perot silence—but court says hard to say (benefits are bundled, and could be some business benefit to former insider silence).
    - AG: Substantive due care is semantics b/c still doctrine of corporate waste (what plaintiffs seem to mean).
    - AG: case gives you a sense of the degree of deference on these issues. Not typical case, and technically not greenmail.

**Review**

* Patterns
  + Range of different ways to finance a business with different legal implication. Common stock. Corporate debt. Preferred. Convertible securities/options.
    - Issues get more interesting when financing is changed over time 🡪 bonds redeemed, multiple class of stock, large dividends, spin offs, m&a
    - Techniques for financing have multiple uses (raise money but also fend off risks) 🡪 e.g. poison pills ward off activists, reverse stock splits can freeze out minority shareholders
  + Ex ante contracting v. ex post litigation
    - Preferred v. common? What preferences? Voting rights and when? Convertible? How do these changes affect economics/pricing?
    - Lots of flexibility here. But degree of formalism 🡪 there to serve transactional flexibility.
  + Courts tend to favor certain securities over others (common over preferred; preferred v. bondholders)
* Exam
  + 3-4 essay questions—fact patterns with “would X have claim?”
    - Some parallels to cases, but not identical. Draw analogies and highlight differences.
    - Clear answers that show knowledge of law and application. *Full application*.
    - State your assumptions
  + Open book (no internet)
  + No word limit