CORPORATIONS

# Agency

## Agents

### Agents v. Non-Agents

* + 1. Agent relationship: parties must (1) agree that (2) one will act on the other’s behalf (3) subject to the other’s control. *See* R2d Agency § 1. Note: agree, not intend.
    2. Servant/Employee – “A servant is an agent…whose physical conduct in the performance of the service…is subject to the right to control by the master.” R2d Agency § 2(2).
    3. Independent Contractor – “An independent contractor is a person…who is not…subject to the other’s right to control with respect to his physical conduct…” R2d Agency § 2(3).

### Bad Cases

* + 1. Recover on Insurance *–* ***Gorton v. Doty (Idaho 1937)***
       1. Synopsis: Gorton sued Doty for injuries sustained as a result of an accident while school’s coach was driving Doty’s car. Court found Doty and coach had principal-agent relationship so Doty is liable.
       2. Tool: Court did not properly apply R2d Agency § 1 to facts. Court characterized Doty’s stipulation that the coach not let the students drive the car as evidence of her control. Even so, Doty never asked the coach to act on her behalf and the coach never agreed. The court just wanted the injured player’s father to recover on Doty’s insurance policy (Gorton’s counsel insinuated that Doty had insurance (insurance only covers accidents by other people driving if other driver is agent)).
    2. Lender Liability – ***A. Gay Jenson Farms Co. v. Cargill, Inc. (Minn. 1981)***
       1. Synopsis: Farmers (P) brought action against Cargill (D) who acted as creditor to Warren Grain & Seed Co., debtor, for damages sustained when D defaulted on contracts made with the farmers. Warren mounted debts and D lent Warren additional funds, but only if Warren agreed to live by its limitations. D sent officers to monitor Warren’s use of funds. Court found this was control and thus found agency relationship so D was liable for Warren’s debts.
       2. Tool:
          1. Court did not properly apply R2d Agency § 1 to facts. Court wanted to allow local voters to collect from the out-of-state multinational the money they had lent the fraudulent local elevator. Court ignored that parties had to agree that one will act on behalf of the other to find agency relationship. Warren did not think it was acting on Cargill’s behalf; it thought it was borrowing money as an independent operation.
          2. “Lender Liability” – A creditor who assumes control of his debtor’s business may become liable as principal for the acts of the debtor in connection with the business. R2d Agency § 14 O (see also comment a.). (Lender liability is not black letter law but name of phenomenon.) Encourages creditors to shut down all troubled firms, goods risks or bad.

## Authority – Contractual Liability

### Rule

* + 1. An agent can impose contractual liability on his principal only when he acts with “authority.”

### Actual Authority – principal tells agent to do something

* + 1. Actual Express – “[A]uthority to do an act can be created by written or spoken words or other conduct of the principal which, reasonably interpreted causes the agent to believe that the principal desires him so to act on the principal’s account.” R2d § 26.
    2. Actual Implied
       1. “[A]uthority to conduct a transaction includes authority to do acts which are incidental to it, usually accompany it, or are reasonably necessary to accomplish it.” R2d § 35.
       2. ***Mill Street Church of Christ v. Hogan (Ky. 1990)***
          1. Synopsis: Bill hired by Church to paint church. Bill asked Sam to help as had been previously done. Sam injures himself and sues for compensation. Old Board finds Sam is not employee and New Board reverses. Court affirms finding that Bill had implied authority to hire Sam, given following facts: Church had allowed Bill to hire Sam or other persons when necessary; no mention of Board of Elders discussion that Sam could not be hired again was given to Bill; one of the Elders told Bill that Gary (someone the Elder suggested) would be difficult to reach and that Bill could hire someone else; interior of church couldn’t be painted by one person; Sam believed Bill had authority to hire him as in the past (apparent authority?); church treasurer paid Bill for work Sam completed (ratification?).
          2. Tool:

Implied authority – actual authority circumstantially proven which the principal actually intended the agent to possess and includes such powers as are practically necessary to carry out the duties actually delegated. Factors:

Agent’s understanding of his authority. “Whether the agent reasonably believes because of present or past conduct of the principal that the principal wishes him to act in a certain way or to have certain authority.”

“Nature of the task or job may be another factor to consider. Implied authority may be necessary in order to implement the express authority.”

“The existence of prior similar practices is one of the most important factors. Specific conduct by the principal in the past permitting the agent to exercise similar powers is crucial.”

Person alleging agency and resulting authority has the burden of proving that it exists. Agency cannot be proven by a mere statement but can be established by circumstantial evidence including the acts and conduct of the parties such as the continuous course of conduct of the parties covering a number of successive transactions.

### Apparent Authority – principal tells a third party that the agent has authority, disclosed principal

* + 1. Rule
       1. Apparent authority only exists “when a third party reasonably believes the actor has authority to act on behalf of the principal and that belief is traceable to the principal’s manifestations.” R3d § 2.03:
       2. An agent can create her own apparent authority only when the statement is truthful when made, and thus had actual authority. E.g. principal cancels authority after having given actual authority.
    2. ***Three-Seventy Leasing Corporation v. Ampex Corporation (5th Cir. 1976)***
       1. Synopsis: Three-Seventy Leasing Corp. (P) sought damages from Ampex Corp. (D) for a breach of contract to sell P computer hardware. District Court found that there was an enforceable contract because Kays had apparent authority to sell on behalf of Ampex. 5th Cir. found that district court’s finding was not clearly erroneous since Ampex appointed Kay as sales representative, let him send a contract, circulated a memo about the sale, and thus gave Kays apparent authority to bind the firm.
       2. Tool: Apparent authority – an agent has apparent authority sufficient to bind the principal when the principal acts in such a manner as would lead a reasonably prudent person to suppose that the agent had the authority he purports to exercise…Further, absent knowledge on the part of third parties to the contrary, an agent has the apparent authority to do those things which are usual and proper to the conduct of the business which he is employed to conduct.
    3. ***Mill Street Church of Christ v. Hogan (Ky. 1990)***
       1. Apparent authority – authority the agent is held out by the principal as possessing. It is a matter of appearances on which third parties come to rely.
       2. “Agent’s agent” v. “Subagent” – Agents generally lack implied authority to hire another worker in any job that involves substantial discretion. If the first agent does have authority to hire, the hired worker is a subagent and an agent of the principal. If the agent does not have authority to hire, the worker is an agent’s agent, an agent of the first agent but not of the principal.
       3. “manifestation” – past conduct can create apparent authority in the present. Suppose a principal had earlier authorized an agent to hire someone else. That past conduct could constitute a “manifestation” to the world that the agent had authority to hire. If the agent now hires again, the principal might find himself bound by apparent authority.

### Inherent Agency Power – undisclosed principal

* + 1. Elements: (1) general agent; (2) state that recognizes it; (3) agent purports to act on behalf of principal
    2. General v. Special Agent: “(1) A general agent is an agent authorized to conduct a series of transactions involving a continuity of service. (2) A special agent is an agent authorized to conduct a single transaction or a series of transactions not involving continuity of service. R2 Agency § 3.
    3. Rule
       1. Inherent agency power indicates “the power of an agent which is derived not from authority, apparent authority or estoppel, but solely from the agency relation and exists for the protection of persons harmed by or dealing with a servant or other agent. R2 Agency § 8A.
       2. “An undisclosed principal who entrusts an agent with the management of his business is subject to liability to third persons with whom the agent enters into transactions usual in such business and on the principal’s account, although contrary to the directions of the principal.” R2 Agency § 195.
       3. R3 Agency (purports to adopt inherent agency power but actually rejects it) § 2.06 Liability of Undisclosed Principal. “(1) An undisclosed principal is subject to liability to a third party who is justifiably induced to make a detrimental change in position by an agent acting on the principal's behalf and without actual authority if the principal, having notice of the agent's conduct and that it might induce others to change their positions, did not take reasonable steps to notify them of the facts.”
    4. ***Watteau v. Fenwick (Queen’s Bench 1892)***
       1. Synopsis: Watteau (P) sold goods to a pub manager, Humble, under the belief that Humble was actually the pub owner. P learned that Fenwick (D) was the actual owner and sought to collect from D for the unpaid balance of goods purchased by Humble. D had told Humble to only buy those goods, (cigars and Bovril) from D. County Court still found D liable. Queen’s Bench affirmed, because Humble was acting with an authority that was inherently reasonable for an agent in that position (cigars were of the type that would usually be supplied to such an establishment). The situation is analogous to a partnership wherein one partner is silent but is still liable for actions of the partnership as a whole.
       2. Tool: An undisclosed principal can be held liable for the actions of an agent who is acting with an authority that is reasonable for a person in the agent’s position regardless of whether the agent has the actual authority to do so.

### Ratification

* + 1. General Rule
       1. Ratification is “the affirmance by a person of a prior act which did not bind him but which was done or professedly done on his account, whereby the act…is given effect as if originally authorized by him.” R2 Agency § 82.
       2. A principal ratifies a contract when (i) someone (who may or may not have been an agent) purports to act on behalf of the principal; (ii) that principal could have authorized the person’s actions but did not (§ 84); and (iii) upon learning of the actions, the principal either (a) indicates that he will treat them as having been authorized or (b) does something that makes sense only if he decided to treat them as authorized (§ 83).
       3. “ratify” v. “adopt” – If requirement “ii,” is not met, then principal cannot ratify after the fact but can only “adopt” the contract. Ratification relates back to the original contractual date while adoption generates a new contract that dates from the time the principal adopted it. If the date of the contract matters, the two doctrines will yield different results. R2d § 84 cmt. d.
    2. Full Knowledge of All Material Circumstances – ***Botticello v. Stefanovicz (Conn. 1979)***
       1. Synopsis: Anthony Botticello (P) entered a real estate leasing agreement with an option to buy with Walter Stefanovicz (D). Plaintiff was unaware that Walter only had an undivided half interest in the real estate, while Mary Stefanovicz (D) owned the other half and refused to accept the terms of the agreement. Walter was not acting as an agent on behalf of Mary, because Mary did not agree to sell property and Walter had never signed as her agent before. A marriage cannot in itself prove an agency relationship, and no agency relationship is established by a joint ownership. One owner cannot bind the other owner through an agency relationship simply because they are joint owners. Just because Mary observed P occupying and improving the land doesn’t mean she ratified sale of the property. There was no ratification by Mary because she was unaware that the benefits she received from the agreement stemmed from a lease with an option to buy.
       2. Tool:
          1. R2 Agency § 82.
          2. “Ratification requires ‘acceptance of the results of the act with an intent to ratify, and with **full knowledge of all the material circumstances**.’”
          3. “If the original transaction was not purported to be done on account of the principal, the fact that the principal receives its proceeds does not make him a party to it.” R2 Agency § 98.

### Estoppel

* + 1. Rule – The defendants either are estopped from denying liability or owe a legal duty they cannot avoid by contract (i.e. a duty they cannot “delegate”). Can call it non-delegable duty/negligence/apparent authority in different cases – puts liability on party that seems on a gut level to be a sensible move.
    2. **Fraud** – ***Hoddeson v. Koos Bros. (NJ App. Div. 1957)***
       1. Synopsis: Joan Hoddeson (P) brought an action against Koos Bros. (D) when D refused to reimburse P for money she gave (no receipt) an alleged salesman imposter at D’s furniture store. Court reversed lower court decision and found that D can be estopped from asserting that no claim existed when there was no agency relationship established. D, as a furniture store, still owed a duty of care to P when she enters the store and has an expectation that she will be tended to by an actual salesperson rather than an impostor. Therefore, a new trial was ordered in order to allow P to establish a duty of care. It’s A TORT!
       2. Tool:
          1. Absent proof of an agency relationship, a party may still have a duty of care for the other party to ensure that the other party is not disadvantaged in dealing with the party.
          2. Duty of care for stores includes minimizing risk of fraud on premises (like minimizing risk of slipping on banana peel even if independent contractor paid to clean).
    3. Inherently Dangerous and More – ***Majestic Realty Associates v. Toti Contracting (NJ 1959)***
       1. Synopsis: Building owner Majestic Realty and tenant Bohen’s Inc. (Ps) brought an action against independent-contractor Toti Contracting and the Parking Authority of the City of Patterson, New Jersey (D’s) for the damage done to the property while Ds demolished an adjoining building. Court found Parking Authority is liable for Toti’s negligence because the demolition work was so inherently dangerous that a party cannot delegate the liability. Public policy dictates that the party hiring the contractor, although innocent of any direct negligence, should bear the burden of damages over a party that is completely innocent.
       2. Tool:
          1. Some actions are so inherently dangerous that a party cannot delegate their liability for the duty of care to another party.
          2. “Ordinarily where a person engages a contractor, who conducts an independent business by means of his own employees, to do work not in itself a nuisance (as our cases put it), he is not liable for the negligent acts of the contractor in the performance of the contract…Certain exceptions have come to be accepted, i.e., (a) where the landowner retains control of the manner and means of the doing of the work which is the subject of the contract; (b) where he engages an incompetent contractor, or (c) where, as noted in the statement of the general rule, the activity contracted for constitutes a nuisance per se…”

## Tort Liability

### **Respondeat Superior**

* + 1. “A master is subject to liability for the torts of his servants committed while acting in the scope of their employment…” R2 Agency § 219; ***Arguello***.

### Servant

* + 1. Rule – R2 Agency § 220

*(1) A servant is a person employed to perform services in the affairs of another and who with respect to the physical conduct in the performance of the services is* ***subject to the other's control or right to control.***

*(2) [Factors:]*

*(a)* ***the extent of control*** *which, by the agreement, the master may exercise over the details of the work;*

*(b) whether or not the one employed is engaged in a distinct occupation or business;*

*(c) the kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision;*

*(d) the skill required in the particular occupation;*

*(e) whether the employer or the workman supplies the instrumentalities, tools, and the place of work for the person doing the work;*

*(f) the length of time for which the person is employed;*

*(g) the method of payment, whether by the time or by the job;*

*(h) whether or not the work is a part of the regular business of the employer;*

*(i) whether or not the parties believe they are creating the relation of master and servant; and*

*(j) whether the principal is or is not in business.*

* + 1. ***Arguello v. Conoco, Inc. (5th Cir. 2000)***
       1. Synopsis: Plaintiffs, Denise Arguello et al., are a group of minorities that were discriminated against by employees of gas stations affiliated with Defendant, Conoco, Inc. Ps asserted that D was not only liable over its employees in the stores it owned, but also a master over the Conoco-branded stores through an ambiguous “Petroleum Marketing Agreement” (“PMA”) between D and the other stores. The PMA references the treatment of customers (should be treated fairly, honestly and courteously) and a provision allowed D to terminate the agreement if the franchisees did not follow the agreement.
       2. Tool:
          1. Once a master-servant relationship is established, a master is subject to liability for the torts of the servant when the servant is acting within the scope of their employment.
          2. “…factors used when considering whether an employee’s acts are within the scope of employment are: 1) the time, place and purpose of the act; 2) its similarity to acts which the servant is authorized to perform; 3) whether the act is commonly performed by servants; 4) the extent of departure from normal methods; and 5) whether the master would reasonably expect such act would be performed.”
          3. Doing something you are not supposed to do may still be within scope of employment.
       3. Holding: Court held that D did not establish a master-servant relationship with the Conoco-branded, independently-owned stations. The PMA was not ambiguous; there was plain language that described the relationship between Defendant and franchisees as separate and outside of any agency relationship (note that courts in other cases completely ignore agreement unlike this court). Court also held that D never controlled day-to-day operations of the stores. Employees at the Defendant-owned stores could have been working within the scope of their employment when they discriminated against the customers. There was evidence that the employees were on the job performing transactions they normally handle, and the extent of the departure from their normal methods is a question of fact that should be presented to the jury.
    2. ***Humble Oil & Refining Co. v. Martin (Tex. 1949)***
       1. Synopsis: George Martin (P) brought an action against Humble Oil & Refining Co. and A.C. Love (D) when P and his children were hit from behind by Love’s car after she left it for Humble Oil to service and it rolled downhill. Humble was a franchisor gas company and this station was operated by Schneider. Court found that a master-servant relationship exists between Humble and Schneider. Humble maintained considerable control over W.T. Schneider: Humble set station’s hours; Humble owned the goods that the operator sold on consignment; ***Humble paid a large fraction of the station’s operating costs***; and Schneider had to file reports. The only discretion left the operator was to hire and fire workers.
       2. Tool: Determining whether a master-servant relationship exists, rather than an independent contractor relationship, is a question of fact that will be answered in the affirmative when the master exerts a considerable amount of control over the responsibilities of the servant.
    3. ***Hoover v. Sun Oil Company (Del. 1965)***
       1. Synopsis: Gerald and Julie Hoover (P) brought an action against owner Sun Oil Co., station operator James Barone and employee John Smilyk (D), after Smilyk’s negligence caused Ps’ car to catch fire. Sun Oil is franchisor gas company and Barone operated the station. Court held that Sun Oil is not responsible for the negligence of Smilyk because he is an employee of Barone, who in turn is an independent contractor. The court did not find any evidence to support a master-servant relationship and therefore allowed Sun Oil’s summary judgment. Barone set station’s hours; took title to what he sold; sold nonfranchised products as well as franchised products***; retained the overall risk of profit and loss by paying minimal rental***.
       2. Tool: A master-servant relationship v. independent contractor – “the test to be applied is that of whether the oil company has retained the right to control the details of the day-to-day operation of the service station; control or influence over results alone being viewed as insufficient…”
    4. Franchises
       1. ***Murphy v. Holiday Inns, Inc. (Va 1975)***
          1. Synopsis: Kyran Murphy (P) slipped and injured herself at a hotel operated by a third party that was franchised by Holiday Inns, Inc. (D) to a third party. Third party agreed to a license agreement/franchise contract with D that declared that they were “not partners, joint adventurers, or agents of the other in any sense.” Yet the court did not stop there. It closely reviewed the terms of the franchise agreement. The agreement dictated the name (Holiday Inn) and look of the building and fixtures. The agreement also required the third party to submit reports and pay D a certain amount per room per day. Court found that Holiday Inn did not have “control over the day-to-day operation” of the hotel.
          2. Tool: The court noted that franchise agreements can still establish a master-servant relationship even though it explicitly stated that there was no agency relationship, but the agreement here did not meet the burden. However, the court seems to raise the bar for proving an agency relationship when the master-principal is obligated to exert further control to protect a trademark.
       2. ***Vandemark v. McDonald’s Corp. (NH 2006)***
          1. Synopsis: Employee sued McDonald’s, claiming that the franchisee was an agent of the franchisor.
          2. Tool: “The weight of authority construes franchiser liability narrowly, finding that absent a showing of control over security measures employed by the franchisee, the franchiser cannot be vicariously liable for the security breach…”
       3. ***Wendy Hong Wu v. Dunkin Donuts (EDNY 2000)***
          1. Synopsis: Dunkin Donuts franchisee brought a vicarious liability claim against Dunkin Donuts after she was raped and assaulted while working the night shift.
          2. Tool: Court examined whether Dunkin Donuts had control over the alleged “instrumentality” that caused the harm. Found Dunkin Donuts not liable since DD did not control how franchisee protected employees.
       4. ***Miller v. McDonald’s Corp. (Ore. App. 1997)***
          1. Synopsis: P sought damages from McDonald’s Corporation (D) franchisee, 3K, for injuries suffered when she bit into a burger with a sapphire in it. Contract explicitly said 3K was not McDonald’s agent. D controlled specifications for equipment and layout of restaurant; D periodically sent consultants to inspect operations; D prescribed hours; and failure to comply could result in a loss of the franchise. Court found that evidence supports a finding that D had the right to control the way in which 3K performed at least food handling and preparation, thus D had right to control the precise part of its business that allegedly resulted in P’s injuries. Also, court argued that local franchisees may have been “apparent agents.” Jury could find that P believed that all McDonald’s restaurants were the same and owned by same entity. Franchise agreement required the franchisee to act in way that identified it with the franchisor. Purpose was to attract the patronage of the public to that entire system. (P argues insufficient evidence that P justifiably relied on D holding 3K out as an agent.)
          2. Tool:

Right to control test for agent relationship: “If, in practical effect, the franchise agreement goes beyond the stage of setting standards, and allocates to the franchisor the right to exercise control over the daily operations of the franchise, an agency relationship exists.” (note that contract specifically said no agency relationship)

Vicarious Liability – “One who represents that another is his servant or other agent and thereby causes a third person justifiably to rely upon the care or skill of such apparent agent is subject to liability to the third person for harm caused by the lack of care or skill of the one appearing to be a servant or other agent as if he were such.” R2 Agency § 267.

“**Apparent agent**” (**servant**) is about whether someone will be treated at though they were your agent at all (different from apparent authority)…?

* + - 1. Note: IN THESE FRANCHISE CASES, courts ignore requirement to form agency relationship in first place. CLOSE CONTROL DOES NOT PROVE AGENCY ON ITS OWN. NEED AGREEMENT. BUT COURTS DON’T CARE
    1. Laundry list of control factors seems easily manipulated. Less cynically read, the laundry lists conceal different patterns of financial exposure. Terms like hours, consignment arrangements, and rental clauses tend to correlate with the parties’ relative financial liability. In turn, ***that financial risk tends to correlate with real-substantive-control***.

### Scope of the Employment

* + 1. Rule – R2 Agency § 228(1): conduct is with the “scope of employment” only if:

*(a) it is of the kind [the servant] is employed to perform;*

*(b) it occurs substantially within the authorized time and space limits;*

*(c) it is actuated, at least in part, by a purpose to serve the master; and*

*(d) if force is intentionally used by the servant against another, the use of force is not unexpectable by the master.*

* + 1. Criminal or Tortious Behavior
       1. R2 Agency § 231 – servant’s acts “may be within the scope of employment although consciously criminal or tortious.”
       2. R2 Agency § 222(2) – “a servant’s use of force against another is within the scope of employment if “the use of force is not unexpectable by the master.”
       3. ***Manning v. Grimsley (1st Cir. 1981)***
          1. Synopsis: David Manning (P) was heckling at D Defendant-employee, Ross Grimsley, while playing for Defendant-employer, Baltimore Baseball Club, Inc. Grimsley aimed ball directly at P and hit him. Court found Grimsley threw the ball to stop heckling which was “affecting his ability to warm up and, if the opportunity came, to play in the game itself.” Court vacated and remanded because jury could have inferred that Grimsley committed battery.
          2. Tool: “Where a plaintiff seeks to recover damages from an employer for injuries resulting from an employee’s assault…what must be shown is that the employee’s assault was in response to the plaintiff’s conduct which was presently interfering with the employee’s ability to perform his duties successfully. This interference may be in the form of an affirmative attempt to prevent an employee from carrying out his assignments.”
    2. Motivation – ***Ira S. Bushey & Sons, Inc. v. United States (2d Cir. 1968)***
       1. Synopsis: Ira S. Bushey’s (P’s) drydock sustained damage when United States Coast Guard’s (D’s) drunken employee, Lane, opened a valve. D argues that it should not be liable because his employee acted outside the scope of employment. The court ruled in favor of P finding that employee’s conduct was not so “unforeseeable” as to make it unfair to impose liability on the D. Employee was drunk and on his way back to the ship when caused damage to the ship. It is reasonably foreseeable that a drunk sailor might do damage to P’s drydock while leaving and exiting the ship. The outcome of the case would have been different had employee set fire to the bar where he had been drinking or caused an accident on the street. The liability of an employer does not reach into areas when the employee creates risks different from those attendant to the actives pursued by the employer.
       2. Tool:
          1. Plaintiffs do not need to show that the agent was motivated by a purpose to serve the master. Instead, it would suffice to show that the conduct arose out of and in the course of the employment.
          2. Thus, rejects R2 Agency § 228(1). Even if an employee’s conduct is not motivated by his employer’s interests, an employer is still vicariously liable for an employee’s negligent acts if the employee’s conduct was reasonably foreseeable and within the scope of his employment.
          3. JUDGE FRIENDLY SIMPLY THREW OUT THE LAW.

## Fiduciary Duties

### Rule

* + 1. Agents owe their principals a duty of loyalty and a duty of care.

### Duty of Care

* + 1. Rule – “Unless otherwise agreed, a paid agent is subject to a duty to the principal to act with standard care and with the skill which is standard in the locality for the kind of work which he is employed to perform and, in addition, to exercise any special skill that he has.” R2d § 379

### Duty of Loyalty

* + 1. Rule
       1. “Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency.” R2d § 387.
       2. “An agent has a duty not to acquire a material benefit from a third party in connection with transactions conducted or other actions taken on behalf of the principal or otherwise through the agent’s use of a third party.” R3 Agency 8.02.
    2. ***Reading v. Regem (King’s Bench 1948)***
       1. Synopsis: Reading (P) is a sergeant in the army who is trying to reclaim money he earned as a smuggler in his army uniform taken from him by his employer, army, Regem (D). King’s Bench found that “The uniform of the Crown and the position of the plaintiff as a servant of the Crown were the only reasons why he was able to get this money, and that is sufficient to make him liable to hand it over to the Crown.”
       2. Tool:
          1. “it is a principle of law that, if a servant takes advantage of his service and violates his duty of honesty and good faith to make a profit for himself, in the sense that the assets of which he has control, the facilities which he enjoys, or the position which he occupies, are the real cause of his obtaining the money as distinct from merely affording the opportunity for getting it, that is to say, if they play the predominant part in his obtaining the money, then he is accountable for it to his master. It matters not that the master has not lost any profit nor suffered any damage, nor does it matter that the master could not have done the act himself.”

An agent cannot profit from transactions he is able to exploit only through association with principal.

Agent may not keep profit he/she makes if (1) only reason you have profits is because agency you have and (2) this is prohibited by principal.

**Agent owes such profits to principle even if principal has not suffered loss**

* + 1. ***Town & Country House & Home Service, Inc. v. Newbery (NY 1958)***
       1. Synopsis: Defendants, Percy Newbery et al., are former employees of Plaintiff, Town & Country House & Home Service, Inc, a Long Island cleaning service. P brought an action after D started their own competing company soliciting P’s customers. Ps had made hundreds of calls and screened neighborhoods to establish customer base. Court found that Ds had a duty to protect P’s trade secrets and are prohibited from profiting from the secrets even after their employment ended. The customer listing was formulated through much effort on behalf of Ps, but their methods of cleaning a house were nothing so secretive as to justify prohibiting Ds from continuing their cleaning services.
       2. Tool: An employee can owe a fiduciary duty to their employer for the employer’s trade secrets after their service has been terminated.

# PARTNERSHIP

## Partners

### Rule

* + 1. “[a] partnership is an association of two or more persons to carry on as co-owners of a business for profit.” UPA §6(1).
    2. “…(a) Each partner shall…share equality in the profits and surplus remaining after all liabilities…are satisfied…(e) All partners have equal rights to the management and conduct of the partnership business.” 1914 UPA § 8 (1997 UPA §401 (b), (f)).
    3. “(2)…common property, or part ownership does not of itself establish a partnership…(3) The sharing of gross returns does not of itself establish a partnership…(4) The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business, but no such inference shall be drawn if such profits were received in payment:…(b) As wages of an employee…(d) As interest on a loan, though the amount of payment vary with the profits of the business…” 1914 UPA § 7. (very circular)
    4. “The law of agency shall apply under this act.” 1914 UPA § 4(3) (1997 UPA § 104(a)). 🡪 every partner is an agent of the partnership for the purpose of carrying on apparently the usual business of the partnership.

### Partner or Employee? *Fenwick v. Unemployment Compensation Commission (NJ 1945)*

* + 1. Synopsis: Respondent employer, John Fenwick, entered a “partnership” agreement with employee receptionist, Arline Chesire, wherein they referred to themselves as partners of a hair salon. The agreement was formed to increase Chesire’s compensation by paying her her salary plus twenty percent of profits. Chesire’s duties did not change. Notwithstanding the partnership agreement, the court called Chesire an employee. She shared firm’s profit but she did not share its losses. She had invested nothing in it. She held no rights to assets on dissolution, no control over the business. Neither of the two had said anything to others about her being a partner.
    2. Tool:
       1. Elements of a partnership include: “the right to share in profits;” “obligation to share in losses;” “ownership and control of the partnership property and business;” “community power in administration;” “language in the agreement;” “conduct of parties toward third persons;” “rights of the parties on dissolution;”
       2. Not what they intended to call it, but what they intended business relationship to be.
       3. NJ UPA defines a partnership as an association of “two or more persons to carry on as co-owners a business for profit.” Act provides that sharing of profits is prima facie evidence of partnership but “no such inference shall be drawn if such profits were received in payment…as wages of an employee.

### Partner or Creditor? *Martin v. Peyton (NY 1927)*

* + 1. Synopsis: Peyton et al. (D) entered an agreement with a broker, John Hall, to loan Hall collateral to keep his business afloat. Charles Martin (P), a creditor of the business, interpreted the agreement as forming a partnership and thus claimed D was liable for debts. Court found that the agreements did not establish a partnership. Although D ensured that they had some control over the operations of Hall’s business (had a veto over some things), the controls they bargained for were to ensure that their investment was secure. D was not able to “initiate a transaction as a partner may do” or “bind the firm by any action of their own.” Hall still was able to control the day-to-day affairs, and Respondents never had control to initiate their own ideas.
    2. Tool: An agreement that offers a degree of control by a first party to protect first party’s assets should not be considered a partnership if factors as a whole indicate that the other party still maintains day-to-day control of the business.
    3. Note: A court inclined to shift liability to a deep pocket can use partnership law to the same effect it used agency law in *Cargill*. What’s the difference? Local farmers v. wealthy investors?

### Apparent Partner?

* + 1. Rule
       1. “If a person…purports to be a partner, or consents to being represented by another as a partner…the purported partner is liable to a person to whom the **representation is made**, if that person, relying on the representation, **enters into a transaction** with the actual or purported partnership.” 1997 UPA § 308(a).
       2. “When a person…represents himself, or consents to another representing him to any one, as a partner…he is liable to any such person to whom such representation has been made, who has, on the faith of such representation, **given credit** to the actual or apparent partnership…” 1918 UPA § 16.
    2. ***Young v. Jones (DSC 1992)***
       1. Synopsis: Robert Young et al. (P) relied on an unqualified audit letter from one of the Defendants, Price Waterhouse-Bahamas (“PW-Bahamas”), and placed $550,000 with a South Carolina bank, which forwarded the money to SAFIG, but SAFIG had cheated on its financial statements, and the money disappeared. P brought suit against PW-Bahamas and PW-US. P argued that PW-Bahamas and PW-US operated as a partnership and alternatively that they were partners by estoppel (i.e. apparent partners) by presenting each other to the public as partners (letterhead just said “PW” and had pamphlets). Court found that firms were not actual partners nor apparent partners because PW-US did not hold out PW-Bahamas as its partner (“nothing in the brochure that asserts that the affiliated entities of Price Waterhouse are liable for the acts of another, or that any of the affiliates operate within a single partnership.”). Also, the investors did not “give credit” to PW-Bahamas. They deposited funds in SAFIG, but not in any PW entity.
       2. Tool: The 1997 Act holds firms liable for the acts of apparent partners if the claimant **enters into a transaction** with them but the investors did not enter into transactions with SAFIG either.
       3. Note: compare to apparent agency/servant in franchise *Miller v. McDonald*.

## Liability

### Rule

* + 1. “A partnership is liable for loss or injury caused to a person…as a result of a wrongful act or omission…of a partner acting in the ordinary course of business of the partnership…” UPA § 305(a) of 1997 Act, § 13 of the 1914 Act.
    2. “[A]ll partners are jointly and severally liable for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.” 1997 UPA § 306(a).
    3. “Each partner…must contribute toward the losses, whether capital or otherwise, sustained by the partnership according to this share of the profits.” UPA § 18(a).
    4. “A judgment creditor of a partner may not levy execution against the assets of the partner to satisfy a judgment based on a claim against the partnership unless…a judgment based on the same claim has been obtained against the partnership and a writ of execution on the judgment has been returned unsatisfied in whole or in part…” 1997 UPA § 307(d). But, firms can buy insurance against most tort liabilities.
    5. In dissolution of partnership, 1914 UPA § 40(b) requires that the firm distribute its assets in the following order: (1) Amounts owed to non-partner creditors; (2) Amounts owed as debt to partners; (3) Capital amounts owed to partners; (4) Profits owed to partners.

## Transfers/Dissolution

### Transfers

* + 1. “No person can become a member of a partnership without the consent of all the partners.” 1914 UPA § 18(g) (1997 UPA §401(i)). Compare to corporate shares which are freely transferable. But note that both these rules are just the default.
    2. “A conveyance by a partner of his interest in the partnership does not of itself dissolve the partnership, nor, as against the other partners…entitle the assignee…to interfere in the management or administration of the partnership…; but it merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled.” 1914 UPA § 27(1) (1997 UPA §503).

### Dissolution

* + 1. 1914 UPA § 29: “The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on…of the business.” (not in 1997 Act)
    2. UPA § 37: “Unless otherwise agreed, the partners who have not wrongfully dissolved the partnership…[have] the right to wind up the partnership affairs…”
    3. 1914 UPA § 30: “On dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed.”

### *Putnam v. Shoaf*

* + 1. “The dissolution of the partnership does not of itself discharge the existing liability of any partner.” 1914 UPA § 36(1) (1997 UPA §703(a)).
    2. “A person admitted as a partner into an existing partnership is liable for all obligations of the partnership arising before his admission, except that this liability shall be satisfied only out of partnership property.” AKA Absent an agreement to the contrary, a new partner could lose the amounts already invested in the partnership, but would not become personally liable on any unpaid debt. 1914 UPA § 17 (1997 UPA §306(b)).

## Fiduciary Duties

### Rules

* + 1. 1997 UPA § 404:

*(a) The only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in subsections (b) and (c).*

*(b) A partner's duty of loyalty to the partnership and the other partners is limited to the following:*

*(1) to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity;*

*(2) to refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to the partnership; and*

*(3) to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.*

*(c) A partner's duty of care to the partnership and the other partners in the conduct and winding up of the partnership business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.*

*(d) A partner shall discharge the duties to the partnership and the other partners under this [Act] or under the partnership agreement and exercise any rights consistently with the obligation of good faith and fair dealing…*

### Punctilio of an Honor/No Secrets – *Meinhard v. Salmon (NY 1928)*

* + 1. Synopsis: Walter J. Salmon (D) entered into a lease with Louisa Gerry for a hotel. D, while in course of treaty with Louisa as to the execution of the lease, was in course of treaty with Meinhard (P), for the necessary funds. P and D were involved in a joint venture in regards to the property, subject to fiduciary duties akin to those of partners. D was the manager of the property. Near the end of the lease, Elbridge Gerry became the owner of the reversion, and he approached D. The two entered into a new lease, which is owned and controlled by D. D did not tell P about it. When P found out about the new lease, he demanded that the lease be held in trust as an asset of the venture between D and P, which D refused. Referee found for P. D appealed.
    2. Tool: “A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior… Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the ‘disintegrating erosion’ of particular exceptions… Salmon had put himself in a position in which thought of self was to be renounced, however hard the abnegation. He was much more than a coadventurer. He was a managing coadventurer… For him and for those like him the rule of undivided loyalty is relentless and supreme.”
    3. Holding: Equitable interest should be allotted to P. D held the lease as a fiduciary, for himself and another, sharers in a common venture. The fact that D was in control as the manager charges him with the “duty of disclosure, since only through disclosure could opportunity be equalized.” “The subject matter of the new lease was an extension of the subject matter of the old one. “
    4. Limit: Salmon should have told Meinhard about the chance to renew, but should he have done more?

### Don’t Lie– *Meehan v. Shaughnessy*

* + 1. Synopsis: James Meehan and Leo Boyle (Ps) left the law firm of Parker Colter (Ds). Ps wanted money they believed was owed to them under their partnership agreement, and Ds argued that Ps breached their fiduciary duties. Court found that Ps conduct regarding their secret planning for their departure was not completely unacceptable. The court was fine with the following acts by P: discussed the idea of leaving; recruited several associates; negotiated a lease for their new office; scoured their ongoing cases to pick ones they wanted; contact clients they wanted and asked them to move. (Contrast with *Town & Country* where they breached fiduciary duty by contacting clients after they left and contrast with *Meinhard* considering that P in this case acted as competitors rather than fiduciaries.) Court found that P breached their fiduciary duties when: they initially lied to their partners about their plans; stalled for two weeks before giving their partners the list of clients they intended to solicit; and misled their clients by failing to make clear that they could stay at their current firm.
    2. Tool: “A partner has an obligation to ‘render on demand true and full information of all things affecting the partnership to any partner.’”

### Can Fire Without Cause if In Agreement – *Lawlis v. Kightlinger & Gray*

* + 1. Synopsis: Lawlis (P), a partner of Kightlinger & Gray (D), suffered from alcoholism. P missed several months of work to seek treatment. D outlined conditions for his return and did not provide any second chances, but when P continued to have problems D gave him a second chance. Once P made a complete recovery, P asked for his shares to be increased. D responded by recommending his senior partner status be severed, and he was eventually expelled from the firm per the procedures outlined in the partnership agreement, which allowed partners to expel each other at any time for any reason with a 2/3 vote (“guillotine provision”). Court found that the firm could validly adopt such a clause per UPA rule.
    2. Tool:
       1. 1914 UPA § 31 (1997 UPA § 601(3)): “Dissolution is caused: (1) Without violation of the agreement between the partners,…(d) by the expulsion of any partner from the business bona fide in accordance with such a power conferred by the agreement between the partners.”
       2. “Where the remaining partners in a firm deem it necessary to expel a partner under a no cause expulsion clause in a partnership agreement freely negotiated and entered into, the expelling partners act in ‘good faith’ regardless of motivation if that act does not cause a wrongful withholding of money or property legally due the expelled partner at the time he is expelled…”
    3. Note: Contrast allowing partners expel each other whenever for whatever with *Meinhard* court demanding of partners a “punctilio of an honor the most sensitive.”

## Management

### Rule

* + 1. “… All partners have equal rights in the management and conduct of the partnership business.” 1914 UPA § 18(e) (1997 UPA § 401(f)).
    2. A partnership will decide all routine matters by majority vote – 1914 UPA § 18(h) (1997 UPA § 401(j)).

### Authority

* + 1. Actual Authority – Absent a decision to the contrary, partners have actual authority to bind the partnership for conduct within the scope of its business – “**Every partner is an agent of the partnership for the purpose of its business**…” 1914 UPA § 9(1) (1997 UPA § 301(1)).
    2. Apparent Authority – Partners also have apparent authority to bind the partnership for actions within the scope of its business unless the third party knows they lack actual authority – “[T]he act of every partner…for apparently carrying on in the usual way the business of the partnership…binds the partnership unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.” 1914 UPA § 9(1) (1997 UPA § 301(1)).

### Cases

* + 1. *National Biscuit Company v. Stroud (NC 1959)*
       1. Synopsis: C.N. Stroud (D) and Earl Freeman ran a grocery store without a written agreement. Freeman had authority to order bread. Stroud called supplier Nabisco (P) and told it he would not pay for more bread. Freeman ordered bread anyway, P delivered, and D refused to pay. Court ruled for P because since Stroud is only one half of the partnership, and not a majority, he is unable to prevent Freeman from exercising his rights as a partner in the management of the partnership business. Without a majority vote, cannot change status quo.
       2. Tool:
          1. NC Uniform Partnership Act – “All partners have equal rights in the management and conduct of the partnership business…Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners; but no act in contravention of any agreement between the partners may be done rightfully without the consent of all the partners.”
          2. “half of the members are not a majority.”
    2. *Summers v. Dooley (Idaho 1971)*
       1. Synopsis: John Summers (P) hired an employee out-of-pocket despite the objections of partner, E.A. Dooley (D). P wants D to reimburse him for half the costs of the additional employee. Court ruled in favor of D, because a decision to change the status quo would require a majority approval, and P’s one vote did not constitute a majority.
       2. Tool: UPA (1914 § 18(h)): “Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners.”
       3. Note: Similar facts to *National Biscuit Company v. Stroud*, but in this case, status quo was no permission while in *National*, status quo was permission.
    3. *Day v. Sidley & Austin (DDC 1975)*
       1. Synopsis: J. Edward Day (P), a Washington attorney, worked as a senior partner for Sidley & Austin (D), a Chicago-based firm. D forced P to share the chairmanship position of the Washington office after they merged with a second firm. Court found for D musing that day may have a bruised ego but he chose to sign a well-defined Partnership Agreement that “clearly provided for management authority in the executive committee.” (Agreement in footnote of CB p. 123) Thus D did not violate any fiduciary duties to P.
       2. Tool: Basic fiduciary duties between partners are: “1) a partner must account for any profit, acquired in a manner injurious to the interests of the partnership, such as commissions or purchases on the sale of partnership property; 2) a partner cannot without the consent of the other partners, acquire for himself a partnership asset, nor may he divert to his own use a partnership opportunity; and 3) he must not compete with the partnership within the scope of the business…”

## Corporations v. Partnerships

|  |  |  |
| --- | --- | --- |
|  | **Corporation** | **Partnership** |
| **Taxes** | “Double tax” – corporation tax and income tax | Income tax |
| **Liability** | Limited liability – corporation may go insolvent but shareholder will only lose money it put in and doesn’t have to give more. | May have to pay additional amounts to creditors than what they put in.  Note: may buy insurance to cover liability in partnership and can negotiate non-recourse with creditor |
| **Transferability** | Shares are transferable (in reality not as easy) | Partnership interests may not be transferred. |
| **Formal Life** | Endures forever (depends on person operating business) | End when partner leaves or dies (can contract around this) |
| **Flexibility** | Inflexible – standard articles of incorporation and bylaws for all corporations (but don’t have to adopt) | Flexible – partnership agreements may be negotiated in many different ways. |
| **Management** | Centralized – run by officers under supervision of board; shareholders elect board (can change rules in bylaws) | Decentralized –majority vote but some votes may require unanimity  (partnership agreements can provide for centralized management board) |

## Other Organization Forms

* 1. S Corporations – corporations that meet various requirements (fewer than specified number of shareholders) could elect to be taxed as “S” corporations. They pay no tax at the corporate level, and their shareholders would instead report their proportional share of the corporation’s income on their personal returns.
  2. Limited Liability Companies – largely follow corporate organization law – investors have limited liability but if you check “partnership box” can avoid double tax 🡪 took pressure off states to adopt newer UPA.
  3. Limited Liability Partnerships – investors can avoid personal liability for many employee torts and taxed as partnership. The reason to become an LLP rather than an LLC involves intrafirm politics: to become an LLP, a firm must simply register with the state; to become an LLC, it will need to abandon its partnership agreement and negotiate an entirely new organization document. For many old law firms, that is more democracy than they want.

# CORPORATIONS AND SHAREHOLDERS

## Legal Roles

* 1. Corporation can borrow money, commit torts, and otherwise incur legal obligations. It can sell property, be wronged, and otherwise obtain legal rights.
  2. Shareholders – “residual claimants” – in a typical corporation, several people pool their money. They hire others to use the money in one or more business ventures. They collect the receipts, pay the bills, and split the remainder among themselves. **Not agents of corporation.**
  3. “Directors” or “Members of the board” – by law, shareholders elect others (or themselves) to look after the firm on their behalf. **Derve as direct agents of the corporation and indirect agents of its shareholders. Some say only officers are agents of corporation.**
  4. Other staff – directors then hire others to run the firm on a daily basis. These people too work as agents for the firm and its shareholders.

## Shareholders and Litigation

### The Authority of the Board

* + 1. When corporation wronged, whether to sue is question for the board, not the shareholder.
    2. Bylaws
       1. 8 Del. C. § 109(a) – Stockholders have power to adopt, amend, or repeal bylaws. Certificate of incorporation may confer above power to directors but this does not divest stockholder of such power.
       2. 8 Del. C. § 109(b) – “bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.”
       3. *Boilermakers Local 154 Retirement Fund v. Chevron Corporation (Del. Ch. 2013)*
          1. Synopsis: Stockholders brought actions against boards of two corporations for adopting forum selection bylaws (all litigation will be done in DE) governing disputes relating to the internal affairs of the corporations, alleging that the bylaws were (1) statutorily invalid as beyond the boards' authority under Delaware General Corporation Law (DGCL), and that (2) the bylaws were contractually invalid because they were unilaterally adopted and thus not enforceable as forum selection clauses.
          2. Tool: 8 Del. C. § 109(a)-(b)
          3. Holding: (1) Bylaws were facially valid under DGCL as the subject matter fell under 109(b). Bylaws were process-oriented, because they regulated where stockholders may file suit, not whether the stockholder may file suit or the kind of remedy that the stockholder may obtain on behalf of herself or the corporation. (2) Unilateral adoption of bylaws did not render them contractually invalid on their face. Stockholders are on notice that, as to those subjects that are subject to regulation by bylaws under 8 Del. C. § 109(b), the board itself may act unilaterally to adopt bylaws addressing those subjects.

### The Business Judgment Rule

* + 1. “Business judgment rule” – “Absent fraud, illegality, a conflict of interest, negligence, or waste, a court will not second-guess the decisions of a board.”
    2. Conflict of interest – violation of duty of loyalty
    3. Negligence (more accurately, gross negligence) – violation of duty of care; not about whether decision was right but about whether you went through proper procedures to get there; judges insist that directors sit down and think through decisions but not that they make right decisions
    4. Waste – whether its decision was so inadequate in value that no person of ordinary, sound business judgment would deem it worth that which the corporation was paid.

### Derivative Suit

* + 1. Definition – To enable shareholders to circumvent the reluctance of directors to sue themselves or their friends, corporate statutes provide for derivative suits. In these suits, (i) shareholders sue the corporation in equity, (ii) to force it to sue the wrongdoer.
    2. Preliminary Requirements (See Rule 23.1 of the Delaware Court of Chancery and FRCP 23.1)
       1. Suit may only be filed by shareholder who held stock at time of contested event.
       2. Shareholder must generally “demand” that a board file the suit itself unless the board faces a conflict of interest.
       3. A shareholder may settle a derivative suit only with the approval of the court.
    3. Demand
       1. Requirement
          1. Demand required when no conflict of interest. Where a demand has actually been made, the stockholder making the demand concedes the independence and disinterestedness of a majority of the board to respond.
          2. Demand Futility – “Demand excused” if board faces a conflict of interest.
       2. Law requires shareholders to present most proposed suits to the board (to “demand” that it file suit). Once the shareholder makes this demand, a court judges the board’s refusal to sue by the business judgment rule – absent a conflict of interest, negligence, fraud, illegality or waste, a court will defer to the board’s decision not to sue.
       3. If board decides to pursue the claim, that ends the derivative suit. Where a demand has actually been made, the stockholder making the demand concedes the independence and disinterestedness of a majority of the board to respond.

### Demand Futility

* + 1. Definition – “the right of a stockholder to prosecute a derivative suit is limited to situations where the stockholder has demanded that the directors pursue the corporate claim and they have wrongfully refused to do so or where demand is excused because the directors are incapable of making an impartial decision regarding such litigation.” ***In re China Agritech, Inc.***
    2. Two Tests (***In re China Agritech, Inc****.*)
       1. Aronson test
          1. Applicability – applies when a derivative plaintiff challenges an earlier board decision made by a majority of the same directors who remain in office at the time suit is filed.
          2. Test – “must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent [duty of loyalty] [with respect to the decision that the derivative action would challenge] and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.” [duty of care]
          3. Example: *China* *Agritech* court does NOT apply because there was never a vote on monitoring system. Therefore, no decision was made by previous board and Rales applies.
       2. Rales test
          1. Applicability

The Delaware Supreme Court envisioned that the Rales test would be used in three principal scenarios: (1) where a business decision was made by the board of a company, but a majority of the directors making the decision have been replaced; (2) where the subject of the derivative suit is not a business decision of the board [aka the board didn’t make a decision]; and (3) where ... the decision being challenged was made by the board of a different corporation.

A director cannot consider a litigation demand under Rales if the director is interested in the alleged wrongdoing, not independent, or would face a “substantial likelihood” of liability if suit were filed.

A director lacks independence when the director is unable to base his or her decisions on the corporate merits of the issue before the board. Close family relationships, like the parent-child relationship, create a reasonable doubt as to the independence of a director.

To show that a director faces a “substantial risk of liability,” a plaintiff does not have to demonstrate a reasonable probability of success on the claim…The plaintiff need only “make a threshold showing, through the allegation of particularized facts, that their claims have some merit.”

* + - * 1. Test – “whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.”

### Derivative v. Direct

* + 1. The Distinction – if a CEO steals from the shareholders themselves, they have a “direct” claim against the miscreant. If the CEO steals from the firm, they have only a “derivative” claim.
    2. Delaware Supreme Court test in determining whether a stockholder’s claim is derivative or direct: (1) who suffered the alleged harm, the corporation or the suing stockholders, individually; and (2) who would receive the benefit of any recovery or other remedy, the corporation or the stockholders, individually.
    3. NY test for determining whether derivative or direct – ***Eisenberg v. Flying Tiger Line, Inc. (2d Cir. 1971)***
       1. Synopsis: The Flying Tiger Corporation interposed a holding company between itself (the operating company) and its shareholders. Eisenberg’s interest in the operating company was replaced by an interest in a holding company. That holding company, in turn, owned all of the shares of the operating company. Eisenberg brought suit to enjoin the reorganization, because it diluted his voting rights as a minority shareholder. Flying Tiger replied that the suit was derivative and demanded that he post bond required under NY law. 2d Cir. held suit direct because it concerned voting rights and let it proceed without posting bond.
       2. Tool:
          1. N.Y. Bus. Corp. Law § 627 – must post bond if derivative suit.
          2. “if the gravamen of the complaint is injury to the corporation the suit is derivative, but if the injury is one to the plaintiff as a stockholder and to him individually and not to the corporation, the suit is individual in nature and may take the form of a representative class action.”
    4. Typical Case Law
       1. Direct –voting rights, allocation of value among the classes of stock, preemptive rights, dividends, or the right to inspect corporate books.
       2. Derivative –violation of duties of care or loyalty, loss to the corporation
    5. Why It Matters
       1. Shareholders like Eisenberg in *Flying Tiger* disguise suits for corporate wrongs as direct suits to avoid the bond-posting requirement.
       2. N.Y. Bus. Corp. Law § 627
          1. P must file a bond only in derivative suits.
          2. P need not file it if they hold more than 5% of firm’s stock or stock worth more than $50K
          3. If the rule applies, D firm may demand that P post a bond for its legal expenses.
          4. The bond must cover not just the firm’s own expenses, but those of the other Ds for which it will become liable as well.
          5. At the end of the litigation, the court will order the bond paid to the firm to cover those costs.

## Shareholders and Corporate Purpose

### Primary Purpose is to Benefit Shareholders – *Dodge v. Ford Motor Co. (Mich. 1919)*

* + 1. Synopsis: Shareholders, Dodge brothers (P), sued to force Ford Motor Company (D), with Henry Ford as CEO, to pay a more substantial dividend and enjoin the new River Rouge complex. Court held that Ps are entitled to a more equitable-sized dividend, but the court will not interfere with D’s business judgments regarding the price set on the manufactured products or the decision to expand the business. Courts generally evaluate dividends by the business judgment rule. But the court found that “the refusal to declare and pay further dividends appears to be not an exercise of discretion on the part of the directors, but an arbitrary refusal to do what the circumstances required to be done.”
    2. Tool:
       1. “It is a well-recognized principle of law that the directors of a corporation, and they alone, have the power to declare a dividend of the earnings of the corporation, and to determine its amount… Courts of equity will not interfere in the management of the directors unless it is clearly made to appear that they are guilty of fraud or misappropriation of the corporate funds, or refuse to declare a dividend when the corporation has a surplus of net profits which it can, without detriment to its business, divide among its stockholders, and when a refusal to do so would amount to such an abuse of discretion as would constitute a fraud, or breach of that good faith which they are bound to exercise towards the stockholders.”
       2. “[I]t is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting other, and no one will contend that, if the avowed purpose of the defendant directors was to sacrifice the interests of shareholders, it would not be the duty of the courts to intervene.”

### Charitable Giving

* + 1. Rule – “Every corporation created under this chapter shall have the power to…(9) Make donation for the public welfare or for charitable, scientific or educational purposes, and in time of war or other national emergency in aid thereof…” Del. Gen. Corp. L. § 122.
    2. Application – Courts have been extremely tolerant in accepting the business judgment of the officers and directors of corporations about whether a charitable donation will be good for the corporation.
    3. ***A.P. Smith Mfg. Co. v. Barlow (US 1953)***
       1. Background: NJ did not pass statute authorizing charitable gifts until 1930 but many companies had charters that dated from earlier years. These firms needed assurance that the 1930 law applied to them too.
       2. Synopsis: A.P. Smith, a fire hydrant firm, (D) donated $1,500 to Princeton. Shareholder Barlow (P) sued to stop the gift. Although a state statute allows corporations to contribute to charities, D asserts that (1) the corporation’s certificate of incorporation does not allow the gift, and (2) the corporation was incorporated prior to the NJ statute that authorizes the gift-giving.
       3. Tool: Corporate gift-giving is an allowable method of increasing goodwill, but the gift should be less than 1% of capital and surplus and directed to an institution owning no more than 10% of the company stock.
       4. Note: The court did not accept Ds’ reasoning that the donation was not allowed because the corporation preceded the statute authorizing the gift-giving. The court explained that the potentially infinite lifespan of corporations would lead to corporations a varying ages to live under various sets of laws.

### Altruistic Purpose Permitted – *Schlensky v. Wrigley (Ill. App. 1968)*

* + 1. Synopsis: William Shlensky (P) filed a derivative action against director, Phillip Wrigley (D) (owns 80% of stock), owner of the Cubs, to force the installation of lights for night baseball at Wrigley field. D did not install lights because he was concerned that night baseball would be detrimental to the surrounding neighborhood. P argued that the team was losing money, and that the other Chicago team, the White Sox, had higher attendance during the weekdays because they played at night. Therefore, reasoned P, the Cubs would draw more people with weekday night games. P asserts that D’s first concern should be with the shareholders rather than the neighborhood. Court did not overturn D’s decisions to not install lights applying the business judgment rule. The court cited some reasons why the light installation could be detrimental, such as lowering the property value of the park itself, a lack of proof on behalf of P that financing would be available for lights and would be certain to be offset by increasing revenues.
    2. Tool: “The response which courts make to such applications is that it is not their function to resolve for corporations questions of policy and business management. The directors are chosen to pass upon such questions and their judgment unless shown to be tainted with fraud is accepted as final. The judgment of the directors of corporations enjoys the benefit of a presumption that it was formed in good faith and was designed to promote the best interests of the corporation they serve.”

## Shareholders and Corporate Liability

### In Tort

* + 1. Veil-piercing allowed under tort law – if a **shareholder** has **ignored corporate formalities**, he lacked the legal authority to run the corporation. If the employees obeyed him anyway, they must have obeyed him in his individual (not corporate) capacity. And if they obeyed him in his individual capacity, they acted as his personal “servant.” As their “master,” he then becomes liable for their torts under respondeat superior.
    2. “Scumbag rule” – judges do not check corporate formalities and then hold shareholders liable if the firm ignores them and absolve them if instead it follows the rules. They ask whether the shareholder is a scumbag. If he is not, they absolve him. If he is, they scour corporate documents for evidence of missed formalities. If they find a missed formality, they hold him liable. In the rare case when they can’t find a missing formality, like in *Walkovsky*, they let the shareholder go.
    3. *Walkovszky v. Carlton (NY 1966)*
       1. Synopsis: Walkovszky (P) was injured by a taxi owned by a corporation of which Carlton (D) was a stockholder. D was a single shareholder in ten separate corporations wherein each corporation had two cabs registered in its name. Each cab has only $10,000 worth of insurance coverage, which is the statutory minimum. P contends that Defendant was fraudulently holding out the corporations as separate entities when they actually work as one large corporation. P sought to hold D personally liable for his injuries. Court held that D would be held liable under the respondeat superior doctrine if he controlled the corporation for his personal benefit at the expense of the corporations benefit. P did not offer proof to make that claim and nothing D did was fraudulent.
       2. Tool: “In determining whether liability should be extended to reach assets beyond those belonging to the corporation, we are guided… by ‘general rules of agency’… In other words, whenever anyone uses control of the corporation to further his own rather than the corporation's business, he will be liable for the corporation's acts ‘upon the principle of respondeat superior applicable even where the agent is a natural person’.”

### In Contract

* + 1. Van Dorn test for piercing the corporate veil (*See Sea-Land*) to make **shareholder** liable:
       1. First, there must be such unity of interest and ownership that the separate personalities of the corporation and the individual [or other corporation] no longer exist
          1. Factors for first element: (1) the failure to maintain adequate corporate records or to comply with corporate formalities, (2) the commingling of funds or assets, (3) undercapitalization, and (4) one corporation treating the assets of another corporation as its own.

Third factor – probably means deliberate undercapitalization. Corporate piercing only exists when undercapitalized to a certain extent so this factor must mean when it is done deliberately.

* + - 1. Second, circumstances must be such that adherence to the fiction of separate corporate existence would sanction a fraud [(intentional wrong)] **or** promote injustice.”
         1. OR, not both required.
         2. Unsatisfied judgment alone does not satisfy injustice prong. After all, creditors try to pierce the corporate veil only when corporations cannot pay.
         3. “courts that properly have pierced corporate veils to avoid “promoting injustice” have found that, unless it did so, some “wrong” beyond a creditor's inability to collect would result: the common sense rules of adverse possession would be undermined; former partners would be permitted to skirt the legal rules concerning monetary obligations; a party would be unjustly enriched; a parent corporation that caused a sub's liabilities and its inability to pay for them would escape those liabilities; or an intentional scheme to squirrel assets into a liability-free corporation while heaping liabilities upon an asset-free corporation would be successful.”
         4. Asset shuffling – 7th Cir. on reappeal from remand found that asset shuffling led to injustice because thus Sea-Land could not intelligently decide whether to extend credit and Marchese was unjustly enriched.
         5. This prong is important because courts do not pierce the corporate veils merely because a shareholder missed some corporate formalities. Too many firms miss them for innocuous reasons.
         6. Why fraud or injustice? Fraud is an intentional act and intent is a question of fact. Claimants will usually need to go to a jury to show fraud. Whether to pierce the veil, however, generally arises at pretrial. Adding injustice lets courts resolve the question without impaneling a jury.
    1. ***Sea-Land Services, Inc. v. Pepper Source (7th Cir. 1991)***
       1. Synopsis: Sea-Land Services (P) delivered a shipment of peppers to Pepper Source (D), but was never paid. Marchese was the sole shareholder of D and several other corporations. He was the co-owner of an additional corporation, Tie-Net. P sued to hold D, Marchese, and other corporations liable. P asserted that the corporations were shells wherein Marchese shifted money around the different entities to avoid creditors collecting from the corporations. Evidence was presented that showed Marchese treated the corporate accounts as his own personal account, and he frequently shifted money around. Court held that unity-of-interest test met, but P did not provide sufficient evidence to establish second prong of Van Dorn test. Unsatisfied judgment alone did not show injustice. Does not allow P to reverse pierce Tie-Net because D only owns 50% so no unity of interest.
       2. Tool: Van Dorn Test supra. 50% ownership is not unity of interest.

### Dividends

* + 1. Rule
       1. Corporations need not pay dividends
       2. Should a firm issue “preferred stock,” it must first pay dividends on the “preferred” shares before paying any on the “common.”
       3. Par value – relevant only when a company first issues stick (initial sale) – person who buys it first must pay at least par value. If the person doesn’t pay par value, the company can sue the person later to get par.
       4. Directors cannot pay dividends whenever they please. Directors may pay dividends if the firm meets one of two tests (Delaware statutes):
          1. If the firm has a large enough surplus (difference between the net assets and legal capital)

Net assets – difference between its total assets and total liabilities

Legal capital – (a) for shares with par value, the number of shares outstanding times the per-share par value; and (b) for shares that do not have par value, whatever portion of the cash received on the issuance of the stock the board decides to designate as legal capital.

* + - * 1. Out of profits – either the current fiscal year or the preceding one.
    1. Economics
       1. When a firm pays a dividend, the price of the stock will fall. The shareholder, though, will have the cash in his pocket. Shareholder can buy more stock with cash if wishes to have money invested or can sell stock if wants cash.
       2. Paying out dividends doesn’t make any difference for shareholders but this is without considering tax implications and managers decisions to pursue good projects.

# FIDUCIARY DUTIES OF DIRECTORS/SHAREHOLDERS

## Business Judgment Rule

### Rule

* + 1. Absent evidence of fraud, illegality, conflict of interest, negligence, or waste, courts will defer to the business judgment of the board.
    2. Negligence – Duty of Care – amount of care which ordinarily careful and prudent men would use in similar circumstances – closer to gross negligence
    3. Conflict of Interest – Duty of Loyalty – A director or officer who secretly deals with his own firm breaches his duty of loyalty. The corporation can ratify the conflict. But if it does not, it can void the transaction, sue him for damages, and demand that he disgorge his profits.

### Kamin v. American Express Company (1st Dept. 1976)

* + 1. Synopsis: Amex shareholders brought a derivative suit to challenge the board’s decision to distribute DLJ shares as a dividend in kind. The shareholders argued that the firm’s strategy cost it $8M in taxes it could avoid only if it sold the shares first; the board replied that a sale would generate an accounting loss that would cause its stock price to plummet (and note also the inside directors’ salaries). Court found potential conflict of interest with salaries (board members’ salaries tied to accounting books) to be speculative (so no violation of duty of loyalty) and that board met its duty of care by calling a meeting, hearing both sides of the argument, and making a decision. With no conflict of interest or negligence, court cited the business judgment rule and approved the board’s decision.
    2. Tool: Business Judgment Rule.

## Duty of Care

### The Basic Rule – *Francis v. United Jersey Bank (NJ 1981)*

* + 1. Synopsis: For the creditors, P&B’s bankruptcy trustee (P) sued the executrix of the estate Lillian Pritchard (D) for negligence as director of P&B. P sued on theory that Lillian’s sons would not have been able to steal from P&B. Court held that Lillian breached duty of care. Although she was bedridden and alcoholic, she should have resigned.
    2. Tool:
       1. Courts do not lower standard to meet fiduciary duties just because of agent’s state of well-being.
       2. Directors owe their fiduciary duties to creditors rather than, or in addition, to shareholders in two contexts: (1) When a firm receives money in trust (as reinsurance brokers routinely did), board members serve as fiduciaries for the people entrusting the funds. (2) When a firm becomes insolvent (as P&B was), board members owe fiduciary duties to creditors (because they become residual claimants). When times are good, board members owe shareholders a fiduciary duty because they stand as the firm’s residual claimants. When times go bad, the creditors effectively replace the shareholders as residual claimants.
       3. NJ statute “makes it incumbent upon directors to discharge their duties in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.”
       4. Board members need not conduct “a detailed inspection of day-to-day activities” but they should “keep informed about the activities of the corporation” and maintain “a general monitoring of corporate affairs.”
       5. Board members, unless on notice of misbehavior, may rely on accounting statements prepared by a reputable accounting firm.
       6. Should directors learn of misconduct, they must do what they can to stop it – dissent from corporate decisions, insist that the minutes record their dissent, consult an attorney, sue the miscreants, etc.

### Made Optional

* + 1. *Smith v. Van Gorkom* – Delaware Supreme Court found Trans Union board members breached duty of care for acting too hastily (2 hour meeting) and not trying hard enough to obtain higher price (approved merger at 145% of the firm’s market price)
    2. Legislative Response – due to outrage in response to *Van Gorkom*, legislature decided to let firms opt out of *Van Gorkom*, and firms did almost universally.
       1. Del. § 102(b)(7) – bylaws may include“ [a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law…”
       2. In other words, firms could agree not to hold executives liable for duty of care violations.
    3. Indemnification
       1. Del. § 145(c) – all firms must indemnify their directors against expenses they incur in defending themselves – successfully – in suits over their work at the firm.
       2. Del. § 145(a) – may indemnify directors and officers even if they lose, provided that they acted in good faith.
       3. Del. § 145 (b) – firms can sometimes indemnify directors and officers even in derivative suits

### Oversight Moved to Duty of Loyalty

* + 1. Bad Law now – *Allis-Chalmers (Del. 1963)*
       1. Absent a reason to suspect misbehavior, “directors were not required to install a corporate system of espionage to ferret out wrongdoing.” If they learn that their officers might be breaking the law, they should investigate. Absent that notice, they have no reason to look. They are “entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong.”
       2. Implication is that one of the decisions protected by the business judgment rule may be a decision that a risk is small enough not to worry much about it.
    2. *In Re Caremark Int’l Inc. Deriv. Litig. (Del. Ch. 1996)* 
       1. Declared Allis-Chalmers bad law
       2. “I am of the view that a director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.”
       3. Led to classic “Caremark claims”
    3. Avoiding Caremark?
       1. Del. § 102(b)(7) lets firms exculpate their directors against duty of care claims, but not against bad faith behavior or duty of loyalty claims.
       2. If *Caremark* monitoring falls under duty of care, then Del. § 102(b)(7) made *Caremark* optional. However, *Stone v. Ritter* found that not installing Caremark monitoring shows bad faith; to act in bad faith is to breach the duty of loyalty; hence firms cannot use Del. § 102(b)(7) to insulate their directors against *Caremark* claims.
       3. Note: “A failure to act in good faith is not conduct that results, ipso facto, in the direct imposition of corporate fiduciary liability. Violation of duty of care and duty of loyalty may result in direct liability.” *Stone v. Ritter*.
    4. Caremark Applied – Note: not attending meetings falls under Francis and not Caremark/Ritter
       1. ***Stone v. Ritter (Del. 2006)***
          1. Synopsis: AmSouth owned a bank that faced charges of violating bank secrecy and money laundering laws for not reporting suspicious conduct among its customers. When AmSouth paid $50 million to resolve the charges, shareholders filed a derivative suit against the board for failing to monitor its employees. AmSouth had adopted an “exculpatory” provision under Del. § 102(b)(7). Court found that *Caremark* was mandatory by shifting *Caremark* to a duty of loyalty and a duty to act in good faith, but held for D finding that oversight was sufficient.
          2. Tool:

Necessary conditions predicate for director oversight liability are 1) utterly failing to implement any reporting or information system or controls, or 2) consciously failing to monitor or oversee operations of such a system thus disabling themselves from being informed of risks or problems requiring their attention.

A refusal to install *Caremark* monitoring constituted “bad faith.” If plaintiffs can show “a sustained or systematic failure of the board to exercise oversight,” then they show bad faith. If plaintiffs show bad faith, they also show a duty of loyalty violation (“The failure to act in good faith may result in liability because the requirement to act in good faith is a subsidiary element, i.e., a condition, of the fundamental duty of loyalty.”). Hence firms cannot use Del. § 102(b)(7) to insulate their directors against *Caremark* claims.

* + - 1. ***In re China Agritech, Inc. Shareholder Derivative Litigation (Del. Ch. 2013)***
         1. Synopsis: China Agritech, Inc. (Agritech) was a fertilizer manufacturer headquartered in China. Albert Rish (plaintiff), a shareholder, filed a derivative suit in the Delaware Court of Chancery against Agritech’s board of directors (defendants), which included Agritech’s two co-founders. Among other claims, Rish asserted that the defendants breached their obligation of good faith due to a systematic lack of oversight at Agritech. In 2008, Agritech established an Audit Committee comprised of directors. In 2009 and 2010, Agritech engaged in a series of major transactions, including acquiring additional interest in a company Agritech’s co-founders owned. At the time, Agritech had five directors including the co-founders. The three other directors sat on the Audit Committee. Despite this and other major transactions, there is no evidence that the Audit Committee met in 2009 or 2010. In August 2010, Agritech disclosed in its Securities and Exchange Commission (SEC) 10-Q filing that material weaknesses had undermined its controls and procedures. In its following 10-Q, Agritech claimed that the weaknesses were fixed and, days later, fired its outside auditor. The Audit Committee approved the firing, but there is no record of the Audit Committee meeting during this time. In addition, Rish alleged that in four of five years, Agritech reported significant profits to the SEC, but reported losses to the parallel regulatory agency in China. Rish argued that making a litigation demand on the defendants would have been futile. The defendants moved to dismiss Rish’s claims on the ground that Rish did not successfully plead demand futility. Court denied motion to dismiss finding that plaintiff met standard under Rales.
         2. Tool:

Caremark

“Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, as in Graham [v. Allis–Chalmers Manufacturing Co., 188 A.2d 125 (Del.1963) ] or in [the Caremark case itself], ... only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.”

Section 102(b)(7) can exculpate directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith/breach of the duty of loyalty.

A failure to act in good faith may be shown, for instance, [1] where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, [2] where the fiduciary acts with the intent to violate applicable positive law, or [3] where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.

Demand Futility – see section supra

## Duty of Loyalty

### The Basic Rule – *Bayer v. Beran (Sup. Ct. of NY 1944)*

* + 1. Synopsis: Bayer et al. (P) filed a derivative shareholder action against directors, Beran et al. (D), contesting their decision to pay for radio advertising that employed a director’s wife and renewed the employment contract of one of the D’s brother. The former advertising budget was $683,000 per year, but the CEO suggested a $1 million radio campaign, which was approved. CEO made two mistakes: failed to tell board that the show would feature his wife and skipped a formal meeting and convinced board members on the fly. Court found that because of potential conflict of interest (violation of duty of loyalty), it did not apply business judgment rule. However, court found no violation of fiduciary duty since radio campaign served legitimate and useful corporate purpose and the company received the full benefit thereof (but what about wife’s career?). Court also found skipping meeting was okay because board members approved individually.
    2. Tool:
       1. Inherent Fairness Test
          1. When potential violation of duty of loyalty, business judgment rule does not apply.
          2. “…personal transactions of directors with their corporations, such transactions as may tend to produce a conflict between self-interest and fiduciary obligation, are, when challenged, examined with the most scrupulous care, and if there is any evidence of improvidence or oppression, any indication of unfairness or undue advantage, the transactions will be voided…Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagement with the corporation are challenged the burden is on the director not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein.”
       2. Board must make decisions as entire board – directors acting separately and not collectively as a board cannot bind the corporation. There are two reasons for this: first, that collective procedure is necessary in order that action may be deliberately taken after an opportunity for discussion and an interchange of views; and second, that directors are the agents of the stockholders and are given by law no power to act except as a board…Liability may not, however, be imposed on directors because they failed to approve the radio program by resolution at a board meeting.

### Ratification

* + 1. Del. Corp. § 144 – a contract is not void or voidable solely due to a potential conflict of interest involving its directors/officers if:
       1. (a)(1) – If a director discloses his conflict of interest, the board can ratify the terms of the transaction. Needs the vote of a majority of the disinterested directors (disinterested directors can be less than a quorum).
       2. (a)(2) – If a director discloses his conflict of interest, the shareholders can ratify it. Needs a vote by the majority. Says nothing about a quorum and nothing about the need for a vote specifically by the disinterested shareholders. However, *Fliegler* court reads in disinterested requirement.
       3. (a)(3) – If the director fails to disclose the conflict, he still can enforce the transaction if he can prove that it is “fair as to the corporation.”
       4. (b) – Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.
    2. Del. Statute does not explicitly demand a meeting of directors or shareholders for ratification, but the importance generally placed on corporate formalities would seem to dictate a formal meeting.
    3. The Requisite Share Vote for (a)(2) – ***Fliegler v. Lawrence (Del. 1976)***
       1. Synopsis: Lawrence, president of Agau, acting in his individual capacity, purchased a lease option for antimony (metal) rights. He offered the rights to Agau but the directors agreed that Agau’s financial position would not allow the purchase. Lawrence then transferred the rights to a company, USAC, formed for the specific purpose of holding those rights. He then gave Agau a long-term option to purchase the holding company. A few months later, Agau’s directors voted to exercise the option. A majority of shareholders voted the same way, but the directors also comprised a majority of shareholders. In a derivative suit, shareholder (P) argued that directors (D) usurped a corporate opportunity for their own individual benefit, and that the transaction was inherently unfair. Ds responded that their vote was ratified by shareholders, thereby shifting the burden of proof to P to prove that the transaction was fair under Del. Corp. § 144(a)(2) (court doesn’t address (a)(1)) and D also offered proof that it was fair. Court held for D reading into (a)(2) “disinterested” in front of shareholders, but finding that D met “fair” standard.”
       2. Tool:
          1. Only disinterested shareholders can vote to fall under Del. Corp. § 144(a)(2).
          2. “shareholder ratification of an interested transaction, although less than unanimous, shifts the burden of proof to an objecting shareholder to demonstrate that the terms are so unequal as to amount to a gift or waste of corporate assets.”
          3. 8 Del.C. Section 144 removes an “interested director” cloud when its terms are met and provides against invalidation of an agreement “solely” because such a director or officer is involved.
    4. Summary

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| *Cases* | *Conflict of Interest* | *Ratification w/ Disclosure* | *BJR* | *BOP* | *Standard* |
| American Express | No (also no fraud, illegality, or negligence) | Not necessary | Yes | Plaintiff | Waste |
| Bayer | Yes | No | No | Defendant | Intrinsic Fairness (insider may still have to disgorge profits) |
| Fliegler | Yes | Yes | Yes | Plaintiff | Waste |

Note: Corporate rules merely restate agency-principal rules

### Dominant Shareholders

* + 1. Introduction
       1. Shareholders work as no one’s agent, so they owe no one a fiduciary duty.
       2. Yet, sometimes shareholders can structure corporate transactions to redistribute wealth from other shareholders to themselves in two broad ways:
          1. Sometimes they control the board. Nominally, directors serve as agents for the firm (and its shareholders) as a whole. Where one shareholder (or one group) dominates the firm, however, the directors serve at his whim. If he orders them explicitly or implicitly to redistribute wealth to him, they refuse at the cost of their job.
          2. Sometimes shareholders themselves take actions with redistributive consequences. To merge one firm with another, for example, both directors and shareholders must approve the transaction. Skew the terms of the merger in his favor, and a controlling shareholder can pocket money at his colleagues’ expense.
       3. To police this misbehavior, court declare that controlling shareholders owe other shareholders a fiduciary duty.
       4. What constitutes control? A majority stake almost always gives control. But where shareholdings are broadly dispersed, even a much smaller stake may give control effectively.
    2. **Business judgment rule applies to controlling shareholders unless there is self-dealing. Then, controlling shareholders have burden to prove “intrinsic fairness” – fair and reasonable** 
       1. ***Sinclair Oil Corp. v. Levien (Del. 1971)***
          1. Synopsis: Sinven was a subsidiary of D with operations exclusively in Venezuela. D, as the majority shareholder of Sinven, caused Sinven to pay dividends that were so large that the amount exceeded the earnings of Sinven. The dividends provided cash to D as well as minority shareholders, but it left no resources for Sinven to expand its operations. D also neglected to meet the terms of the contract between them and Sinven. The agreement required Sinven to sell all of its products to D at specified prices, but D was late in payments and did not fulfill their minimum purchasing obligations. P therefore brought this action, claiming (1) the dividends were excessive; (2) D breached fiduciary duties by placing business opportunities with its 100% subsidiaries rather than the 97% Sinven; and (3) that D caused its 100%-owned Sinclair International to breach the contracts with the 97%-owned Sinven. Court held that (1) **there was no self-dealing since D paid equal dividends on all shares**; thus the business judgment rule applied and court did not find waste. (2) D did not receive corporate business opportunities in Venezuela so found in favor of D on this. (3) D owed Sinven a fiduciary duty; in causing International to breach its contracts with Sinven, it violated that duty and was liable.
          2. Tool: “A parent does indeed owe a fiduciary duty to its subsidiary when there are parent-subsidiary dealings. However, this alone will not evoke the intrinsic fairness standard. This standard will be applied only when the fiduciary duty is accompanied by self-dealing-the situation when a parent is on both sides of a transaction with its subsidiary. Self-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary.”
       2. ***Zahn v. Transamerica Corporation (3d Cir. 1947)***
          1. Synopsis: A-F was a tobacco company that had as its principal asset leaf tobacco which they bought in late 1942 and early 1943 for $6,361,981. By April of 1943 the value of the tobacco was about $20 million. Transamerica (D), a holding company, was the majority shareholder which entitled them to control nearly every aspect of A-F’s operations. D converted all of their Class A stocks to class B stocks, and then called for a redemption of outstanding Class A stocks at $80.80 per share. The company’s charter allowed for the redemption, but the timing of it was suspicious because right after the redemption, D liquidated A-F. As a result, owners of Class A shares lost out on what P valued to be a $240 per share return. P redeemed some Class A shares, so P sought equitable relief to turn in outstanding shares at $240 per share and sought the difference between the $80.80 and $240 for the redeemed shares. D argued that they followed the corporate charter when they voted for the redemption. Court held that because calling the A shares transferred money from the A shareholders to D, the transaction was **self-dealing**. D had to show the deal was **intrinsically fair** which it did not so held in favor of P.
          2. Tool:

“The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors.”

“When voting as a stockholder he may have the legal right to vote with a view of his own benefits and to represent himself only; but when he votes as a director he represents all the stockholders in the capacity of a trustee for them and cannot use his office as a director for his personal benefit at the expense of the stockholders.”

“directors may not declare or withhold the declaration of dividends for the purpose of personal profit or, by analogy, take any corporate action for such a purpose.”

**When there is self-dealing, have to show intrinsically fair 🡪 prove that transaction was fair and reasonable. This standard is what a disinterested board would do. Facing multiple tiers of securities, a disinterested board should adopt those strategies that maximize the returns to the junior-most security (the residual claimant, the security paid last).**

### Corporate Opportunities

* + 1. Previous Cases
       1. *Meinhard v. Salmon* (NY 1928) – Salon ran a joint venture with Meinhard to exploit a lease from Gerry. Near the end of the term, Gerry invited Salmon to invest in a new lease that would replace the expiring one. Salmon accepted, Meinhard sued, and J. Cardozo declared that Salmon breached his duty of loyalty to Meinhard. The new lease was an “opportunity” of the joint venture. Had the two operated a corporation rather than a joint venture, J. Cardozo might have called it a “corporate opportunity.” Salmon could not “take” the opportunity for himself without first offering it to their firm.
       2. *Fliegler v. Lawrence* (Del. 1976) – Lawrence ran Agau, which mined for silver and gold. Through his work for the company, he acquired several antimony mines. Lest minority shareholders claim that the antimony mines were “corporate opportunities” to Agau, he did not immediately exploit them in his own firm USAC. Instead, he “offered” them to Agau. Only after the Agau board “rejected” his offer did he develop them himself.
    2. Agent-Principal Rules – “Unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal.” R2 Agency 388.
    3. What is a Corporate Opportunity?
       1. *Beam ex re. Martha Stewart Living Omnimedia Inc. v. Stewart* – an opportunity is within the corporation’s line of business when it is “an activity as to which [the corporation] has fundamental knowledge, practical experience and ability to pursue.”
       2. ALI 5.05(b) – a corporate opportunity is one of three types of business opportunities:

*(1) Any opportunity to engage in a business activity of which a director or senior executive becomes aware, either:*

*(A) In connection with the performance of functions as a director or senior executive, or under circumstances that should reasonably lead the director senior executive to believe that the person offering the opportunity expects it to be offered to the corporation; or*

*(B) Through the use of corporate information or property…; or*

*(2) Any opportunity to engage in a business activity of which a senior executive becomes aware and knows is closely related to a business in which the corporation is engaged…*

* + - * 1. Director v. Officer (aka Executive)

Director – Directors work part time and may serve on the boards of several firms in the same industry

Officer (aka Exeuctive) – typically work full time for a firm

* + 1. What should one do with a Corporate Opportunity? If a director or an officer receives a corporate opportunity, he will need to offer it to the firm. Only if the firm then rejects it can he exploit it for himself.
       1. ALI 5.05(a) – a director or senior executive may not take advantage of a corporate opportunity unless:

*(1) The director or senior executive first offers the corporate opportunity to the corporation and makes full disclosure concerning the conflict of interest and the corporate opportunity;*

*(2) The corporate opportunity is rejected by the corporation; and*

*(3) Either:*

*(A) The rejection of the opportunity is fair to the corporation;*

*(B) The opportunity is rejected in advance, following such disclosure, by disinterested directors…; or*

*(C) The rejection is authorized in advance or ratified, following such disclosure, by disinterested shareholders…*

* + - 1. ALI 5.05(c) – A party who challenges the taking of a corporate opportunity has the burden of proof, except that if such party establishes that the requirements of Subsection (a)(3)(B) or (C) are not met, the director or senior executive has the burden of proving that the rejection and the taking of the opportunity were fair to the corporation.
    1. ***In re eBay, Inc. Shareholders Litigation (Del. Ch.)(Memorandum Opinion)***
       1. Synopsis: Shareholders of eBay, Inc. (P) filed these consolidated derivative actions against certain eBay directors and officers (D) for usurping corporate opportunities. Ps allege that eBay’s investment banking advisor, Goldman Sachs, engaged in “spinning,” a practice that involves allocating shares of lucrative initial public offering of stock to favored clients. In effect, the plaintiff shareholders allege that Goldman Sachs bribed certain eBay insiders, using the currency of highly profitable investment opportunities, which should have been offered to eBay rather than the favored insiders. Court agreed that these were corporate opportunities or bribery and that both violated duty of loyalty.
       2. Tool: Could be seen as a stretch. eBay regularly invested in securities and had the money to buy these shares too. But don’t all big corporations invest in securities to some extent? Why is corporate opportunity a separate doctrine when it is covered under duty of loyalty?

# INSIDER TRADING

## State Law

### Fraud

* + 1. Committed when you lie, or don’t say anything and you have duty to disclose.
    2. Otherwise, caveat emptor (buyer beware)

### Directors’ Fiduciary Duties

* + 1. State courts differ on whether directors owe fiduciary duties to individual shareholders, as opposed to a firm as a whole.
    2. Even if directors do owe their shareholders a fiduciary duty, they do not breach it when they sell their stock to an outside investor. Because the investor becomes a shareholder only upon the sale, the director assumes a fiduciary duty to the buyer only after the consummation of the transaction.
    3. Yet, even if directors owe a fiduciary duty only to the firm, they may not keep the profits they make.
       1. R2d Agency – If a director has inside information…profits made by him in stick transactions undertaken because of his knowledge are held in constructive trust for the principal. He is also liable for profits made by selling constructive information to third persons, even though the principal is not adversely affected.

## Securities Law

### Applicability of Securities Law Provisions

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| All investment interests in a firm | | | | |
|  | Securities – Subject to 10b-5 | | | |
|  | 1933 Act Registration Requirements | | |
|  | Largest Firms – 1934 Act Registration Requirements | |
|  | Equity Securities – Subject to 16(b) |

### Registration

* + 1. Introduction
       1. 1933 (Securities) Act – mandated the disclosure (“registration”) of information.
       2. 1934 (Securities) Exchange Act – required even more stringent disclosure of the big firms that listed their shares on national exchanges, instituted a variety of rules for the resale market, and created the SEC to enforce it all. Insider trading is covered under section 10b-5.
    2. 1933 Act
       1. § 5 Requirement

(*a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person…:*

*(1)…to sell such security through the use or medium of any prospectus or otherwise…*

*(b) It shall be unlawful for any person, directly or indirectly –*

*(1)…to carry or transmit any prospectus relating to any security…unless such prospectus meets the requirement of [this Act]…*

*(c) It shall be unlawful for any person…to offer to sell or offer to buy…any security, unless a registration statement has been filed as to such security…*

* + - 1. The § 2 “Security”
         1. § 2(a)(1) defines security (defined similarly in 1934 Act):

*The term “security” means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness…investment contract,…any put, call, straddle, option , or privilege on any security,…or, in general, any interest or instrument commonly known as a “security.”…*

* + - * 1. “investment contract” – catchall – any contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a…third party.
        2. Note that general partnership interest, land, and assets (?) are not securities. Horse breeding schemes have been held to be securities. LLC interests may or may not be securities.
      1. The § 4 Exemptions
         1. § 4

*The provision of section 5 shall not apply to:*

*(1) transactions by any person other than an issuer, underwriter, or dealer.*

*(2) transactions by an issuer not involving any public offering*

* + - * 1. Shouldn’t rely on this exemption because future sales can change what initial sale meant (E.g. in terms of public offering or being an underwriter).
        2. Because of these risks, well-advised closely held corporations issue their shares only through elaborate “safe harbors.” SEC typically keys safe harbors to the following factors: (1) number of offerees; (2) the relationship of the offerees to each other and to the issuer; (3) the size of the offering [i.e., the amount of money raised]; (4) the number of units [i.e., shares, in the case of stock] offered; and (5) the manner of the offering [i.e., the type and quantity of advertising].
    1. Penalties for False or Omitted Statements
       1. § 11

*(a) …. In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—*

*(1) every person who signed the registration statement;*

*(2) every person who was a director of (or person performing similar functions) or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;*

*(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;*

*(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;*

*(5) every underwriter with respect to such security.*

*If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.*

|  |  |  |  |
| --- | --- | --- | --- |
| Registration Statement | Non-Expertized Portion | Expert | Liable only on portions they certify - § 11(a)(4) |
| Non Expert | Avoid liability if exercise due diligence (if, after reasonable investigation, they had reasonable grounds to believe and did believe that the statements therein were true) - § 11(b)(3)(A) |
| Expertized Portion | Expert | Avoid liability if exercise due diligence (if, after reasonable investigation, they had reasonable grounds to believe and did believe that the statements therein were true) or registration did not fairly represent his statement - § 11(b)(3)(B) |
| Non Expert | Avoid liability if they had no reasonable ground to believe and did not believe that the statements therein were untrue or that the registration statement did not fairly represent his statement - § 11(b)(3)(C) |

*(b) Persons exempt from liability upon proof of issues. Notwithstanding the provisions of subsection (a) no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof—*

Note: lawyers are non-experts. Experts include accountants, engineers and appraisers

*(c) Standard of reasonableness*

*In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.*

* + - 1. Materiality – ***Escott v. BarChris Construction Corp. (SDNY 1968)***
         1. Synopsis: BarChris made bowling alleys. BarChris found itself short of funds. It issued debentures (unsecured bonds/subordinated), but filed for bankruptcy and defaulted. Investors who bought debentures sued under §11 on the grounds that the registration statement hid the firm’s precarious financial straits. Several of the defendants pleaded “due diligence” defenses – yes we missed the inaccuracies, but we had diligently checked it for mistakes – arising under §11 (b). Court held as to each defendant: BarChris – 11(b) gives issuer no due diligence defenses but BarChris had no money anyway; BarChris’s president and VP – lied about not knowing what registration said and education doesn’t matter because directors face minimum standard that if they cannot meet, the should not serve; board members – due diligence defenses don’t apply because didn’t investigate firm enough; accountant – liable only on numbers he certified; lawyer sued as a director – due diligence defense doesn’t apply because didn’t check what he was told, plus more was required of him as corporate counsel in the way of reasonable investigation.
         2. Tool:

Materiality – It is a prerequisite to liability under Section 11 of the Securities Act that the fact which is falsely stated in a registration statement, or the fact that is omitted when it should have been stated to avoid misleading, be material. Term “material” limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered. Matters as to which an average prudent investor ought reasonably to be informed are those which such an investor needs to know before he can make an intelligent, informed decision whether or not to buy the security.

Lawyer could not rely on what the officers told him goes to why some law firms prohibit their partners from serving on client boards.

Court found lawyers to be non-experts or else everything would fall under expert category.

### Short-Swing Profits – 16(b)

* + 1. 1934 Exchange Act
       1. § 16 (b): “For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer…, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security…within any period of less than six months,…shall inure to and be recoverable by the issuer…This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security…
       2. §16(a) defines “beneficial owner” as a person who owned “more than 10 per centum of any class of any equity security…which is registered pursuant to section 12 of [the 1934 Securities Exchange Act].
    2. Steps
       1. Is this company subject to 16b? Have to register under 34 Act (very large - those with at least $10 million in assets and 500 shareholders) and traded on national exchange.
       2. Is it equity security? Section 16(b) applies only to trades in equity securities: stock, convertible debt, and options to buy and sell stock and convertible debt.
       3. Is there a purchase or sale within 6 month period? Firms may recover only those gains on matching pairs of purchases and sales that occur within six months.
       4. Do you have a specified insider? Need to be one of these in beginning of first of transactions in 6 month period.
          1. Directors – members of the board
          2. Officers – firm’s president, principal financial officer, principal accounting officer, any vice-president in charge of a principal business unit, division, or function, and other officer who performs a policy-making function.
          3. Holders of more than 10% of the firm’s stock

Have to be 10% shareholder immediately prior to purchase and sale. *See Reliance* and *Foremost*.

Courts examine each class of equity security separately. If an investor holds more than 10 percent of any one class, he is then liable on matching transactions within any (including any other) class. Courts do not match purchases and sales across classes.

* + - 1. What is the recovery to the firm?
         1. Traders disgorge their profits to the firm. If a corporation will not sue to recover § 16(b) profits, shareholders may file a derivative suit on its behalf.
         2. Covers low-priced purchases followed by higher-priced sales along with high-priced sales followed by low-priced purchases.
         3. Pair whichever transactions (within a given stock class) within a six-month window maximize the amount he owes. Ignore purchases that cannot be matched with a higher-priced sale and sales that cannot be matched with a lower-priced purchase. Courts ignore whether the investor lost money over the period as a whole.
         4. The acquisition of an option to buy or sell has the same effect as the purchase or sale of the underlying stock. Courts can thus pair the purchase of an option to buy with either a matching sale of the stock itself or an offsetting option to sell.
         5. Both derivative securities and the underlying securities to which they relate shall be deemed to be the same class of equity securities.
    1. ***Reliance Electric Co. v. Emerson Electric Co. (US 1972)***
       1. Synopsis: Emerson Electric bought 13.2% of the stock of Dodge through a tender offer and Dodge then negotiated a defensive merger into its ally, Reliance Electric. Faced with the prospect of becoming a minority shareholder in a firm it could not control, Emerson negotiated a pair of sales: one that took its holdings barely below 10% and another that disposed of the rest. SCOTUS found that Emerson was not a 10% shareholder at the time of its second sale so it was subject to § 16(b) only on the first sale.
       2. Tool:
          1. Section 16(b) of the Securities Exchange Act of 1934: a corporation may recover for itself the profits realized by an owner of more than 10% of its shares from a purchase and sale of its stock within any six-month period, provided that the owner held more than 10% both at the time of the purchase and sale.
          2. A company can split its sale of shares into more than one part to reduce their holdings under the statutory minimum percentage of shares (10%) to reduce their liability under Section 16(b).
       3. Note: Emerson should not have fallen under 16(b) at all because it did not own any stock before its tender offer. But, Emerson didn’t want to appear greedy so didn’t argue this point.
    2. ***Foremost-McKesson, Inc. v. Provident Securities Company (US 1976)***
       1. Synopsis: Provident owned securities, but wanted to liquidate. Foremost agreed to buy its securities. It would give Provident cash and convertible debt (equity securities for 16(b) purposes). Because the convertible debt, if converted, would have constituted more than 10% of Foremost stock, this transaction made Provident a beneficial owner under 16(b). Provident then distributed the debt and cash to its shareholders and liquidated. Court found that Provident was not subject to 16(b), because it did not own a 10% stake immediately before the acquisition.
       2. Tool: Test is whether D owned the stake before the purchase.
          1. 16(b)’s last sentence – it “shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved…”
          2. Under Section: 16(b), the phrase “at the time of the purchase” in the exemption provision means the time right before a purchase in a purchase-sale, thus “a beneficial owner must account for profits only if he was a beneficial owner before the purchase.”

## Rule 10b-5

### Statute – 10b-5

* + 1. Rather than obtain new legislation, then head of SEC, Cary, manipulated an otherwise ignored antifraud rule: Rule 10b-5 in *In re Cady, Roberts*. The rule said nothing about insider trading, so the trick was to declare insider trading fraudulent.
    2. Only criminal penalty, no civil recovery (for purposes of this class) 🡪 **requires scienter (intent)**
    3. 10b-5

*It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,*

*(1) to employ any device, scheme, or artifice to defraud,*

*(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or*

*(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.*

### Abstain or Disclose – Texas Gulf Sulphur

* + 1. ***Securities and Exchange Commission v. Texas Gulf Sulphur Co. (2d Cir. 1969)*** Synopsis: SEC sued Ds. Ds were officers, employees or were closely tied to employees of Texas Gulf. Texas Gulf was conducting mining exploration in Canada. One area was deemed promising by the survey, and a hole was drilled with the resulting core analyzed. The analysis showed that the minerals present in the area were extremely rich in minerals. Ds did not disclose the results of the analysis to outsiders, including other officers and shareholders of Texas Gulf. Ds did proceed to purchase shares and calls once they knew about the results. The trading activity and sample drilling did prompt rumors in the industry of a significant find by Texas Gulf, and on April 12, 1964 Ds sent out a misleading press release to calm the speculation. The press release misrepresented the actual results of the samples. Ds decided to announce the results on April 15, although the news did not reach the public until April 16. Ds still traded between April 12 and the announcement. Ds claimed that the information was not material to the value of the company and therefore did not feel obligated to publicly disclose the information. They also argued that any trading after they released the news at midnight of April 16 was legitimate because technically the news was disseminated to the public.
    2. Insider Trading
       1. If the officers served as agents to their shareholders, they owed a duty (as fiduciaries) to disclose both their identity and any important relevant information they held when buying stock from them. If they bought without disclosing, they committed a fraud. Under the new logic Cady outlined, they violated Rule 10b-5. (Recall that not all courts previously held that corporate officers owed fiduciary duties to their shareholders.)
       2. Texas Gulf Sulphur declared *In re* *Cady, Roberts* settlement the law:
          1. *The essence of the Rule [10b-5] is that anyone who, trading for his own account in the securities of a corporation, has “access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone” may not take “advantage of such information knowing it is unavailable to those with whom he is dealing,” i.e., the investing public…****Insiders****, as directors or management officers are, of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an ‘****insider’*** *within the meaning of Sec. 16(b) of the Act…*
       3. **Insiders have duty to “abstain or disclose” to those you have fiduciary duty toward**:
          1. *Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.*
       4. Texas Gulf Sulphur did not derive its duty to abstain or disclose from any agency-principal relationship but located the duty in the securities market itself:
          1. *The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks – which market risks include, of course the risk that one’s evaluative capacity or one’s capital available to put at risk may exceed another’s capacity or capital. The insiders here were not trading on an equal footing with the outside investors.*
    3. **Materiality** – Only need to disclose “material” information
       1. Any information important enough to matter to the insider was important enough to be “material:”

*The basic test of materiality is whether a reasonable man would attach importance in determining his choice of action in the transaction in question. This, of course, encompasses any fact ‘which in reasonable and objective contemplation might affect the value of the corporation's stock or securities.’ … Thus, material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities.*

* + - 1. Effectively, if an insider cares about a piece of information, it is material. Materiality turns on what an insider does with the information. If he thinks it important enough to trade on it, it is material. Thus, the test eliminates “materiality” as an issue in real-world litigation.
    1. “**In Connection With**” Purchase or Sale of a **Security**
       1. Texas Gulf Sulphur expands the scope of activities “in connection with” the purchase or sale of a security. Rule 10b-5 bans fraud only “in connection with” such a purchase or sale.
       2. Although Texas Gulf Sulphur issued the press release, it neither bought nor sold any stock. Arguably, it did not issue the statement in connection with a purchase or sale. However, if it issued a statement that was of the “sort that would cause reasonable investors to rely” on it, then – according to the court – it issued a statement in connection with a purchase or sale.
       3. Note: So deciding not to engage in trade not illegal because no purchase or sale.
    2. Wait Time
       1. *Before an insider acts, has to wait not just until procedures for public release of the information are carried out, but should wait at least until the “news could reasonably have been expected to appear over the media of widest circulation.”*
    3. Holding: Ds withheld information that was material to shareholders and therefore were acting on insider information when they purchased their shares and calls on Texas Gulf stock. The court looked at the conduct of Ds as evidence that the information was material: they purchased a great deal of shares in Texas Gulf, they deliberately kept the information from others, and the timing of their purchases occurred during the period that they exclusively held the information. It did not matter that there was still an element of uncertainty in the eventual mineral mining, but the key element was whether a reasonable person would believe that the information would be relevant to the price of the stock. Further, Defendants should not act upon the information until the information is disseminated to the point that the public would have had a reasonable opportunity to act on it. Remand on issue of whether press release violated of Rule 10b-5 so court can consider witness testimony, etc.
    4. Problem: Financial analysts fall under Texas Gulf Sulphur’s level-playing field approach, which is rejected in Chiarella.
    5. **Jordan v. Duff and Phelps, Inc. (7th Cir. 1987)**
       1. Synopsis: James Jordan (P) was a securities analyst at Duff & Phelps (D). P owned 1% of firm’s stock (privately held). In buying the stock, P signed a shareholders agreement and a stock purchase agreement. The stock purchase agreement provided that if P left the firm, he agreed to resell the stock to the firm for its book value at the end of the previous calendar year and that nothing in the agreement conferred on him any right to be continued in employment. P decided to move, got another job, and resigned from Duff & Phelps. P obtained a book value for his stock of $23K. Later P heard that D was in merger talks and had been in merger talks while P was still at the firm that would have put the shares he was eligible for at a value of $452,000, plus be entitled to another $194,000 in “earn-out” money. P wanted his stock back, but D refused. P sued D for violating 10b-5 by not abstaining or disclosing (*Texas Gulf*) the merger talks to P saying he would have never resigned if knew about the merger talks. Merger talks failed but later there was a leveraged buy-out.
       2. Tools:
          1. Shareholder relationship > at-will employment relationship
          2. Seems to suggest that shareholder cannot contract away fiduciary duties at least as it relates to agreement that is not shareholders agreement.
          3. “Close corporations buying their own stock, like knowledgeable insiders of closely held firms buying from outsiders, have a fiduciary duty to disclose material facts.”
          4. At-will employee does not mean he can be fired for any reason.
          5. “The relevance of the fact does not depend on how things turn out…a failure to disclose an important beneficent event is a violation even if things later go sour.”
       3. Easterbrook (majority): P could have chosen to stay and keep his stock; to decide whether to stay he needed information D had but did not disclose (information was material); D had a fiduciary relation to P as shareholder; and in repurchasing P’s stock without disclosing the information P needed to decide whether to keep his stock (and stay) or sell it (and go), D violated 10b-5.
       4. Posner (dissent): P had a right to the information only if he had a right to stay at Duff & Phelps; as an at-will employee, he had such a right only if he obtained it as an adjunct to any right he might acquire as a minority shareholder; and through the shareholders’ agreement he waived any such right.

### Duty to Trading Partner Required – Chiarella v. United States (US 1980)

* + 1. Synopsis: D worked for printing company which was retained by the acquiring corporation in connection with a tender offer for the shares of another corporation. The acquiring corporation made every reasonable effort to keep the identity of the tender offer target a secret, even from the employees of the printer. D figured out the identity of the target and bought shares of its stock through a broker. When the tender offer was announced, the target shares rose in value and D sold his shares at a profit. D was indicted for violating 10(b) and Rule 10b-5 by the Court of Appeals. The Supreme Court reversed holding that D’s conduct was not a violation because he was not an insider of the corporation whose shares he had traded, so he stood in no relationship of trust and confidence to the target shareholders. D may have owed a fiduciary duty to the acquirer through his job, but he did not buy the acquirer’s stock.
    2. Tool: “One who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.” 🡪 Chiarella had no duty to target so did not violate 10b-5.
    3. Dissent (Burger): Chairella “misappropriated” information about the takeover. When Chiarella broke Pandick rules, he misappropriated the information and committed a fraud on Pandick and its clients. This fraud constituted a Rule 10b-5 violation. (This argument was not presented to the jury).

### Tippee (Typically Investor) Liability – Dirks v. Securities & Exchange Commission (US 1983)

* + 1. Synopsis: Secrist, an insider, (tipper) that worked for Equity Funding of America told Dirks (tippee) that the company was overstating their assets and that Dirks, who was an officer that provided investment analysis for a broker-dealer firm, should investigate the fraud. Dirks interviewed other employees who corroborated the fraudulent allegations. Dirks told investors and clients (secondary tippees) about the fraud, and they reacted by selling their stake in the company. When the stock was being heavily traded and dipped from $26 to $15, the New York Stock Exchange halted trading and the SEC investigated and found fraud. SEC then filed suit against Dirks for violations of 10b-5 for using the insider information and perhaps receive commissions from those clients. The trial court and appellate court agreed with SEC, reasoning that anytime a tippee knowingly has inside information that they should publicly disclose it or refrain from acting upon it. SCOTUS found that Secrist did not gain, because he was just motivated by a desire to expose the fraud, so Dirks and his clients could freely trade.
    2. Tool:
       1. Tippees and secondary tippees violate Rule 10b-5 when a tipper breaches a fiduciary duty in tipping the information and the tippee knows or has reason to know of the breach.
          1. *[A] tippee assumes a fiduciary duty to shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.*
       2. Also, tipper must gain.
          1. *[T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.*
          2. Note: this is problematic because there are two fiduciary duties – loyalty and care. But in Dirks, court says there is violation only if there is gain. Therefore, Dirks really only talking about duty of loyalty, because can violate duty of care without personal gain (e.g. saying something to another co-worker in an elevator and someone else overhears).
    3. Additional Observations from *Dirks*
       1. An investor does not violate 10b-5 simply by trading on an informational advantage. Market specialists will always have an information advantage. Only by trading on that advantage will they cause market prices to reflect the information about the firm. And only if market prices reflect that information can uninformed investors trade at prices that reflect the consensus estimate of the firm’s anticipated performance. Thus, *Texas Gulf Sulphur* language about “identical market risks” is not the law.
       2. A firm’s lawyers and accountants, for purposes of *Dirks*, are “temporary insiders” rather than tippees. **Footnote 14**:
          1. *Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders.*
       3. Outsider becomes a temporary insider only if he accepts an appointment with a firm. **Footnote 22**:
          1. *[T]he defendant investment banking firm…investigated another corporation that was a possible target of a takeover bid by its client. In the course of negotiations the investment banking firm was given, on a confidential basis, unpublished material information. Subsequently, after the proposed takeover was abandoned, the firm was charged with relying on the information when it traded in the target corporation’s stock…In the absence of any fiduciary relationship, the Court of Appeals found no basis for imposing tippee liability on the investment firm.*
    4. Look-Alike Facts – *SEC v. Switzer*
       1. Synopsis: Investor overhears tip at a track meet. Heard CEO talk about his firm’s impending merger. Investor bought stock in the CEO’s firm, the firm announced the merger at a high price, and the investor pocketed a profit. SEC sued the investor for violating 10b-5. Court acquitted investor, because tipper did not earn a personal gain.
       2. Tool: Under *Dirks*, duty of care violations did not count. Only duty of loyalty violations that earn the tipper a gain matter.

### Misappropriation

* + 1. SEC didn’t like Chiarella outcome so comes up with Rule.
    2. § 14e-3 of the 1934 Act

*It shall be unlawful for any person…to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer…The Commission shall…by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.*

* + 1. To the SEC, insider trading was wrong whether the insider served as a fiduciary to his **trading partner** or not. To implement the statute, SEC wrote Rule 14e-3:

*“If any person has taken a substantial step or steps to commence, or has commenced a* ***tender offer*** *(the offering person), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Exchange Act for any other person who is in possession of* ***material information*** *relating to such tender offer which information he knows or has reason to know is* ***nonpublic*** *and which he knows or has reason to know has been acquired directly or indirectly from:*

*(1) the offering person,*

*(2) the issuer of the securities sought or to be sought by such tender offer, or*

*(3) any officer, director, partner, or employee or any other person activing on behalf of the offering person or such issuer,*

*to purchase or sell or cause to be purchased or sold any of such securities or an securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.”*

* + - 1. Both §§ 10(b) and 14(e) banned “Fraud.” The Court had held that fraud under §10(b) required a fiduciary relationship between the trading partners. In Rule 14e-3, the SEC defined “Fraud” under § 14(e) without such a requirement. Could the SEC do this? Then comes O’Hagan.
    1. ***United States v. O’Hagan (US 1997)***
       1. Synopsis: O’Hagen was a partner at Dorsey & Whitney. His firm had been retained by Grant Met, which planned to announce a tender offer for Pillsbury. Having embezzled funds from a client, O’Hagen needed cash. Buying Pillsbury stock and options on Pillsbury stock, he netted $4.3 million. The SEC noticed and prosecutors indicted him for violating both Rule 14e-3 and Rule 10b-5. SCOTUS found O’Hagen violated 10b-5 by not disclosing to the firm or the client that he was using the nonpublic information, and his use of it was at the client’s expense.
       2. Tool: Rule 14e-3 and misappropriation are both good law.
          1. Misappropriation violates 10b-5 which bans deceptive conduct and misappropriation is deceptive (**Need rule to break to be deceptive toward someone you owe fiduciary duty to**). However, full disclosure forecloses liability under the misappropriation theory:

*Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no “deceptive device” and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty*

* + - * 1. Must disclose to all entities to which you have a fiduciary duty in order to avoid liability:

*Where, however, a person trading on the basis of material, nonpublic information owes a duty of loyalty and confidentiality to two entities or persons – for example, a law firm and its client – but makes disclosure to only one, the trader may still be liable under the misappropriation theory.*

* + - * 1. Even if principals say to stop behavior still free to trade under 10b-5, but may not be under state law:

*[T]he textual requirement of deception precludes 10(b) liability when a person trading on the basis of nonpublic information has disclosed his trading plans to, or obtained authorization from, the principal – even though such conduct may affect the securities markets in the same manner as the conduct reached by the misappropriation theory…Once a disloyal agent disclosed his imminent breach of duty, his principal may seek appropriate equitable relief under state law.*

* + - * 1. If principal authorizes trading, may be liable.

*[I]n the context of a tender offer, the principal who authorizes an agent’s trading on confidential information may, in the Commission’s view, incur liability for an Exchange Act violation under Rule 14e-3(a).*

* + 1. Other Duties of Trust or Confidence
       1. *United States v. Chestman* (2d Cir. 1991) – Court held that husbands and wives do not owe each other fiduciary duties. For the SEC, the result was an obvious nightmare. To trade on inside information, a CEO need simply place the trade in his or her spouse’s account. When the SEC comes calling, the two can then invent a “What did you do at the office today, honey?” conversation. So long as neither wants to put the other in prison, they are both home free.
       2. To address the problem, in 2000 the SEC adopted **Rule 10b5-2:**

*For purposes of this section, a “duty of trust or confidence” exists in the following circumstances, among others:*

*(1) Whenever a person agrees to maintain information in confidence;*

*(2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or*

*(3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling…*

# CONTROL ISSUES

## Choosing the Team that Runs the Firm

### The Mechanics

* + 1. The law provides that shareholders vote once a year to elect the members of the board of directors. Those directors then monitor, hire, and fire the officers who run the firm day in and day out. The law also gives shareholders a vote on transactions involving the life of the firm – e.g. mergers, liquidations, and sales of substantially all the corporate assets.
    2. Often, shareholders vote at the annual meeting by proxy - by appointing someone there to vote in their stead as their agent.
       1. “Proxy card” – the document by which they appoint a voting agent
       2. “Proxy fight” – process by which rival board candidates solicit shareholder support
       3. “Proxy rules” – federal rules that govern the content of their solicitation material. Apply to same firms that fall under 16(b). Heavily regulated by 1934 Act.
       4. “Proxy statement” – statement required of a firm when soliciting shareholder votes. This statement is filed in advance of the annual meeting.
    3. Private Actions for Federal Proxy Violations – a shareholder can sue under 1934 Exchange Act § 14.

### Paying for the Proxies

* + 1. In contests over policy, the incumbent board may charge the firm for reasonable proxy solicitation expenses whether they win or lose (*Rosenfeld* clarifies that even when lose) – ***Levin v. Metro-Goldwyn-Mayer, Inc. (SDNY 1967)***
       1. Synopsis: Levin, shareholder, launched a proxy fight to oust O’Brien, MGM president. The Levin group and the MGM incumbents both solicited proxies for the annual meeting. Levin then sued to enjoin the incumbents from using corporate facilities in the effort. Specifically, he argued that MGM should not use corporate funds to hire lawyers or proxy solicitation specialists. Court held for D noting that the differences were about business policies, not personality conflict; D did not spend an unreasonable amount (MGM spent $125K); and D disclosed what they were doing.
       2. Tool: There is no law against the solicitation of proxies through the use of corporate resources, and if there is no showing of irreparable harm to Ps then proxy solicitation should not be prohibited.
    2. In contests over policy, the insurgent candidates may charge the firm for their proxy solicitation expenses, provided the amounts are reasonable, the insurgents win, and the shareholders approve the expenditure – ***Rosenfeld v. Fairchild Engine & Airplane Corp. (NY 1955)***
       1. Synopsis: Fairchild founded the Fairchild Engine & Airplane firm. Ward ran the firm. Fairchild did not like the direction Ward was taking the firm so he campaigned other shareholders to oust Ward, he won, and Ward resigned. Ward and his allies spent $106K in corporate funds to solicit proxies. After the shareholders had approved the payment, the Fairchild group charged the firm $127K for their won proxy solicitation expenses. In a derivative suit challenging these expenses, the NY Court of Appeals held that parties could charge the firm when there was a good faith dispute over policy and the expenses were reasonable.
       2. Tool: Incumbents can may reasonable expenditures whether they win or lose but contestants only if they win – “In a contest over policy, as compared to a purely personal power contest, corporate directors have the right to make reasonable and proper expenditures, subject to the scrutiny of the courts when duly challenged, from the corporate treasury for the purpose of persuading the stockholders of the correctness of their position and soliciting their support for policies which the directors believe, in all good faith, are in the best interests of the corporation. The stockholders, moreover, have the right to reimburse **successful** contestants for the reasonable and bona fide expenses incurred by them in any such policy contest, subject to like court scrutiny.”
       3. Dissent: all disputes involve policy

### Contacting the Shareholders

* + 1. Right to Shareholder’s List
       1. 14a-7
          1. 14a-7: when an insurgent group wants to contest management and solicit proxies, Rule 14a-7 gives management a choice: it can either mail the insurgent group’s material to the shareholders directly and charge the group for the cost, or it can give the group a copy of the shareholder list and let it distribute its own material.
          2. Federal proxy rules do not give insurgent a right to demand the shareholder list.
          3. Insurgents want to see the list to know which shareholders own substantial amounts of stock to target them.
          4. Generally, the state law will give you a right to the list. If the insurgent has a right the shareholders list under state law, Rule 14a-7 does not circumscribe that right.
       2. ***Crane Co. v. Anaconda Co. (NY 1976)***
          1. Synopsis: Evans (head of Crane Co.) looked to buy a minority stake. Anaconda management interpreted his interest as a hostile acquisition and moved to block him. Evans proposed a tender offer in exchange for Crane bonds. To implement this tender offer, Evans wanted to contact the shareholders. He asked for the shareholder list, Anaconda refused, Evans sued in NY. Although Anaconda was a Montana corporation, it did business in NY, and NY law let its residents demand a shareholders’ list from an out-of-state firm if they met one of two conditions: (1) They had owned the company’s stock for at least 6 months or (2) they owned at least 5% of stock. Crane owned 11% of Anaconda so it met the second condition. Anaconda argued that Crane did not want the list for the business of mining (Anaconda’s business), but wanted it to plan to buy stock. Court held in favor of Crane stating that the “statute should be liberally construed in favor of the stockholder.”
          2. Tool:

“Any resident of this state who shall have been a shareholder of record, for at least six months immediately preceding his demand, of a foreign corporation doing business in this state, or any resident of this state holding, or thereunto authorized in writing by the holders of, at least five percent of any class of the outstanding shares, upon at least five days' written demand may require such foreign corporation to produce a record of its shareholders setting forth the names and addresses of all shareholders, the number and class of shares held by each and the dates when they respectively became the owners of record…”

Business Corporation Law § 1315 – lets a firm deny the list if a stockholder wants it “for a purpose which is in the interest of a business or object other than the business of the foreign corporation.” In this case, tender offer was deemed business interest.

The “statute should be liberally construed in favor of the stockholder.”

* + - 1. ***State ex rel. Pillsbury v. Honeywell, Inc. (Minn. 1971)***
         1. Synopsis: Pillsbury was part of an anti-war group that decided to target Honeywell, Inc., for their manufacturing of anti-personnel fragmentation bombs that would be used in the Vietnam War. Pillsbury purchased 100 shares of Honeywell stock. He then demanded the firm’s shareholder list and “all corporate records dealing with weapons and munitions manufacture.” Honeywell refused. Honeywell was incorporated in Delaware (HQ in Minn.) and Delaware law allowed it to refuse the shareholder’s list if it could show that Pillsbury wanted it “for an improper purpose.” It could not refuse the business records unless Pillsbury could himself prove that he wanted them “for a proper purpose.” The Minn. Supreme Court denied Pillsbury’s claim, because Pillsbury had “utterly no interest in the affairs of Honeywell before he learned of Honeywell’s production of fragmentation bombs.” Pillsbury only cared about opposition to Honeywell’s policy as opposed to the firm’s profits or shareholder list. Thus, he lacked proper purpose.
         2. Tool: From Delaware statute – Company can deny shareholders’ list if it can prove it is wanted for an “improper purpose.”
    1. Proxy Materials
       1. Rule 14a-8
          1. Rule 14a-8 provides an opportunity for a shareholder to have his or her proposal placed alongside management's proposals in that company's proxy materials for presentation to a vote.
          2. The rule generally requires the company to include the proposal unless the shareholder has not complied with the rule's procedural requirements or the proposal falls within one of the 13 substantive bases for exclusion: (1) not a proper subject for action by shareholder; (2) proposal would violate the law; (3) contrary to proxy rules including #9; (4) concerns a personal grievance; (5) relates to operations that account for less than 5% of assets and less than 5% of revenue (Note that in *Lovenheim*, court found that if a proposal raises ethical issues of significance, it cannot be excluded under reason 5); (6) company would lack power to implement; (7) ordinary business (note that SEC tends not to let firms exclude proposals that the company form a committee to study aspects of its ordinary business operations. See e.g. *Lovenheim*); (8) relates to election of membership of board; (9) directly conflicts with one of company’s own proposals to be submitted at same meeting; (10) company has already substantially implemented proposal; (11) substantially duplicates another proposal; (12) If the proposal deals with substantially the same subject matter as another proposal…that has…been previously included in the company’s proxy materials within the preceding 5 calendar year, a company may exclude it from its proxy materials for any meeting held within 3 calendar years of the last time it was included if the proposal received: (i) Less than 3% of the vote if proposed once within the preceding 5 calendar year; (ii) Less than 6% of the vote on its last submission to shareholders if proposed twice previously within the preceding 5 calendar years; or (iii) Less than 10% on its last submission to shareholders if proposed three times or more previously within the preceding 5 calendar years; (13) relates to specific amount of cash or stock dividends.
       2. ***Lovenheim v. Iroquois Brands, Ltd. (DDC 1985)***
          1. Synopsis: P wanted to insert a proposal in the proxy statement regarding a supplier of pate de fois gras that force-fed the geese in order to enlarge the livers. The pate represented less than .05 percent of Ds sales, and the product operated at a loss. Therefore, Ds wanted to omit the proposal. Ds believed that only a proposal related to economic purposes are required to be accepted per Rule 14a-8(c)(5), and that the 5% threshold was not exceeded. P argued that material social issues that were relevant to the business would not fit under the Rule’s exception. Court held that the pate issue was significant to its pate business regardless that it did not comprise greater than 5% of sales.
          2. Tool:

Rule 14a-8 of 1934 Exchange Act: “If any security holder of an issuer notifies the issuer of his intention to present a proposal for action at a forthcoming meeting of the issuer's security holders, the issuer shall set forth the proposal in its proxy statement and identify it in its form of proxy and provide means by which security holders [presenting a proposal may present in the proxy statement a statement of not more than 200 words in support of the proposal].”

Exception – Rule 14a-8(i)(5): “an issuer of securities may omit a proposal and any statement in support thereof from its proxy statement and form of proxy: if the proposal relates to operations which account for less than 5 percent of the issuer's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the issuer's business.”

The meaning of “significantly related” is not limited to economic significance.

## Allocating Control in the Close Corporation

### Problem

* + 1. Shareholders are trying to recruit a manager and in order to do so want to give him control over the firm during his tenure as CEO.

### Potential Solutions

* + 1. Stock – can sell majority stake in the firm, but this is likely too expensive. Even then, may want to limit ability to sell stock so that someone else doesn’t step in.
    2. Vote Classes
       1. Voting stock – Sell stock that votes (to give controlling vote at shareholder’s meeting) but does not entitle recruit to dividends or a liquidation distribution. Approved in ***Stroh v. Blackhawk Holding Corp. (Ill. 1971)***
          1. Synopsis: Blackhawk Holding Corp. (D) designated two classes of stock, Class A and Class B. Each share of the Class B stock was entitled to a vote in corporate matters, but the articles of incorporation provided that Class B stock was not entitled to dividends of any kind. Stroh, et al. (P) brought suit as owners of Class B stock, claiming that the provision effectively invalidated their stock. Illinois law defined “shares” as “the units into which the proprietary interests in a corporation are divided” and the plaintiffs claimed that the word “proprietary” connoted some kind of economic interest. Court held for D finding that provisions did not invalidate stock.
          2. Tool:

State constitution requires only that a shareholder not be deprived of his voice in management. It does not require that a shareholder, in addition to the management aspect of ownership, must also have an economic interest.

The rights to earnings and the rights to assets – the economic rights – may be removed and eliminated from the other attributed of a share of stock. Only the management incident of ownership may not be removed.

The constitution requires only that the right to vote be proportionate to the number of shares owned, not to the investment made in a corporation.

* + - 1. Nonvoting stock – most states allow it. Delaware, for example, allows firms to “issue one or more classes of stock” with “such voting powers, full or limited, or no voting powers…as shall be stated…in the certificate of incorporation.”
    1. Cumulative Voting
       1. In “straight voting,” shareholders vote for slates – an entire board of directors.
       2. In “cumulative voting,” investors can “cumulate” their votes and allocate them to a few candidates (i.e., less than a full slate). This allows a minority shareholder with a substantial block of stock to obtain board representation roughly proportional to his fractional interest in the firm.
    2. Voting Trusts – shareholders create a “voting trust,” assign stock to it, and name themselves beneficiaries and name recruit as trustee. Shareholders retain economic incidences but recruit could vote the stock as he pleases. This separates the economic incidents of stock ownership from the vote. Shareholders would then arrange for the trust to dissolve when the recruit quits his or her job. Have encountered some skepticism from courts and legislatures.
    3. Vote Pooling Agreements – shareholders may agree to pool their stock and vote as recruit wishes. ***Ringling Bros. – Barnum & Bailey Combined Shows v. Ringling (Del. Sup. Ct. 1947)***
       1. Synopsis: John Ringling named John and Ida North the executors of his estate. To eliminate the circus’s meddlesome creditors, John North decided to buy them out. He needed cash. The bank in return for the loan required that John North run the circus. To give North control, Edith and Aubrey agreed to put their stock in a voting trust. (Good under DE law). Eventually, Edith wanted her son Robert to run circus and Aubrey would marry James Haley and wanted him to run it too. To place their men in management, Edith and Aubrey signed a “vote pooling agreement” known as the “Ladies’ Agreement” (provided that if they didn’t agree, Karl Loos would dictate vote). After fire and after James Haley left prison (due to charges from fire), there was a shareholders meeting. James attended the meeting in Aubrey’s stead. Aubrey and Edith now not agreeing so Loos chose to vote in aim or original goal – reduce North’s power. James did not vote as Loos ordered. John and James counted James’s votes as legally cast, held a meeting of the directors so elected, and replaced Robert with James as Ringling president. Infringement ensued. Court held vote pooling agreement legal but unenforceable, because the agreement contained “no express delegation or grant of power” (nevermind the agreement provided that Loos’s decision thereon shall be binding upon the parties hereto). However, it was still legal so James’ votes do not count at all.
       2. Tool: Vote pooling agreement is legal but not enforceable. Court may reject votes of a registered shareholder where his voting of them is found to be in violation of rights of another person.”
    4. Irrevocable Proxies – give recruit voting control by assigning him or her a proxy to vote a given number of their shares. Would have to promise not to revoke their proxies, for example, as long as recruit works for the firm. Early courts treated a proxy as irrevocable only when the person taking the rightt o vote had another “interest” in the firm, such as, for example, working at the firm.
    5. The Logic – Eventually, the courts realized the logic to the arrangements ex-ante and started enforcing all of them. When they did, parties found themselves with the panoply of heavily overlapping options that they enjoy today.

## Restrictions on the Power of the Board

### General

* + 1. Agreements by which the shareholders simply commit to electing themselves, or their representatives, as directors, are generally considered unobjectionable, and are now expressly validated in many jurisdictions. (e.g. NY Bus. Corp. Law § 620(a)).
    2. Courts have had more difficulty with shareholder agreements requiring the appointment of particular individuals as officers or employees of the corporation, since such agreements do deprive the directors one of their most important functions. The modern view, reflected in Galler and Zion, is that such agreements are enforceable, at least for closely held corporations, as long as they are signed by all shareholders (and, perhaps in situations in which any non-signing minority shareholders cannot or do not object).

### New York

* + 1. Shareholders cannot enter agreements about who they will elect to a board (*McQuade*) unless the shareholders are unanimous in making such agreements (*Clark*).
    2. ***McQuade v. Stoneham (NY 1934)***
       1. Synopsis: McQuade (P) and McGraw each purchased 70 shares of NEC stock from the majority 1,306 shares that Stoneham owned. NEC was the company that owned the New York Giants. At the time of purchase, the parties agreed in writing to do everything in their power to keep Stoneham as president, McGraw as vice-president and Plaintiff as treasurer. P and Stoneham had a number of conflicts concerning the operations of NEC and the 7-member board of directors of NEC voted in a new treasurer (McGraw and Stoneham abstained from the vote but others who answered to Stoneham voted). P was not removed for any misconduct or ineptitude, but rather for his conflicts with Stoneham. P brought this action to be reinstated as treasurer, and he cited the agreement that he entered with McGraw and Stoneham that provided for each of them to use their “best endeavors” to keep each other in their respective positions. NY Court of Appeals held in favor of D, because directors may not by agreements entered into as stockholders abrogate their independent judgment.
       2. Tool:
          1. “[T]he stockholders may not, by agreement among themselves, control the directors in the exercise of the judgment vested in them by virtue of their office to elect officers and fix salaries. Their motives may not be questioned so long as their acts are legal. The bad faith or improper motives of the parties does not change the rule…Directors may not by agreements entered into as stock-holders abrogate their independent judgment.”
          2. Shareholders can agree about how they would vote their stock. Shareholders act for themselves; they are not agents of anyone else. They can properly agree about whom they will elect to the board. What they cannot do is agree about what actions those directors will take once elected. Directors are agents for the corporation and owe a legal duty to promote the interests of allshareholders – including shareholders not party to any agreement.
    3. ***Clark v. Dodge (NY 1936)***
       1. Synopsis: D companies, Bell & Company, Inc. and Hollings-Smith Company, Inc., were co-owned by Clark (P) (25% of shares) and Dodge (D) (the remaining 75% of shares). The companies manufactured medicine, the formulae that were known only by P. P entered into an agreement with D wherein P agreed to disclose the formulae to the son of D in return for a promise that D would keep P as a director and would be entitled to 25% of all net income providing that P was competent in his position. Afterwards, D did not vote P in as director, stopped delivering 25% of the income to P. P sought reinstatement and money owed from the stopping of payments and money wasted by D. Defendant countered, citing *McQuade*, that the agreement was invalid because it required D as a shareholder to usurp the directors’ judgment. The Court held that the agreement was not invalid. The *McQuade* court invalidated a similar agreement because it affected the rights of others that were not part of the agreement, and therefore it fell under the public policy argument. In this case, the only shareholders were D and P, and therefore the agreement between the two did not have any, or at least negligible, consequences on the public.
       2. Tool: An agreement between shareholders, wherein the shareholders entering the agreement are the only shareholders of the company, is valid even if the agreement contemplates controlling management decisions. – “If the enforcement of a particular contract damages nobody – not even, in any perceptible degree, the public – one sees no reason for holding it illegal, even though it impinges slightly upon the broad provision of section 27 [“The business of a corporation shall be managed by its board of directors.”]…Where the directors are the sole stockholders, there seems to be no objection to enforcing an agreement among them to vote for certain people as officers.”

### California

* + 1. Shareholders can enter agreements about who they will elect to a board as long as there is no complaint from the minority (Galler). Pooling agreements are legal in close and non-close corporations as long as they don’t directly allow for non-unanimous agreements about who will be elected to board; indirectly leading to such a result is legal (Ramos).
    2. ***Galler v. Galler (Ill. 1964)***
       1. Synopsis: Emma’s (P) late husband, Benjamin Galler and his brother, Isadore Galler, owned all but 12 shares of a close corporation, Galler Drug (each of the brothers sold six shares to a third party – employee Rosenberg – that was subject to a buyback provision allowing each brother to reclaim their six shares). The brothers, in an effort to provide for their families if something were to happen to either brother, entered a shareholder agreement that would guarantee that their spouses would be elected to the board and also provided an annual payout to the spouses. After Benjamin’s death, Isadore and his son (D) refused to honor the agreement. P sued to review the agreement in order to enforce the provisions therein. D argued that the shareholder agreement was unenforceable because it violated state statutes that render invalid shareholder agreements that seek to control management decisions. Court held agreement valid citing a number of prior cases, including *Dodge v. Clark*, to support the premise that because this agreement did not harm the public and was fair to the parties of the agreement, there is no offense to any public policy concerns.
       2. Tool:
          1. “Where, as…here, no injury to a minority interest appears, no fraud or apparent injury to the public or creditors is present, and no clearly prohibitory statutory language is violated, we can see no valid reason for precluding the parties from reaching any arrangements concerning the management of the corporation which are agreeable to all.”
          2. By the logic of *McQuade*, the agreement was void. It was a non-unanimous agreement (there was a minority shareholder) among shareholders that bound what they could do as directors. By the logic of *Clark*, the agreements would have been valid if the two brothers had held all the stock. The question was whether Rosenberg’s 12 shares moved the case from Clark to McQuade. On the ground that Rosenberg did not complain about the agreement, the court applied Clark and enforced the promise.
    3. ***Ramos v. Estrada (Cal. App. 1992)***
       1. Synopsis: Ramos (P) owned 50% of the shares of Broadcast Corporation, a company formed by Ramos to start a Spanish-speaking television station in Ventura, CA. The other shares were distributed to five other couples. Broadcast Corp. merged with another company, Ventura 41 Television Associates, to form Coasta del Oro Television, Inc. The Ventura 41 group would receive 5,000 shares, and the Broadcast Corp. group would initially receive 5,000 shares with another two shares after six months of operation. This allowed for each side to pick four directors and for Broadcast Corp. to elect a fifth director once the board expanded to nine directors. Each member of the Broadcast group entered into a shareholder agreement that required everyone to vote according to the will of the majority, thereby assuring that the group would maintain a director majority. If a member of the group did not vote according to the majority, then they were required to offer their shares for sale to the other members. After the merger, Angel Estrada et al. (D) chose to vote with the Ventura 41 group and against the will of the majority of the Broadcast Corp. group, declaring that the agreement was invalid. Ps then attempted to enforce the share buyback clause. The trial court upheld the agreement and ordered the sale of Ds’ shares back to the members of the Broadcast Corp. group. The Cal. App. Court held the agreement was valid despite the fact that the corporation at issue was not a close corporation. California close corporation laws allow for such a shareholder’s voting agreement.
       2. Tool: Shareholder agreements, whether or not it is a close corporation, that require shareholders to vote according to the will of the majority (“pooling agreements”) are valid. California close corporation laws (Section 706) allow for such a shareholder’s voting agreement (use 706 even though at the time it didn’t apply since corporation was not a close corporation). The legislative comments concerning the California statute governing close corporations, Section 706, indicate that legislators did not intend the law to invalidate pooling agreements in instances where they were not close corporations.
       3. Discussion: The Broadcast members made no agreement about whom they would elect president or as other officers (generally did not touch what you would do once you become member of the board, director). Neither could they legally have done so. To include such an agreement would have been to constrain what they each could do as director, and by McQuade, Clark, Galler, such an agreement was valid only if practically unanimous. The Broadcast members owned only half of the Television shares. Instead, Estrada violated the stockholders’ agreement when she repudiated it. She had repudiated it because the others had dropped her from their slate. And they had dropped her from the slate because she had voted to fire Ramos. By so doing, she forfeited her stock. In short, the Ramos block used a formally valid shareholder agreement (penalty clause in pooling agreement) to accomplish indirectly something it could not legally do directly.

### Close Corporation Statutes

* + 1. In the real world, people will not buy stock in a new corporation unless they know who will run it and what they will make.
    2. For the most part, states provide statutes that codify the outcome of *McQuade* and *Clark*.
    3. California Example
       1. Cal. Corp. Code 300(a) – entrusts management to the board
       2. Cal. Corp. Code 706(a) – lets shareholders agree among themselves about how they will vote their shares. At the time of *Ramos*, this section applied only to statutory close corporations, but today it applies to any firm.
       3. Cal. Corp. Code 300(b) – “[N]o shareholders’ agreement, which relates to any phase of the affairs of a close corporation…shall be invalid as between the parties thereto on the ground that it so relates to the conduct of the affairs of the corporation as to interfere with the discretion of the board…”
          1. Cal. Corp. Code 158 – close corporation must have no more than 35 shareholders and must elect to be treated as a statutory close corporation.
          2. Cal. Corp. Code 186 – defines a shareholders’ agreement to include only unanimous deals among all shareholders of a close corporation.
          3. Cal. Corp. Code 301(d) – shareholders must take responsibility for the fiduciary duties that directors would otherwise owe.

## The Freeze Out

### The Problem

* + 1. Dividends and the Publicly Traded Firm
       1. Dividends are taxed as firm income and then as dividends when paid out to shareholders. If retained at the firm, only taxed once as firm income.
       2. Investors will need eventually to cash out their investment, but eventually does not need to be soon. When it does come, they can sell their stock for the cash they want – and recover their earnings at the often-lower capital gains tax rate.
    2. Dividends and the Closely Held Firm
       1. In a closely held firm, it may be more difficult to find a willing buyer of stock, so shareholders may be more likely to want dividends.
       2. Shareholders that work for the firm as employees can regularly liquidate parts of their investment without declaring dividends. Instead, they can simply pay themselves salaries and can pay themselves more than their services are worth. In essence they are paying themselves a market salary plus a dividend (disguised as a salary). Firms can properly deduct salaries as corporate income. They cannot deduct dividends. Thus, by disguising dividends as salary, firms can obtain a tax deduction to which they would not otherwise be entitled.

### Massachusetts

* + 1. *Donahue*
       1. Court observed that minority shareholders run a risk that the majority can refuse to pay them dividends, pay them a salary, or repurchase their shares – and effectively freeze them out.
       2. Court held that “stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another.
       3. “If the stockholder whose shares were purchased was a member of the controlling group, the controlling stockholders must cause the corporation to offer each stockholder an equal opportunity to see a ratable number of his shares to the corporation at an identical price.”
       4. Note: odd decision because could have been decided in favor of plaintiff on many other legal grounds as opposed to making up new law. Also, the partnership fiduciary duty is not higher than that owed by corporate directors or controlling shareholders.
    2. ***Wilkes v. Springside Nursing Home, Inc. (Mass. 1976)***
       1. Synopsis: Wilkes, Riche, Quinn and Pipkin bought a piece of property together. The four incorporated their operation as the Springside Nursing Home. Each man took a quarter stake in the firm and served on the corporate board. Each worked for the firm and received a salary. Wilkes served as janitor. Quinn wanted to buy some of Springside’s real estate. Wilkes demanded a hirer price. Quinn resented this and induced others to drop Wilkes from the corporate board and fire him as a janitor. Springside did not pay dividends and did not pay market wages. Instead, it avoided the double tax on distributed earnings by disguising its nondeductible dividends and deductible wages. When Wilkes was fired, he did not just lose his janitorial wage, he lost his share of the profits – the dividend distribution that the four had been hiding in their salaries. Wilkes sued for violation of *Donahue* fiduciary duties. Court ruled in favor of Wilkes finding that defendants did not establish legitimate business purpose for firing Wilkes.
       2. Tool:
          1. *Donahue* said that closely held shareholders have same fiduciary duties as partners, but Court here finds they didn’t mean this entirely because need to give shareholders some flexibility.
          2. Three part test: (1) high fiduciary duty as established in *Donahue*, but (2) if challenged need to come up with legitimate business purpose, and (3) if you do, plaintiff can still win if it can show there was less harmful way to minority interest to accomplish business purpose.
       3. Note: Court’s rule was superfluous. The majority trio were directors and owed the firm a fiduciary duty as directors. They were controlling shareholders – and owed Wilkes a fiduciary duty under the logic in ***Sinclair***. When the three paid one another more than the market value of their services but excluded Wilkes from the tax scam, they faced a straightforward conflict of interest. The business judgment rule did not protect them. Instead, both as directors and as controlling shareholders they breached their fiduciary duties (note: tax considerations do not give rise to duty of loyalty problems or there would always be issues).
       4. Note: **not followed by Delaware**
    3. ***Smith v. Atlantic Properties, Inc. (Mass. App. Ct. 1981)***
       1. Synopsis: Wolfson (D) and three other investors (Ps) formed Atlantic Properties and each bought a quarter of the firm’s stock. Firm’s charter and bylaws provided that any proposal had to be approved by at least 80% of directors so each investor essentially had a veto. D wanted to reinvest the firm’s earning in renovating buildings while the other three wanted to distribute earnings as dividends. In the 1960’s the top marginal personal income tax rate was 91% so shareholders in close corporations had an incentive to keep their profits in corporate solution. In response, Congress imposed an accumulated earnings tax (AET), which did not apply to firms that distributed their earnings. Thus, if the firm had paid dividends or used earning to make improvements, it could have avoided the AET. However, the investors could not get a unanimous vote so it had to pay the AET. Note that D was high earner so had interest in not paying out dividends and others were not as wealthy. Court found that minority shareholders, if have a controlling interest, (in addition to controlling shareholders) owe other shareholders fiduciary duties. Since D violated these duties by unreasonably exercising veto, court found he owed damages to other investors.
       2. Tool: A minority shareholder owes fiduciary duties to other shareholders if it has a controlling interest.
       3. Note: Silly decision because either all four violated duties to each other or none of the four did. Court cites Wilkes, but Wilkes adds nothing of value. Under the traditional approach that Delaware would soon articulate in Sinclair, all four were controlling shareholders. As such, all four owed each other a duty of loyalty. But because all four took equal shares of any dividend, profit, or AET, the situation presented no self-dealing. None of them violated his Sinclair duty, so no one owed money to the others. Instead, they should each pay a quarter of the AET. Each of the four was also presumably on the board. In that capacity, each owed the others a duty of care and loyalty. The case involved no self-dealing, but the brinksmanship may have violated a duty of care. Because they each plated the same brinkmanship, either all of them violated the duty of care or none of them did. Either way, the results are the same.

### Jordan v. Duff and Phelps, Inc. (7th Cir. 1987)

* + 1. Synopsis: James Jordan (P) was a securities analyst at Duff & Phelps (D). P owned 1% of firm’s stock (privately held). In buying the stock, P signed a shareholders agreement and a stock purchase agreement. The stock purchase agreement provided that if P left the firm, he agreed to resell the stock to the firm for its book value at the end of the previous calendar year and that nothing in the agreement conferred on him any right to be continued in employment. P decided to move, got another job, and resigned from Duff & Phelps. P obtained a book value for his stock of $23K. Later P heard that D was in merger talks and had been in merger talks while P was still at the firm that would have put the shares he was eligible for at a value of $452,000, plus be entitled to another $194,000 in “earn-out” money. P wanted his stock back, but D refused. P sued D for violating 10b-5 by not abstaining or disclosing (*Texas Gulf*) the merger talks to P saying he would have never resigned if knew about the merger talks. Merger talks failed but later there was a leveraged buy-out.
    2. Tools:
       1. Shareholder relationship > at-will employment relationship
       2. Seems to suggest that shareholder cannot contract away fiduciary duties at least as it relates to agreement that is not shareholders agreement.
       3. “Close corporations buying their own stock, like knowledgeable insiders of closely held firms buying from outsiders, have a fiduciary duty to disclose material facts.”
       4. At-will employee does not mean he can be fired for any reason.
       5. “The relevance of the fact does not depend on how things turn out…a failure to disclose an important beneficent event is a violation even if things later go sour.”
    3. Easterbrook (majority): P could have chosen to stay and keep his stock; to decide whether to stay he needed information D had but did not disclose (information was material); D had a fiduciary relation to P as shareholder; and in repurchasing P’s stock without disclosing the information P needed to decide whether to keep his stock (and stay) or sell it (and go), D violated 10b-5.
    4. Posner (dissent): P had a right to the information only if he had a right to stay at Duff & Phelps; as an at-will employee, he had such a right only if he obtained it as an adjunct to any right he might acquire as a minority shareholder; and through the shareholders’ agreement he waived any such right.

## Control Block Sales

### Overview

* + 1. When an investor holds enough stock to control a firm, his shares will often sell for more (on a per-share basis) than the other shares, because they give the buyer control. Should the buyer know of a way to increase profitability, the control block will give him the power to accomplish that transformation. And yet, when controlling shareholders did sell their blocks at a premium, some courts blanched. Eventually they came to allow the control premiums – and do today. ***Perlman*** exemplifies the early skepticism. ***Zetlin*** and ***Frandsen*** show the modern approach.

### No Control Block Premiums – Perlman v. Feldman (2d Cir. 1955)

* + 1. Synopsis: Feldman owned 37% of Newport Steel. Due to the Korean War, steel was at a premium and it turned Newport Steel into a more profitable venture. In this market, several of Newport’s customers organized the Wilport Company. Through it, they bought the Feldmann family’s 37% at $20 per share when the market price of the stock stood at $12. For selling their control block at a premium, the family found themselves sued by other Newport shareholders on a breach of fiduciary duty claim. Although the court found no fraud, no misuse of confidential information, no outright looting of a helpless corporation, it held the Feldmanns liable anyway, because they were “siphoning off for personal gain corporate advantages to be derived from a favorable market situation” (find this to be case of misappropriating corporate opportunities leading to breach of duty of loyalty).
    2. Tool: A majority shareholder, who sells his shares to a third party who then obtains a controlling interest, owes the minority shareholder their share of the premium paid by the third party for the controlling interest.
    3. Note: When a court bans control-block premiums, it simply increases the cost of these value-enhancing transactions. When it requires control-block sellers to negotiate higher prices for all the other shareholders (the “take me along provisions”), it increases the cost of executing value-enhancing deals. Minority shareholders may receive higher prices in those value-enhancing transactions that still occur. But they will experience fewer such transactions on which to capture the higher prices.
    4. Nefarious Reasons: In a sense could see this as Wilport looting firm, because Wilport could buy steal at the flat formal price (submarket price) while everyone else still had to buy it at the formal-price-plus interest-free-loan.
    5. A Test: The value of Newport’s shares appreciated. The data refutes the court’s proposition that Wilport appropriated a corporate opportunity of Newport. If Wilport stole, Newport stock would have fallen. If Wilport improved firm efficiency, it would have risen.

### Control Block Premiums Allowed – Zetlin v. Hanson Holdings (NY 1979)

* + 1. Synopsis: Zetlin owned 2% of Gable Industries, Inc. Hanson Holdings owned 44.4% of the outstanding shares which they sold to Flintkote Co. for $15, giving Flintkote the controlling majority. The open market value of the shares was $7.38 per share. Zetlin sued Hanson arguing that he should be able to share in the premium that Hanson negotiated, because controlling shareholders owe a duty to the minority to negotiate take-me-along provisions on their behalf. NY Court of Appeals rejected this.
    2. Tool: “[A]bsent looting of corporate assets, conversion of a corporate opportunity, fraud or other acts of bad faith, a controlling stockholder is free to sell, and a purchaser is free to buy, that controlling interest at a premium price…”

### Right of First Refusal – Frandsen v. Jensen-Sundquist (7th Cir. 1986)

* + 1. Synopsis: The Jensen family owned 52% of the Jensen-Sundquist insurance agency, and Jensen-Sundquist owned a majority interest in the First Bank of Grantsburg (FBG). Dennis Frandsen held an 8% interest in Jensen-Sundquist. Frandsen had an agreement with the Jensen family that: (1) Should the Jensen family offer to sell their stock to anyone, they will first offer it to Frandsen at the same price (right of first refusal); and (2) Should Frandsen not wish to buy the stock offered to him under (1), the Jensen family will offer to but Frandsen’s stock at the same price. First Wisconsin Bank (FWC) wanted to buy FBG. FWC proposed a cash-out merger: Jensen-Sundquist would merge into FWC, former Jensen-Sundquist shareholders would receive cash, and FWC would merge the FBG into another FWC subsidiary. In turn, Frandsen responded by announcing that he would exercise his right and buy the Jensen family shares at the cash-out merger price. The Jensen family refused and restructured the transaction as a purchase of FBG stock by FWC. Under the new transaction, FWC would pay cash to Jensen-Sundquist, and Jensen-Sundquist would distribute the cash in liquidation. Frandsen sued to enforce his rights. Court held that a sale of stock is not a merger (“in a merger the shares of the acquired firm are not bought, they are extinguished”), even when the two accomplish the same result. Frandsen had negotiated an agreement triggered by an offer to sell, He could have negotiated an agreement triggered by a merger but he did not. The agreement was not breached because there was never a sale of the majority’s shares to First Wisconsin. The court read the terms of the agreement literally to include only what the agreement allowed for, which is the sale of the majority’s shares. And absent a breach of the agreement, or unfair competition, First Wisconsin cannot be liable for tortious interference.
    2. Tool: An agreement that gives a shareholder the right of first refusal does not convey the right to control the sale of assets or the liquidation of the company. The right of refusal “is enforceable but only if the contract clearly confers it…”

## Board Seat Sales

### Can’t Sell to Obvious Thief – Harris v. Carter

* + 1. Controlling shareholders owe fiduciary duties to other shareholders. Thus, a controlling shareholder breaches these fiduciary duties when he sells his stock and transfers control to an obvious thief.

### Can Seller Stack the Board? Essex Universal Corp. v. Yates (2d Cir. 1962)

* + 1. Synopsis: Yates (D) owned 28% of Republic Pictures. D agreed to sell Essex (P) the bulk of his stock at $2 above market. This stake would give Essex control. D and P also agreed that D would have a special meeting and have 8 of the 14 directors resign to be replaced with Essex nominees. Otherwise, because Republic maintained a staggered board, P would not have acquired complete control for some time. When it came time to sell, D refused (the price of the stock had risen and he wanted more money) arguing that the contract violated the fiduciary duties he owed the other Republic shareholders.
    2. Tool: Case did not answer the question of whether the seller can stack the board with the buyer’s designees.
    3. J. Lumbard: “immediate transfer of management control to one who has achieved majority share control but would not otherwise be able to convert that share control into operating control for some time” is legal. “it is commonly known that a person or group owning so large a percentage of the voting stock [(28.3%)] of a corporation which, like Republic, has at least the 1,500 shareholders normally requisite to listing on the New York Stock Exchange, is almost certain to have share control as a practical matter.” Remanded because whether Essex was thus to acquire the equivalent of majority stock control was factual issue to be determined by district court.
    4. J. Friendly: Found this type of contractual provision violated public policy except when it was “entirely plain that a new election would be a mere formality – i.e., when the seller owned more than 50% of the stock…”
    5. J. Clark: needs more facts to decide case.
    6. Note: Where there is an incumbent management team and board of directors that does not have a significant percentage of the voting shares, an outsider who acquires a large, but less-than-majority block of voting shares may well be unable to exert any control over the corporation. Indeed, it is not uncommon that outsiders who acquire substantial minority positions are denied any representation whatever on the board of directors, even though the incumbent directors collectively own far fewer shares than the outsider.

### Removal of Directors

* + 1. Current NY Code § 706. Removal of Directors

*(a) Any or all of the directors may be removed for cause by vote of the shareholders. The certificate of incorporation or the specific provisions of a by-law adopted by the shareholders may provide for such removal by action of the board, except in the case of any director elected by cumulative voting, or by the holders of the shares of any class or series, or holders of bonds, voting as a class, when so entitled by the provisions of the certificate of incorporation.*

*(b) If the certificate of incorporation or the by-laws so provide, any or all of the directors may be removed without cause by vote of the shareholders.*

*(c) The removal of directors, with or without cause, as provided in paragraphs (a) and (b) is subject to the following:*

*(1) In the case of a corporation having cumulative voting, no director may be removed when the votes cast against his removal would be sufficient to elect him if voted cumulatively at an election at which the same total number of votes were cast and the entire board, or the entire class of directors of which he is a member, were then being elected; and*

*(2) When by the provisions of the certificate of incorporation the holders of the shares of any class or series, or holders of bonds, voting as a class, are entitled to elect one or more directors, any director so elected may be removed only by the applicable vote of the holders of the shares of that class or series, or the holders of such bonds, voting as a class.*

* + 1. Current Delaware Gen. Corp. Law § 141(k): “any director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors,” with exceptions protecting cumulative voting, and with an exception that: “Unless the certificate of incorporation otherwise provides, in the case of a corporation whose board is classified as provided in subsection (d) of this section, shareholders may effect such removal only for cause.” Subsection (d) permits the certificate or the by-laws to provide that the board may be “Divided into one, two, or three classes” to achieve staggered terms and for classification of shares for the purpose of electing directors.

# MERGERS and ACQUISITIONS

## Mergers

### Approval Process

* + 1. Typical
       1. First, the executives of small and large would cut a deal – a merger agreement.
       2. Second, the boards of the two companies would approve the agreement (De. Corp. 251(b)).
       3. Third, the shareholders of the two corporations would approve the merger by (in Delaware) majority vote (Del. Corp. 251(c)).
    2. Other Mergers – not all mergers require shareholder approval
       1. Relatively small firm merging into large firm – under Del. Corp. 251(f), both the board and the shareholders of the small disappearing firm would vote on the merger. At the larger surviving firm, only the board would vote. A merger qualifies for this abbreviated procedure if the amount of stock issued by the surviving firm to the shareholders of the disappearing firm constitutes less than 20 percent of the surviving firm’s outstanding stock at the outset.
       2. Parent firm merging subsidiary into itself – Under Delaware law (it defines a subsidiary as a firm owned at least 90% by another), the parent board must approve the merger agreement. The shareholders do not need to vote. Neither the subsidiary’s board not its minority shareholders have any say either.
       3. Shareholders of disappearing firm receive only cash – will not trigger the 20 percent stock threshold in 251(f) at surviving firm so will not have to vote on merger.
    3. Asset Sales – Can closely mimic merger if just sell assets of one firm to another. Need majority vote among the shareholders of the selling corporation but not the buying firm.

### Appraisal and De Facto Mergers

* + 1. General
       1. Not all mergers and merger-like moves yield identical results. Some give rise to appraisal rights while others do not.
       2. Appraisal rights/Dissenter’s rights – gives a shareholder who objects to certain transactions the right to dissent from the transaction and obtain the appraised value of his shares.
          1. This makes sense for small corporation because no market to sell shares but unnecessary for big corporations because there is market in public traded stock.
          2. Challenge for acquirer because won’t know until merger takes place how many dissenters there will be and thus how much cash they will need.
          3. Del. Corp. 262(b)(2) – “no appraisal rights…shall be available for the shares of any class or series of stock, which…were…listed on a national securities exchange” (only for closely held firms)
       3. Some state courts follow defacto doctrines while others do not.
    2. De Facto Merger Doctrine – ***Farris v. Glen Alden Corporation (Pa. 1958)***
       1. Synopsis: List (a DE corporation) owned 38% of Glen Alden (smaller PA corporation). The boards of the two firms decided to combine them. Because both DE and PA law gave merged shareholders appraisal rights, the boards instead arranged (i) for List to sell its assets to Glen Alden, (ii) for Glen Alden to pay for the assets with its stock, (iii) for List to liquidate and distribute the Glen Alden stock to its shareholders, and (v) for Glen Alden to rename itself List-Alden. The resulting List-Alden firm would hold all the assets of the two corporations and be owned by the shareholders of the two firms. Stephen Farris, a shareholder of Glen Alden, sued arguing it was a de factor merger and thus as a dissenting shareholder he was owed appraisal rights. Court found this was a de facto merger considering the following – company would change from coal mining company to diversified company; prior company had half the assets and one-seventh of the debt of new company; control of Glen Alden would pass to directors of List; Farris’ proportionate interest would be reduced to two-fifths of what it was before; ownership would pass to the stockholder of List; and value of stock would decrease for Farris.
       2. Tool: A reorganization by a corporation to acquire the assets of another organization operates as a de facto merger if the nature of the corporation is significantly changed and the shareholder’s interest is significantly altered to the point where to refuse the rights and remedies of a dissenting shareholder would in reality force him to give up his stock in one corporation and against his will accept shares in another.”
       3. Aftermath: Pennsylvania legislature clarified law and intent to abolish de facto mergers and Third Circuit accepted that it was not the law of PA.
    3. Rejects DeFacto Merger Doctrine – ***Hariton v. Arco Electronics, Inc. (Del. 1963)***
       1. Synopsis: Arco sold its assets to Loral in exchange for Loral shares and then distributed the Loral stock in liquidation. An Arco shareholder sued for appraisal rights. The Supreme Court of Delaware held that the agreement was valid because it complied with Delaware’s statute regarding the sale of assets. The two statute provisions operate independently, and an agreement is valid if it complies with one or the other.
       2. Tool: If a corporate board chooses to structure a transaction through the asset sale section of the law, the court will not re-characterize it by the merger section. Boards could apply the statutory provisions they wanted. Under Delaware law, some corporate combinations granted dissenters appraisal rights. Others did not. Effectively, the court declared appraisal an optional remedy.
    4. Rejects De Facto Non-Merger Doctrine – ***Rauch v. RCA Corporation (2d Cir. 1988)***
       1. Synopsis: General Electric decided to merge RCA into a subsidiary, Gesub. RCA had two classes of stock, common and preferred. To carry out the acquisition, RCA and Gesub shares were converted to cash and Gesub then merged into RCA. General Electric agreed to pay the common $66 per share and the preferred $40. The RCA charter provided, however, that the company could redeem the preferred at $100 per share. A provision in RCA’s certificate of incorporation provided a $100 per share value if preferred stock were ever redeemed by RCA. Holding preferred stock, Lillian Rauch (P), on behalf of a class of holders of preferred stock, argued that the merger acts as an end-around to avoid paying P her $100 per share and that the court should recharacterize the transaction as a redemption of the preferred at $100 per share. 2d Cir. held that it would not recharacterize the merger as a redemption after the fact, because merger and redemption provisions were “of equal dignity.”
       2. Tool:
          1. A conversion of shares to cash to complete a merger is legally distinct from a redemption of shares and therefore redemption provisions or laws governing redemption are inapplicable. Delaware statute specifically allows for a merger which provides for the conversion of shares into cash.
          2. “action taken under one section of [Del. Corp. Law] is legally independent, and its validity is not dependent upon, nor to be tested by the requirements of other unrelated sections under which the same final result might be attained by different means…the provisions of the Delaware Gen. Corp. Law are of **equal dignity**, and a corporation may resort to one section thereof without having to answer for the consequences that would have arisen from invocation of a different section.”

NOTE: This is practically speaking making appraisal rights OPTIONAL, because there are many different ways to achieve the practical effect of a merger, and some ways do not require appraisal rights.

* + - * 1. Limits to this ruling – court mentioned that Delaware provides specific protection to shareholders who believe that they have received insufficient value for their stock as the result of a merger: they may obtain an appraisal under 262. P disavowed any appraisal theory or remedy though. Probably because she knew she would not have gotten more.

## Freeze-Out Mergers

### Introduction

* + 1. Why – the fiduciary duty that controlling shareholders owe the minority under cases like Sinclair, can cause trouble. Suppose one person owns stock in two different firms that do business together and the service provided between firms does not have a clear market price. That person owes a fiduciary duty to the selling firm to not charge too low and a duty to the buying firm not to pay too much. That person can solve this problem by eliminating the minority shareholders in both firms. However, that person can’t just offer to buy their stock because they may hold out for a high price.
    2. How – The freeze-out merger (sometimes known as a cash-out merger) solves the hold-up problem. To “freeze out” you form a shell corporations of which you own 100%. Then merge the already existing firm into shell firm. As compensation, distribute cash (some acquirers use stock) to the minority shareholders. To accomplish these mergers, both the directors and the shareholders of the firms will need to approve the transaction. A majority of the minority usually will approve the merger, because they do not gain anything by blocking value-increasing mergers.

### Delaware

* + 1. Singer (Del. Sup. Ct. 1977) – Requires freeze outs to have business purpose.
    2. Tanzer (Del. Sup. Ct. 1977) – shareholder business purpose is enough
    3. **Weinberger (Del. Sup. Ct. 1983)** – abandoned business purpose requirement, because there always is a shareholder business purpose. Requires: (1) price is fair and (2) fair procedures. Suppose have ratification by majority of minority shareholders, burden shifts to plaintiff.

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| **Delaware Law** | **Burden of proof** | **Standard** |
| No ratification | Defendant | Fair price and fair procedures |
| One ratification (majority of shareholders) | Plaintiff | Inherent fairness test – has to show unfair |
| Double ratification (as in Kahn) | plaintiff | Waste (business judgment rule) |

* + 1. Double Ratification Standard – ***Kahn v. M & F Worldwide Corp. (Del 2014)***
       1. Synopsis: Appeal from a final judgment entered by the Court of Chancery in a proceeding that arises from a 2011 acquisition by MacAndrews & Forbes Holdings – a 43% stockholder in M&F Worldwide Corp. – of the remaining common stock of MFW. From the outset M&F’s proposal to take MFW private was made contingent upon two stockholder-protective procedural conditions. First, M&F required the merger to be negotiated and approved by a special committee of independent MFW directors. Second, M&F required that the merger be approved by a majority of stockholders unaffiliated with M&F. The merger closed in Dec. 2011 after it was approved by a vote of 65.4% of MFW’s minority stockholders.
       2. Tool:
          1. “We hold that business judgment is the standard of review that should govern mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned ab initio upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders.”
          2. “To summarize our holding, in controller buyouts, the business judgment standard of review will be applied if and only if: (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.”

### Massachusetts – Coggins v. New England Patriots Football Club, Inc. (Mass. 1986)

* + 1. Synopsis: William Sullivan, Jr. (D) bought the New England Patriots in 1959 for $25,000. Four months later, he had nine others buy into the team for $25,000 each, and each of the ten owners was given 10,000 shares. Another four months later, 120,000 nonvoting shares were issued for $5 each. In 1974, the other owners removed Sullivan from his presidency but by November of 1975, after securing a personal loan for over $5 million, he owned all 100,000 voting shares (at $102 per share) and put in his own directors. The loan required Sullivan to use the Defendant corporation’s profits and assets to repay the loan, but he could not do this without complete ownership (can’t use team’s assets as security for personal loan). To freeze out the other shareholders, Sullivan then created a second corporation, appointed the same directors, and then voted to merge the two companies into the new one. The shareholders of the old company would receive $15 per share. P was a fan of the team and proudly owned ten shares of the corporation. P brought this action after he was forced to sell his shares pursuant to a freeze-out merger initiated by directors who, he asserted, violated their fiduciary duties when they voted while holding directorships for both companies. Ds argued that each class of shares approved of the merger. The court held that Sullivan, as controlling shareholder, owed the other shareholders a fiduciary duty under Wilkes. It also noted that Delaware had imposed a business purpose requirement on freeze-out mergers. It realized that DE had abandoned this requirement since then, but liked the requirement anyway. Hence, MA would require controlling shareholders to show a business purpose for any freeze-out merger. Court held that Sullivan did not show a business purpose of the corporation (just for what he did as a shareholder). Court would not undue merger, however, since it occurred many years prior to decision. Instead, Coggins would receive the value that his shares would have reached if Sullivan had let him hold them. (If you complain about a merger, you have the right to appraisal, which gives you the value of the company immediately prior to appraisal.)
    2. Tool: To be legal, freeze out merger must pass following tests:
       1. Business purpose – corporate directors who benefit must “demonstrate how the legitimate goals of the corporation are furthered.” (under *Singer*)
       2. Fairness – “examining the totality of the circumstances” that it was “fair to the minority”

## Hostile Acquisitions

### The Federal Statutory Framework

* + 1. The Genesis
       1. Before the Williams Act, most bidders moved fast. If they could buy control within a few days, they could deny the target board the time necessary to launch defenses. And to induce shareholders to tender quickly, they would take stock tendered on a first-come, first-served basis.
       2. The Williams Act changed all this. Because of the act along with state anti-takeover statutes and court jurisprudence, it became easier for target firm management to entrench themselves. In effect, the Act gave them earlier warning about an outside bid. Suppose that the acquirer can improve performance and the incumbent managers can prevent the acquirer from gaining control. The two have an obvious deal to make: The incumbents will agree to a “friendly” transaction and transfer control to the acquirer, and the acquirer will share some of the resulting efficiency gains with the departing managers. Obviously, the incumbents breach their fiduciary duties to the shareholders when they do this: They are extracting a bribe to leave room for better managers. However, if the two parties couch the payoffs as a “consulting contract” where the departing managers promise to share their expertise with their successors, it is a fiduciary breach no court will ever stop.
    2. The Statute – Williams Act imposed the following rules on tender offers that applied to firms registered under the 1934 Act (the 16(b) companies).
       1. Disclosure of 5% Threshold – should anyone acquire more than 5% of the stock of a firm, he must disclose his identity and plans to the SEC and the firm within ten days. Effectively, the rule prevents “creeping tender offers” – acquisitions where the bidder tries to obtain a solid base in the target’s stock before anyone learns his plans.
       2. Disclosure of Offeror Identity – should anyone initiate a tender offer, he must file an elaborate document with the SEC disclosing background, identity, amount of funds, number of shares he already owns and plans for the target’s business.
       3. Minimum Offer Window – an acquirer must keep his offer open for at least 20 business days. No more “Saturday night specials.”
       4. Withdrawal of Tendered Stock – investors who tender shares to an acquirer may withdraw them at any time during the course of the tender offer.
       5. Pro Rata Acceptance – If investors tender more shares than an acquirer wants to buy, he must take them pro rata from each investor.
       6. Uniform Pricing – An acquirer must pay the same price for all shares. Even if you raise purchase price after having paid people, need to go back and pay same amount.
    3. State Statutes – won’t be tested on this but can be found in casebook on p. 805.

### Overview

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|  | **Burden of Proof** | **Standard** |
| **No conflict of interest** | Plaintiff | Business Judgment Rule |
| **Conflict of interest** | Defendant | Inherent fairness |
| **Corporate Control Transaction (*Cheff* which is cited by *Unocal*)** | Defendants – Directors are defendants so there is always conflict of interest because it is there job | Insider (getting salary) – implied that standard is have to show that fair and reasonable (inherent fairness standard) to company (not explicitly told this because not majority of defendants in *Cheff*)  Outsider – intermediate standard – must show “reasonable grounds to believe [that there existed] a danger to corporate policy and effectiveness.” “It is important to remember that the directors satisfy their burden by showing good faith and reasonable investigation…” (sounds like duty of care and loyalty) |
| **Corporate Control Transaction once Determined that Corporation will be Sold (*Revlon*)** |  | …”the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.” |

### Greenmail

* + 1. Definition – Purchase by a corporation of a potential acquirer’s stock, at a premium over the market price. Note that this decreases the value of other shares though. Essentially paying out dividend that other shareholders are not getting.
    2. Comparison with other Transactions
    3. ***Cheff v. Mathes (Del. Ch. 1964)***
       1. Synopsis: Holland manufactured furnaces and air conditioners, and it directly hired its retail sales staff (a practice that the directors believed was a key to Holland’s success). Maremont assembled a large position in Holland’s stock and demanded a place on the board. Holland CEO Cheff (D) refused. Maremont was well-known for taking over companies and then liquidating their assets. Cheff discussed this with other directors, and they agreed to thwart Maremont’s attempts to buy Holland in order to keep Holland running in its current state. The Holland board voted to use Holland funds to purchase the shares at a premium price of $20 per share (the net quick asset value was $14). Shareholders (P) challenged the board’s decision arguing that the directors used Holland’s funds to ensure that their positions with the company remained intact.
       2. Tool:
          1. “Under the provisions of 8 Del.C. § 160, a corporation is granted statutory power to purchase and sell shares of its own stock. Such a right, as embodied in the statute, has long been recognized in this State… The charge here is not one of violation of statute, but the allegation is that the true motives behind such purchases were improperly centered upon perpetuation of control. In an analogous field, courts have sustained the use of proxy funds to inform stockholders of management's views upon the policy questions inherent in an election to a board of directors, but have not sanctioned the use of corporate funds to advance the selfish desires of directors to perpetuate themselves in office…Similarly, if the actions of the board were motivated by a sincere belief that the buying out of the dissident stockholder was necessary to maintain what the board believed to be proper business practices, the board will not be held liable for such decision, even though hindsight indicates the decision was not the wisest course… On the other hand, if the board has acted solely or primarily because of the desire to perpetuate themselves in office, the use of corporate funds for such purposes is improper.”
          2. When challenged by shareholders, outside directors who adopt defensive tactics in a hostile acquisition must show “reasonable grounds to believe [that there existed] a danger to corporate policy and effectiveness.” “It is important to remember that the directors satisfy their burden by showing good faith and reasonable investigation; the directors will not be penalized for an honest mistake of judgment, if the judgment appeared reasonable at the time the decision was made.” The standard is thus intermediate: Outside directors cannot rely on the business judgment rule, but neither must they prove the “inherent fairness” of what they did.
       3. Holding: The Supreme Court of Delaware held that the “directors are of necessity confronted with a conflict of interest,” but the conflict is more minor than for corporate officers who would lose a full-time position. Court found that directors proved that they showed reasonable grounds to believe that there was a danger to corporate policy and effectiveness. There was a legitimate threat that Maremont would push to alter the sales strategy of Holland, which the directors believed was an essential component to the company. There was also a legitimate concern that they would lose quality personnel under Maremont’s control. The price paid was reasonable considering that there is always a premium for buying a bulk parcel of shares. In hindsight the decision may not have been the best, but the business judgment rule will not penalize honest mistakes of judgment.

### Self-Tender

* + 1. Introduction
       1. Any-and-All Tender Offer – when a tender offer is made, shareholders have an incentive not to sell if they think the acquirer will increase the price of stock by more than what is being offered by improving company. However, if too many shareholders make a decision not to sell, then the tender offer will fail.

|  |  |  |
| --- | --- | --- |
|  | Succeed | Fail |
| Tender Offer | $140 | $100 (what stock currently worth) |
| No Tender | $160 | $100 |

* + - 1. The Two-Tiered Solution – Suppose acquirer is willing to pay $140 per share for all outstanding stock. Rather than make an “any and all” offer, acquirer will announce a two-tiered bid. Acquirer will first buy exactly half of the outstanding shares in a tender offer. Once he obtains that stock, he will cash out the remaining shareholders in a freeze-out merger (merge target into sub) of the firm into one of his own wholly owned firms. He will buy the stocks in the first tier (the tender offer) at $160. He will cash out the rest in the merger at $120.
         1. Results: everyone has incentive to tender; acquirer pays the same total price; and even the back-end merger takes place at a generous price.

|  |  |  |
| --- | --- | --- |
|  | Succeed | Fail |
| Tender Offer | $160 (or $140-160 if stipulates that if he gets more than 51% will pro rata) | $100 |
| No Tender | $120 | $100 |

* + 1. Self-Tender Defense Allowed and Don’t Have to Pay Hostile Acquirer – ***Unocal Corporation v. Mesa Petroleum Co. (Del. 1985)***
       1. Synopsis: Mesa Petroleum Co. (P) was a corporation led by a well-known corporate raider. P offered Unocal Corp. (D) a two-tier tender offer wherein the first tier would allow for shareholders to sell at $54 per share and the second tier would be subsidized by securities that the court equated with “junk bonds”. The threat therefore was that shareholders would rush to sell their shares for the first tier because they did not want to be subject to the reduced value of the back-end value of the junk securities. D directors met to discuss their options and came up with an alternative that would have D corporation repurchase their own shares (self-tender) at $72 if and only if Mesa purchased 37%. Shareholders had an incentive to tender to Unocal but then nobody tendered to Mesa so Unocal’s conditional offer would never take effect and everyone was stuck with stock as it was originally worth at $38. The shareholders were livid. Under pressure, the D board relented and agreed to buy back (redeem) 29% of the stock at $72 regardless of whether P obtained 37%. P then demanded that D buy a proportional share of its stock too. D refused and P sued. P stood to lose because the rest of the stockholders would receive an effective dividend in which it did not share and its shares would lose value since D was paying out at more than they were worth. The lower court held that D could not exclude a shareholder from a tender offer.
       2. Tool:
          1. “When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders …In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person’s stock ownership. They satisfied that burden if they showed “Good faith and reasonable investigation.” *Chef v. Mathes*. A board would find it easier to meet this standard if a majority of its members were not full-time officers.
          2. Board’s defensive measures “must be reasonable in relation to the threat posed. This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise… such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on “constituencies” other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange.”
       3. Holding: The court held that the two-tiered bid was coercive but that D could exclude P from its repurchase of its own shares. The directors for D corporation have a duty to protect the shareholders and the corporations, and one of the harms that can befall a company is a takeover by a shareholder who is offering an inadequate offer. There was evidence to support that the company was in reasonable danger: the outside directors approved of their self-tender, the offer by P included the junk bonds, the value of each share was more than the proposed $54 per share, and P was well-known as a corporate raider. D showed good faith and reasonable investigation.
    2. **SEC Reaction – after the Unocal decision, the SEC demonstrated its disapproval of discriminatory self-tenders by amending its rules to prohibit issuer tender offers other than those made to all shareholders. Rule 13e – 4(f)(8). The SEC rule does not, however, prohibit “poison pills,” which can have much the same effect.**

### Poison Pills

* + 1. Introduction
       1. Pills take a variety of forms, but most are based on a form of security known as a “right.” (Hence, the pill’s official name, the Shareholder Rights Plan.) A traditional right, typically known as a warrant, grants the holder the option to purchase new shares of stock of the issuing corporation. Warrants are traded as separate securities, having value because they typically confer on the holder the right to buy issuer common stock at a discount from the prevailing market price. The poison pill variant of the right adds three additional elements not found in traditional rights: a flip-in element, a flip-over element, and a redemption provision.
       2. The pill is typically adopted by the board of directors without any shareholder action. When adopted, the rights attach to the corporation’s outstanding common stock, cannot be traded separately from the common stock, and are priced so that exercise of the option would be economically irrational.
       3. The rights become exercisable, and can be traded separately from the common stock, upon a so-called distribution event, which is typically defined as the acquisition of, or announcement of an intent to acquire, some specified percentage of the issuer’s stock by a prospective acquirer. (Twenty percent is a commonly used trigger level.) Although the rights are now exercisable, and will remain so for the remainder of their specified life (typically ten years), they remain “out of the money.”
       4. The pill’s flip-in element is triggered, typically, by the actual acquisition of some specified percentage of the issuer’s common stock. (Again, 20 percent is a commonly used trigger). If triggered, the flip-in pill entitled the holder of each right – except, and this is key, the acquirer and its affiliates or associates – to buy two shares of the target issuer’s common stock or other securities at half price. In other words, the value of the stock received when the right is exercised is equal to two times the exercise price of the right. The deterrent effect of such a flip-in pill arises out of the massive dilution the pill causes to the value of the target stock owned by unwanted acquirer.
       5. The pill’s flip-over feature typically is triggered if, following the acquisition of a specified percentage of target’s common stock, the target is subsequently merged into the acquirer or one of its affiliates. In such an event, the holder of each right becomes entitled to purchase common stock of the acquiring company, again at half-price, thereby impairing the acquirer’s capital structure and drastically diluting the interest of the acquirer’s other stockholders.
       6. Because the rights trade separately from the issuer’s common stock, an acquirer remains subject to the pill’s poisonous effects even if an overwhelming majority of the target’s shareholders accept the bidder’s tender offer. In the face of a pill, a prospective acquirer thus has a strong incentive to negotiate with the target’s board. Most pills include a redemption provision pursuant to which the board may redeem the rights at a nominal price at any time prior to the right being exercised. (Some pills become non-redeemable after the triggering event.) Proponents of pills contend that these plans thus do not deter takeover bids, but rather simply give the target board leverage to negotiate the best possible deal for their shareholders.

Two-Tier Tender Offer 🡪 everyone tenders

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| --- | --- | --- |
|  | Tender offer succeeds | Tender offer fails |
| Tender | $47 | $33 |
| Don’t Tender | Less than $47, say $40 | $33 |

With Poison Pill 🡪 nobody tenders

|  |  |  |
| --- | --- | --- |
|  | Tender offer succeeds | Tender offer fails |
| Tender | $47 | $33 |
| Don’t Tender | $65 (Company promises to buy back at higher price) | $33 |

* + 1. Duty Changes Once Determined that Corporation will be Sold ***– Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. (Del. 1985)***
       1. Synopsis:
          1. Pantry Pride’s CEO approached Revlon’s CEO and offered a $42-43 per share price for Revlon, or $45 if it had to be a hostile takeover. Revlon hired investment banker Lazard who opined that Revlon would yield $60-70 per share.
          2. Poison Pill: Revlon adopted a poison pill plan called the “Note Purchase Rights Plan,” which gave each shareholder a right to exchange a share for $65 Revlon note (debt) payable in one year. The pill took effect if and when someone acquired 20% or more of Revlon stock at a price below $65. The acquirer had no rights under the pill, and the Revlon board could redeem it for 10 cents apiece. In effect, if any hostile acquirer obtained a 20% foothold and did not cut a deal with incumbent Revlon managers, the firm paid the other shareholders $65 per share (in one year).
          3. Pantry Pride countered with a $47.50 price per common share if Revlon board redeemed the pill.
          4. Buyback: This pushed Revlon to repurchase ten million shares at about $57 ($47.50 in notes and $10 in preferred stock). 87% shareholders tendered.
          5. Lockup, Cancellation Fee, and No-shop Agreement: Pantry Pride continued to increase their bids, and Revlon decided to seek another buyer in Forstmann. Revlon made an agreement to have Forstmann pay $57.25 per share subject to certain restrictions such as a right to buy two of Revlon’s health-care product divisions for $525 million (a “lockup”) (below market price or else Perelman would not have cared and was way below valuation Revlon essentially paid investment banker to give them beforehand in order to rationalize rejecting initial offer from Pantry Pride); $25 million cancellation fee for Forstmann; and a no-shop provision (Revlon could not look for other buyers).
          6. Plaintiffs, MacAndrews & Forbes Holdings, Inc., sought to enjoin the agreement because it was not in the best interests of the shareholders. Defendants, Revlon, Inc. and its directors argued that they needed to also consider the best interests of the noteholders. Defendants, Revlon, Inc. and its directors, appealed a decision by the lower court to enjoin an option granted by Defendants to another Defendant, Forstmann Little & Co.
       2. Tool:
          1. When a takeover is inevitable, the directors’ duty is to achieve the best price for the shareholder.
          2. **The court held that the Unocal doctrine that outlined a director’s duty to the corporation and the shareholder no longer extended to the corporation once it was determined that the corporation would be sold.**
          3. “A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders. Unocal, 493 A.2d at 955. However, **such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.”**
       3. Holding:
          1. Poison pill and 10 million share buy-back – incumbent board reasonably concluded that Pantry Pride’s initial $45 per share offer was grossly inadequate. Court noted that board was aware that Pantry Pride CEO planned a bust-up takeover (he would jettison the firm’s health-care products divisions and return it to its core cosmetics business). Given these threats, the board acted in “good faith and upon reasonable investigation.” It adopted tactics that were not unreasonable, considering the threat posed. It faced the Unocal standards, in short, and met them.
          2. Lockup, cancellation fee, and no-shop agreement – Court found these were illegal. “[W]hen Pantry Pride increased its offer to $50 per share, and then to $53, it became apparent to all that the break-up of the company was inevitable. The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders’ benefit. This significantly altered the board's responsibilities under the Unocal standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.” Board’s tactics stopped an auction and thus violated its fiduciary duty to its shareholders.
          3. Noteholders – Revlon board claimed to favor Forstmann in part because it promised to protect the note holders. Doing so, the board explained, followed from its right under Unocal to protect “other constituencies.” In rejecting the board’s claim, the Revlon court explained: “Here, the rights of the noteholders were fixed by agreement, and there is nothing of substance to suggest that any of those terms were violated. The Notes covenants specifically contemplated a waiver to permit sale of the company at a fair price. The Notes were accepted by the holders on that basis, including the risk of an adverse market effect stemming from a waiver. Thus, nothing remained for Revlon to legitimately protect, and no rationally related benefit thereby accrued to the stockholders.”

Ramseyer finds this odd. Note holders either had a legitimate claim or they did not. The court could hardly mean that the board had an obligation to ignore its contractual promises to the note holders. Boards owe fiduciary duties to shareholders, but those duties do not extend to breaking contracts with their creditors. Even if claims were not legitimate, boards regularly manage litigation and can decide not to always fight “bogus” claims.