### Corporations

### Agency

1. Three elements of agency (R.2d §1):
   1. A consents to agency
   2. B acts on behalf of A
   3. A exercises control over B
      1. Placement of conditions can be used to identify control, leading to agency relationship – *Gorton v. Doty* (football coach in car accident)
      2. Totality of circumstances can create an agency relationship – *Cargill* (control over grain elevator transformed relationship from buyer-supplier to principal-agent)
         1. Clark thinks both of these cases are stretches
2. Five types of agency authority:
   1. Actual (R.2d §7)
      1. Can be classified as either implied actual authority or express actual authority
         1. Implied authority is authority principal intended agent to have
         2. Agent’s reasonable belief that principal wanted him to have authority is critical *– Mill Street Church* (contractor hired brother, not church member)
   2. Apparent (R.2d §8)
      1. Exists when a principal leads a reasonably prudent person to believe that agent has specific authority – *Ampex* (salesman should have authority to bind principal to sell)
         1. Formal limits on authority only matter if third parties know of the limitation
   3. Inherent (R.2d §8A)
      1. Principal is bound by agent’s actions that are within the scope of authority usually given to agents, despite lack of actual authority (or even undisclosed principal) – *Watteau* (bartender may purchase bread) – see also R.2d §194-95
         1. But see R.3d §2.06, which might introduce a notice requirement for principals – without notice of third party’s reliance, principal is not bound?
   4. Estoppel (R.2d §8B)
      1. Agency by estoppel requires 1) principal’s intentional or careless acts/omissions causing the appearance of authority, 2) reasonable, good faith reliance on that authority, and 3) a detrimental change of position – *Hoddeson v. Koos Bros* (furniture store)
   5. Ratification (R.2d §82)
      1. Ratification requires 1) acceptance of results, 2) intent to ratify agent’s actions, and 3) full knowledge of all material circumstances – *Botticello* (wife’s acceptance of rent payments was not ratification)
      2. Also found if principal receives benefit from agreement and fails to repudiate – R.2d §98
3. Master is a principal who employs an agent to perform service and has the right to control the physical conduct of the servant (manner of the work) – R.2d §2(2)
   1. Factors in determining if an actor is a servant or an independent contractor: (R.2d §220(2))
      1. Extent of control which the master may exercise over the work’s details
         1. Almost carries dispositive weight in *Humble Oil* and *Sun Oil*
      2. Is employee is engaged in a distinct occupation/business?
      3. Is the kind of work that usually done without supervision?
      4. Level of skill required
      5. Who supplies the tools and workplace for the employee?
      6. Length of time for which the person is employed
      7. Method of payment (hourly or commission)
      8. Is the work part of the employer’s regular business?
      9. Do the parties believe they are creating a master-servant relationship?
         1. Carries very little weight in *Humble Oil*
      10. Is the principal in business?
   2. Usually, masters are not liable for servants’ torts unless committed within scope of employment
      1. Exceptions for master’s negligence/recklessness, master’s intent of conduct/consequences, and servant’s apparent authority – R.2d §219(2)
      2. Scope of employment doctrine allows for efficient loss spreading – places cost of loss on party most likely to be able to prevent a repeat incident
      3. An employee’s conduct is within the scope of employment if: (R.2d §228)
         1. It is of the kind he is employed to perform
         2. It occurs substantially within authorized time/space limits
         3. It is actuated at least in part by a purpose to serve the master
            1. But see *Ira S. Bushey* (drunken sailor damages dry dock) – scope of employment includes activities that are reasonably foreseeable

Business cannot disclaim responsibility for accidents characteristic of its activities

* + - 1. If force is intentionally used, such use is not unexpected by the master
         1. But see *Manning v. Grimsley* (baseball chin music at fan) – plaintiff must show employee’s assault was in response to plaintiff’s conduct which was presently interfering with employee’s ability to perform duties successfully
    1. In determining if conduct is sufficiently similar/incidental to authorized conduct as to be within the scope of employment, the following factors are considered: (R.2d §229)
       1. Whether the act is one commonly done by such servants
       2. Time, place, and purpose of the act
       3. Previous relations between the master and servant
       4. Extent to which master’s business is apportioned between different servants
       5. Whether or not the act is outside the master’s enterprise (or if within the enterprise, has not been entrusted to a servant)
       6. Whether the master reasonably expected such act to be done
       7. Similarity between the act done and act authorized
       8. Whether instrumentality by which harm is done was given to servant by master
       9. Extent of departure from normal method of accomplishing an authorized result
          1. Unacceptable behavior does not automatically remove employee from scope of employment – *Arguello v. Conoco* (racist employee)
       10. Whether act is seriously criminal
           1. Consciously criminal/tortious acts may be within scope of employment – R.2d §231

1. If a franchise contract regulates franchise activity, giving franchisor “control”, agency exists – *Holiday Inns*
   1. Law moves away from result in *Holiday Inns* in *McDonald’s* – because promotion of uniformity blurs distinction between franchised and company-owned establishments, franchisors have created apparent agency – R.2d §267
      1. Victim must have relied on principal’s holding out of franchisee as agent
   2. Control over the specific part of business that lead to the suit is necessary – *Vandermark*
   3. Control need not actually be exercised – the *right* to control is sufficient
   4. Daily operational control is required – “debranding” power is insufficient – *Arguello v. Conoco*
2. Independent contractors are not subject to the principal’s right to control his physical conduct in the performance of the work – R.2d §2(3) (see also *Majestic Realty v. Toti Contracting*)
   1. Exceptions to general rule that principal is not liable for independent contractor’s negligence
      1. Landowner retains control of manner/means of doing work (not really an exception – not an independent contractor)
      2. Contractor is incompetent and principal negligently selected contractor anyway
         1. Might include financial incompetence (lack of adequate insurance, etc.)
      3. Activity is “inherently dangerous”, constituting a nuisance per se
         1. Different from ultrahazardous activity, which carries strict liability
3. Agents have three fiduciary duties: Care (§379), Obedience (§385), and Loyalty (§387)
   1. There are four subtypes of the duty of loyalty:
      1. Using agency to generate secret profits – *Reading, Rash*
         1. If a servant’s position is the predominant cause in allowing him to unjustly enrich himself, the master is entitled to the money dishonestly received – *Reading v. Regem* (smuggling soldier)
            1. Agents cannot make any profits above what was explicitly granted by the principal under the duty of loyalty – R.3d §§8.02, 8.05
            2. Disgorgement is the remedy for deterrence value, and due to the difficulty of determining actual damages (reputation loss of “sole loyalty” of agent to principal)
      2. Avoiding routine conflict-of-interest transactions – *Rash*
         1. Clark’s routine conflict-of-interest (self-dealing) transaction requires:
            1. Power to cause or influence a deal
            2. Existence of a fiduciary relationship to employer
            3. Personal incentive to abandon duty
      3. Avoiding competition with the principal – *Rash*
         1. Agent has a duty to disclose the principal all information the principal should rightly know – *Rash v. J.V.* (employee causes company to contract with employee’s wholly-owned scaffolding business)
            1. These facts include “ownership” in a self-dealing transaction and information on market rates if the agent is overcharging the principal
      4. No taking of property when leaving – *Town & Country House* 
         1. Agent has duty not to use confidential information (even after agency’s termination) – see R.2d §§395-96
         2. Preparation to leave does not necessarily violate duty of loyalty
   2. Note important distinction between arms-length and fiduciary transactions – fiduciaries have an affirmative duty to inform

### Partnerships

1. A partnership is an association of 2 or more people to carry on as co-owners a business for profit – UPA §6
   1. Crucial elements of a partnership are 1) Intention to be partners, 2) Co-ownership of the business, and 3) a profit motive – *Sandvick v. LaCrosse* (oil and gas lease renewal)
      1. A business is defined as “a *series* of acts directed toward an end” – RUPA §202(c) cmt. 1
      2. Clark says a “business” might also require more than simply passive investing
   2. Elements to consider in establishing partnership: (*Fenwick* – Hair salon employee)
      1. Intention of the parties
         1. Essential element is basically that of co-ownership – UPA §6
      2. Right to share in profits
         1. Prima facie evidence that a partnership exists, but no such inference is drawn if profits were wages, connected with a loan, or were consideration –UPA §7
         2. This element is not dispositive – *Southex* (home show)
      3. Obligation to share losses
      4. Ownership/control of partnership property/business
      5. Control over business operations
      6. Language of the agreement
      7. Parties’ conduct toward third parties
      8. Rights of parties on dissolution
   3. Too close of an entanglement can lead to liability as a partnership – *Martin v. Peyton* (business loan to failing bank) – cf. *Cargill*
      1. Does *Cargill* come out differently because defendant in *Cargill* is international conglomerate? Because Cargill involved a more dominant relationship with more involvement in daily operations?
   4. Partnership existence is normally assessed under totality of the circumstances – *Southex*
   5. General partnerships don’t require a written agreement or any state filing
   6. A person who represents himself (or allows himself to be represented as) a partner such that someone relies on said representation is liable to the reliant for the actions of the “partners” – *Young v. Jones* (PWC-Bahmas)
      1. The two critical elements are a representation and reliance (“gives credit”)
         1. Can an argument be made for apparent partnership, a la *McDonald’s*?
         2. Cf. *Hoddeson v. Koos Bros.* (furniture store agency by estoppel)
   7. A joint venture has the following elements: (*Sandvick v. LaCrosse* – oil and gas lease renewal)
      1. Contribution of money, property, time or skill to a common undertaking
      2. Right of mutual control
      3. Agreement for sharing of profits and (usually) losses
      4. Express or implied contract showing joint venture
2. Partners owe each other and the partnership duties of care and loyalty – RUPA §404
   1. Essence of breach of fiduciary duty between partners is that one partner advantages himself at the expense of the partnership – *Day v. Sidley Austin*
   2. Duty of loyalty prevents a partner from taking an opportunity for personal gain that belongs to partnership – *Meinhard v. Salmon* (extension of contract belonged to expiring partnership)
      1. Partners owe “the punctilio of honor most sensitive” to each other
      2. Parties were not partners, but joint venturers – had a defined, limited duration
      3. Duty was to disclose opportunity but *not necessarily* to continue partnership
         1. No duty to disclose opportunity lacking nexus to the subject of the partnership
      4. Nondisclosure can create an impermissible conflict of interest – *Sandvick*
      5. Without concerns of self-dealing or secret profits, unlikely that breach of duty of loyalty has occurred – *Day v. Sidley Austin* (no legal injury for losing power within partnership)
   3. Partnership agreement may identify specific activities that will not be held as violations of the duty of loyalty, or may provide for the authorization of an otherwise disloyal act after full disclosure of all material facts – RUPA §103(b)(3)
   4. Partners must give accounting of anything affecting partnership to partner on demand – UPA §20
      1. Although logistical arrangements as part of preparation to leave are permissible, lying about leaving or using a position of trust for personal benefit (to the detriment of the partnership) violates the duty of loyalty – *Meehan v. Shaughnessy* (law firm breakup)
      2. Being “ready to move” as soon as notice of intent to leave is given might be a breach – Cf. *Town & Country Home*
3. Default rules established by the UPA may be altered in almost any way by the partnership agreement
   1. A partnership may be dissolved by expulsion of any partner *bona fide* in accordance with the partnership agreement – UPA §31(1)(d)
      1. If agreement specifies no-cause termination, good faith exists as long as expulsion does not wrongfully withhold money or property legally due to the expelled partner – *Lawlis* (alcoholic attorney expelled)
      2. Partnership may also be dissolved by the termination of a definite term specified in the agreement, the express will of any partner if no definite term is specified, or by the express will of all the partners before a specified definite term – UPA §31
         1. Partnership agreement can have an implied promise to continue partnership – i.e., until debts have been repaid – *Owen v. Cohen* (mean bowling alley owner)
      3. Any partner may, by express will, wrongfully dissolve the partnership at any time, but may be liable to his partners for damages
   2. Every partner is an agent of the partnership – UPA § 9
      1. However, if partner has no authority and third party knows it, partnership not bound
   3. Any conflicts of ordinary partnership business may be decided by a majority – UPA §18(h)
      1. Because there can be no majority in an evenly-divided partnership, there is no limit of authority on a partner within ordinary matters of partnership business – *Nabisco* (partnership is bound to pay for bread even though partner said he would not)
         1. When third party rights are affected, agency power of partners trumps the partnership deadlock, and the partnership is bound – Compare *Nabisco* with *Summers v. Dooley* (partner cannot require reimbursement from another partner if he refuses to pay for initial outlay)
   4. All partners are liable jointly (and severally, under RUPA) for all partnership debts – UPA §15
   5. Initially, each partner is repaid all contributions to the partnership (by debt or equity) – after *all* liabilities are paid, partners share equally in remaining profits – UPA §18(a)
      1. All partners must contribute towards losses according to his share in the profits
         1. If a partner contributes only services to a partnership (no capital), he is not obligated to help offset partnership capital losses – *Kovacik* 
            1. This result is probably contrary to the plain language of §18, and is explicitly rejected in a comment to RUPA §401(b)
   6. All partners have equal rights in the management of the partnership business – UPA §18(e)
   7. No partner is entitled to salary for acting in the partnership business – UPA §18(f)
4. A partner’s property rights are 1) rights in specific partnership property, 2) interest in the partnership, and 3) right to participate in management – UPA §24
   1. All partners have equal possessory rights in specific partnership property, but that right is not assignable – UPA §25(2)
      1. No partner has rights in the specific property owned by the *partnership* – *Putnam v. Shoaf* (ex-partner had no right to damages paid by embezzling accountant)
   2. Interest in the partnership is an interest in the partner’s share of the profits, and may be assigned because no management rights attach
   3. Partnership management rights are not assignable
5. If a partner’s dissolution is rightful, the partnership is wound up and all partners get paid *unless* otherwise provided for in UPA §38 or the partnership agreement
   1. Partnership buy-out agreements are binding even though purchase price is less than the actual value of the partnership interest – *G&S Investments* (crackhead partner’s capital account was 0)
6. If a partner’s dissolution is wrongful, the partner will be paid but might 1) be paid in the future, 2) be offset for damages, or 3) be forced to allow other partners to continue the partnership
   1. A partner’s conduct that makes it not reasonably practicable to carry on the partnership is grounds for dissolution by a court – UPA §32(1)(d)
      1. Under RUPA §601(5)(iii), a partner can be dissociated by judicial decree that it is not reasonably practicable to carry on the partnership with the partner
      2. Partners who ask for judicial determination have *rightfully* dissociated offending partner
         1. If dissociated, RUPA §701(b) allows dissociated partner to be bought out at the greater of liquidation value or going concern value of his partnership interest
         2. UPA §38 only allows the liquidation value to be given to a dissociating partner
   2. One partner’s cost overruns don’t create grounds for judicial dissolution – *Collins v. Lewis* (partnership will continue even though one partner refuses to contribute more capital)
   3. The filing of a complaint asking for judicial dissolution of a partnership does not accomplish the dissolution – *G&S Investments*
   4. Any partner is able to participate in a judicially supervised auction for partnership property – *Prentiss v. Sheffel* (minority partner tries to block majority partners from sale)
      1. Courts may have to be involved in partnership dissolution even without a wrongful dissolution – in *Prentiss*, partners couldn’t agree on what to do with the business
7. Limited partners may become liable as general partners if they exercise a sufficient amount of control over the business – *Holzman v. De Escamilla*; see also RUPA §303(a)
   1. Limited partner is only liable to persons who transacted with the partnership who reasonably believed that the limited partner was a general partner

### Corporations

1. General overview and policy statements:
   1. Political, cultural and social factors have contributed to an “evolution” towards corporations
      1. Technological incentives of economies of scale, necessitating large firms
      2. Wealth distribution, creating a need for numerous investors
      3. Legal system recognizing private property, permitting capital investment from private sector
      4. Other political factors (strong rule of law, non-corrupt courts, etc.)
      5. Therefore, the form that aggregates capital from many investors and operates with many employers/owners has a Social Darwinian advantage
   2. Four characteristics of corporations have enabled them to become the dominant business form
      1. Investor liability
         1. Allows risk to be shifted to those better able to bear it
         2. Default rules reduce transaction costs (no credit checks on individual investors)
         3. Shifts costs of business on to others (e.g., tort victims)
         4. However, leads to fraud & unfairness to creditors
      2. Investor ability to transfer interest
         1. Fundamentally different from partnerships, where only profit interest is transferable
         2. Leads to greater investor liquidity, which creates a lower cost of capital
         3. However, leads to fraud & unfairness in securities transactions
      3. Legal personality (how difficult is it to kill?)
         1. Makes the entity more durable, preserving going concern value
         2. However, leads to lack of social conscience & extensive corporate power
      4. Managerial power
         1. Bifurcates ownership, management & employees, creating a republican model
         2. Permits role specialization
         3. Eliminates redundant activity (associated with truly democratic system)
         4. Creates a clearly defined hierarchy
         5. However, leads to fraud & unfairness to SHs (principal-agent problem)

#### Investor Liability - Piercing the Corporate Veil

1. Piercing the corporate veil occurs in one of two scenarios:
   1. Corporation is fragment of larger enterprise that actually run the business (enterprise liability)
      1. Asset-partitioning as a technique of limiting liability is permissible – *Walkovzsky v. Carlton* (taxi company with only two cabs)
   2. Company is dummy for individual SHs who use business purely for personal (not corporate) ends
      1. This is the only way to get personal SH liability, and is an extreme form of agency liability
2. Two necessary elements to justify piercing the veil are: (*Sea-Land v. Pepper Source*)
   1. Unity of interest & ownership such that separate personalities don’t exist
      1. Factors to find unity of interest: 1) Failure to keep corporate records, 2) Commingling of funds, 3) Undercapitalization and 4) Company treats others’ assets as its own
      2. In parent-subsidiary cases, the totality of the circumstances determines if the sub is simply the parent’s alter ego. Factors to consider include: (*Silicone Gel Breast Implants*)
         1. Presence of common directors/officers
         2. Presence of common business departments
         3. Consolidation of financial statements/tax returns
         4. Parent financing of subsidiary
         5. Parent caused subsidiary’s incorporation
         6. Subsidiary operates with grossly inadequate capital
         7. Parent pays the subsidiary’s expenses
         8. Subsidiary receives no business except that given it by the parent
         9. Parent uses the subsidiary’s property as its own
         10. Daily operations of the two corporations are not separate
         11. Subsidiary does not observe basic corporate formalities (separate books, records, SH/board meetings)
   2. Separate corporate existences would sanction fraud or promote injustice
      * 1. Requires more than simple inability to collect – how much more is unclear
        2. *Silicone Gel Breast Implants* (might) deny step two’s utility – just differing state law, or a fundamental distinction between tort and contract cases?
3. Clark understands corporate veil cases through the lens of fraudulent conveyance law
   1. Under §4(a), if a transaction is motivated by intent to defraud and is an unfair transfer done by a business debtor left with unreasonably little capital, it is fraudulent as to future creditors
   2. §5(a) is broader, finding fraudulent conveyance if transfer was done without receiving reasonably equivalent value in exchange and debtor is insolvent – “constructive fraudulent conveyance”
      1. Insolvency is presumed if debts are not being paid when due
   3. Corporate veil cases are a loose form of fraudulent conveyance law, since corporate veil cases don’t necessarily require a finding of fraud, and policy judgment that plaintiffs shouldn’t carry burden of proving knowledgeable defendant’s fraud in corporate cases
4. Limited partners do not incur general liability for an LLP’s obligations because they are officers of the corporate general partner (*Frigidaire Sales*)
   1. Formalities trumped equitable principles here, probably because of the tort-contract distinction – creditors knew what the deal was
      1. In cases of contract, in the absence of fraud or manifest injustice, the corporation’s separate entity should be respected

#### Managerial Power – Boundaries

1. Forum selection bylaws, duly enacted by the board, are enforceable if such power has been given to the board under DGCL §109(a) – *Boilermakers v. Chevron*
   1. SHs may check this authority by repealing board bylaws or voting board members out
   2. Bylaws are a binding part of the contract between a Delaware corporation and its SHs
      1. Corporation can *change* its bylaws under DGCL §109(a) – that right is part of the contract SHs agreed to by purchasing shares
      2. Bylaws have a process-oriented nature; if bylaws bind SHs as such (not third party tort victims), they are valid
   3. Forum selection clauses (in bylaws) can be good because they reduce litigation costs, channels litigation to courts with high expertise and history of favorability for corporate defendants, and reduces the holdup power of plaintiff lawyers
      1. Might burden local SHs (forcing travel to distant locations) and reduces the disciplinary power of SHs over boards of directors
2. A suit is direct or derivative under a two-part test: (*Tooley*)
   1. Who suffered harm (corporation or SHs)?
      1. SH’s case was strengthened in *Eisenberg* because SHs originally had stock in an operating company, and later had stock only in a holding company
         1. Suit was permitted as a direct class-action, since SHs were ultimately harmed
      2. SHs have a right to a BoD that is overseeing the company – abdication of this duty creates a direct claim – *Grimes* 
         1. Abdication of managerial oversight must be formal – limits on a board’s freedom of future action don’t rise to actionable abdication (large severance payments do not effectively prevent a board from exercising oversight powers)
         2. Generally, executive compensation decisions are protected under BJR
   2. Who received benefit of any recovery (corporation or SHs)?
      1. In a derivative action, the wronged individual (corporation) will get the benefit of any recovery – if SHs want a “piece of the action”, they must file a direct suit
         1. SHs cannot recoup their legal fees from the company in direct suits
      2. Defendant board members and plaintiff’s attorneys are incentivized to settle derivative claims – the corporation pay directors’ legal fees, and plaintiffs’ attorneys will get a large portion of settlement funds without too much additional work
3. Derivative suits leverage highly incentivized private parties to monitor/protect the corporation from bad management, and is the most effective remedy (AG might lack resources to bring suit, voting out BoD raises collective action problems)
   1. BoD always has option to create a special litigation committee to determine action for a derivative lawsuit, and *Zapata* allows courts to decide if the spirit of the law has been violated
   2. However, derivative lawsuits conflict with traditional power allocation (boards make corporate decisions) and might not benefit plaintiffs (incentive to settle for large attorneys’ fees)
4. Before a derivative suit may be filed, a SH must demand the BoD resolve the issue
   1. Demand is *not* required before a direct lawsuit may be filed
   2. Demand requirement avoids litigation by incentivizing ADR-type remedies, allows corporation to control potentially beneficial litigation (if demand is accepted), and may screen out some baseless suits (“strike suits” entered into for personal gain)
5. The demand requirement may be avoided if 1) board wrongfully rejected a pre-suit demand, or 2) SHs prove demand is futile. There are several different formulations of the futility test:
   1. *Grimes* (Delaware)creates a three-pronged test:
      1. Majority of BoD has material financial/familial interest in transaction
      2. Majority of BoD is dominated/controlled by an alleged wrongdoer or interested party
         1. Demand is not excused simply because a plaintiff sues all directors
      3. Underlying transaction was not a valid exercise of the business judgment rule
         1. This usually implies a lack of adequate process in the board’s decision
      4. *Grimes* is criticized for its phrasing that demand is excused if there is a “reasonable doubt” that the board is capable of making an independent decision
      5. *Rales* is Delaware’s test for excuse of demand in cases where corporate *action* is not at issue (i.e., *Caremark* violations) or if the futility is alleged against a board member who did not participate in the challenged decision
   2. *Marx v. Akers* (NY) rejects universal demand requirement and creates alternate three-prong test
      1. Majority of directors are interested (links *Grimes* prongs one and two)
         1. Directors are self-interested when they receive a direct financial benefit from a transaction that is different from the benefit to SHs generally - *Marx*
      2. Directors failed to inform themselves to reasonably necessary degree about transaction
      3. Directors failed to exercise their business judgment in approving the transaction
         1. Transaction must be “so egregious” that it couldn’t have been a valid BJ
         2. Acts as a catch-all provision (in both tests) to give equity courts more power
      4. In practice, the *Grimes* and *Marx* tests are not terribly different
   3. Showing of futility must be made using “tools at hand”; judicially ordered discovery is unavailable
   4. Wrongful rejection is reviewed under BJR
      1. BJR presumption is overcome if SH can allege “particularized facts” using “tools at hand” that create a “reasonable doubt” that board is entitled to benefit of the presumption
   5. If demand is made & rejected, SH is estopped from claiming that making demand was excused
      1. Prevents the board from being unduly harassed by SHs
6. Directors can create “special litigation committees” (SLCs) in response to derivative lawsuits
   1. Can be used as a delaying tactic against derivative litigation, and also allows the company to retake control of the litigation
   2. Threshold inquiry of SLC viability is whether members are sufficiently disinterested to be neutral
      1. Sounds similar to a demand-excused inquiry, but burden of proof has shifted to SLC to demonstrate independence and adequacy of procedures
      2. Interested directors may not serve on the SLC and have its independent judgment be “above reproach”
         1. *Possibility* of bias is all that is required – SLC has burden of persuasion
      3. The natural hesitancy of directors to brand fellow directors as wrongdoers is not enough of a barrier to bar the use of SLCs
   3. Under New York law, BJR protects against judicial review of the decision made by the SLC – *only* procedures used to *come* to that decision are reviewable – *Auerbach*
      1. If procedures are inadequate (indicating bad faith or fraud), a court may intervene
   4. Delaware opts for a different, two-step inquiry (*Zapata*)
      1. SLC’s independence, good faith, & bases supporting recommendations are all reviewed
         1. Domination/control by an interested party is not sole determinant of SLC independence. Independence turns on whether a director is for *any* reason incapable of bearing only corporation’s best interests in mind – *Oracle* (Stanford professors can’t be on SLC when officers make substantial donations, SLC members have substantial personal relationships with defendants)
            1. Relationship must be of a bias-producing nature – personal friendship, mere external business relationship is insufficient - *Martha Stewart*
      2. Court applies its own, independent BJ to determine if the SLC’s decision was reasonable

#### Legal Personality – Purpose of Corporations

1. There is a tension between conceptions of corporations as profit-maximizing institutions (property model) and general welfare promoters (stakeholder model)
2. Corporations have a fiduciary duty to maximize SH value, obey the law (even if disobedience would be profit-maximizing) and meet all obligations to non-SHs
3. Potential caveats to pure profit maximizations include:
   1. Corporations may engage in (limited) charitable giving – DGCL §122(9)
      1. Might lead to increased giving (but only to charities that directors favor (highbrow charities at the expense of religious charities)
      2. Corporations have implied power to pursue goals within the public interest that will benefit the corporations in the long run – *A.P. Smith* (donation to Princeton)
         1. Example of BJ deference
         2. Since corporations are creatures of statute, legislature has an implied reserved power to alter terms of incorporation at any time – simply part of the deal SHs agreed to on buying stock
   2. Company may end seriously unethical actions (matter of conscience exception)
      1. Resisting takeover attempts to protect workers’ jobs? Voluntary pollution reduction?
         1. BoD may not change the corporation’s primary purpose to benefiting others, providing only incidental benefits inure to SHs– *Dodge v. Ford*
            1. Can the result here be partially explained by FCL?
            2. Ford probably could have gotten away with this if he’d stated “real” reason for dividend plowback – keep money out of Dodge hands (which they planned to use to start a competitor)
            3. Otherwise questionable undertaking might be permitted if ultimate result is uncertain (expanding capacity to meet increasing demand)
4. Legislators should optimize ability for corporations to improve welfare while meeting fiduciary obligations
5. Courts will not interfere with directors’ judgment absent a showing of fraud, illegality, or conflict of interest – *Wrigley* (failure to install lights for Cubs night games out of concern for community)
   1. Plaintiffs must do more than show that a different decision could have been made – a more direct attack, showing that actions demonstrate a lack of interest in profits is necessary

### Fiduciary Duties

1. Duties are generally owed only to SHs. However, in some circumstances, duties may be owed to others
   1. If insolvent, directors may have a duty to creditors – *Francis v. United Jersey Bank*
   2. Director of banks, similar institutions may owe duties to those whose funds are held in trust

#### Duty of Care

1. Mere errors in judgment are an insufficient basis for courts to insert themselves in corporate governance (such as declaration of dividends) – *Kamin v. AmEx* (bad choice on form of dividend was not breach)
   1. Fraud, illegality, self-dealing, bad faith or non-feasance must be shown to rebut BJR
   2. Directors owe the duty of care that a businessman of ordinary prudence would exercise in the management of his own affairs – *Francis v. United Jersey Bank*
2. Plaintiffs can show duty of care violation (around BJR) if they effectively attack decision-making *process* - NOT substantive merits
   1. The party attacking a board’s decision as uninformed bears the burden of proving that the business judgment was informed, and that the lack of information proximately caused harm
   2. If successful in attacking BJR presumption, burden shifts to directors to prove transaction meets burden of “entire fairness”
      1. Elements to consider include timing, initiation, negotiation, structure, disclosure to/approval by directors *and* SHs – *Cinerama v. Technicolor*
   3. SH ratification only cures breach of duty of care if the ratification is made by SHs fully informed about *all material facts* surrounding the transaction – *Van Gorkom*
   4. If SHs have ratified the transaction, the duty of care claim is extinguished - *Wheelabrator*
3. Directors violate duty of care when they make unintelligent/uninformed judgment – *Smith v. Van Gorkom*
   1. Could be characterized as a breach of duty of care (for lack of information) or breach of duty to disclose (lack of material information about the proposed merger to SHs)
   2. Directors may not abdicate decision to SHs to approve or disapprove of the agreement
   3. Although directors can rely in good faith on reports made by officers (DGCL §141(e)), if the “report” is made by a similarly uninformed director, there is no protection
   4. Absence of several key methods of ensuring transactional fairness (fairness opinions, cursory oral presentations and inadequate time to review prepared materials, half-baked market auction) undercut directors’ claims of informed judgment in *Van Gorkom*
      1. Increases role for investment bankers, outside counsel, and BoD. Does this ensure better deals for SHs?
      2. Existence of a market premium doesn’t speak to the *fairness* of the deal to existing SHs – there is no indication of intrinsic value
         1. BoD’s “collective wisdom and experience” is inadequate for the same reason
4. BJR may not be used as a shield against non-feasance (dereliction of duty of ordinary care) – *Francis v. United Jersey Bank* (mom owed duty to discover and discourage sons’ embezzlement)
   1. Lack of knowledge of business affairs is not an acceptable defense
      1. Good faith, reasonable reliance on advice of counsel and/or properly prepared financial statements might excuse non-feasance (cf. DGCL §141(e))
   2. Upon discovery of an illegal course of action, director *must* object, and if not corrected, resign
5. DGCL §102(b)(7) allows companies to place director exculpation clauses in their articles of incorporation
   1. Relieves directors of personal liability for breaches of fiduciary duties, but *cannot* limit liability for breaches of duty of loyalty or acts/omissions not in good faith (or which involve intentional misconduct or a knowing violation of law)
   2. This is not an end to the duty of care – injunctions are still possible. Only *personal* liability of directors is limited for breaches

#### Duty of Loyalty

1. If a breach of the duty of loyalty (self-dealing) is alleged, directors bear burden of proving *both* good faith *and* entire fairness –BJR will not protect directors – *Bayer v. Beran* (president’s wife as opera singer)
   1. Entire fairness is proven if there is a legitimate/useful corporate purpose, and the corporation received full benefit (terms were as good as they would have been in an arms-length transaction)
      1. Fairness can trump a process deficiency (lack of formal approval at board meeting) IF fully informed– *Bayer, Wheelabrator*
2. DGCL §144(a) creates a safe harbor for interested transactions if:
   1. (1) Material facts of interest *and* contract are disclosed/known to BoD, and BoD in good faith approves by affirmative vote of majority of disinterested directors (even if less than a quorum)
      1. Explicit disclosure might not be necessary – a clear understanding of material facts might be sufficient – *Benihana* (financing scheme benefitted a director)
         1. Might have been a different case if director had used confidential information in negotiating deal with Benihana
      2. If majority of disinterested directors ratify, BJR is re-instituted with burden on plaintiff
   2. (2) Material facts of the interest *and* contract are disclosed/known to SHs, and transaction is specifically approved in good faith by **majority** of **all outstanding disinterested** SHs – *Fliegler*
      1. If this procedure is followed, complaining plaintiff must rebut BJR, without lack of process as an excuse (must prove waste) – *Wheelabrator*
         1. Requires a transaction “so one sided that no business person of ordinary, sound judgment could conclude” that the deal was a good one – “rare, unconscionable cases where directors **irrationally** squander or give away corporate assets” - *Disney*
   3. (3) Transaction is fair to the corporation at the time approved
3. Corporate action may not be taken for the primary purpose of board entrenchment – *Benihana*
   1. What if primary purpose is permissible, but collateral purpose (dilution of voting rights) isn’t?
   2. What if dilution of voting rights is good for corporation?
4. A director may not take an opportunity for himself if: (*Broz v. CIS*)– director buys cellular license after offering to company
   1. Company is financially able to take opportunity
   2. Opportunity is in line with the company’s business
      1. “In line with company’s business” means “fundamental knowledge, practical experience, and ability to pursue” – *Martha Stewart*
   3. Company is interested or has reasonable expectancy in the opportunity and
   4. By taking the opportunity, director’s self-interest will conflict with the corporation’s
      1. Outcome might turn on if director was made aware/offered opportunity only because of status as a director
         1. If opportunity looks like a bribe/kickback to directors, court is more likely to stretch to find violation– *eBay* (access to pre-IPO securities was violation because eBay was “in business” of investing)
            1. This resembles R.2d §388. See also *Reading*
      2. Lack of formal presentation to BoD, while not determinative, is best practice (no conflict of interest if BoD declines to take advantage of opportunity)
         1. Similar to *Rash v. J.V.* – adequate disclosure might make problems disappear
5. Majority or “dominating” SHs can owe fiduciary duties to minority shareholders
   1. A parent’s actions will be analyzed under entire fairness if the parent receives a benefit to the exclusion and at the expense of a subsidiary – *Sinclair v. Levien*
      1. If all SHs receive an equal benefit, however, BJR continues to apply (dividend disproportionately benefits parent, but because all SHs also received dividend, waste must be shown to invalidate)
      2. However, parent’s breach of contract (and causing sub not to pursue action against parent) is self-dealing and must be analyzed under entire fairness
   2. Majority/controlling SHs have an affirmative duty to disclose material information to minority SHs in order to protect their interests – *Zahn v. Transamerica* (controlling SH plots to redeem Class A shares, liquidate company to appropriate more of liquidation value)
      1. If true intentions had been disclosed, class A SHs could have made informed decision to maximize value (convert to class B or receive redemption value)
      2. Controlling SHs may not benefit one class of SHs at the expense of another – fiduciary duty is owed to *all* SHs
   3. If defendants demonstrate ratification by majority of minority (disinterested) SHs, plaintiffs must prove entire *un*fairness – *Wheelabrator* 
      1. This is easier than getting around BJR or proving waste, due to concern for manipulation of minority SHs by majority
         1. To get this lower burden (as opposed to BJR under DGCL §144(2)), plaintiffs must show defendants exercise de facto or de jure control over company
   4. If a special committee of independent directors approve a transaction, the plaintiffs will bear the burden of entire *un*fairness – *Kahn v. Lynch*
      1. If both a special committee *and* precondition of transaction approval by majority of disinterested SHs are present, the standard of review *finally* shifts to BJR – *Kahn v. MFW*

#### Duty of Good Faith

1. Great deal of uncertainty as to whether good faith is a freestanding duty (along with care and loyalty) or subsumed into these two inquiries
   1. *Cede v. Technicolor* states that there is a triad of fiduciary duties
   2. *Stone v. Ritter* returns to two fiduciary duties: care and loyalty (good faith is a branch of latter)
2. Because compensation decisions are protected by BJR, plaintiffs must allege breach of duty of care or bad faith – *Disney*
   1. Bad faith is defined as either 1) conduct motivated by actual intent to harm (subjective bad faith) or 2) intentional dereliction of duty; conscious disregard of responsibilities
      1. Gross negligence, without more, does not rise to bad faith
      2. DGCL §102(7) can’t exculpate personal liability for breach of duty of loyalty or bad faith
3. *Caremark* duties require directors to attempt in good faith to assure that an adequate corporate information/reporting system exists
   1. Only a sustained/systemic failure to exercise oversight will establish a lack of good faith
      1. Similar to *Disney’*s articulated standard of conscious disregard of known fiduciary duties
      2. Probably elevates standard of bad faith to some kind of mal-intent
   2. Oversight liability attaches if: (*Stone v. Ritter*)
      1. Directors failed to implement *any* reporting systems
         1. Liability also attaches if reporting systems were not *meaningful* – *Rich v. Chong*
      2. Directors failed to monitor/oversee existing reporting systems

#### Disclosure & Fairness

1. Securities Act of 1933 is primarily concerned with the primary securities market. Emphasis is on disclosure
2. Securities Exchange Act of 1934 is primarily concerned with secondary markets (insider trading, regulation of proxy contests and tender offers, etc.)
3. Under §2(1) of the ’33 Act, a security is either something that falls within a list of specific instruments (stock, bonds, etc.) or a list of general, catch-all provisions.
   1. §2 includes an escape hatch – definitions should be followed unless “context otherwise requires”
      1. Allows courts to ask if the act *should* cover these instruments – policy analysis
   2. Agreement cannot invoke securities laws simply by labeling itself “stock” or “security”
      1. Five common characteristics of stock are: 1) Right to receive dividends; 2) Negotiability; 3) Ability to be pledged; 4) Voting rights; and 5) Capacity to appreciate in value
   3. Under *Howey*, an “investment contract” is defined as 1) an investment of money, 2) in a common enterprise, 3) with expectation of profits, 4) solely from efforts of others
      1. “Solely” has been replaced with question of whether investor may exercise meaningful control over his investment – *Robinson v. Glynn* (owner convinced investor propriety phone technology was being used – it wasn’t)
         1. Totality of the circumstances inquiry – *Robinson* court refuses to broadly hold that LLC interests are (or are not) securities within ’33 Act’s meaning
      2. Close corporations’ stocks, bonds, notes, etc. *are* securities, although might not be subject to registration requirements
      3. Limited partnership interests *are* securities BUT general partnership interests are not
4. Under §5 of the ’33 Act, a security cannot 1) be offered for sale unless registration statement has been filed, 2) be sold until registration statement has become effective, and 3) be sold until prospectus has been delivered to the buyer
   1. §4(2) creates an exception to §5 requirements if the offering was not a public offering
      1. Regulation D (Rules 501-506) flesh out the bare provisions of §4(2)
         1. If issuer raises less than $1m, may sell to unlimited number of buyers without registration (Rule 504)
         2. If less than $5M, may sell to 35 or fewer buyers (Rule 505)
         3. If more than $5M, may sell to 35 or fewer sophisticated buyers (Rule 506)
         4. Accredited investors don’t count for buyer limits
         5. Issuer cannot widely advertise the security, and must file a notice of sale with the SEC soon after it issues the securities
         6. Reg. D exempts only initial sale – later sellers must find another exemption
            1. Restrictions only apply to issuers, underwriters or dealers - §4(1)
            2. Rule 144 allows buyers to resell Reg. D securities after one year, and then only in limited quantities
      2. Four relevant factors to decide if offering is private: (*Doran* – private oil drilling venture)
         1. Number of offerees and their relationship to each other and the issuer
            1. Number of buyers is irrelevant – failure to produce evidence regarding number of offerees is fatal
         2. Number of units offered
         3. Size of the offering
         4. Manner of the offering
      3. Applicability turns on whether investors “need” the protection of the Act
         1. Sophistication cannot substitute for access to information – such access must be proven either by provision of information that *would have been* included in a registration statement *to* ***all*** offerees, or investor access to the information
   2. §12(a)(1) provides strict liability for sales made in violation of §5. The remedy is rescission
5. §11 provides a private cause of action for victims of fraud committed in connection with the sale of securities through the use of a registration statement
   1. May not be used in an exempt offering, since the material misstatement/omission must be made in a registration statement
   2. Defendant has burden of proving the misconduct did not cause plaintiff’s damages
   3. Because there is no privity requirement, everyone *remotely* involved in the registration statement may be named as a defendant – *BarChris* (bowling alley financial lies)
   4. Due diligence is the only defense to a §11 claim, but is NOT available to the issuer
      1. Burden is met if a prudent man managing his own property would have
         1. If a portion expertised by others, no reasonable grounds to believe (and *did not* believe) that there were MMOs
         2. If any other portion, after reasonable investigation had reasonable grounds to believe (and *did* believe) that there were no MMOs
      2. Objective standard – lack of education, experience, or time on BoD are invalid excuses
6. §12(a)(2) imposes civil liability on anyone who offers/sells a security who makes a material misrepresentation or omission (MMO) in connection with the offer or sale. The six elements are: 1) Sale of a security; 2) In interstate commerce; 3) By means of a prospectus/oral communication; 4) Containing an MMO; 5) Defendant offered/sold the security; 6) Defendant knew/should have known of MMO
   1. Only applies to communications used in connection with **public** offerings – no secondary transactions or private placements
   2. Due diligence can also be a defense against §12(a)(2) claims
7. **A misstatement/omission is material if there is a substantial likelihood that a reasonable investor *would* consider it important in deciding how to vote – *TSC Industries*** 
   1. **Significantly alter the total mix of info available – *Basic***
   2. **“Materiality” depends on a balancing of the probability that the event will occur with the anticipated magnitude of the event in light of the totality of the company activity – *TGS***
8. Rule 10b-5 prohibits a) employing any device or scheme to defraud, b) making any MMO, or c) engaging in fraud/deceitful act in connection with purchase/sale of a security
   1. Elements of a 10b-5 claim:
      1. Jurisdiction – Interstate commerce
      2. Standing – An actual buyer/seller of a security (*Blue Chip*) or option (*Beneficial Corp*)
      3. Scienter – False statement made with “intent to deceive, manipulate or defraud” (*Ernst*)
         1. Includes recklessness but not ordinary negligence
      4. MMO in connection with the sale of a security
         1. Plaintiff must show MMO deceived/manipulated and was connected to the sale – breach of fiduciary duty does *not* violate the Rule – *Santa Fe Industries*
            1. Without manipulation (deceit by behavior), only state statutory remedies (i.e., appraisal) are available
      5. Reliance must be proven, or implied through fraud on the market (FotM) theory *– Basic*
         1. *Basic* presumes reliance if 1) misrepresentations are publicly known, 2) material, 3) stock was traded in an efficient market, and 4) timing is correct
         2. *Basic* is thus actually two presumptions – if 1, 2, and 3, then we presume that the MMO affected the stock price. If 4, there was reliance on the MMO
         3. *Halliburton* tried to overturn *Basic*’s FotM theory, but failed
            1. Court emphasized rebuttable-ness of presumption of reliance
            2. Defendant can rebut “price impact” (presumptions 1, 2, and 3) at class certification stage
         4. Non-public information is presumed not priced into a security, and so cannot be the basis for a FotM theory of Rule 10b-5 – *West v. Prudential Securities*
            1. Nor can FotM be based on securities that don’t trade in an efficient market (no opportunity for false information to impact price)
      6. Economic loss
      7. Causation: Causal connection between MMO and loss
   2. There is no liability for aiding/abetting Rule 10b-5 violations – *Central Bank*

#### Insider Transactions

|  |  |
| --- | --- |
| Insider Trading SHOULD NOT be illegal: | Insider Trading SHOULD be illegal: |
| Compensates entrepreneurs | Secret profits should be disallowed; harms market integrity |
| Helps accurately price securities | Slows the release of info (Insiders keep it quiet) |
| Can’t be stopped, and wasteful to try | Deters a significant amount of insider trading |
| States should be able to decide;  Corps may just move to most favorable states | Markets are nationally based; Feds have advantage |
| Individual corporations and their investors should be able to contract about it | There is a need for a legal default rule; |
| At *least* let corporations opt out | Investors would never vote to allow that! |

1. Under state law, proving fraud is necessary to state a claim for illegal insider trading – *Goodwin v. Agassiz*
   1. Relief might be granted if a director personally seeks out a SH to buy shares without disclosing material, non-public information
2. For purposes of Rule 10b-5, trades are made “on the basis of” material nonpublic information if the person making the trade was aware of the information when making the trade – Rule 10b5-1
   1. Requires 1) fiduciary relationship, 2) possession of material nonpublic information, 3) trade of securities 4) “on the basis of” (scienter) the information, 5) resulting in profit (or loss avoidance)
   2. Directors, officers, and 10+% owners of an issuer’s securities must make filings within 10 business days of gaining that status (2 business days for any subsequent change)– ’34 Act §16(a)
3. Insiders are not foreclosed from trading securities of his own company; he must only abstain in extraordinary situations which are reasonably certain to have a substantial effect on the market price if the situation were disclosed (in other words, if information is “material”) – *SEC v. TGS*
   1. Basic statement of rule is “disclose or abstain”!
   2. Cf. *Reading* – no secret profits due solely to insights given you by reason of your status as insider!
   3. The duty to abstain arises *only* in the context of a relationship of trust between a corporation’s SHs and its employees – *Chiarella v. U.S.* (ingenious individual who correctly identified target of tender offer not liable under Rule 10b-5)
4. A tippee assumes insider’s fiduciary duty when an insider breaches it by disclosing information to the tippee, and tippee knows/should know of the breach (“inheritance theory” of disclose-or-abstain) – *Dirks* (reporter not guilty of insider trading because insider received no benefit by disclosing information)
   1. If the insider will benefit, directly or indirectly, from the disclosure, there has been a breach
   2. Clark thinks the rule should be broader – an “improper purpose” test to determine breach
5. Traders also violate insider trading laws by breaching fiduciary duty owed to *source* of inside information (“misappropriation theory”) – *U.S. v. O’Hagan* (external lawyer’s knowledge of forthcoming tender offer was obligated not to trade based on the information)
   1. Targets individuals who trade on inside information without fiduciary duty to SHs
   2. Disclosure of intent to trade by trader to insider removes insider trading (but liability for state law violation of duty of loyalty might still remain)
   3. Similarly, Rule 14e-3(a) also does not require any fiduciary duty in finding a violation of §14(e) (relating to fraud connected with a tender offer):
      1. Once substantial steps have been taken to launch a tender offer, anyone who possesses material information with reason to know that the information is non-public & that it was acquired directly/indirectly from someone related to either offeror or target may not buy/sell related securities until information is publicly disclosed
   4. Rule 10b5-2 lists three situations in which a duty of trust/confidence for purposes of the “misappropriation theory” should be presumed:
      1. Trader agrees to keep information confidential
      2. A pattern/practice of sharing confidences such that trader knows/reasonably should know that the insider expects the trader to maintain confidentiality
      3. Trader is a spouse, parent, child or sibling of the insider
         1. These situations also create presumption of personal benefit for tippee liability
6. ’34 Act’s §21(d) allows the SEC to seek a civil penalty of treble damages for insider trading
   1. §20A gives an additional private right of action for individuals who traded securities in opposite direction of the violation “contemporaneously”
      1. Remedy limited to insider’s profits, minus SEC disgorgement, distributed pro rata among plaintiffs
7. Regulation FD prohibits selective disclosure of material nonpublic information
   1. If disclosure was intentional (knows or reckless to not know that info was material and nonpublic), public disclosure must be immediate
   2. If disclosure was unintentional, public disclosure must be made promptly (as soon as reasonably practicable after director, executive officers, etc. discovers disclosure)
      1. Exceptions for disclosures to confidential disclosures, disclosures to credit rating agencies or persons with a duty of trust/confidence
8. Officers, directors and 10+% owners must repay corporation any profits made buy a purchase and sale (in any order) of a company’s (subject to ’34 Act) equity security within a 6-month window – ’34 Act §16(b)
   1. Once insider reduces holdings below 10% threshold, short-swing profits are not covered by §16 (owner must be 10+% owner at time of *both* purchase *and* sale) – *Reliance Electric*
      1. Similarly, short-swing profits are not covered under §16 on purchases *before* 10% threshold has been crossed – *Foremost-McKesson v. Provident Securities*
   2. Courts match stocks in such a way as to maximize company recovery (*not* FIFO or strict matching)
   3. Unconventional transactions do not fall within §16(b) (exception to general rule of substance over form). Three factors determine unconventionality:
      1. Was transaction volitional?
      2. Did owner have influence over transaction?
      3. Did owner have access to confidential information about transaction/issuer?

#### Indemnification & Insurance

1. DGCL §145 allows corporations to indemnify directors, officers, employees or agents
   1. May indemnify expenses (legal fees, judgments, settlements, etc.) in third party suits, if officer had good faith reasonable belief that actions were not opposed to company’s best interest and had no reasonable cause to believe that conduct was illegal
   2. May indemnify expenses in derivative suit if as above and officer not held liable to corporation
      1. If the suit is settled, corporation **may not** indemnify officer for settlement amount
      2. Court can allow indemnification if officer is “fairly and reasonably entitled to indemnity” despite being adjudged liable or if case is settled
   3. Must indemnify expenses if officer is successful on the merits or otherwise
      1. If officer didn’t pay anything (even if corporation paid settlement amounts “on officer’s behalf”), the suit was successful and must be indemnified – *Waltuch v. Conticommodity*
   4. Indemnification under (a) or (b) premised on approval by majority vote of independent directors (or independent committee of directors), independent legal counsel in a written opinion, or SHs
   5. May advance expenses even if officer later found not to be entitled to expenses by signing a letter promising to repay them if not so entitled
      1. Corporation may pre-commit to advance expenses, even if officer wouldn’t be entitled to indemnification if unsuccessful on the merits – *Citadel v. Roven* (§16(b) dispute)
   6. Corporation can add more indemnification protections beyond those given in §145
      1. Indemnification cannot be inconsistent with DGCL limits (such as §145(a)’s “good faith” requirement) – *Waltuch v. Conticommodity* (no indemnification for bad faith conduct, despite contract that indemnifies all conduct)
   7. May buy insurance to pay for officer legal fees regardless of indemnification’s availability

#### Post-SOX Governance Changes

1. Four major sources of corporate governance change followed early 2000’s accounting scandals: SOX, NYSE listing requirements, governance rating agencies, and a stricter tone in state case law (e.g., *Oracle*, *Disney*)
   1. Changes fall into two rough categories: Audit-related and Board-related
      1. Audit-related changes are further divided into conflict-reducing and action-forcing
         1. Conflict-reducing
            1. SOX §201 (’34 Act §10A(g)) prohibits external auditors from providing other, non-audit services to clients

Governance rating agencies have stricter standards for “non-audit services” than SOX does

* + - * 1. SOX §301 gives power to hire, fire and compensate external auditors to an independent audit committee

Audit committee members must be financially literate, include at least one “financial expert”

* + - * 1. SOX §203 limits personnel flow between auditors and audited firms
      1. Action-forcing
         1. SOX §404 requires audits of internal accounting controls

Hugely expensive and of questionable value

Disproportionately impacts small public companies – is this leading smaller companies to go private?

* + - * 1. SOX §302 requires officers to certify quarterly/annual reports
        2. PCAOB is a new independent regulatory body for external auditors
    1. Board-related changes also divide into conflict-reducing and action-forcing
       1. Conflict-reducing
          1. NYSE listing standards require a majority of independent directors

Definition of independence is stricter (can’t have been employee in past 3 years, no close relative who is employee, not officer of a company that does significant business, not affiliated with charities that receive substantial contributions from the company)

Some governance rating agencies encourage a supermajority of independent directors

* + - * 1. Audit, compensation and nominating committees must be formed and comprised solely of independent directors
        2. Some ratings agencies argue for independent chairperson
        3. NYSE standard of regular executive sessions (no management present)
      1. Action-inducing
         1. Some ratings agencies limit number of boards directors may serve on
         2. Agencies also insist independent directors own large amounts of stock
         3. NYSE standards require adoption of corporate governance guidelines, code of business conduct and ethics and periodic self-assessment
  1. Changes emphasize board’s monitoring role instead (at the expense of?) its managerial role
     1. Do the changes turn the board into compliance checkers, distracting them from more important business decisions?
     2. Can management and BoD effectively work together if monitoring dynamic is at the fore
  2. SOX also requires more detailed financial disclosure, identification of critical accounting policies, and expensing of stock options
  3. SOX also created environment of reform for future shareholder-empowering standards
     1. Freer proxy access for dissenting SHs was passed under Dodd-Frank, killed by D.C. Circuit in *Business Roundtable*, and is now pushed through bylaw changes
        1. Wide support for bylaw changes freeing proxy access, moving away from staggered BoD elections and environmental-related bylaws
  4. SOX should allow empirical studies to determine effectiveness of its provisions, and allow for amendment if necessary

1. Dodd-Frank included four major governance-related reforms:
   1. Advisory SH votes on executive compensation – “say-on-pay” votes
   2. SEC authority to make proxy access rules (but SEC’s first attempt was struck down by D.C. Circuit)
   3. Bounties for whistleblowers
   4. Tougher claw-back provisions (returns executive compensation in the event of an accounting error, even if the error was no-fault)

### Problems of Control

#### Proxy Fights

1. ’34 Act §14(a) prohibits solicitation of proxies in violation of SEC rules
   1. “Solicitation” is construed *broadly* – *Studebaker v. Gittlin* (asking SHs to join effort to demand SH list under state law constitutes proxy solicitation)
   2. Proxies may not be solicited without a “proxy statement” disclosing info relevant to SH decision
   3. Proxy solicitation materials may not contain any MMOs under Rule 14a-9
      1. §14(a) contains an implied private right of action (derivative & direct) – *J.I. Case v. Borak* 
         1. Private rights of action are necessary supplements to SEC enforcement power, since the SEC simply doesn’t have adequate resources to pursue all violations
         2. Since class actions are not permitted for direct SH suits, allowing a derivative is necessary to provide adequate incentives to mistreated SHs
      2. MMO need not have a demonstrable, decisive effect on the voting to demonstrate causation. Causation exists if the proxy statement *itself* was an essential link in transaction – *Mills* *v. Electric Auto-Lite*
         1. Causation not established if management controls a sufficient number of shares to approve a transaction without minority votes, solicits proxies regardless, and materials contain an MMO – *Virginia Bankshares v. Sandberg*
         2. Remedy is difficult to ascertain – recession of merger only appropriate in extreme circumstances; damages should only be awarded if capable of proof
            1. SHs may get attorney’s fees from corporation (even without recovery!)
      3. Failure to include Black-Scholes option valuations in disclosing director compensation is not an MMO as a matter of law – *Seinfeld v. Bartz*
         1. SEC regulations now require options to be treated as expenses in financial reports of registered companies, requiring *some* method of valuation
2. Rule 14a-7 allows management to either mail an insurgent group’s proxy requests to SHs directly (charging group for cost) or give SH list to insurgent group (former is preferred to preserve confidentiality)
   1. Cf. Rule 14d-5, which provides a similar choice in the context of tender offers
3. Incumbent directors may use corporate funds in a proxy fight if not illegal, unfair, excessive, and as long as fight centers on policy differences (not merely personality) – *Levin v. MGM*
   1. Unclear exactly what the standard is – it sounds similar to BJR
   2. Successful insurgents may be reimbursed by corporation if SHs approve – *Rosenfeld v. Fairchild Engine & Airplane*
      1. Dissent argues for a stricter definition of “reasonableness” in determining whether expenses should be reimbursed
      2. Also argues that distinction between personality and policy is almost impossible to draw

#### Shareholder Proposals & Demands

1. Rule 14a-8 governs submission of shareholder proposals for inclusion in a corporation’s proxy statement
   1. SHs holding $2k or 1% of company’s securities for 1+ year may submit proposals – Rule 14a-8(b)
   2. Each SH may submit one proposal per SH meeting, not to exceed a total of 500 words – 8(c)-(d)
   3. Burden is on company to prove it may exclude a SH proposal from proxy statement – 8(g)
   4. Company may include a statement giving reasons why SHs should vote against a proposal – 8(m)
2. There are multiple reasons a company may exclude a SH proposal from proxy statement – Rule14a-8(i):
   1. (1) Not a proper subject for action by SHs under state law
      1. Leads to many “request” proposals – form a committee, examine impact, etc.
   2. (2) Would cause a violation of law
      1. Bylaws cannot proscribe actions that may limit BoD’s ability to act according to their fiduciary duties (DGCL §109 vs. §141) – *CA, Inc. v. AFSCME* (SHs may not propose mandatory reimbursement of expenses incurred in electing new directors to board)
         1. If there had been a fiduciary out, probably would have been permissible
         2. Fiduciary out requirement is a bizarretransplant from M&A law
   3. (3) Proposal is a violation of proxy rules (Rule 14a-9)
   4. (4) Relates to a personal grievance or special interest not shared by other SHs at large
   5. (5) Relates to operations accounting for less than 5% of company’s total assets, net earnings and gross sales, **and** not otherwise significantly related to business (relevance)
      1. Otherwise significant can include social/ethical considerations – *Lovenheim v. Iroquois Brands* (animal cruelty proposal may be included despite lack of economic significance)
   6. (6) Company lacks power/authority to implement proposal
   7. (7) Proposal deals with company’s ordinary operations (management functions)
   8. (8) Would disqualify a nominee from election, remove a director, question competence of one or more nominees or directors, include a specific candidate for election to BoD or otherwise effect outcome of election of directors (director elections)
      1. SH proposal to change *process* of BoD election does *not* violate the rule – *AFSCME v. AIG*
         1. SHs who want proxy access can put forward proposals under Rule (8)(i)(8) to amend bylaws, permitting SH’s nominees inclusion on corporation’s proxy card
         2. Cf. DGCL §109(a), giving SHs power to amend/repeal bylaws
   9. (9) Conflicts with the corporation’s proposal to be submitted at the same meeting
   10. (10) Already substantially implemented
   11. (11) Duplication of a proposal to be included at the same meeting
   12. (12) Resubmissions of proposals from past 5 years if proposal was voted on within 3 years and:
       1. received less than 3% of vote if proposed once within past 5 years
       2. received less than 6% of vote if proposed twice within past 5 years
       3. received less than 10% of vote if proposed three or more times within past 5 years
   13. (13) Proposal relates to specific amount of dividends
3. SEC acts as referee in SH proposal exclusion cases
   1. Company must file notice of intent to exclude. SEC can then file “no-action letter,” recommend inclusion (or face possibility of enforcement action), or recommend revision to make proposal includable. Loser may appeal to Commissioners and/or district court (see *Lovenheim*)
4. Demand for SH list must be for purposes relating to the business of the companyand not inimical to corporation or SHs– *Crane v. Anaconda* (New York) (telling SHs about tender offer was valid purpose)
   1. Rule 14a-7 is insufficient, because corporations can elect to simply mail opponent’s proxy materials to SHs directly, rather than give up the list
   2. New York can force foreign corporations to supply SH list to NY residents, even if SHs are only requesting list on behalf of another interested party – *Sadler v. NCR* (SHs arrangement to give list to AT&T, who was unable to demand SH list, did not make demand void)
      1. New York amended §1315 to clarify that corporation is not required to provide SH lists that do not currently exist to demanding SHs
   3. DGCL §220 allows SHs inspection rights of SH lists “for any proper purpose” – whether a person seeking inspection is entitled to it is determined exclusively by the Court of Chancery
      1. “Proper purpose” requires concern with investment return (economic interest) – *Pillsbury v. Honeywell*
         1. Because the power to inspect may be the power to destroy, only those with a bona fide interest in the corporation may enjoy that power
      2. §220(c) shifts burden based on requested documents – if SH list, corporation must prove inspection is for improper purpose. If any other “book or record”, SH must demonstrate proper purpose
         1. When SH requests records, demand must be made with “rifled precision”
5. Corporations have broad power to alter economic and/or voting rights associated with stock – *Stroh v. Blackhawk Holding* (shares with no economic rights guaranteed control to corporate founders are permissible) (see also DGCL §151(a))
   1. Complex formulae that allow differences in voting power within a single class of stock based on the number of other shares owned is permissible – *P & W v. Baker*

#### Close Corporations

1. Four stages of attempts to deal with problems raised by close corporations:
   1. Contract law adjusts to cope (voting agreements, employment contracts, buy-sell agreements)
   2. General fiduciary duties are extended to owners of close corporations
   3. Legislature finally acts by easing burdens for complaining minorities to achieve dissolution
      1. Initial stage was fraud or oppression – *Alaska Plastics*
      2. Shifts to concerns with “prejudicial conduct” – *Pedro v. Pedro*
      3. Eliminates requirement of bad conduct – minorities’ “reasonable expectations” are protected – *Haley v. Talcott*
   4. Different form of organization (LLC)
2. Close corporation status may be elected by a corporation with less than 30 SHs – DGCL §342(1)
   1. §351 allows articles of incorporation of close corporation to provide that business will be managed by the SHs rather than a BoD
3. SHs may contract to exercise their voting rights in a particular way – *Ringling Bros. v. Ringling* (DE)
   1. Alternative method is the creation of a voting trust – SHs give shares to trustee, who votes shares as a block (useful for family to maintain control if others might attempt a takeover) – DGCL §218
   2. Violation of SH voting agreement may lead to a rejection of votes cast by offending party, or declaring the entire election invalid
   3. Voting agreements may be valid even *without* close corporation status – *Ramos v. Estrada* (CA)
      1. California Corporations Code §709 allows courts to enforce SH agreements through equitable remedies (specific performance, recession, etc.)
4. However, **directors** *may not* enter into agreements as SHs requiring them to act in a certain way – *McQuade v. Stoneham* (NY) (agreement ensuring election of specific directors invalid)
   1. Fiduciary duties do not permit directors to sign contracts that require breach of those duties
   2. Where directors are the only SHs of a corporation, courts will not interfere with agreement to vote for particular officers – *Clark v. Dodge*
      1. Undercuts rationale that problem in *McQuade* was infringement on statutory requirements for BoD to have full discretion to exercise fiduciary duties
      2. Argues that since nobody can be harmed by enforcement of the agreement, parties should be able to create a contractual relationship that works for them, despite statute
      3. Echoed in *Galler v. Galler* (Illinois) (wife of director sues to enforce contract providing posthumous salary – absence of a complaining minority interest, fraud/injury to public or creditors and clearly prohibitory statutory language made SH agreement permissible
         1. Also concerned with potential for freeze-out, since close corporation shares are illiquid and therefore minority SHs might be at the mercy of majority
   3. NY Business Corporation Law §620 now allows BoD restrictions if:
      1. Restrictions are in articles of incorporation
      2. Restrictions are approved by all SHs
      3. Subsequent SHs have notice and/or give consent
         1. Requirements are so onerous that they *only* make sense for close corporations
   4. Modern law is that SH agreements that require the appointment of certain individuals as officers/employees are enforceable, as long as agreed to by all SHs

#### Abuse of Control

1. SHs in a close corporation owe each other fiduciary duties of utmost good faith and loyalty (similar to partnership law) – *Donahue* (majority SHs denied minority SHs opportunity to sell shares back to corporation). There is a two-part test to determine if majority’s actions violate these duties – *Wilkes v. Springside Nursing Home* (MA) (one of four founding members kicked out after many years)
   1. Can controlling group demonstrate a legitimate business purpose for its actions?
   2. Can minority show purpose could have been achieved through means less harmful to minority?
      1. Rationale for heightened duties is ease with which majority may oppress minority (due to illiquidity of ownership stake), probable reliance on employment from corporation, right of minority to eventually realize *some* return on investment in corporation
      2. Balanced against majority’s right to exercise “selfish ownership”
   3. MA later creates a distinct test if a freeze-out is illegitimate – majority cannot frustrate “reasonable expectations” of benefit from minority’s share ownership – *Brodie v. Jordan* (widow of former owner wants out of the close corporation)
      1. Proper remedy for freeze-outs is to restore minority to the position she would have been in absent any wrongdoing (buyout inappropriate – no market for security existed)
         1. Implies a “spectrum” of drastic action by courts – compelling dividends is fairly benign, forced buy-outs are more invasive, and forced dissolution is nuclear
   4. Minority SHs can have fiduciary duties, if they exercise an effective veto – *Smith v. Atlantic Properties* (partner’s refusal to pay dividend led to increased taxes)
      1. Breach of this duty requires conduct beyond “reasonable” – might even require recklessness in running serious, unjustified risks
   5. **COMPARE MA (strong protections for minority SHs) with DE (you made your bed, so lie in it)**
2. If status as SH is subservient to status as employee, employment will not be protected – *Ingle v. Glamore Motor Sales* (NY) (Buy-sell agreement if SH ceases to be an employee for any reason)
   1. Distinction is drawn between duties owed to SH and employee
   2. Highlights doctrinal clash between employment-at-will and partner-like rights of minority SHs in close corporations
3. Close corporations that purchase their own stock must disclose all material information to seller – *Jordan v. Duff & Phelps* (7th Cir.) (did not tell employee of impending merger)
   1. SHs cannot, through their silence, take opportunistic advantage of each other without violating both 10b-5 and the duty of loyalty
   2. Dissent is concerned about expansion of fiduciary duties – wants to elevate employee-at-will status to the determinative inquiry

#### Dissolution

1. Statutory standards allowing courts to order dissolution of close corporations have evolved towards greater favorability to minority SHs seeking dissolution
   1. Four factors the courts (might) consider in determining how protective of minority SHs to be:
      1. Role of the parties’ reasonable expectations
      2. Remedies (Buyout as less disruptive solution? Statutory authorization, or equitable powers?)
      3. Is dissolution statute restricted, in whole or in part, to close corporations?
      4. How do statutes/courts interact with contractual rights?
2. Initially, dissolution is only available if directors’ actions are illegal, oppressive or fraudulent, or if corporate assets are being wasted – *Alaska Plastics* (1980) (Divorcee excluded from board meetings, did not receive “directors’ fees” like the other owners)
   1. Because liquidation is such an extreme remedy, other equitable remedies (such as buy-out of minority SHs) may be used
   2. Where a controlling SH takes advantage of a special benefit (directors’ fees), fiduciary duty requires corporation to offer that benefit to all SHs – “equal access”
3. *Meiselman v. Meiselman* (N.C. 1983) begins the shift to ordering dissolution when “reasonably necessary” for protection of rights and interests of complaining SHs
   1. Limited “rights and interests” to those expectations embodied in express or implied understandings
   2. Driving rationale is that minority SHs in close corporations are unable to bargain for their own protection, and must be defended by the courts
4. By *Pedro v. Pedro* (Minn. 1992), courts no longer have to rely on equitable powers – statute itself allows forced buy-out as a remedy for freeze-outs of minority SHs
   1. Court looks to minority’s “reasonable expectations” when awarding damages
5. *Stuparich v. Harbor Furniture* (CA 2000) is an example of a modern, liberal statute – no requirement of oppressive or unfairly prejudicial conduct, just “reasonably necessary” to protect SHs’ rights or interests
   1. Nevertheless, plaintiffs lose because large dividends were still being given – context *matters*
   2. BJR may still be invoked to discourage judicial intervention in close corporations
6. *Haley v. Talcott* (DE 2004) (Redfin Grill dispute between two partners) is a purely equitable decision – dissolution of an LLC whenever “not reasonably practicable to carry on the business in conformity with the LLC agreement” (similar to UPA §32(1)(d))
   1. Because contracted-for protections do not provide an equitable outcome (exiting partner remains personally liable for mortgage), court may order dissolution
   2. Almost seems to be default rule that court may order involuntary dissolution!

#### Transfer of Control

1. Control premiums permitted in sale of corporate assets/shares if there is not: (*Zetlin v. Hanson Holdings*)
   1. A sale to a known corporate looter
   2. Conversion of a corporate opportunity
      1. Buyer’s offer to purchase entire corporation, seller convinces to purchase only a control premium may be conversion of a corporate opportunity
      2. If the control premium actually represents a corporate opportunity to take advantage of special conditions, premium may be invalidated – *Perlman v. Feldman* (steel shortage during Korean War foreclosed premium for selling to consumers of steel products)
         1. Analogy to Corporate Opportunity Doctrine – payment of *stock* premium to obtain cheaper *steel* does not benefit all SHs ratably
   3. Fraud
   4. Other misconduct
      1. If misconduct is found, court may give premium to either SHs or corporation
2. “Equal opportunity rule” (premium must be shared with minority SHs) is the norm – U.S. is the exception
3. Although minority SHs may contract for provisions to protect themselves in the event of a sale of corporate assets, courts will generally construe these protections narrowly – *Frandsen v. Jensen-Sundquist*
   1. Court construes right of first refusal to protect only investor’s reasonable expectations (not to be frozen-out by new majority), not ongoing participation following complete buy-out
   2. Court has to elevate form over substance here (sale of assets + liquidation ≠ sale of shares?)
      1. Skeptical of elevating substance over form when detailed contract is involved?
   3. Typical contractual restrictions on transfer include:
      1. Flat prohibitions (likely invalid)
      2. SH approval
      3. Right of first refusal (SH must offer corporation or other SHs right to purchase before selling on open market)
      4. First-purchase option (sale price determined by previous agreement)
      5. Stock buy-back (contingent right (not obligation) for corporation to repurchase)
      6. Mandatory buy-sell (same as above, but can also be offer to purchase/obligation to sell at a specific price among SHs or corporation)
4. Controlling SHs may receive payment to ensure immediate transfer of management control to new SH – *Essex v. Yates*
   1. “Naked” sale of corporate office is forbidden as a conflict of directors’ fiduciary duties
   2. Effective working control *might* be sufficient to allow immediate transfer – burden of proof is on party attacking transaction to show a block of stock is not large enough to constitute control

### Mergers & Acquisitions

1. Seven possible standards of review for mergers/acquisitions (in Delaware):
   1. Business Judgment Rule – related to duty of care (*Van Gorkom*)
      1. Plaintiffs must allege either process defect or irrationality/waste
   2. Inequitable action (bad motive) – *Schnell v. Chris-Craft* (courts intervene if corporate action is technically legal but sketchy)
   3. *Unocal* (“Enhanced scrutiny”) – requires 1) Finding of threat; and 2) Defenses must be within “range of reasonableness”
   4. *Revlon* – Directors must get the best deal for SHs
   5. *Blasius* – “Compelling justification” for defensive measures designed to disenfranchise SHs
   6. No impermissible restrictions on BoD authority, fiduciary duties
      1. Mechanisms cannot interfere with BoD’s fiduciary duties (i.e., no-hand poison pills, dead-hand poison pills), must always have fiduciary out
   7. Entire fairness (Freeze-out mergers)
2. Reasons for acquisitions include:
   1. Increasing economic value: create synergies, produce economics of scope and scale
   2. Take advantage of undervalued stock
   3. Suppress competition (but might create antitrust problems
   4. Empire building (vertical/horizontal integration)
   5. Tax consideration – using losses to offset other income

#### Mergers

1. There are multiple potential merger techniques:
   1. Sale of all (or substantially all) assets followed by liquidation
      1. Allows acquirer to avoid inheriting unforeseen liabilities
      2. Usually requires majority SH approval for seller, not for purchaser– DGCL §271
         1. Vote not required in DE if sale is to a subsidiary
         2. BoD can abandon proposed sale at any time without SH authorization
      3. States differ on appraisal rights (no in Delaware, yes in Pennsylvania)
      4. Dissolution is governed by DGCL §275, and requires a majority vote from both the BoD and the SHs (or unanimous vote of SHs)
         1. Proxy statement rules (Rules 14a) apply to requests for SH vote
   2. Statutory merger – governed by DGCL §251
      1. Both company’s SHs and BoDs must approve by majority vote
         1. No vote of survivor’s SHs is required if: (§251(f))
            1. Agreement does not amend articles of incorporation
            2. Each share of stock remains unchanged after the merger
            3. No more than 20% of number of current shares outstanding will be issued as a result of the merger
      2. SHs desiring appraisal must go through complex process: (DGCL §262)
         1. Before vote on merger, SHs submit written demand for appraisal
         2. SHs do not vote in favor of merger, and continuously hold shares post-merger
         3. SH must demand appraisal *again* within 20 days after merger is excuted
            1. No appraisal rights if stock was listed on national securities exchange on date of notice of merger vote, if held by 2,000+ SHs, or if SH vote was not required to effectuate merger – §262(b)(1)
            2. But SHs may receive appraisal rights if required to accept anything other than stock (or cash in lieu of fractional shares of stock) – (b)(2)
         4. Court will determine fair value of shares, plus interest – may also shift fees
         5. Appraisal may not be an adequate remedy – many traps for the unwary, and no ability to get to a class-action
      3. Unless vote is not required, both companies must issue proxy statements, surviving company must issue new registration statement for any newly issued shares

|  |  |  |
| --- | --- | --- |
| Summary of Sale v. Merger: | Sale (for cash) | Merger (for stock) |
| 1)T’s SHs’ investment | Terminated | Continued, though in A, not T |
| 2) A’s consideration given | Replaces assets | Extends assets |
| 3) A’s SHs’ investment  and voting rights | Smaller impact | Larger impact |
| 4) Target | Corporation’s life *might* end (if liquidated) | Corporation’s life ends |
| 5) Management | Dual -> Unitary | |
| 6) Technical: inclusion of assets and liabilities in the transfer | Piecemeal,  by affirmative acts | Global (corporation gets assets and liabilities) by operation of statute |
| **Consequences** | | |
| Tax (Cf. Difference #1) | Taxable “sale” – SH pay tax | Tax-**deferred** “reorganization” |
| Accounting treatment  (Cf. #2) | Purchase accounting | |
| Antitrust (cf. #5) | Anticompetitive? | |
| Securities Regulations | Proxy statement by T | 1) Proxy statements by T & A (’34 Act)  2) Registration statement  from A (if issuing new stock) (’33 Act) |
| DGCL – Note that appraisal is *always* subject to DGCL §262(b) exceptions | **T’s SHs**: vote, no appraisal  **A’s SHs**: no vote, no appraisal | **T’s SHs**: Vote, appraisal  **A’s SHs**: Vote, appraisal |

* 1. Stock purchase through A’s direct solicitation of T’s SHs – may offer cash or shares of A
     1. No need to get votes from either company’s SHs
     2. Upon acquiring 90% of outstanding shares, acquiring company may complete a short-form merger under DGCL §253
        1. One of the companies must be a DE corporation
        2. SHs may not vote on merger and do not have appraisal rights, unless subsidiary is a DE corporation and acquiring company does not own all shares - §263(d)
  2. Subsidiary merger – A forms a new sub (S) that merges with T
     1. Rationales include:
        1. Avoiding vote/proxy statement for A’s SHs (only BoD needs to approve)
        2. Maintains advantages of mergers (easier to deal with T’s holdouts than buying shares individually, automatic transfer of all assets)
        3. Keeps T’s liabilities in a separate corporate entity from A
     2. Could also do a “reverse sub merger” where S & T merge, with T as survivor
        1. Maintains advantages of standard sub merger, but *also* extinguishes minority SHs and preserves T as an entity (preserving contract and tax advantages)

1. Courts occasionally blur line between sale of assets and mergers through the de facto merger doctrine – if it looks like a merger, courts treat it as one – *Farris v. Glen Alden* (PA)
   1. Elevates substance over form – attempts to stop corporations from avoiding statutory requirements of SH vote or appraisal rights by constructing a favorable “form” of merger
   2. Delaware courts have refused to create a de facto merger doctrine – *Hariton v. Arco Electronics*
      1. Different statues maintain “equal dignity” (§§271 and 275 vs. 251) – action taken under one section is independent of requirements of another, even if result is the same
      2. DE courts also decline to create de facto non-merger doctrine – *Rauch v. RCA* (§§151(b) and 160(a) (which allow corporations to redeem any shares it wants) are distinct from §251 (laying out requirements for conversion of shares to cash in a merger))
         1. Clark thinks this is more accurately called a de facto redemption case
2. Freeze-out mergers (controlling SH is on both sides of the merger) are reviewed for entire fairness – *Weinberger v. UOP*
   1. SHs must allege fraud, misrepresentation, or other misconduct as burden of production
   2. If transaction is approved by majority of minority SHs plaintiff must prove unfairness
      1. Majority retains burden to prove SH vote was fully informed
   3. Burden may also shift if merger is negotiated by independent director committee – *Kahn v. Lynch*
   4. The concept of “fairness” has two components: (*Weinberger v. UOP*)
      1. “Fair dealing” addresses transaction’s timing, process of negotiation, approval process
         1. Includes concept of “complete candor” – controlling SH must show that it disclosed all material facts
         2. Goal is to make the transaction appear to be an arm’s-length deal!
      2. “Fair price” relates to economic and financial aspects – price is the dominant feature
         1. Fairness of price may be assessed by any generally accepted valuation method
            1. However, DGCL §262(h) might restrict use of historic comparisons of prior mergers (price determined exclusive of merger-related value)?
   5. Controlling SH does not need to demonstrate a “business purpose” to justify merger – entire fairness doctrine is strong enough to protect minority interests – *Weinberger v. UOP*
      1. MA embraces business purpose test – court’s test extends general principles of *Wilkes* to freeze-out mergers generally – *Coggins v. New England Patriots*
         1. Two-prong test for freeze-out mergers in MA:
            1. Did merger further legitimate corporate goals?

Can avoiding SEC filings or holdup litigation be legitimate corporate purposes?

* + - * 1. Was transaction fair under the totality of the circumstances?

Factors to be examined include merger’s purpose, adequacy of disclosure, and price

* + - 1. Dissenting SHs are not limited to appraisal if a fiduciary duty has been breached, but may receive recissory damages (what plaintiffs would have had without merger)
  1. Appraisal may not be an adequate remedy in cases of fraud, self-dealing, waste or overreaching. In these cases, courts may employ any form of appropriate equitable/monetary relief - *Rabkin*
  2. Defendants may shift burden and get BJR if the following conditions are met: (*Kahn v. MFW*)
     1. Controlling SHs *condition* merger on approval of *both* an independent committee and majority of minority SHs
     2. Independent committee is actually independent – can select advisors & reject proposal
     3. Independent committee meets its duty of care in negotiations (adequate procedures)
     4. SHs are both fully informed *and* un-coerced
        1. Gives parties *incentives* to use both measures that ostensibly protect minorities, employs features of normal, non-controlled merger making traditional deference to directors’ decisions more appropriate
  3. A tender offer freeze-out occurs in two stages: an acquirer first launches a tender offer, then effects a short-form merger (under DGCL §253)
     1. Tender offer freeze-outs get BJR protection if four conditions are met: (*Pure Resources*)
        1. Tender offer cannot be coercive
        2. Freeze-out is conditioned on tender of majority of minority shares
        3. Short form merger is guaranteed to occur promptly after threshold is met
        4. No retributive threats against either target’s SHs or BoD are made

#### Takeovers

1. The Williams Act is a series of amendments to the ’34 Act that focus on tender offers
   1. §13(d) requires disclosure if buyer obtains 5+% of a company’s stock
      1. Disclosure must be made within 10 business days, must include source of funds and purpose for purchase
   2. §13(e) requires any issuer repurchases of stock (self-tender offers) to be subject to SEC rules
      1. However, issuers may purchase
   3. §14(d) governs disclosure of tender offerors
   4. §14(d)(5) allows offerees to withdraw their tenders as long as the offer window is open
   5. §14(d)(6) requires offerors to buy shares pro rata from all offerees if the offer is oversubscribed
   6. §14(d)(7) requires all offerees receive the best price offered during the tender offer window
   7. §14(e) is a general antifraud provision with regard to tender offers
      1. It is unlawful for anyone to make an MMO in connection with a tender offer
   8. Rule 14d-10 require tender offers to be made available to all security holders in a class
   9. Rule 14e-1 creates a minimum offer period of 20 days
   10. Rule 14e-5 prohibits offeror from buying shares *outside* the tender offer if offer window is open
2. Many defensive measures are available to targets of hostile takeover attempts. The most common are:
   1. Exclusionary self-tender offers (*Unocal* – now forbidden by Rule 13e-4(f)(8))
   2. Poison pills (permitted in Delaware by *Moran*)
      1. Generally includes three elements:
         1. “Flip-in” – If acquirer buys a specified percentage of shares, SHs (except acquirer) may buy two shares additional shares at ½ price – dilutes target stock
         2. “Flip-over” – Triggered when target merges into acquirer – SHs may buy two shares of acquirer’s stock at ½ price – massively dilutes acquirer’s stock
         3. “Redemption” – BoD may redeem rights at a nominal price before exercise
      2. Dead-hand pills can be redeemed only by directors who were in office when the pill became exercisable. Struck down in *Carmody* as impermissible SH disenfranchisement
      3. No-hand pills prevent all members of BoD (if majority is nominated/supported by hostile bidder) from redeeming pill for a specified time period. Struck down in *Quickturn* as impermissible infringement on BoD’s ability to discharge fiduciary duties
   3. Asset lock-up (corporation agrees to sell assets at below-market price) (*Revlon*)
   4. Share lock-up (if stock trades on NYSE, SHs must approve lock-up of 20+% of shares) (*QVC*)
   5. Large termination fees (*Revlon*)
   6. Contract preventing removal of existing defensive measures (*QVC* – impermissible restriction on BoD’s ability to carry out fiduciary duties)
   7. Payment of greenmail (*Cheff v. Mathes* – no longer widely used due to 50% penalty tax)
3. Corporation may purchase its own stock (DGCL §160) in response to hostile takeover attempt, but only if it has a sincere belief that the buyout is necessary to maintain proper business practices – *Cheff v. Mathes*
   1. BoD initially bears burden of persuasion due to intrinsic conflict of interest involved in using corporate funds to perpetuate management control`
   2. The BoD will receive the benefit of the BJR if it can pass the following two-prong test:
      1. BoD had reasonable grounds for believing the takeover to be a threat
         1. Can be satisfied by showing good faith and reasonable investigation
         2. In *Cheff*, concerns about employee retention (considered critical to company’s long-term success) were sufficient to find “threat”
      2. Primary purpose was *not* retention of control
   3. Technique here (purchasing stock to force buyout from incumbent board) is “greenmail” – rarely used today due to 50% penalty tax on proceeds
4. A board of director’s response to a takeover attempt must pass *Unocal*’s two-part test
   1. Standard of review is “enhanced scrutiny,” “intermediate scrutiny” or “conditional BJR” (BJR if threat is real) due to “omnipresent specter” that BoD may be acting primarily in its own interest
   2. Step 0 – Did BoD have authority to adopt defenses? (DGCL, articles of incorporation, etc.)
   3. Step 1 – Did BoD have reasonable grounds to believe that the takeover attempt threatened corporate policy and effectiveness? – see *Cheff*
      1. Shown through good faith and reasonable investigation
         1. Proof is materially enhanced if majority of BoD are outside directors – even better if independent committee presents its recommendation to BoD - *Unocal*
      2. There are three basic categories of threats to a corporation: (*Mentor Graphics*)
         1. Opportunity loss – hostile offer might deprive SHs of opportunity to select a superior alternative offered by management
         2. Structural coercion – risk that disparate treatment of non-tendering SHs might distort SH’s tender decisions
            1. Two-tiered front-end tender offer in *Unocal* offered $55 to both stages of tendering SHs, but second tier would only receive junk bonds
         3. Substantive coercion – risk that SHs will mistakenly accept underpriced offer because they disbelieve management’s representations of intrinsic value
            1. This threat should be construed broadly, including value to be lost from failure to consummate planned merger – *Time* (had planned to merge with Warner Bros. before Paramount’s hostile offer)
            2. Quality of consideration offered may also play a role – *Unocal* (junk bonds for later-tendering SHs)
      3. As long as the *primary purpose* is permissible, directors’ mixed motives is OK
   4. Step 2 – Is the defense proportional to the threat posed?
      1. Response cannot be “draconian”, which means “coercive” or “preclusive” - *Unitrin*
         1. Defenses are coercive if they “cram down” a management-sponsored alternative on SHs
         2. Defenses are preclusive if they deprive SHs of right to tender offers or preclude bidders from gaining control by restricting proxy contests (or otherwise)
            1. Adopting staggered BoD can be preclusive – *Hilton Hotels v. ITT*
      2. In addition to not being coercive/preclusive, BoD’s defensive measures must be “otherwise within range of reasonableness” – *Unitrin*
         1. Broad language gives courts discretion to confront new fact patterns
            1. However, courts generally allow BoD to exercise discretion in selecting the measures they will use to defend against takeovers
         2. Response must be “reasonably related” to the threat – *Time* (Paramount could buy new Time Warner – really? What about financing/antirust problems?)
      3. All defenses *must* have a fiduciary out – *Omnicare* (lack of *any* possible result other than consummation of merger (absolute lock-up) due to combination of forced SH vote and voting agreement without fiduciary out is impermissible)
         1. Even with fiduciary outs, no-shop provisions are generally viewed unfavorably – “counterproductive” devices should be eliminated in a bidding war – *QVC*
   5. *Unocal* applies even in *friendly* mergers – *Omnicare*
5. If the BoD embarkson a transaction, a new *Revlon* duty arises – the board is no longer “defender of the corporate bastion”, but become auctioneers that *must* get the best deal possible for SHs – *Revlon*
   1. Other constituencies may only be considered to the extent there are rationally related benefits to the SHs
   2. Board *cannot* play favorites when bidders make relatively similar offers – anything else is a breach of the duty of loyalty
      1. Prematurely ending an active auction for the corporation is impermissible, even if accomplished by otherwise legal methods such as an asset lock-up or no-shop provision
         1. What about “last, best offer” lock-ups or cancellation fees? Ending auctions *might not* always be bad!
   3. *Revlon* duties ARE NOT triggered when a sale is “inevitable”, or when a company is “in play” – **BoD must embark on a transaction on its own initiative or in response to a hostile offer *that will result in a change of control* *–*** *Lyondell v. Ryan*
      1. “Change of control” is *not* found if ownership remains in “fluid aggregation of SHs” –Compare *QVC* with *Time* 
         1. Last chance for SHs to get a control premium, so courts will protect them!
      2. *Time* creates two slightly different circumstances which might trigger *Revlon*:
         1. A corporation initiates an active bidding process to sell itself
         2. In response to a bidder’s offer, a target seeks an alternative transaction involving the breakup of the company
            1. If a board’s reaction is merely a defensive reaction, *Revlon* is NOT triggered, but *Unocal* duties attach
         3. Test is reformulated slightly in *QVC* – *Revlon* duties attach when:
            1. A corporation undertakes a transaction which will cause a change in corporate control OR
            2. A break-up of the corporate entity
   4. There is no specific formula to meet *Revlon* duty – each BoD will face unique situation – *Lyondell*
   5. There is only ***one*** *Revlon* duty – to get the best price possible for the SHs – *Lyondell*
   6. There is a difference between conscious disregard of fiduciary duties (violation of duty of loyalty via breach of good faith) and flawed effort to carry them out – *Lyondell*
6. BoD action intended to disenfranchise SHs in response to a hostile tender offer is strongly suspect under *Unocal’s* proportionality prong – board must demonstrate “compelling justification” – *Blasius*
   1. If a BoD seeks to wield power over corporate assets in a takeover, BJR or *Unocal* applies. If BoD seeks to change relationship between SHs and BoD, however, *Blasius* is invoked – *Hilton v. ITT*
   2. Courts will examine circumstantial evidence to determine if primary purpose for defensive measures that disenfranchise SHs was board entrenchment.
      1. Factors include timing, entrenchment, BoD’s stated purpose, BoD’s plan’s benefits, and effects of action
   3. Note that *Blasius* was *not* invoked in *Time* (BoD recast merger as asset purchase to avoid SH vote), because Time’s SH vote was only required due to NYSE regulations – not strong enough
7. There are six broad categories of anti-takeover state statutes:
   1. Fair price provisions (prohibit discriminatory two-tiered offers, seen in *Unocal*)
   2. Control share acquisition statutes (shares lose voting rights unless approved by majority of minority SHs, approved as constitutional in *CTS*)
   3. Business combination statutes (DGCL §203)
      1. If bidder gets 15% of target’s stock, a 3-year moratorium on merger begins unless:
         1. Bidder acquires 85% of shares
         2. Target’s BoD approves a tender offer *before* bidder acquires 15%; or
         3. Target’s BoD approves a merger *after* bidder acquires 15% AND 2/3 of minority SHs approve
      2. Clark says that these statutes are not actually that burdensome
   4. Non-SH constituency statues (Pennsylvania’s is far more draconian than Delaware’s)
      1. Allows directors to consider *all* stakeholders within *Revlon* duty
   5. Explicit authorization of discriminatory poison pills
   6. Disgorgement of gain from sale within 18 months of seeking control (Pennsylvania is insane)
8. In *Edgar v. MITE,* Court emphasized Williams Act’s neutrality between target management and offeror
   1. Focus shifts in *CTS v. Dynamics* to protection of SHs from *both* target management *and* offeror
      1. States may take actions that might have the effect of limiting tender offers in their states – see, e.g., appraisal rights statues, forced acceptance by majority of minority