<u>CORPORATIONS</u>

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2. ACTING THROUGH OTHERS: THE LAW OF AGENCY

2.1 Introduction to Agency

Restatement (Second) Agency §1. Definition of Agency
Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.

2.2 Agency Formation, Agency Termination, and Principal's Liability

2.2.1 Formation

Agents may be:

- Special agents (agency is limited to a single act or transaction)
- General agents (agency contemplates a series of acts or transactions)

Principals may be:

- Disclosed (3rd parties understand that agent is acting on behalf of particular principal)
- Undisclosed (3rd parties are unaware of principal and belief that agent herself is principal)
- Partially disclosed (3rd parties understand they're dealing w/ agent but don't know principal)

2.2.2 Termination

Either the principal or agent can terminate the agency at any time. If the contract between them fixes a set term of agency, then the P's decision to revoke or an A's decision to renounce gives rise to damages for breach of contract.

2.2.3 Parties' Conception Does Not Control

Agency relations may be implied even when the parties have not explicitly agreed to an agency relationship.

Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285 (Minn. 1981)

- An agreement may result in the creation of an agency relationship although the parties did not call it an agency and did not intend the legal consequences of the relation to follow. The existence of the agency may be proved by circumstantial evidence which shows a course of dealing between the two parties.
- A creditor who assumes control of his debtor's business may become liable as principal for the acts of the debtor in connection with the business. The point at which the creditor becomes a principal is that at

which he assumes de facto control over the conduct of his debtor, whatever the terms of the formal contract with the debtor may be.

2.2.4 Liability in Contract

Both parties must manifest their intention to enter an agency relationship. The manifestation need not necessarily be in writing, nor is it essential that it even be verbal. What is necessary is for the agent to reasonably understand from the action or speech of the principal that she has been authorized to act on the principal's behalf.

Actual Authority: authority that a reasonable person in the position of A would infer from the conduct of P (can be express or implied). Includes incidental authority to do those implementary steps that are ordinarily done in connection with facilitating the authorized act.

Apparent Authority: authority that a reasonable third party would infer from the actions or statements of P. True even if, unbeknownst to the 3rd party, P had explicitly limited authority of A.

Inherent authority or inherent power: not conferred on agents by principals but represents consequences imposed on principals by the law. This doctrine gives a general agent the power to bind a principal (whether disclosed or undisclosed) to an unauthorized contract as long as a general agent would ordinarily have the power to enter such a contract, and the third party does not know that matters stand different in this case. Basically, the risk of loss caused by the disobedience of agents should fall upon the principal rather than upon third parties.

Nogales Service Center v. Atlantic Richfield Co., 126 Ariz. 133 (Ariz. Ct. App. 1980)
- A general agent for a disclosed or partially disclosed principal subjects his principal to liability for acts done on his account which usually accompany or are incidental to transactions which the agent is authorized to conduct if the other party reasonably believes the agent is authorized to do them and has no notice that he is not so authorized.

2.2.5 Liability in Tort

In most circumstances, principals are liable for torts committed by a class of agents known as servants, as distinguished from another class of agents (and nonagents) known as independent contractors. Only master-servant relationship ordinarily triggers vicarious liability.

Restatement (Second) Agency §220: How to determine between servant and independent contractor.

Restatement (Second) Agency §215: Master/principal who unintentionally authorizes conduct of servant/agent which constitutes a tort is subject to liability.

Restatement (Second) Agency §216: P may be liable for even unauthorized tortuous conduct.

Restatement (Second) Agency §219. When Master is Liable for Torts of his Servants
(1) A master is subject to liability for the torts of his servants committed while acting in the scope of their employment.
(2) A master is not subject to liability for the torts of his servants acting outside the scope of their employment, unless:
    (a) The master intended the conduct or the consequences, or
    (b) The master was negligent or reckless, or
    (c) The conduct violates a non-delegable duty of the master, or
    (d) The servant purported to act or speak on behalf of the P and there was reliance upon apparent authority, or he was aided in accomplishing the tort by the existence of the agency relation.

Restatement (Second) Agency §228: When conduct is within the scope of employment.

Humble Oil & Refining Co. v. Martin, 148 Tex. 175 (1949)
- The question of a master-servant relationship is ordinarily one of fact.

- The relationship established between an oil company, which maintained a filling station for the distribution of its own products, and the manager of such station, is that of master and servant, when said manager operates the station under a "Commission Agency Agreement" and makes regular reports to said company, which not only direct him in the management of the station but shares in its receipts and disbursements, even though it exercises no control over the employees, who look to the manager of the station as their director.

Hoover v. Sun Oil Co., 212 A.2d 214 (Del. Super. Ct. 1965)
- Whether the operator of a service station is an independent contractor of the oil company that owns the service station varies according to the contracts involved and the conduct and evidence of control under those contracts. The test to be applied is that of whether the oil company retains the right to control the details of the day-to-day operation of the service station; control or influence over results alone is viewed as insufficient.
- The same rule of law applies in nearly all cases involving whether a service station operator is an independent contractor, and the differences in result are explained by different fact situations and greater evidence of oil company control. The degree of control over the method of operation is determinative.

2.3 The Governance of Agency (The Agent's Duties)

2.3.1 The Nature of the Agent's Fiduciary Relationship

An agent is a fiduciary of her principal. The legal power over property (including information) held by the fiduciary is held for the sole purpose of advancing the aim of a relationship pursuant to which she came to control that property.

Generally, fiduciaries have three types of duties:
- Duty of obedience to the documents creating the relationship (R2A §§ 383, 385); i.e. duty to obey the principal's commands
- Duty of loyalty to always exercise fiduciary power in a manner that the holder of the power believes in good faith best advances the interest or purposes of the beneficiary, and not to exercise such power for a personal benefit.
- Duty of care to act in good faith, as one believes a reasonable person would act, in becoming informed and exercising an agency or fiduciary power.

2.3.2 The Agent's Duty of Loyalty to the Principal

Restatement (Second) Agency §387. General Principle
Duty to act solely for the benefit of the principal

Restatement (Second) Agency §388. Duty to Account for Profits Arising out of Employment
Duty to give P any profits made by A in transactions conducted on behalf of P.

Restatement (Second) Agency §389. Acting as Adverse Party Without Principal's Consent
Unless otherwise agreed, duty not to deal with P as adverse party in transaction connected with agency without P's knowledge

Restatement (Second) Agency §390. Acting as Adverse Party With Principal's Consent
A who acts on his own account (with knowledge of the principal) in a transaction in which he is employed has a duty to act fairly and disclose all facts which A knows or should know would reasonably affect P's judgment…unless P has manifested that he knows such facts or doesn't care.

Tarnowski v. Resop, 51 N.W.2d 801 (Minn. 1952)
- All profits made by an agent in the course of an agency belong to the principal, whether they are the fruits of performance or the violation of an agent's duty. It matters not that the principal has suffered no damage or even that the transaction has been profitable to him.
- If an agent has received a benefit as a result of violating his duty of loyalty, the principal is entitled to recover from him what he has so received, its value, or its proceeds, and also the amount of damage thereby caused.

- Where, because of an agent's violation of his duty to his principal, it becomes necessary for the P to sue a third party to recover what he had parted with as a result of a fraud, the principal may recover of the agent his attorneys' fees and expenses of his suit against the third party and such other losses/expenses as are the direct consequence of the agent's wrongful conduct.

2.3.3 The Trustee's Duty to Trust Beneficiaries

The private trust is a legal device that allows a "trustee" to hold legal title to trust property, which the trustee is under a fiduciary duty to manage for the benefit of another person - the trust beneficiary. Differs from agency to the extent that trustee is subject to the terms of the trust as fixed by the trust's settler/creater, rather than being under the control of the beneficiary.

Restatement (Second) of Trusts §203: trustee is accountable for any profits made through trust.

Restatement (Second) of Trusts §205. liability in case of breach of trust.

Restatement (Second) of Trusts §203. liability for breach of loyalty.

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3. THE PROBLEM OF JOINT OWNERSHIP: THE LAW OF PARTNERSHIP

3.1 Introduction to Partnership

Property is held under a "tenancy in partnership." This form of tenancy provides that the partnership qua firm, rather than the individual partners, exercise true ownership rights over the property. In the event of partnership bankruptcy or liquidation, this title gives credits of the partnership first priority over the claims of the creditors of individual partners.

Uniform Partnership Act (UPA): A default partnership agreement that can be superseded by an express agreement among the partners.
Revised Uniform Partnership Act (RUPA): Reforms the UPA – adopted in NY and CA.

3.1.1 Why Have Joint Ownership?

Partners go into business together because they cannot afford to finance the business on their own, or do not want to risk funds. Why not just borrow money? Often, selling an ownership stake is a cheaper way to raise capital than to borrow more funds. In other words, whatever the costs of co-ownership, after a certain point they may be lower than the agency costs of the debt contract.

3.1.2 The Agency Conflict Among Co-Workers

Fundamental problems in the law of business organizations:
- Conflict between agents and principals
- Conflict between principals and third parties (such as creditors)

Partnership adds:
- Conflict between controlling and "minority" co-owners.

Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928)
A joint venture existed in which two partners pooled their money in order to lease a building for shops and offices. Defendant partner was more business savvy and, in an effort to increase his wealth, he entered into an agreement with another businessperson to purchase surrounding property as a leasehold estate. Plaintiff was entitled to proceeds resulting from defendant's purchase of a leasehold estate where defendant's lucrative position arose from the creation of a joint venture.
- Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties.
- A co-adventurer has the duty to concede and reveal any chance to compete and any chance to enjoy the opportunity for benefit that had come to him alone by virtue of his agency.

3.2 Partnership Formation

UPA §6. Partnership defined
A partnership is an association of two or more persons to carry on as co-owners a business for profit.

UPA §7. Rules for Determining the Existence of a Partnership
In determining whether a partnership exists, these rules shall apply:
(1) Except as provided by section 16 (partner by estoppel), persons who are not partners as to each other are not partners as to third persons.
(2) Joint tenancy, tenancy in common, tenancy by the entireties, joint property, common property, or part ownership does not of itself establish a partnership, whether such co-owners do or do not share any profits made by the use of the property.
(3) The sharing of gross returns does not of itself establish a partnership, whether or not the persons sharing them have a joint or common right or interest in any property from which the returns are derived.
(4) The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business, but no such inference shall be drawn if such profits were received in payment: (a) As a debt by installments or otherwise, (b) As wages of an employee or rent to a landlord, (c) As an annuity to a widow or representative of a deceased partner, (d) As interest on a loan though the amount of payment vary with the profits of the business, or (e) As the consideration for the sale of a good will of a business or other property by installments or otherwise.

Vohland v. Sweet, 433 N.E.2d 860 (Ind. Ct. App. 1982)

- To establish the partnership relation, as between the parties, there must be (1) a voluntary contract of association for the purpose of sharing the profits and losses, as such, which may arise from the use of capital, labor or skill in a common enterprise; and (2) an intention on the part of the principals to form a partnership for that purpose. The intent, the existence of which is deemed essential, is an intent to do those things which constitute a partnership. It is the substance, and not the name of the arrangement between them, which determines their legal relation toward each other.
- Under UPA §7(4), receipt by a person of a share of the profits is prima facie evidence that he is a partner in the business. Lack of daily involvement for one partner is not per se indicative of absence of a partnership. A partnership may be formed by the furnishing of skill and labor by others. The contribution of labor and skill by one of the partners may be as great a contribution to the common enterprise as property or money. There must be a voluntary contract to carry on a business with intention of the parties to share the profits as common owners thereof.

3.3 Relations with Third Parties

- The Rights of Partnership Creditors
  - UPA §15: PRs jointly and severally liable on partnership torts; jointly liable on P'ship contracts.
  - RUPA §306: PRs jointly and severally liable on partnership torts and contracts. BUT:
  - RUPA §307(d): Must exhaust business assets before pursuing personal assets.
- Three Aspects of Creditors' Rights:
  - Whom can creditors pursue? Who is a partner?
  - When can a ex-partner escape partnership debts?
  - How do partnership creditors fare in competition with personal creditors for assets when the partnership and its partners are all bankrupt (a common scenario)?

3.3.1 Third-Party Claims Against Partners

Dissolution of a partnership does not itself affect a partner's individual liability on partnership debts. When a partner withdraws from a partnership but others continue the business, the departing partner is still liable for partnership obligations incurred prior to her departure…but she no longer exercises control over the capacity of the continuing business to satisfy the obligations. UPA §36(3) makes life easier by releasing departing partner from person liability when a creditor renegotiates his debt with the continuing partners after receiving notice of the departing partner's exit.

UPA §36. Effect of Dissolution on Partner's Existing Liability
(1) The dissolution of the partnership does not of itself discharge the existing liability of any partner.
(2) A partner is discharged from any existing liability upon dissolution of the partnership by an agreement to that effect between himself, the partnership creditor, and the person or partnership continuing the business; such agreement may be inferred from the course of dealing between creditor having knowledge of dissolution and the continuing partnership.
(3) Where a person agrees to assume the existing obligations of a dissolved partnership, the partners whose obligations have been assumed shall be discharged from any liability to any creditor of the partnership who, knowing of the agreement, consents to a material alteration in the nature or time of payment of such obligations.

Munn v. Scalera, 436 A.2d 18 (Conn. 1980)
- Where the principals agreed to accept performance from the surviving partner, the former partner was released.
- Pursuant to UPA §36(3), the former partner was released because the principals materially changed the partnership's obligation by the principals' agreement to underwrite the procurement of materials for the surviving partner.
- The language UPA §36 fits most aptly the situation in which (1) all of the obligations of the partnership are assumed by the remaining partner; and (2) all of the assumed obligations are in the form of obligations to pay. In such circumstances, the statute discharges the withdrawing partner as surety whenever the creditor and the remaining partner as principal agree to a material variation in the assumed debts by an alteration in the nature or manner of payment of those debts.

3.3.2 Third-Party Claims Against Partnership Property

UPA §25. Nature of Partner's Right in Specific Partnership Property
UPA §25(1): Partnership property owned by the partners as "tenants in partnership."
Gives individual partners virtually no power to dispose of partnership property, thus transforming this property into de facto business property
UPA §25(2): Partner cannot possess or assign rights in partnership property, a partner's heirs can't inherit it, and partner's creditors cannot attach or execute upon it.

Nevertheless, partner retains a transferable interest in the profits arising from the use of partnership interest, and the right to receive partnership distributions. The contributors of equity capital do not "own" the assets themselves, but rather, own the rights to the net financial returns.

UPA §27, RUPA §503: Partner's transferable interest in profits can be transferred.

UPA §28, RUPA §504: Individual creditors of partners can obtain a "charging order," which is a lien on the partner's transferable interest that is subject to foreclosure unless redeemed by repayment of debt.

3.3.3 Claims of Partnership Creditors to Partner's Individual Property

UPA: Follows the jingle rule, giving partner's creditors priority over partnership creditors.
RUPA: Follows the parity treatment rule codified in §723 of the Bankruptcy code, and gives partnership creditors equal right to go after individual assets.

3.4 Partnership Governance and Issues of Authority

National Biscuit Co. v. Stroud, 106 S.E.2d 692 (N.C. 1959)
- Where there is a general partnership of two persons, without restrictions on the authority of either partner to act within the scope of the partnership business, one of the partners cannot, by notice to a third person that he would not be personally liable for goods thereafter sold the partnership in the ordinary course of the partnership business, relieve himself of liability for such goods.
- All partners have equal rights in the management and conduct of the partnership business. Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of

the partners; but no act in contravention of any agreement between the partners may be done rightfully without the consent of all the partners.
- In cases of an even division of the partners as to whether or not an act within the scope of the business should be done, of which disagreement a third person has knowledge, it seems that logically no restriction can be placed upon the power to act. The partnership being a going concern, activities within the scope of the business should not be limited, save by the expressed will of the majority deciding a disputed question; half of the members are not a majority.

3.5 Termination (Dissolution and Disassociation)

Under UPA
§29. Dissolution: dissolution caused by any partner ceasing to be associated with the business.
§30. Partnership Not Terminated by Dissolution: Partnership continues until winding up completed.
§37. Right to Wind Up: Unless otherwise agreed, partners who have not dissolved the partnership have a right to wind up the partnership affairs.
§38. Right of Partners to Partnership Property: When dissolution is caused in any way, each partner may have the partnership property applied to discharge liabilities, and surplus applied to pay in cash the net amount owing to the respective partners. UNLESS OTHERWISE AGREED.

Under RUPA
§601. Disassociation: partner can dissociate himself from partnership, but partnership continues
§801. Dissolution: events which cause dissolution and wind up

3.5.1 Accounting for Partnership's Financial Status and Performance

Partnership Balance Sheet: Total Assets – Liabilities = Partners Capital
Income Statement of Profit and Loss: As of a certain date, Gross receipts – Cost = Profit
Capital Account: Effect of the partners' capital on the operating of the business over the year.

Ability of partners to opt out of statutory wind-up in a partnership at will

Adams v. Jarvis, 127 N.W.2d 400 (Wis. 1964)
- The dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business. On dissolution, the partnership is not terminated, but continues until the winding up of partnership affairs is completed.
- If a partnership agreement provides for continuation after the withdrawal of a partner, sets forth a method of paying the withdrawing partner his agreed share, does not jeopardize the rights of creditors, the agreement is enforceable.

Mode of liquidation in a statutory wind-up

Dreifuerst v. Dreifuerst, 280 N.W.2d 335 (Wis. Ct. App. 1979)
- In a partnership at will, partners can rightfully dissolve the partnership with or without the consent of a dissenting partner. Unless otherwise agreed, partners who have not wrongfully dissolved a partnership have a right to wind up the partnership. Winding-up is the process of settling partnership affairs after dissolution. Winding-up is often called liquidation and involves reducing the assets to cash to pay creditors and distribute to partners the value of their respective interests. In-kind distribution is permissible only in very limited circumstances. If the partnership agreement permits in-kind distribution upon dissolution or wind-up or if, at any time prior to wind-up, all partners agree to in-kind distribution, the court may order in-kind distribution.
- The Court of Appeals of Wisconsin does not read § 38 of the UPA as permitting an in-kind distribution under any circumstances, unless all partners agree. §38 of the Act is quite clear that if a partner may force liquidation, he is entitled to his share of the partnership assets, after creditors are paid in cash.
- A sale is the best means of determining the true fair market value of partnership assets. Generally, liquidation envisions some form of sale. Since the statutes provide that, unless otherwise agreed, any partner who has not wrongfully dissolved the partnership has the right to wind up the partnership and force liquidation, he likewise has a right to force a sale, unless otherwise agreed. While judicial sales in some instances may cause economic hardships, these hardships can be avoided by the use of partnership agreements.

Limitations on the power to force statutory dissolution and wind-up

Page v. Page, 359 P.2d 41 (Cal. 1961)

- All partnerships are ordinarily entered into with the hope that they will be profitable, but that alone does not make them all partnerships for a term and obligate the partners to continue in the partnerships until all of the losses over a period of many years have been recovered.
- A partnership may be dissolved by the express will of any partner when no definite term or particular undertaking is specified.
- Evidence tending merely to prove that the partners of a linen supply partnership expected to meet current expenses from current income and to recoup their investment if the business were successful, or a common hope that the partnership earnings would pay for all necessary expenses, did not establish even by implication a "definite term or particular undertaking."
- A partner has the right to dissolve the partnership by express notice to the other partner. If, however, it is proved that he acted in bad faith and violated his fiduciary duties by attempting to appropriate to his own use a new prosperity of the partnership without adequate compensation to his copartner, the dissolution would be wrongful and he would be liable.

3.6 Limited Liability Modifications of the Partnership Form

In addition to minimum features of partnership form: 1) Dedicated pool of business assets; 2) a class of beneficial owners; 3) Clearly delineated class of agents authorized to act for the entity, limited liability can be added as a fourth feature. Business creditors cannot proceed against the personal assets of the firm's equity investors, but can only rely on the assets of the partnership.

3.6.1 The Limited Partnership

All limited partners must have at least one general partner, with unlimited liability, in addition to one or more limited partners. Limited partners may not participate in management or control, beyond voting on major decisions such as dissolution. If limited partners exercise management powers, they risk losing their limited liability protection as de facto general partners. Great pass-through tax benefits over a corporation (unless equity is publicly traded on a securities market).

Uniform Limited Partnership Act (ULPA) §7. Limited Partner Not Liable to Creditors

A limited partner shall not be liable as a general partner unless, in addiotn to the exercise of his rights and powers as a limited partner, he takes part in the control of the business.

Revised Uniform Limited Partnership Act (RULPA) §303. Liability to Third Parties

Same as ULPA §7; however, the limited partner is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner.

Delaney v. Fidelity Lease, Ltd., 526 S.W.2d 543 (Tex. 1975)

- Respondent limited partners were personally liable when they acted through respondent limited partnership's corporate general partner in the lease agreement with petitioner lessor.
- Personal liability that attaches to a limited partner when he takes part in the control of the business cannot be evaded merely by acting through a corporation.

3.6.2 Limited Liability Partnerships and Companies

3.6.2.1 The Limited Liability Partnership

General partnership in which partners retain limited liability (generally limited only with respect to partnership liabilities arising from the negligence, malpractice, wrongful act, or misconduct of another partner or agent not under the partners' direct control). See Delaware LLP Act §1515(b). Also a minimum capitalization or insurance requirement in most states.

3.6.2.2 The Limited Liability Company

Combines limited liability, control, and pass through taxation. LLCs enjoy limited liability even when members control the firm. Members have the right to withdraw at any time. Transferees of interest may not become members without approval of a specific percentage of other members. LLC's can be taxed like partnerships under IRS "check the box" regulations that allow unincorporated businesses to choose taxation as a business or corporation.

4. THE CORPORATE FORM

Core Characteristics	GP	Corp.
Entity Taxation?	No	Yes
Legal personality with indefinite life?	No	Yes
Limited liability?	No	Yes
Transferable shares?	No	Yes
Centralized management under an elected board?	No	Yes

4.1 Introduction to the Corporate Form

Basic characteristics of the corporate form

1. legal personality with indefinite life
2. limited liability for investors
3. free transferability of share interests
4. centralized management
5. appointed by equity investors

Benefits of Corporate Form

- eliminates messy problems of personal liability; creditors only rely on business assets
- allows investors to enter and exit the firm: all they have to do is buy or sell shares
- prevents minority investors from trying to hold up the firm by threatening to dissolve it
- makes it easy for third parties who contract with the firm to know whom they are dealing with as an authorized agent; all they need is a board resolution

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4.2 Creation of the Fictional Legal Entity

- A corporation is a separate person in the eyes of the law
- Charter and bylaws are different because bylaws are easier to change, deal with workings, charter is like a constitution

4.2.1 A Note on the History of Corporate Formation

- Corporation formation requires governmental action
- States have the reserved sovereign power to form corporations
- Internal affairs doctrine: The law of the state of incorporation governs the internal affairs of a corporation, including such matters as who votes, on what, and how often.

4.2.2 The Process of Incorporating Today

- Corporation's legal life begins when its charter is filed. DGCL §106.
- First act of business in newly formed corporation are electing directors (if not named in the charter), adopting bylaws, and appointing officers.

4.2.3 The Articles of Incorporation, or "Charter"

- May contain any provision not contrary to law.
- Must provide for voting stock, a board of directors, and shareholder voting for certain transactions; must name the original incorporators, state the corporation's name and (very broadly) its business, and fix its original capital structure.
- Contractual freedom is the overriding concept.
- Articles of Incorporation (Typical Contents): Name of Company, Address, Purpose (usually "any lawful act"), capital structure (classes, number of common shares, rights of preferred shareholders if any), other miscellaneous provisions.

4.2.4 The Corporate Bylaws

- Must conform to both the corporation statute and the corporation's charter.
- Generally, bylaws fix the operating rules for the governance of the corporation.
- In Delaware, shareholders have the inalienable right to amend the bylaws. DGCL §109(b)
- Bylaws (sample structure):
  Article I: Stockholders; Article II: Board of Directors; Article III: Committees; Article IV: Officers; Article V: Stock; Article VI: Indemnification; Article VII: Miscellaneous

4.2.5 Shareholders' Agreement

- Formal agreements among shareholders typically address such questions as restrictions on the disposition of shares, buy/sell agreements, voting agreements (See DGCL §218(c)), and agreements with respect to employment of officers or payments of dividends.
- Generally, corp. is a party to these contracts, and courts will specifically enforce agreement where all shareholders are parties as well. Where some shareholders are not parties, specific enforcement – especially against the corporation – may turn on whether the agreement is fair to shareholders who were not signatories.

4.3 Limited Liability

Benefits of Limited Liability:

- Reduces need to monitor managers
- Reduces need to monitor other shareholders
- Makes shares fungible (which also facilitates takeovers, see below)
- Facilitates diversification (without LL, minimize exposure by holding only one company)
- Enlists creditors in monitoring managers (because creditors bear some downside risk)

4.4 Transferable Shares

Benefits of Transferable Shares:

- Permits takeovers => disciplines management
- Allows shareholders to exit without disrupting business
- And because of LL, shares are fungible => facilitates active stock markets, increasing liquidity.
- While free transferability is a characteristic of corporations, it is not mandatory. DGCL §202 allows close corporations to restrict free transfer as long as conspicuous notice appears.

4.5 Centralized Management

- Centralized management gives a firm efficiency, this increases with the size and complexity of the firm
- A fundamental issue of corporate law is determining which set of legal rules is most likely to ensure that managers that control companies will advance the financial interests of their shareholders
  - what can the law do to encourage managers to be diligent
  - how can the law assist shareholders acting collectively vis-à-vis managers
  - how can the law encourage companies to make investment decisions that are best for shareholders
- The main technique to do this is to require, as a default rule, that management be appointed by a board of directors that is elected by the holders of common stock.
- Legally speaking, the corporate officers are agents of the company, while corporate law often treats the board as if it were a quasi-principal (although, of course, the board is the economic agent of the shareholders).
- As a practical matter, initiation and execution are the province of management, whereas monitoring and approval are the province of the board.

4.5.1 Legal Construction of the Board

- the corporate board is the ultimate locus of managerial power
- directors are weaker than they look on paper
- inside directors dilute power and outside directors have limited time to deal with issues
- Sarbanes-Oxley strengthens power of outside directors

4.5.1.1 The Holder of Primary Management Power

- If the board thwarts the will of a majority of the shareholders, the shareholders have options like removing directors, or in some jurisdictions, by consent solicitation.
- Although the board has primary power to manage the business and affairs of the corporation (eg. DGCL §141), it rarely exercises nitty-gritty power. Instead, it designates officers. But the managerial power of the board is very broad, and includes the power to appoint/compensate/remove officers, power to delegate authority to subcommittees/ officers/others, power to amend bylaws, power to declare/pay dividends, power to approve certain extraordinary corporate actions such as amendments to articles of incorporation, mergers, sale of assets, dissolutions, and power to make major business decisions.
- DGCL §271 requires board approval for sale of assets.

Automatic Self-Cleaning Filter Synd. Co., Ltd. V. Cunninghame

- McDiarmid and friends own 55% of Automatic Self-Cleansing Filter (ASCF). ASCF charter vests control in the board, subject to "extraordinary resolutions" approved by 75% of shareholders. McDiarmid and friends bring such a resolution to sell the company's assets; resolution gets 55% of vote and fails. McDiarmid then asks the court to order the board to sell the assets.
- If the mandate of the directors (control subject to 75% requirement) is to be altered, it can only be done by the machinery of the memorandum and articles themselves.

4.5.1.2 Structure of the Board

- Default = members of the board elected to one-year terms by stockholders.
- Even if staggered board (up to 3 classes under DGCL §141(d)) or elected by certain classes of stock, directors owe their fiduciary duty to the corporation and to all shareholders.

4.5.1.3 Formality in Board Operation

- Corporate directors are not legal agents of the corporation. Governance power resides in the board of directors, not in the individual directors who constitute the board.
- Directors act as a board only at a duly constituted board meeting and by majority vote (unless charter requires super majority) that is formally recorded in the minutes of the meeting). Proper notice must be given and quorum must be present.
- DGCL 141(f): Board may act without a meeting if members give unanimous written consent to corporate action in question.

4.5.2 Corporate Officers: Agents of the Corporation

- The board has the power to delegate authority to corporate officers as it sees fit
- Unlike directors, corporate officers are unquestionably agents of the corporation and are therefore subject to fiduciary duty of agents.

Jennings v. Pittsburgh Mercantile Co., 202 A.2d 51 (Pa. 1964)

- Apparent authority is defined as that authority which, although not actually granted, the principal (1) knowingly permits the agent to exercise or (2) holds him out as possessing.
- An agent cannot, simply by his own words, invest himself with apparent authority. Such authority emanates from the actions of the principal and not the agent.
- In order for a reasonable inference of the existence of apparent authority to be drawn from prior dealings, these dealings must have (1) a measure of similarity to the act for which the principal is sought to be bound, and, granting this similarity, (2) a degree of repetitiveness.

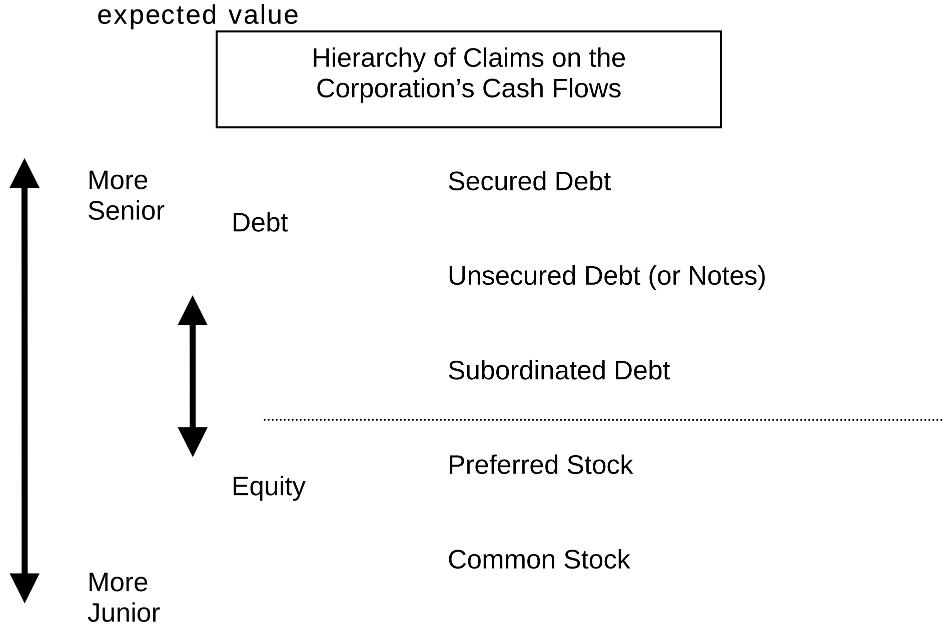
Menard, Inc. v. Dage-MTI, Inc., 726 N.E.2d 1206 (Ind. 2000)

- An agent's inherent authority subjects his principal to liability for acts done on his account which usually accompany or are incidental to transactions which the agent is authorized to conduct if (even though forbidden by the principal) the other party reasonably believes that the agent is authorized to do them

and has no notice that he is not so authorized. An individual's inherent authority is derived from the status of the office that he or she holds, so that a third party is not required to scrutinize too carefully at a knowledge or awareness that the officer's authority has possibly been limited.
- When the president and general manager does an act within the domain of the general objects or business of the corporation, and within the scope of the usual duties of the chief officer, it will be presumed that he had the authority to do it, and whoever would assert the contrary must prove it.
- The proper inquiry into a third-party's reasonable belief is a broad-based inquiry into the scope of the agent's inherent authority in light of his agency relation with the principal. The proper inquiry into a third-party's notice of an agent's authority is a narrow inquiry focusing on the specific transaction in question.

5. DEBT, EQUITY, AND ECONOMIC VALUE

- Corporations are financed with a mix of debt and equity
- A dollar today is worth more than a dollar tomorrow
- Risk averse investors discount expected value for systematic (non-diversifiable) risk
- Efficient Capital Market Hypothesis suggests that market prices provide the best guess of expected value



5.1 Capital Structure

- The **cost of debt is typically lower** than the cost of equity because (a) debt creates a tax benefit for profitable companies that equity does not; and (b) debt is a less risky investment than equity for the investor, so the cost of debt will be lower.
- Each firm's **optimal leverage** (ratio of debt to total capital), balances the benefits from the lower cost of debt against the "cost of financial distress" that arises from too much debt.
- Thus, most firms are capitalized with a mix of debt and equity.

5.1.1 Legal Character of Debt

- Corporate Debt:
  - Bank loans, notes, and bonds
  - Fixed maturity date for repayment of principal (the amount borrowed)
  - Regular interest payments
  - Interest payments deductible for tax purposes
- Corporate Equity:
  - Common stock
    - No fixed payments or rights to return of investment
    - Voting and control rights
    - Residual claimant
  - Preferred stock
  - Dividend payments are not deductible

5.1.2 Legal Character of Equity (common and preferred stock)

- Owners of stock can vote to elect directors and that stock carries one vote per share. Any deviation from one vote per share must appear in the corporation's charter.
- Charter contains the specifics of the firm's equity securities, including whether there are multiple types of stock with different voting rights, preferences upon liquidation (some stockholders get more than others if firm liquidates), or other terms that affect the company's stock.
- Other terms include the company's redemption and call rights and the shareholder's exchange, conversion, and put rights. A redeemable stock is one that the corp. may redeem on terms stated in the charter, either at election of board or some set time. An exchange right is a right to switch one security for another. A conversion right is a right to convert security into another at stated conversion rate. In this context, a put right is the shareholder's right to force the company to buy stock at a fixed right, while a call right is the corporation's option to force shareholders to surrender stock at a fixed price. Stock that is called becomes the company's "treasury" stock that continues to be issued, but no longer outstanding in the market. Stock that is redeemed is cancelled and may not be reissued.
- Preferred Stock
  - Generally, carries a stated dividend, but it is payable only when declared by board.
  - Usually, unpaid dividends accumulate and all accumulated dividends must be paid to preferred stockholders before any dividends are paid to common stockholders.
  - Ordinarily, preferred stock does not vote so long as dividend is current; if it is not, preferred shareholders get votes or designated board seats.
  - On fundamental matters such as mergers in which their rights may be affected, holders of preferred stock are accorded a class vote where they can veto proposed deal. In Delaware, this right must be created specifically in document creating stock.

5.2 Basic Concepts of Valuation

5.2.1 The Time Value of Money

5.2.2 Risk and Return

5.2.3 Diversification and Systematic Risk

5.2.4 The Relevance of Prices in the Securities Market

5.3 Estimating the Firm's Cost of Capital

5.3.1 Estimating the Firm's Cost of Debt

5.3.2 Estimating the Firm's Cost of Equity

5.3.3 The Optimal Balance Between Debt and Equity

5.3.3.1 Value of Debt in the Balance Sheet

5.3.3.2 The Risks of Excessive Debt

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6. THE PROTECTION OF CREDITORS

Corporate law pursues three basic strategies in its efforts to protect creditors:

- It can impose more or less extensive mandatory disclosure duty on corporate debtors
- It can promulgate (usually de minimis) rules regulating the amount and disposition of corporate capital.
- It can impose duties on corporate participants such as directors, creditors, or shareholders.

6.1 Mandatory Disclosure

Federal securities law imposes disclosure on public companies to the benefit of creditors. Closely held corporations have very few disclosure requirements.

6.2 Capital Regulation

6.2.1 Financial Statements

- Stockholders equity is the difference (plug value) between the assets and liabilities of the corporation. This is the amount of equity or ownership stake that shareholders have in the business, although this obviously does not determine the market value of equity.
- Stockholders equity divided into: stated (or legal) capital, capital surplus, and accumulated retained earnings (or earned surplus). Stated capital is amount shareholders transferred to the corp. at the time of original sale of stock (usually par value x number of outstanding shares). If no par, certain % must be set aside as stated capital. If stock sold for more than par value, excess goes to capital surplus. Retained earnings are profits not distributed to shareholders.

6.2.2 Distribution Constraints

- Distribution of corporate capital (dividends) is often restricted
  - NY: dividends cannot make a corporation insolvent (unable to pay its immediate obligations as they become due) and cannot be paid out of stated capital (only surplus)
  - DGCL §170: Nimble dividend test
    - Dividends can be paid out of capital surplus (like NY), or if no capital surplus, out of net profits in the current or preceding fiscal year.
  - CA: dividends can be paid either out of retained earnings or assets, but assets must be 1.25 times greater than liabilities and current assets must equal current liabilities.
  - RMBCA: dividends can't be paid if: a) it prevents payment of debts as they become due or b) assets are less than liabilities plus preferential claims of preferred shareholders.

6.2.3 Minimum Capital and Capital Maintenance Requirements

Statutory minimum capital requirements are either truly minimal ($1000) or entirely non-existent. Neither DGCL nor RMBCA requires a minimum capital amount as condition of incorporation. Further, even if companies cannot dip into minimum capital to pay shareholders, normal competitive business activity can easily dissipate a company's capital, leaving nothing for creditors.

6.3 Standard-Based Duties

6.3.1 Director Liability

- Where a firm is insolvent (but no one has yet invoked federal bankruptcy protections), Del. Ch. Ct. has suggested that directors owe a duty to consider the interests of corporate creditors.
- When a corporation is in the "vicinity of insolvency," its directors should not consider shareholders' welfare alone but should consider the welfare of the community of interests that constitute the corporation. Credit Lyonnais Bank Nederland v. Pathe Comm. Corp.

6.3.2 Creditor Liability: Fraudulent Transfers

- Fraudulent conveyance law imposes an effective obligation on parties contracting with an insolvent (or soon to be insolvent) debtor to give fair value for the cash or benefits they receive, or risk being forced to return those benefits to the debtor's estate. This provides a means to void any transfer made for the purpose of delaying, hindering, or defrauding creditors. Creditors can void transfers under either the UFTA or UFCA by establishing that they were either actual or constructive frauds.

> Uniform Fraudulent Transfer Act (UFTA) §4. Transfers Fraudulent as to Present & Future Creditors
> (a) A transfer made … by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made … if the debtor made the transfer…
> (1) with the actual intent to hinder, delay, or defraud any creditor
> (2) without receiving reasonably equivalent value in exchange for the transfer … and the debtor:
> (i) was engaged … in a business … for which the remaining assets … were unreasonably small… or
> (ii) intended … believed or reasonably should have believed [insolvency would result].

6.3.3 Shareholder Liability

Shareholders may either find themselves liable to corporate creditors, or have any "loans" they have made subordinated to other creditors under equitable subordinate or corporate veil piercing.

6.3.3.1 Equitable Subordination

- Equitable subordination is a means of protecting unaffiliated creditors by giving them rights to corporate assets superior to those of other creditors who happen to be significant shareholders. Doctrine invoked when compelled by considerations of equity.
- First requirement is that creditor be an equity holder and typically an officer of the company. Secondly, this insider-creditor must have behaved unfairly or wrongly in some way towards the corporation and its outside creditors.

Costello v. Fazio, 256 F.2d 903 (9th Cir. 1958)

- Directors and officers stripped the business of 88 percent of its stated capital at a time when it had a minus working capital and had suffered substantial business losses. Such actions were done for personal gain, under circumstances where corporation and its creditors would be endangered. Taking advantage of their fiduciary positions, they sought to gain equality of treatment with general creditors.
- Where a claim is found to be inequitable, it may be set aside or subordinated to the claims of other creditors. The question to be determined when the plan or transaction that gives rise to a claim is challenged as inequitable is whether, within the bounds of reason and fairness, such a plan can be justified. Where claims are filed by persons standing in a fiduciary relationship to the corporation, another test that equity will apply is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain.
- A bankruptcy court may subordinate a claim of one creditor to those of others in order to prevent the consummation of a course of conduct by the claimant, which, as to them, would be fraudulent or otherwise inequitable.

6.3.3.2 Piercing the Corporate Veil

- The courts can pierce the corporate veil and hold shareholders liable directly on contract or tort obligations. Factors that may play a role in veil-piercing decisions: a disregard for corporate formalities, thin capitalization, small number of shareholders, and active involvement by shareholders in management.
- **Tests go under various names:**
  - **Van Dorn test (7th Circuit – applied in Sea Land):** (1) such unity of interest and ownership that the separate personalities of the corporation and the individual [or other corporation] no longer exist; and (2) circumstances must be such that adherence to the fiction of separate corporate existence would <u>sanction a fraud or promote injustice</u>.
  - **Laya test (applied in Kinney Shoe):** (1) unity of interest and ownership such that the separate personalities of the corporation and the individual shareholder no longer exist; and (2) <u>an inequitable result would occur</u> if the acts were treated as those of the corporation alone. BUT: if both prongs satisfied, there is still a potential "third prong" -- D might still prevail by showing P assumed the risk.
- Generally consist of **two components:**
  - **Evidence of "lack of separateness,"** e.g., shareholder domination, thin capitalization, absence of corporate formalities/co-mingling of assets
  - **Unfair or inequitable conduct** – this is the wildcard in veil-piercing cases.
- **Probably no piercing:** against public corporation; against passive shareholders or minority shareholders; if all formalities are observed and nothing "funny" with the accounts.
- **Undercapitalization** alone is not enough to PCV, but egregious undercap makes PCV much more likely.

Sea-Land Services, Inc. v. Pepper Source, 941 F.2d 519 (7th Cir. 1991)

- A corporate entity will be disregarded and the veil of limited liability pierced when two requirements are met: First, there must be such unity of interest and ownership that the separate personalities of the corporation and the individual or other corporation no longer exist; and second, circumstances must be such that adherence to the fiction of separate corporate existence would sanction a fraud or promote injustice.

- As for determining whether a corporation is so controlled by another to justify disregarding their separate identities, the Illinois cases focus on four factors: (1) the failure to maintain adequate corporate records or to comply with corporate formalities, (2) the commingling of funds or assets, (3) undercapitalization, and (4) one corporation treating the assets of another corporation as its own.

Kinney Shoe Corp. v. Polan, 939 F.2d 209 (4th Cir. 1991)
- A two prong test to be used in determining whether to pierce a corporate veil in a breach of contract case. First, is the unity of interest and ownership such that the separate personalities of the corporation and the individual shareholder no longer exist. Second, does an equitable result occur if the acts are treated as those of the corporation alone.
- Individuals who wish to enjoy limited personal liability for business activities under a corporate umbrella should be expected to adhere to the relatively simple formalities of creating and maintaining a corporate entity. This is a relatively small price to pay for limited liability.
- Grossly inadequate capitalization combined with disregard of corporate formalities, causing basic unfairness, are sufficient to pierce the corporate veil.
- A third prong (of Laya test) may apply in certain cases. When, it would be reasonable for a party entering into a contract with the corporation to conduct an investigation of the credit of the corporation prior to entering into the contract, such party will be charged with the knowledge that a reasonable credit investigation would disclose. If such an investigation would disclose that the corporation is grossly undercapitalized, such party will be deemed to have assumed the risk of the gross undercapitalization and will not be permitted to pierce the corporate veil. This third prong is *permissive* and *not mandatory*.

6.4 Veil Piercing on Behalf of Involuntary Creditors

Walkovszky v. Carlton, 223 N.E.2d 6 (N.Y. 1966)
- Whenever anyone uses control of the corporation to further his own rather than the corporation's business, he will be liable for the corporation's acts upon the principle of respondeat superior applicable even where the agent is a natural person. Such liability, moreover, extends not only to the corporation's commercial dealings, but to its negligent acts as well.
- If the corporation is a "dummy" for its individual stockholders who are in reality carrying on the business in their personal capacities for purely personal rather than corporate ends, the stockholders would be personally liable.
- The corporate form may not be disregarded merely because the assets of the corporation, together with the mandatory insurance coverage of the vehicle which struck the plaintiff, are insufficient to assure him the recovery sought.

6.5 Can Limited Liability in Tort be Justified?

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7. NORMAL GOVERNANCE: THE VOTING SYSTEM

- **Cumulative Voting:** Each shareholder gets votes equal to number of shares owned times number of seats to be filled. **Example:** ACME has 3 shares outstanding; I own 2 shares and you own 1 share. Three ACME directors are up for re-election. **Straight Voting:** I would win each seat 2 to 1. **Cumulative Voting:** You cast 3 shares all for one candidate => guaranteed to get one seat on the board, because my 6 votes cannot be divided three ways so that all three are greater than 3.
- **Implication:** Cumulative voting system improves likelihood of minority representation on the board, but also hinders takeovers.

7.1 The Role and Limits of Shareholder Voting

- **Shareholders vote on three kinds of matters:** (1) election of directors; (2) “organic” or “fundamental” changes, e.g., mergers, sales of all assets, corporate dissolutions, charter amendments; and (3) shareholder resolutions.
- **Proxy system:** if you can’t attend the annual shareholder meeting (ASM), you can still vote by finding a representative (proxy) who goes to the meeting and votes on your behalf.
- **Registered shares:** each share has a holder of record, which facilitates getting in touch with the ultimate beneficial holder.
- **State law mandatory rules:** every corporation must have a board and at least one class of voting stock and must have an annual election of directors.

7.2 Electing and Removing Directors

7.2.1 Electing Directors

- Must have a board of directors, even if board only has one member. DGCL §141(a).
- Must have at least one class of stock; in absence of customization, one stock-one vote. DGCL §212(a).
- Must have annual election of directors. DGCL §211.
- Delaware allows for staggered board of one-third classes. DGCL §141(d).
- Flexible framework for holding the annual meeting of shareholders. Charter or bylaws establish the following within range of alternatives permitted by statute: a corporation's actual notice period (10-60 days per DGCL §222(b)), quorum requirement (DGCL §216), and record date (at which shareholders entitled to vote at the meeting per DGCL §211(c)).

7.2.2 Removing Directors

DGCL §141(k) – Shareholder removal of a board
Any director or the entire board can be removed with or without cause by the majority of shareholders entitle to vote at an election of directors, except:
(i) Unless stated otherwise, classified board can only be removed for cause.
(ii) If corporation has cumulative voting, no director can be removed without cause if the votes cast against his removal would be sufficient to elect him.

Hilton Hotels Corp. v. ITT Corp., 978 F. Supp. 1342 (D. Nev. 1997)
- While a corporate board has several powers in undertaking defensive measures to resist a hostile takeover, nothing authorizes the incumbent board of a corporation to entrench itself by effectively removing the right of the corporation's shareholders to vote on who may serve on the board of the corporation in which they own a share.
- The Unocal test requires the court to consider the following two questions: 1) Does the board have reasonable grounds for believing a danger to corporate policy and effectiveness exists? 2) Is the response reasonable in relation to the threat? If it is a defensive measure touching on issues of control, the court must examine whether the board purposefully disenfranchised its shareholders, an action that cannot be sustained without a compelling justification.
- Even if an action is normally permissible, and the board adopts it in good faith and with proper care, a board cannot undertake such action if the primary purpose is to disenfranchise the shareholders in light of a proxy contest.

7.3 Shareholder Meetings and Alternatives

- ***Special meetings***: Meetings other than annual ones called for special purposes (only way to vote on fundamental transactions, amend bylaws, remove directors etc.) Special meetings may be called by the board or such persons designated in charter or bylaws. DGCL §211(d).
- ***Shareholder Consent Solicitations***: alternative to special meeting that permits shareholders to act in lieu of a meeting by filing written consents. Any action that may be taken at a meeting may also be taken by written concurrence of the holders of the number of voting shares required to approve action at a meeting attended by all shareholders. DGCL §228.

7.4 Proxy Voting and its Costs

Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291 (N.Y. 1955)
- Since appellees corporation acted in good faith in a contest over policy, they had the right to incur reasonable and proper expenses for the solicitation of proxies and in defense of their corporate policies, and were not obliged to sit idly by. Stockholders had the right to reimburse successful contestants for reasonable and bona fide expenses incurred by them in any such policy contest, subject to court scrutiny.
- Management may look to the corporate treasury for the reasonable expenses of soliciting proxies to defend its position in a bona fide policy contest.

7.5 Class Voting

DGCL §242(b)(2). Class Voting
The holders of the outstanding shares of a class shall be entitled to vote as a class upon a proposed amendment, whether or not entitled to vote thereon by the certificate of incorporation, if the amendment would increase or decrease the aggregate number of authorized shares of such class, or alter the powers, preferences, or special rights of the shares of such class so as to affect them adversely.

- RMBCA §10.04 requires vote whenever a change is made. DE only deals with adverse changes.

7.6 Shareholder Information Rights

- Delaware requires companies honor shareholder requests for stock lists and books and records.
- The stock list discloses the identity, ownership interest and address of each registered owner of company stock.
- Requests for books and records are reviewed with care.

General Time Corp. v. Talley Industries, Inc., 240 A.2d 755 (Del. 1968)
– *DGCL §220(b)* provides that a stockholder shall have the right to a list of stockholders for any proper purpose which is defined as a purpose reasonably related to his interest as a stockholder. *DGCL §220(c)* prescribes that the burden of proof shall be upon the corporation to establish that the stockholder desires the list for an improper purpose.
– The desire to solicit proxies for a slate of directors in opposition to management is a purpose reasonably related to the stockholder's interest as a stockholder. Such a purpose is directly related to stockholder status and, as such, proper. Once the status of a stockholder is established under *DGCL §220*, he is entitled to the list of stockholders if his primary purpose is reasonably related to that status.

7.7 Techniques from Separating Control From Cash Flow Rights

7.7.1 Circular Control Structures

➢ The law prohibits management from voting stock owned by the corporation. Stock held by a corporation/subsidiary may sometimes belong to the issuer and thus be prohibited from voting.

DGCL §160(c): "Shares of its own capital stock belonging to the corporation or to another corporation (if a majority of the shares entitled to vote in the election of directors of such other corporation is held, directly or indirectly, by the corporation) shall neither be entitled to vote nor be counted for quorum purposes."

Speiser v. Baker, 525 A.2d 1001 (Del. Ch. 1987)
– Shareholder invested the capital of another corporation into the corporation for the specific purpose of controlling the other corporation. This action was contrary to *DGCL §160*. Also, the shareholder exercised his power as a director solely for his personal benefit and not for the benefit of the corporation.
– It is not to be tolerated that a company should procure stock in any shape which its officers may wield to the purposes of an election; thus securing themselves against the possibility of removal.

7.7.2 Vote Buying

➢ Shareholders cannot sell their right to vote, other than via a transfer of shares. If sell stock after a record date, generally must give transferee a proxy to vote the stock.

Schreiber v. Carney, 447 A.2d 17 (Del. Ch. 1982)
➢ Voting agreements in whatever form, should not be considered to be illegal per se unless the object or purpose is to defraud or in some way disenfranchise the other stockholders. This is not to say, however, that vote buying accomplished for some laudable purpose is automatically free from challenge. Because vote buying is so easily susceptible of abuse it must be viewed as a voidable transaction subject to a test for intrinsic fairness.

- Delaware permits stockholders wide latitude in decisions affecting the restriction or transfer of voting rights. A shareholder may exercise wide liberality of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profit, or determined by whims or caprice, so long as he violates no duty owed his fellow stockholders.

7.7.3 Controlling Minority Structures

- **Pyramiding**: Controller owns 50.1% of A, which owns 50.1% of B, which owns 50.1% of C. A controls C through the pyramid, the voting flows downwards. A only has 12.5% stake in cash flows. US tax law makes it undesirable: every cash flow between corporations is taxed at corporate level.
- **Cross ownership**
- **Dual class equity structure**: High vote and low vote stock

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7.8 The Collective Action Problem

Public shareholders often approved devices that entrenched minority shareholders. Even a one-share, one-vote rule cannot protect shareholders who habitually approve management proposals.

7.9 The Federal Proxy Rules

- **Securities Act of 1933 ("33 Act"):** deals with disclosure procedures that companies must follow when selling securities on the public markets.
- **Securities Exchange Act of 1934 ("34 Act"):** establishes (among other things) disclosure requirements for corporations after they have gone public. All public companies are subject to proxy regulation under § 14(a) of the Act.
- **Regulation 14A (Rules 14a-1 through 14a-12):** substantive regulation of the process of soliciting proxies and communication among shareholders.
- **Schedule 14A:** what you need to disclose in a "full dress" registration statement.

Functional Elements of Proxy Rules

1. Disclosure requirements
2. Regulation of proxy solicitation and shareholder communication
3. Shareholder access to corporate proxy machinery
4. General antifraud rule

Major elements

1. Disclosure requirements
2. Proxy solicitation regulation
3. Town meeting provision
4. Antifraud provision

7.9.1 Rules 14a-1 to 14a-7: Disclosure and Shareholder Communication

- **SEC §14(a). Solicitation of proxies in violation of rules and regulations:** It shall be unlawful for any person to solicit any proxy in contravention of such rules and regulations as the Commission may prescribe
- **Rule 14a-2(b)(1):** If no attempt is made to solicit a proxy, i.e., just discussion, this rule exempts communications among shareholders from registration and disclosure requirements.
- **Rule 14a-6(g):** Even if a shareholder communication satisfies the above rule, large shareholders (>$5 million share value) may be required to file a memo with the SEC incorporating the information discussed.

7.9.2 Rule 14a-8: Shareholder Proposals

- **Rule 14a-8:** When a company must include a shareholder's proposal in its proxy statement. . . . Under a few specific circumstances, the company is permitted to exclude your proposal, but only after submitting its reasons to the Commission . . ."
- **Rule 14a-8 requirements:** Must hold $2,000 or 1% of the corporation's stock for a year ((b)(1)); must file with management 120 days before management plans to release its proxy statement ((e)(2)); proposal may not exceed 500 words (d); and proposal must not run afoul of subject matter restrictions . . .
- **Thirteen grounds for excluding proposals from the company's solicitation materials (14a-8(i)):** e.g., improper under state law ((i)(1)), relates to a matter of ordinary business ((i)(7)), relates to a matter < 5% of business ((i)(5)), relates to election of directors ((i)(8)), conflicts with company's proposal ((i)(9)). Burden is on the company to demonstrate grounds for exclusion (g).
- **Proposed Rule 14a-11**: Would permit 5% shareholder(s) to nominate a director or directors and require management to include nominee(s) in company proxy materials if triggering event occurs:
  - "Withhold" vote of 35% or more for a director nominee during the prior year.
  - Passage of a shareholder resolution in the prior year, proposed by a 1% shareholder, asking that the shareholder proxy access machinery be implemented.

7.9.3 Rule 14a-9: The Antifraud Rule

- **Rule 14a-9:** *prohibits* proxies which contain any statement which, at the time and in light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading."
  - For long time, only enforced by SEC
  - In 1964 implied private right of action was found. Misrepresentation Actionable If:
    - Materiality: Likely to be considered important by a reasonable shareholder in deciding how to vote.
    - Culpability: Negligence or recklessness, depending on the circuit.
    - Damages: In an action for monetary relief.
    - Causation: Need not show actual reliance, only that proxy solicitation was an essential link in transaction. (*Mills v. Electric Auto-Lite Co.*)

Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083 (1991)

- Corporate directors' knowingly false statements of reasons, opinions, or beliefs may be actionable under Rule 14a-9 as misstatements of material fact; but (2) causation of damages compensable through a private action under 14(a) cannot be demonstrated by a member of a class of minority shareholders whose votes are not required by law or corporate bylaw to authorize the transaction giving rise to the 14(a) claim. Here, there was a freeze-out merger, and the dissenting shareholder had appealed.

7.10 State Disclosure Law: Fiduciary Duty of Candor

Whenever directors communicate publicly or directly with shareholders about a corporation's affairs, with or without request for shareholder actions, directors have a fiduciary duty to exercise care, good faith, and loyalty.

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8. NATURAL GOVERNANCE: THE DUTY OF CARE

8.1 Introduction to the Duty of Care

Duty of Care: ALI §4.01 (a)

A director or officer has a duty to the corporation to perform the director's or officer's functions:

(1) in good faith,

(2) in a manner that he or she reasonably believes to be in the best interests of the corporation, and

(3) with **the care that an ordinarily prudent person would reasonably be expected to exercise** in a like position and under similar circumstances.

8.2 The Duty of Care and the Need to Mitigate Director Risk Aversion

- Duty of care is litigated much less than the duty of loyalty, primarily because the law insulates officers and directors from liability based on negligence (as opposed to knowing misconduct) in order to avoid inducing risk-averse management of the firm.

Gagliardi v. Trifoods Int'l, 683 A.2d 1049 (Del. Ch. 1996)

- The business outcome of an investment project that is unaffected by director self-interest or bad faith cannot itself be an occasion for director liability. A bad faith transaction is one that is authorized for some purpose other than a genuine attempt to advance corporate welfare or is known to constitute a violation of applicable positive law. There can be no personal liability of a director for losses arising from illegal transactions if a director is financially disinterested, acted in good faith, and relied on advice of counsel reasonably selected in authorizing a transaction.
- The so-called business judgment rule in effect provides that where a director is independent and disinterested, there can be no liability for corporate loss, unless the facts are such that no person could possibly authorize such a transaction if he or she were attempting in good faith to meet their duty.

8.3 Statutory Techniques for Limiting Director and Officer Risk Exposure

Law protects officers and directors from breach of the duty of care in three ways:

1. Corporations authorized to indemnify expenses arising from litigation
2. Corporations authorized to purchase liability insurance
3. Corporations authorized to waive director (and sometimes officer) liability for acts of negligence or gross negligence DGCL §102(b)(7).

8.3.1 Indemnification

- DGCL §145: requires corporations to indemnify officers and directors (even employee/officer at times) for expenses (attorney fees, settlement amounts, and sometimes, even judgments) incurred when sued by reason of their corporate activities.
- Limit: The losses under §145 must result in actions take in good faith on behalf of the corporation and cannot arise from a criminal conviction

Waltuch v. Conticommodity Services, Inc., 88 F.3d 87 (2d Cir. 1996)

- Indemnification rights granted by a corporation may be broader than those set out in *DGCL §145(a)*, but they cannot be inconsistent with the scope of the corporation's power to indemnify, as delineated in the statute's substantive provisions.
- *DGCL §145(a)* permits the corporation to grant additional rights: the rights provided in the rest of §145 "shall not be deemed exclusive of any other rights to which those seeking indemnification may be entitled." They are permissive in the sense that a corporation may exercise less than its full power to grant the indemnification rights set out in these provisions.
- *DGCL §145(a)* explicitly allows a corporation to circumvent the "good faith" clause of § 145(a) by purchasing a directors and officers liability insurance policy.

8.3.2 Directors and Officers Insurance

DGCL §145(f) allows corporations to pay the premiums on directors and officers liability insurance. Delaware law is pushing towards insurance, §145(g), even for bad faith and lack of success.

8.4 Judicial Protection: The Business Judgment Rule

ALI §4.01(c). The Business Judgment Rule

A director or officer who makes a business judgment in good faith fulfills the duty under this section if the director or officer:
(1) is **not interested** in the subject of the business judgment;
(2) is **informed** with respect to the subject of the business judgment to the extent that the director or officer reasonably believes is appropriate under the circumstances; and
(3) **rationally believes that the business judgment is in the best interests of the corporation**.

Kamin v. American Express Co., 54 A.2d 654 (N.Y. Misc. 1976)

- Courts will not interfere unless the powers of the management have been illegally or unconscientiously executed, or unless it be made to appear that the acts were fraudulent or collusive and destructive of the rights of the stockholders. Mere errors of judgment are not sufficient as grounds for equity interference; the powers of those entrusted with corporate management are largely discretionary.
- Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.

8.4.1 Understanding the Business Judgment Rule

Business judgment rule protects **disinterested directors** who were **duly informed** and acted in **good faith**, no matter how stupid their decisions may seem ex post. The party attacking a board decision must rebut the presumption that its business judgment was an informed one.

8.4.2 Duty of Care in Takeover Cases: Note on Smith v. Van Gorkom

- Under the business judgment rule there is no protection for directors who have made an unintelligent or unadvised judgment. Under the business judgment rule director liability is predicated upon concepts of gross negligence. The concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.
- Van Gorkom came up with $55/share price for Trans Union to sell to Pritzker without proper research or reasoning. Board accepted price without making an informed decision, and Pritzker was given an agreement with lockup. A premium in price was not enough to determine fairness of price, because board did not inform itself it could not rely on protections of BJR. Though DCGL §141(e) protects the board for good faith belief in statements of officers, this was not an opinion that could shield liability.

8.4.3 Additional Statutory Protection: Authorization for Charter Provisions Waiving Liability for Due Care Violations

Director's insurance skyrocketed in cost after *Smith v. Van Gorkom*. Because of Smith v. Van Gorkom DGCL §102(b)(7) was enacted that prevented director's from liability for losses caused by transactions in which the director had no conflicting financial interest or otherwise was alleged to violate a duty of loyalty.

Director Immunity for Breach of Duty of Care (DGCL § 102(b)(7))

Certificate of incorporation may also contain… a provision eliminating … the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty [except] (i) for any breach of the director's duty of loyalty [or] (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law….

McMillan v. Intercargo Corp., 768 A.2d 492 (Del. Ch. 2000)

- Directors of Intercargo were sued for not getting highest possible value for sale of Intercargo to XL and failed to disclose information to the shareholders. Charter immunizes directors under DGCL §102(b)(7), so P must plead breach of the duty of loyalty, bad faith, or intentional misconduct. Since there was no pleading of bad faith the claim was dismissed.
- A court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise. Courts will determine whether the directors' decision was, on balance, within a range of reasonableness.

8.5 The Technicolor Case and Delaware's Unique Approach to Adjudicating Due Care Claims Against Corporate Directors

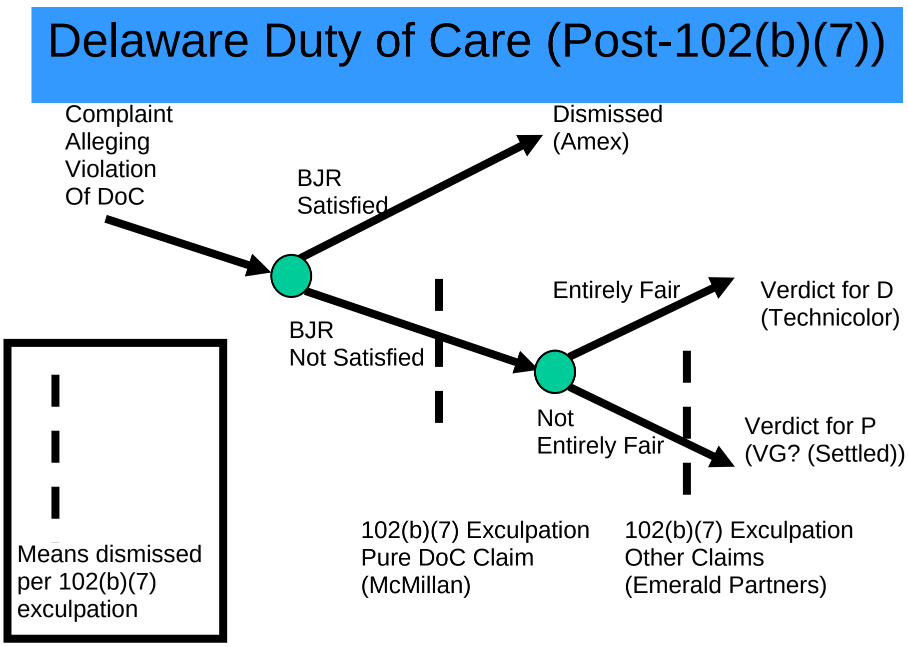
Cinerama, Inc. v. Technicolor, Inc. (CEDE III), 663 A.2d 1156 (Del. 1995)

"[B]reach of the duty of care, without any requirement of proof of injury, is sufficient to rebut the business judgment rule. . . . A breach of either the duty of loyalty or the duty of care rebuts the presumption that directors have acted in the best interests of the shareholders, and requires the directors to prove that the transaction was entirely fair."

– If plaintiff established board negligence, he does not need to prove causation or damages, the directors must prove due care or fairness.

[Emerald Partners v. Berlin, 787 A.2d 85 (Del. 2001)]

– If a shareholder complaint unambiguously asserts only a due care claim, the complaint is dismissible once the corporation's § 102(b)(7) provision is properly invoked.
– To rebut the presumptive applicability of the business judgment rule, a shareholder plaintiff has the burden of proving that the board of directors, in reaching its challenged decision, violated any one of its triad of fiduciary duties: due care, loyalty, or good faith. If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule operates to provide substantive protection for the directors and for the decisions that they have made. If the presumption of the business judgment rule is rebutted, however, the burden shifts to the director defendants to prove to the trier of fact that the challenged transaction was entirely fair to the shareholder plaintiff.
– Two scenarios can provide the basis for shifting the burden to the plaintiff to demonstrate that the transaction complained of was not entirely fair. First, an approval of the transaction by an independent committee of directors who have real bargaining power that can be exerted in dealings with a majority shareholder who does not dictate the terms of the merger may supply the necessary basis for shifting the burden. Second, the approval of the transaction by a fully informed vote of a majority of the minority shareholders will shift the burden.



8.6 The Board's Duty to Monitor: Losses "Caused" by Board Passivity

In order to show that the corporation's directors breached their duty of care by failing adequately to control its employees, plaintiffs have to show either (1) that the directors knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the losses complained of, although this last element may be thought to constitute an affirmative defense.

[Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981)]

– Directors are under a continuing obligation to keep informed about the activities of the corporation. Directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look. Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies.
– Upon discovery of an illegal course of action, a director has a duty to object and, if the corporation does not correct the conduct, to resign. A director may have a duty to take reasonable means to prevent illegal conduct by co-directors; in an appropriate case, this may include threat of suit.
– A corporate director's negligence does not result in liability unless it is a proximate cause of the loss. Thus, the plaintiff must establish not only a breach of duty, but in addition, that the performance by the director of his duty would have avoided loss, and the amount of the resulting loss.

– A director who is present at a board meeting is presumed to concur in corporate action taken at the meeting unless his dissent is entered in the minutes of the meeting or filed promptly after adjournment.

Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963)

– Corporate directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. If such occurs and goes unheeded, then liability of the directors might well follow, but absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.
– The question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances. If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him.

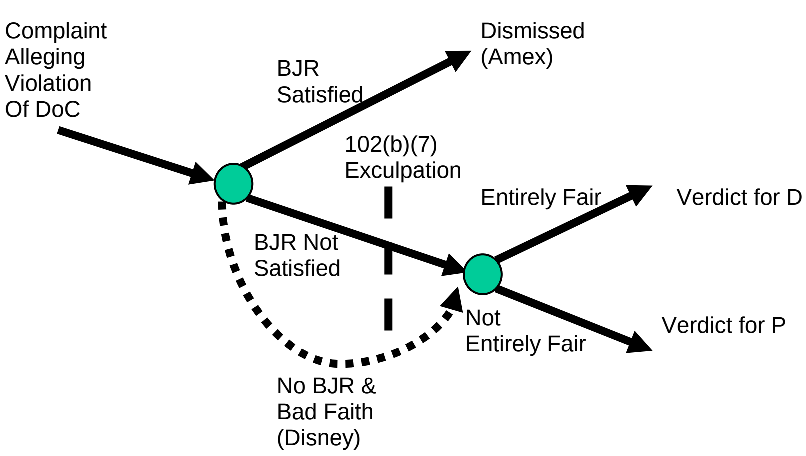
In re Caremark International, Inc. Derivative Litigation 698 A.2d 959 (Del. Ch. 1996)

– A director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.
– Where a director in fact exercises a good faith effort to be informed and to exercise appropriate judgment, he or she should be deemed to satisfy fully the duty of attention. If the shareholders thought themselves entitled to some other quality of judgment than such a director produces in the good faith exercise of the powers of office, then the shareholders should have elected other directors.

In re Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003)

– Acts or omissions not undertaken honestly and in good faith, or which involve intentional misconduct, do not fall within the protective ambit of § 102(b)(7). Where a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director's actions are either not in good faith or involve intentional misconduct.
– Knowing or deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct that may not be taken honestly and in good faith to advance the best interests of the company. Put differently, if all of the alleged facts, if true, imply that defendant directors know that they are making material decisions without adequate information and without adequate deliberation, and that they simply do not care if the decisions cause the corporation and its stockholders to suffer injury or loss, viewed in this light, the defendant directors' conduct falls outside the protection of the business judgment rule. Of course, the alleged facts need only give rise to a reason to doubt business judgment protection, not a judicial finding that the directors' actions are not protected by the business judgment rule.
– Directorial self-compensation decisions lie outside the business judgment rule's presumptive protection, so that, where properly challenged, the receipt of self-determined benefits is subject to an affirmative showing that the compensation arrangements are fair to the corporation.

Delaware Duty of Care Post-Disney



8.7 "Knowing" Violations of Law

Miller v. A.T.&T., 507 F.2d 759 (3d Cir. 1974)
- Even though committed to benefit the corporation, illegal acts may amount to a breach of fiduciary duty.
- Directors must be restrained from engaging in activities which are against public policy. For reasons of public policy, payments of corporate funds for certain purposes must be condemned. Officers of a corporation making payments must be held strictly accountable, and be compelled to refund the amounts so wasted for the benefit of stockholders.
- Depending on the circumstances, proof of the allegations in a complaint might sustain recovery, under the rule that directors are liable for corporate loss caused by the commission of an "unlawful or immoral act."

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9. CONFLICT TRANSACTIONS: THE DUTY OF LOYALTY

- Ordinary Business Decisions – Duty of Care
- Conflicted Transactions – Duty of Loyalty
  - Self dealing (Director or Controlling Shareholder on Both Sides of the Transaction)
  - Taking Corporate Opportunities

The duty of loyalty requires a **corporate director, officer, or controlling shareholder** to exercise her institutional power over corporate property (including information) in a **good faith effort to advance the interests of the company**. The duty of loyalty requires that such a person who transacts with the company **fully disclose all material facts to the corporation's disinterested representatives** and to **deal with the company on terms that are intrinsically fair** in all respects. Thus, officers, directors, and controlling shareholders may not deal with the corporation in any way that benefits themselves at the expense of the corporation.

9.1 Duty to Whom?

9.1.1 The Shareholder Primacy Norm

Directors owe their loyalty to the corporation as a legal entity. Director loyalty to corporation is ultimately loyalty to equity investors. But what if a corporation is insolvent?

A. P. Smith Mfg. Co. v. Barlow, 98 A.2d 581 (N.J. 1953)
- Corporations are permitted to make substantial contributions which have the outward form of gifts where the activity being promoted by the so-called gift tends reasonably to promote the goodwill of the business of the contributing corporation. Trial courts recognize in such cases that although there is no dollar and cent supporting consideration, yet there is often substantial indirect benefit accruing to the corporation which supports such action. So-called contributions by corporations to churches, schools, hospitals, and civic improvement funds, and the establishment of bonus and pension plans with the payment of large sums flowing therefrom have been upheld many times as reasonable business expenditures rather than being classified as charitable gifts.

9.1.2 Constituency Statutes

Statues that state that directors have the power (but not the obligation) to balance the interests of non-shareholder constituencies against the interests of shareholders in setting corporate policy. Delaware has *not* adopted a constituency statute, but has said that in creating takeover defenses, the board my consider the interests of corporate constituencies other than shareholders as long as these have some relationship to long-term shareholder value.

9.2 Self-Dealing Transactions

- Look at who the players are (ceo, director)
- Look at nature of company (public, closely-held)

Interested Directors; Quorum (DGCL 144)
(a) No contract or transaction between a corporation and one or more of its directors or officers … shall be void or voidable solely for this reason … if:
(1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or
(2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or
(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

9.2.1 Early Regulation of Fiduciary Self-Dealing

9.2.2 The Disclosure Requirement

State ex rel. Hayes Oyster Co. v. Keypoint Oyster Co., 391 P.2d 979 (Wash. 1964)
- Directors and other officers of a private corporation cannot directly or indirectly acquire a profit for themselves or acquire any other personal advantage in dealings with others on behalf of the corporation. An officer does not need to have an intent to defraud or injury to occur for fiduciary duty to be violated.
- A corporation cannot ratify the breach of fiduciary duties unless full and complete disclosure of all facts and circumstances is made by the fiduciary and an intentional relinquishment by the corporation of its rights.
- Whenever a corporation chooses to affirm a contract made by an officer in violation of his fiduciary duty, the corporation can recover whatever profits the officer acquired under the contract.
- A corporation is charged with constructive notice of facts acquired by an agent while acting within the scope of his authority; and if such facts disclose that the agent's transaction constituted a breach of trust, the corporation cannot profit from such transaction.

9.2.3 Controlling Shareholders and the Fairness Standard

Dominant value in DE is that a controlling shareholder's power over the corporation, and the resulting power to affect other shareholders, gives rise to a duty to consider their interests fairly whenever the corporation enters into a control with the controller or its affiliate.

Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971)
- The standard of intrinsic fairness involves both a high degree of fairness and a shift in the burden of proof. Under this standard, the burden is on the parent company to prove, subject to careful judicial scrutiny, that its transactions with the subsidiary were objectively fair.
- When the situation involves a parent and a subsidiary, with the parent controlling the transaction and fixing the terms, the test of intrinsic fairness, with its shifting of the burden of proof, is applied. The rule applies when the parent has received a benefit to the exclusion and at the expense of the subsidiary. A parent owes a fiduciary duty to its subsidiary when there are parent-subsidiary dealings, but this alone will not evoke the intrinsic fairness standard. This standard will be applied only when the fiduciary duty is accompanied by self-dealing, when a parent is on both sides of a transaction with its subsidiary. Self-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary.

9.3 The Effect of Approval by a Disinterested Party

9.3.1 The Safe Harbor Statutes

Cookies Food Products, Inc. v. Lakes Warehouse, 430 N.W.2d 447 (Iowa 1988)
- In duty of care challenges against a corporate director the burden of proof is on plaintiffs because of the business judgment rule which affords directors the presumption that their decisions are informed, made in good faith, and honestly believed by them to be in the best interests of the company.
- When self-dealing is demonstrated, the duty of loyalty supersedes the duty of care, and the burden shifts to the director to prove that the transaction is fair and reasonable to the corporation. There is a different burden imposed which requires the director challenged in a self-dealing suit to carry the burden of establishing his good faith, honesty, and fairness.

9.3.2 Approval by Disinterested Members of the Board

Cooke v. Oolie, 2000 LEXIS 89 (Del. Ch. 2000)

- Under *Del. Code Ann. tit. 8, § 144(a)(1)*, a court will apply the business judgment rule to the actions of an interested director, who is not the majority shareholder, if the interested director fully discloses his interest and a majority of the disinterested directors ratify the interested transaction. The disinterested directors' ratification cleanses the taint of interest because the disinterested directors have no incentive to act disloyally and should be only concerned with advancing the interests of the corporation. The court will presume, therefore, that the vote of a disinterested director signals that the interested transaction furthers the best interests of the corporation despite the interest of one or more directors.
- Delaware law generally entitles the majority shareholder to sell his controlling block of stock for a premium, which he need not share with the corporation's other shareholders. That the shareholder is also a director does not disable the director-shareholder from negotiating the most favorable terms achievable for the sale of his stock. The director-shareholder, however, may not misuse his corporate office to his own advantage and to the exclusion of the other shareholders.
- Inside information is a corporate asset; its misuse gives rise to a derivative claim, not a class claim. The assertion that directors sold their corporate offices in breach of their fiduciary duty of loyalty constitutes a derivative claim.

9.3.3 Approval by a Special Committee of Independent Directors

To be given effect under DE law, a special committee must be properly charged by the full board, comprised of independent members, and vested with the resources to accomplish its task. The mission of the committee is not only to negotiate a fair deal, but to obtain the best available deal. Even if the committee process is done well, it only shifts the burden of proving fairness from the defendants to the plaintiffs in a controlled transaction.

Parent-Subsidiary Squeeze-Out Transaction: Typical Structure

1. Parent notifies Sub of going private or minority squeeze-out proposal.
    - Parent issues press release announcing proposal
    - Proposal subject to Special Committee approval
2. Sub sets up Special Committee of independent directors
    - Special Committee hires investment banker and lawyers
    - Special Committee gets up to speed
3. Parent negotiates with Special Committee and hopefully agree (eventually) on price.

Judicial Scrutiny of Typical Structure

- If the transaction is challenged, Delaware courts apply entire fairness standard when reviewing minority-squeeze-out transactions.
- Under entire fairness review, directors have the burden of proof to show that the transaction as a whole is fair to minority shareholders.
- BUT: burden of disproving entire fairness is shifted to plaintiffs through: (1) Properly functioning special committee, e.g., special committee must be comprised solely of independent directors and have real negotiating power; and (2) approval of transaction by majority of minority shareholders, e.g., closing of merger or tender offer conditioned upon approval of a majority of the minority.

9.3.4 Shareholder Ratification of Conflict Transactions

The law must limit the power of an interested majority of shareholders to bind a minority that is disinclined to ratify a submitted transaction. Further, even a **majority vote cannot** really **protect** wildly unbalanced transactions that irrationally dissipate corporate assets… "**Waste doctrine**"

Lewis v. Vogelstein, 699 A.2d 327 (Del. Ch. 1997)

- In all events, informed, uncoerced, disinterested shareholder ratification of a transaction in which corporate directors have a material conflict of interest has the effect of protecting the transaction from judicial review except on the basis of waste.
- In addition to a claim that ratification is defective because of incomplete information or coercion, shareholder ratification is subject to a claim by a member of the class that the ratification is ineffectual (1) because a majority of those affirming the transaction has a conflicting interest with respect to it or (2) because the transaction that is ratified constitutes a corporate waste. As to the second of these, shareholders may not ratify a waste except by a unanimous vote.

- A corporate waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade. Such a transfer is in effect a gift. If, however, there is any substantial consideration received by the corporation, and if there is a good faith judgment that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude a post that the transaction is unreasonably risky.
- In order for stock option grants to be valid a two-part test has to be satisfied. First it is necessary that the court conclude that the grant contemplates that the corporation receive sufficient consideration. Secondly, the plan or the circumstances of the grant must include conditions or the existence of circumstances which may be expected to insure that the contemplated consideration in fact pass to the corporation.

In re Wheelabrator Technologies, Inc., 663 A.2d 1194 (Del. Ch. 1995)

- In a parent-subsidiary merger, the standard of review is ordinarily entire fairness, with the directors having the burden of proving that the merger is entirely fair. However, where the merger is conditioned upon approval by a majority of the minority stockholder vote, and such approval is granted, the standard of review remains entire fairness, but the burden of demonstrating that the merger is unfair shifts to the plaintiff. That burden-shifting effect of ratification is held applicable in cases involving mergers with a de facto controlling stockholder, and in a case involving a transaction other than a merger.
- In only two circumstances does the Delaware Supreme Court hold that a fully-informed shareholder vote operates to extinguish a claim: (1) where the board of directors takes action that, although not alleged to constitute ultra vires, fraud, or waste, is claimed to exceed the board's authority; and (2) where it is claimed that the directors fail to exercise due care to adequately inform themselves before committing the corporation to a transaction. In no case does the Supreme Court hold that stockholder ratification automatically extinguishes a claim for breach of the directors' duty of loyalty. Rather, *the operative effect of shareholder ratification in duty of loyalty cases is either to change the standard of review to the business judgment rule, with the burden of proof resting upon the plaintiff, or to leave entire fairness as the review standard, but shift the burden of proof to the plaintiff.*

(Burden of Proof)	**Interested Director**	**Interested Controller**
1. Disclosed and disinterested directors authorize	**BJR (P)**: Cooke	**Entire Fairness (?)**: Cookies (Iowa)(D) Kahn v. Lynch (Del.)(P)
2. Disclosed and shareholders ratify	**Waste (P)**: Lewis/Wheelabrator	**Entire Fairness (P)**: Wheelabrator (dicta)
Neither 1 nor 2	**Entire Fairness (D)**: Hayes Oyster (Wash.)	**Entire Fairness (D)**: Sinclair (dicta)

9.4 Director and Management Compensation

9.4.1 Perceived Excessive Compensation

9.4.2 Option Grants and the Law of Director and Officer Compensation

Lewis v. Vogelstein, 699 A.2d 327 (Del. Ch. 1997)

In early DE law a two part test had to be satisfied for stock option grants to be valid: (1) the corporation had to receive sufficient consideration; and (2) the expected consideration must in fact pass to the corporation. Court was suspicious about these being one time options; sounds like a one time windfall; however, they're still options, not like giving stock.

9.4.3 Corporate Governance and SEC Regulatory Responses

9.5 Corporate Opportunity Doctrine

9.5.1 Determining Which Opportunities "Belong" to the Corporation

- Three lines of corporate opportunity doctrine
  1. **expectancy or interest test**: expectancy of interest must grow out of an existing legal interest (narrowest protection for the corporation)

2. **line of business test**: anything that a corporation could be reasonable expected to do is a corporate opportunity
3. **fairness test**: multiple factors such as how manager learned about it, whether he used corporate assets, good faith and loyalty, and company's line of business

9.5.2 When May a Fiduciary Take a Corporate Opportunity

Broz v. Cellular Information Systems, 673 A.2d 148 (Del. 1996)

- While presentation of a purported corporate opportunity to the board of directors and the board's refusal thereof may serve as a shield to liability, there is no per se rule requiring presentation to the board prior to acceptance of the opportunity.
- A corporate officer or director may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation.
- A director or officer may take a corporate opportunity if: (1) the opportunity is presented to the director or officer in his individual and not his corporate capacity; (2) the opportunity is not essential to the corporation; (3) the corporation holds no interest or expectancy in the opportunity; and (4) the director or officer has not wrongfully employed the resources of the corp. in pursuing or exploiting the opportunity.

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10. SHAREHOLDER LAWSUITS

10.1 Distinguishing Between Direct and Derivative Claims

- Derivative or direct.
- Conceptualize derivative suits as two suits in one:
  1. Suit vs. directors based on their failure to sue on underlying claim.
  2. Suit on underlying claim.
- Differences between derivative and direct suits:
  1. Who recovers.
  2. Procedural hurdles.

10.2 Solving a Collective Action Problem: Attorneys' Fees and the Incentive to Sue

- Dispersed public shareholders unlikely to sue.
- Solution: Plaintiff's attorney can collect 10-25% of monetary recovery and can be paid even if no monetary recovery under substantial benefit rule (e.g., Fletcher).
- But agency problems abound:
  1. Strike or nuisance suits.
  2. P's atty maximizes profits not shareholder wealth.
  3. Directors prefer settlement to trial; prefer dismissal above all else.
- Derivative suit procedural hurdles are an attempt to mitigate agency problems. DEMAND RULE.

Fletcher v. A. J. Industries, Inc., 266 Cal. App. 2d 313 (Cal. Ct. App. 1968)

- Where a common fund exists to which a number of persons are entitled and in their interests successful litigation is maintained for its preservation and protection, an allowance of counsel fees may properly be made from such fund, and the common-fund doctrine is an exception to the general rule that the party in an action may not recover attorneys' fees unless a statute expressly permits such recovery.
- Under the "substantial benefit" rule, an extension of the "common fund" doctrine, the successful plaintiff in a stockholder's derivative action may be awarded attorneys' fees against the corporation if the latter received "substantial benefits from the litigation, although the benefits were not "pecuniary" and the action had not produced a fund from which they might be paid.
- In a stockholder's derivative action, to find that benefits realized by the corporation were sufficiently "substantial" to warrant an award of attorneys' fees to plaintiff stockholders, the trial court need not determine that abuses existed in the corporate management, and that the derivative action corrected

them; it will suffice if the court finds, upon proper evidence, that the result of the derivative action maintained the health of the corporation and raised the standards of fiduciary relationships and of other economic behavior, or prevented an abuse which would have been prejudicial to the rights and interests of the corporation or would have affected the enjoyment or protection of an essential right to the stockholder's interest.

10.3 Standing Requirements

10.4 Balancing the Rights of Boards to Manage the Corporation and Shareholders' Rights to Obtain Judicial Review

10.4.1 The Demand Requirement of Rule 23

Plaintiff must a) be a shareholder for the duration of the action; b) have been a shareholder at the time of the alleged wrong; c) be able to fairly and adequately represent the interests of the shareholders (no conflict of interest); d) demand requirement.

Fed. R. Civ. Proc. 23.1: Derivative Actions by Shareholders
"In a derivative action … the complaint shall allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and … the reasons for the plaintiff's failure to obtain the action or for not making the effort."

RMBCA: must make demand unless irreparable injury (§7.42), and if demand is refused shareholder may continue by alleging with particularity that board is **not** disinterested (§7.44(d)) or did not act in good faith (§7.44(a)).

Delaware: In practice, demand rarely made due to *Speigel v. Buntrock* presumption (see bottom of AK p. 367) that plaintiff that makes demand concedes that the board is disinterested.

- Assuming plaintiff pleads demand futility, court screens based on two-part *Aronson/Levine* test: P must establish either that directors are interested/dominated or must allege facts that "creat[e] a reasonable doubt of the 'soundness' of the challenged transaction sufficient to rebut [BJR]."

Levine v. Smith, 591 A.2d 194 (Del. 1991)

- Since a conscious decision by a board of directors to refrain from acting may be a valid exercise of business judgment, where demand on a board has been made and refused, courts apply the business judgment rule in reviewing the board's refusal to act pursuant to a stockholder's demand to file a lawsuit. The burden is on the party challenging the decision to establish facts rebutting this presumption.
- When a shareholder files a derivative suit asserting a claim of demand futility, hence demand excused, the basis for such a claim is that the board is (1) interested and not independent, and (2) that the transaction attacked is not protected by the business judgment rule.
- The premise of a shareholder claim of futility of demand is that a majority of the board of directors either has a financial interest in the challenged transaction or lacks independence or otherwise failed to exercise due care. On either showing, it may be inferred that the board is incapable of exercising its power and authority to pursue the derivative claims directly.

Rales v. Blasband, 634 A.2d 927 (Del. 1993)

- The essential predicate for the Aronson test is the fact that a decision of the board of directors is being challenged in the derivative suit. Where there is no conscious decision by the corporate board of directors to act or refrain from acting, the business judgment rule has no application. The absence of board action, therefore, makes it impossible to perform the essential inquiry contemplated by Aronson--whether the directors have acted in conformity with the business judgment rule in approving the challenged transaction.
- This situation would arise in three principal scenarios: (1) where a business decision was made by the board of a company, but a majority of the directors making the decision have been replaced; (2) where the subject of the derivative suit is not a business decision of the board; and (3) where the decision being challenged was made by the board of a different corporation. It is appropriate in these situations to examine whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations. If plaintiff satisfies this burden of showing board cannot, the need to show demand will be excused as futile.

10.4.2 Special Litigation Committees

- Divide between Delaware which allows court to itself judge the appropriateness of a special litigation committee's decision to dismiss a derivative suit and NY which holds that if a committee is independent and informed, its action is entitled to deference under BJR.
- Zapata: "First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusion. . . The corporation should have the burden of proving independence, good faith, and a reasonable investigation. [Second,] . . . the court should determine, applying its own independent business judgment, whether the motion should be granted."

Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981)
The court should apply a two-step test to the motion an independent committee files to dismiss a derivative suit. First, the court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. The corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness. If the court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the court shall deny the corporation's motion. If, however, the court is satisfied that the committee was independent and showed reasonable bases for good faith findings and recommendations, the court may proceed, in its discretion, to the next step. The second step provides the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee. **The court should determine, applying its own independent business judgment, whether the motion should be granted.**

Zapata (Delaware approach): "The Court of Chancery should, when appropriate, give special consideration to matters of law and public policy in addition to the corporation's best interest."
Joy v. North: "The court's function is thus not unlike a lawyer's determining what a case is 'worth' for purposes of settlement."

Joy v. North, 692 F.2d 880 (2d Cir. 1982)

- The burden is on the special litigation committee to demonstrate that the action is more likely than not to be against the interests of the corporation.
- Where the court determines that the likely recoverable damages discounted by the probability of a finding of liability are less than the costs to the corporation in continuing the action, it should dismiss the case.
- The costs which may properly be taken into account in a shareholder derivative suit, are attorney's fees and other out-of-pocket expenses related to the litigation and time spent by corporate personnel preparing for and participating in the trial. Where the court finds a likely net return to the corporation which is not substantial in relation to shareholder equity, it may take into account two other items as costs: first, it may consider the impact of distraction of key personnel by continued litigation; and second, it may take into account potential lost profits which may result from the publicity of a trial.

In re Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003)
Independence test when reviewing SLC is whether the individual SLC member was incapable of making a decision with only the best interests of the corporation in mind, or, as a corollary, without considering any way in which his decision would impact him. The ties that the SLC members and directors had to one university, as alumni, tenured faculty professors, very major contributors, and speakers were too vivid to be ignored. Thus, fails Zapata two-step.

10.5 Settlement and Indemnification

10.5.1 Settlement by Class Representatives

10.5.2 Settlement by Special Committee

Carlton Investments v. TLC Beatrice Int'l Holdings, 1997 LEXIS 86 (Del. Ch. 1997)

- Where a proposed settlement is negotiated by an special litigation committee, under Delaware law, it is to be reviewed under a two step approach. First, the court must analyze the independence and good faith of the committee and the bases supporting its conclusions. Second, the court is directed to exercise its own business judgment to determine whether the settlement should be approved, considering both the corporation's best interests and matters of law and policy.

- The court must determine whether the special litigation committee acted independently, basing its conclusions upon the merits of the issue rather than being governed by extraneous considerations or influences.

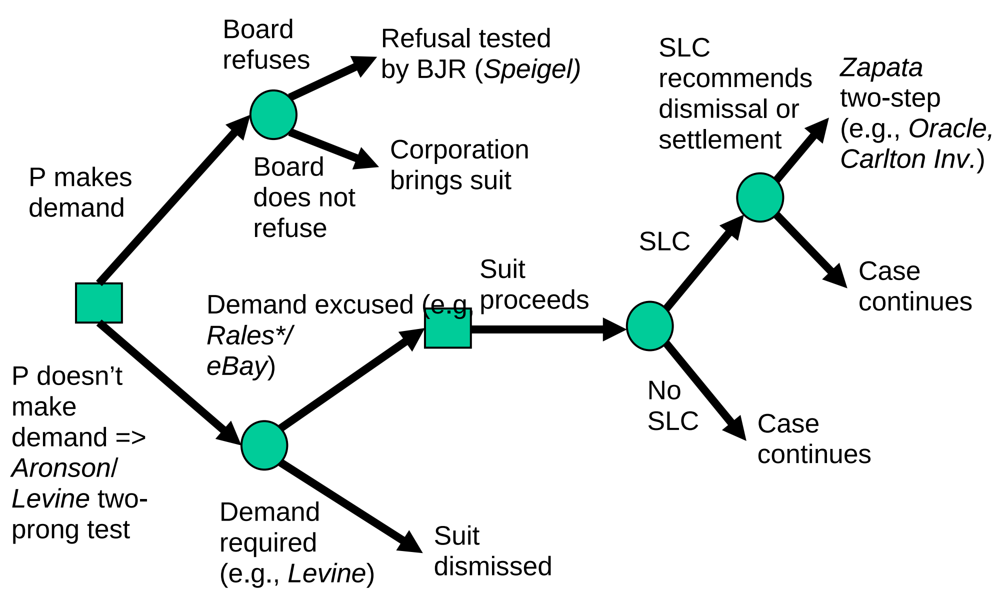
10.6 Assessing Derivative Suits

Any time there is a big drop in share price attorneys file derivative suits; the Private Securities Litigation Reform Act was passed in response. Once a securities class action is filed, PSLRA requires court to name as lead plaintiff the shareholder that the court determines best represents the plaintiff class. Rebuttable presumption that this will be the largest shareholder, though they do not have to accept. Whoever is appointed lead plaintiff selects the lead counsel for the plaintiff class. The idea is to permit the largest shareholder to take control of litigation and settlement of securities class actions and end the prior race to the courthouse by class action attorneys. PLSRA also provides safe harbor for certain forward looking statements of executives and eliminates joint and several liability among defendants.

10.6.1 When Are Derivative Suits in Shareholders' Interests?

10.6.2 Postscript on Empirical Studies

10.6.3 Delaware Derivative Suit Tree



* Single-prong test in Rales.

11. TRANSACTIONS IN CONTROL

11.1 Sales of Control Blocks: The Seller's Duties

11.1.1 The Regulation of Control Premia

Zetlin v. Hanson Holdings, Inc., 397 N.E.2d 387 (N.Y. 1979)
Recognizing that those who invest the capital necessary to acquire a dominant position in the ownership of a corporation have the right of controlling that corporation, it has long been settled law that, absent looting of corporate assets, conversion of a corporate opportunity, fraud or other acts of bad faith, a controlling stockholder is free to sell, and a purchaser is free to buy, that controlling interest at a premium price.

Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955)
- A director and dominant stockholder stand in a fiduciary relationship to the corporation and to the minority stockholders as beneficiaries. Absolute and most scrupulous good faith was the very essence of a

director's obligation to his corporation. The same rule that applies to directors applies to a majority stockholder for in that capacity he chooses and controls the directors, and thus is held to have assumed their liability.

- When the sale of a controlling block of stock necessarily results in a sacrifice of the element of corporate good will and consequent unusual profit to the fiduciary who has caused the sacrifice, he should account for his gains.
- In a time of market shortage where a call on a corporation's product commands an unusually large premium, in one form or another, a fiduciary may not appropriate to himself the value of this premium. Minority shareholders are entitled to a recovery against a self-dealing majority shareholder in their own right, instead of in right of the corporation.

11.1.2 A Defense of the Market Rule in Sales of Control

11.2 Sale of Corporate Office

How should we analyze the sale of a relatively small block of stock in a widely held firm at a premium price by CEO or directors who simultaneously promise to resign in favor of the buyer's appointees upon conclusion of the sale?

	Carter v. Muscat	Brecher v. Gregg
Size of "Control" Block	9.7%	4%
Premium Received by Seller	"slightly above market"	35%
Fate of Newcomers	Directors re-elected by shareholders	CEO fired by board
Holding	Upheld	Disgorgement of control premium

11.3 Looting

Normally a shareholder has a right to sell and has no duties when acting in good faith, however, a controlling shareholder assumes the fiduciary duty of a director and a sale of a controlling share that involves an assured change of directors warrants a fiduciary duty.

Harris v. Carter, 582 A.2d 222 (Del. Ch. 1990)

- A shareholder has a right to sell his or her stock and in the ordinary case owes no duty in that connection to other shareholders when acting in good faith.
- While a person who transfers corporate control to another is surely not a surety for his buyer, **when** the **circumstances would alert a reasonably prudent person to a risk that his buyer is dishonest** or in some material respect not truthful, **a duty devolves upon the seller to make such inquiry as a reasonably prudent person would make**, and generally to exercise care so that others who will be affected by his actions should not be injured by wrongful conduct.

11.4 Tender Offers: The Buyer's Duties

Four Elements of the Williams Act

- **Early Warning System (§13(d)):** requires disclosure whenever anyone acquires more than 5% of the stock.
  - **Basic Rule (Rule 13d-1(a)):** investor must file a 13D report within 10 days of acquiring 5%+ beneficial ownership. Partial exemptions for qualified institutional investors and passive investors.

- **Updating requirement (Rule 13d-2):** must amend 13D annually and in some cases more promptly.
- **Key Definitions:** "beneficial owner" means power to vote or dispose of stock (13d-3(a)); "group" is anyone acting together to buy, vote, or sell stock (13d-5(b)(1)). Each group member deemed to beneficially own each other member's stock.

- **General Disclosure: (§14(d)(1)):** requires tender offeror to disclose identity and future plans, including any subsequent going-private transactions.
- **Anti-Fraud Provision (§14(e)):** prohibits "any fraudulent, deceptive, or manipulative" practices in connection with a tender offer.
- **Terms of the Offer (§14(d)(4)-(7)):** governs the substantive terms of the tender offer, e.g., duration, equal treatment.
  - **14e-1:** Tender offers must be open for 20 business days
  - **14d-10:** Tender offers must be made to all holders; all purchases must be made at the best price
  - **14d-8:** Tender offers that are oversubscribed must be taken up pro rata
  - **14d-7:** Shareholders who tender can withdraw while tender offer open
  - **14e-5:** Bidder cannot buy "outside" tender offer

Brascan, Ltd. v. Edper Equities, 477 F. Supp. 773 (D.N.Y. 1979)
Edper wished to acquire Brascan, but it's friendly offer was rebuffed so it sought out large shareholders and purchased a large block of shares. This did not constitute a tender offer. The legislative history of the Williams Act distinguishes between tender offers and other large stock accumulations. Only 2 of the list below was fully met, 3 and 5 were slightly met.

Wellman v. Dickinson: Eight Factors considered in determining whether acquisitions constitute a tender offer:
1. "active and widespread solicitation"
2. "the solicitation is made for a substantial percentage of the issuer's stock"
3. "a premium over the prevailing market price"
4. "the terms of the offer are firm rather than negotiable"
5. "whether the offer is contingent on the tender of a fixed minimum number of shares"
6. "whether the offer is open only for a limited period of time"
7. "whether the offerees are subjected to pressure to sell their stock"
8. "whether public announcements of a purchasing program . . . precede or accompany a rapid accumulation"

11.5 The Hart-Scott-Rodino Act Waiting Period

Intended to give the FTC and DOJ ability to block deals that violate antitrust laws. If no antitrust violations, affects timing of transactions:

1. **Minimum waiting period before closing a transaction (§18a(b)(1)(B)):**
   - 30 days for open market transactions, mergers, and negotiated deals;
   - 15 days for cash tender offers;
   - May be extended for another 30 days (10 days for cash tender offers) if DOJ or FTC makes a Second Request (§18a(e)(2)).
2. **Who must file ((§18a(a)(2)):**
   - The acquirer in all deals > $200 million.

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12. FUNDAMENTAL TRANSACTIONS: MERGERS AND ACQUISITIONS

12.1 Introduction

12.2 Economic Motives for Mergers

12.2.1 Integration as a Source of Value

- **Efficiency Motives (increasing the size of the pie):** economies of scale/scope (e.g., manufacturing efficiencies, extending management talent to a larger asset base), vertical integration (e.g., Newport Steel), replacing bad management (reducing agency costs), diversification (?).

12.2.2 Other Sources of Value in Acquisitions: Tax, Agency Costs, and Diversification

- **Redistributive Motives:** shifting value from government (taxes), creditors (e.g., LBO's), or consumers (e..g., monopoly pricing).

12.2.3 Suspect Motives for Mergers

- **Bad Motives:** hubris, overestimation of synergies/ (underestimation of costs), empire building (all possibly driven by poor economic incentives).

12.3 The Evolution of the U.S. Corporate Law of Mergers

12.3.1 When Mergers Were Rare

12.3.2 The Modern Era

Today, Delaware and many other states allow mergers to proceed with the approval of only a bare majority of the outstanding shares of each class that is entitled to vote on them. In addition, shareholders who do not want to participate in the new (combined) entity have a statutory right to seek a judicial appraisal of the fair value of their stock as an alternative to accepting the merger consideration. Originally, consideration was only shares in the new company – now there is a "cash out" merger in which shareholders can be forced to exchange their shares for cash as long as the procedural requirements for a valid merger are met.

12.4 The Allocation of Power in Fundamental Transactions

- The merger is part of a handful of corporate decisions that require **both shareholder as well as board approval**. Other such decisions include sales of substantially all assets, amendments to the articles of incorporation (charter) and voluntary dissolutions.
- Mergers require a shareholder vote on the part of both the target and the acquiring company, except that the acquiring company's shareholder's don't vote when the acquiring company is much larger than the target. DGCL §251(b).

12.5 Overview of Transactional Form

12.5.1 Assets Acquisition

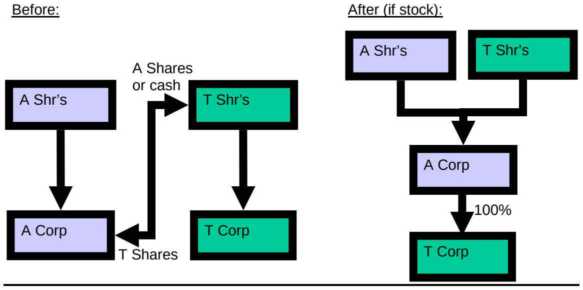
- Sales of substantially all assets require a vote by the target's shareholder's (DGCL §271), but purchases of assets does not require shareholder approval.
- **Asset Acquisition (DGCL §271) – Basic Steps**
  1. The boards of the two firms – A(cquirer) and T(arget) – negotiate the deal.
  2. Only T's shareholders get voting rights under state law. (But stock exchange rules may require shareholder vote of A in stock deal.)
  3. Transaction costs are generally high because title to the actual physical assets of T must be transferred to A.
  4. After transfer, selling corporation usually distributes the consideration received to its stockholders and liquidates.
- **Why Asset Acquisition?**
  - May avoid T's unmatured corporate liabilities.
  - May avoid vote by shareholders of A.

Katz v. Bregman, 431 A.2d 1274 (Del. Ch. 1981)

- Proposed sale of defendant corporation's assets, which constituted over 51 percent of total assets and which generated approximately 45 percent of defendant corporation's 1980 net sales, would constitute a sale of substantially all of defendant corporation's assets.
- If the sale is of assets quantitatively vital to the operation of the corporation and is out of the ordinary and substantially affects the existence and purpose of the corporation then it is beyond the power of the Board of Directors.

12.5.2 Stock Acquisition

Compulsory share exchange (RMBCA §11.03): A tender offer negotiated with the board that once approved by a majority of shareholders becomes compulsory for all shareholders; acquiring company's shares are then distributed pro rata.



Stock Acquisition – 2 Step Tender Offer / Merger

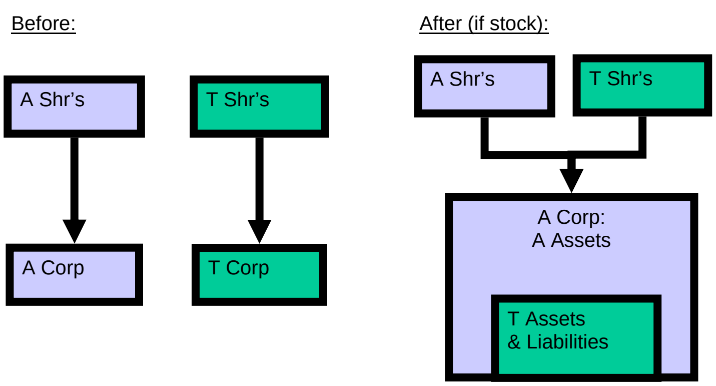
1. A makes a tender offer for shares of T.
2. Assuming that A wishes to acquire 100% of T and avoid costs of T remaining a public company, A will use a merger to eliminate T's remaining public SH.
3. If A acquired 90% or more of T stock through tender offer, T can implement a "short form" merger under DGCL § 253.
4. If A acquired less than 90% through tender offer, A will have to implement a traditional merger under DGCL § 251.

12.5.3 Mergers

- In most states a valid merger requires the majority vote by the outstanding stock of each constituent corporation entitled to vote
    - o Delaware does not give class vote protection to preferred stock

Steps of a Statutory Merger (DGCL §251)

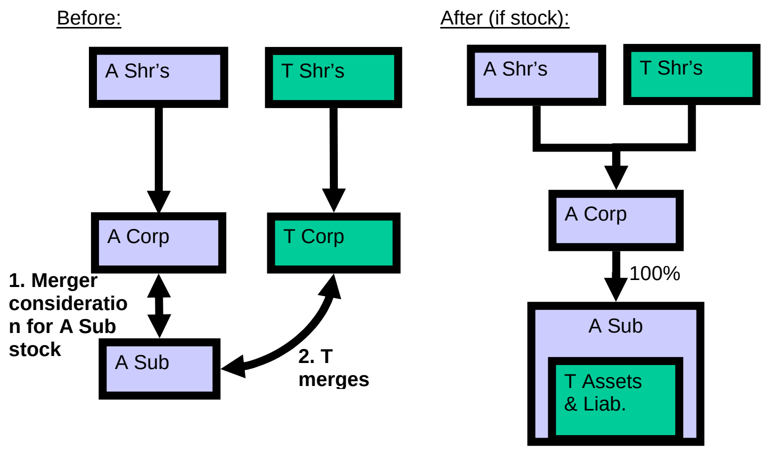
1. A & T boards negotiate the merger.
2. Proxy materials are distributed to SH as needed.
3. T SH always vote (§251(c)); A SH vote if A stock outstanding increases by > 20% (§251(f)).
4. If majority of shares outstanding approves, T assets merge into A, T SH receive A stock, cash, or other consideration. Certificate of merger is filed with the secretary of state.
5. Dissenting SH who had a right to vote have appraisal rights.
6. A assumes T's liabilities as well as its assets.



Short Form Merger (DGCL §253)

12.5.4 Triangular Mergers

- T Corporation is merged into subsidiary of A company. You end up with A and a subsidiary.
- If subsidiary survives it is forward merger, when the acquired company survives it is reverse



12.6 Structuring the M&A Transaction

12.6.1 Timing

12.6.2 Regulatory Approvals, Consents, and Title Transfers

12.6.3 Planning Around Voting and Appraisal Rights

12.6.4 Due Diligence, Representations and Warranties, Covenants, and Indemnification

12.6.5 Deal Protection and Termination Fees

12.6.6 Accounting Treatment

12.6.7 A Case Study: Excerpt from Timberjack Agreement and Plan of Merger

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12.7 Taxation of Corporate Combinations

Taxation of Corporate Combinations

- **General Rule:** A merger or reorganization that qualifies under IRC §368 is tax-deferred under IRC §354, i.e., no recognition of gain to the seller, except to the extent that they receive cash or other "boot." A gets carry-over basis in stock or assets acquired; T gets carry-over basis in stock received.
- **Paradigm cases:**
- **Cash for stock** (e.g., Timberjack): Former TJ shareholders are taxed on gains and losses just as if they had sold shares on the market.
- **Stock for stock** (e.g., HP/Compaq): Former Compaq shareholders who receive HP shares do not recognize gain or loss on the exchange. Their basis in their Compaq stock carries over to their newly acquired HP stock.

Taxation of Investments Generally

- **VERY General Rule for U.S. Investors Not Involved in an M&A Transaction (caveat, caveat, caveat):** Gains and losses on investments are not taxed until there is a "realization event," e.g., sale or other disposition (including exchanges).
- U.S. investor who purchases Google for $100/share in 2004 and sells for $400/share in 2006 is taxed on $300/share gain in 2006 tax year. Irrelevant whether investor uses proceeds to buy boat, bread, or shares of Oracle.
- If U.S. investor arranges to trade his Google shares with another investor for Oracle shares, the result is the same: Google investor is taxed on $300/share gain.

12.8 The Appraisal Remedy

Shareholder Voting & Appraisal – Summary

	Statutory Merger (DGCL §251, RMBCA §11.02)	**Asset Acquisition (DGCL §271, RMBCA §12.01-.02)**
T Voting Rights	**Yes** – need majority of shares outstanding (DGCL §251(c)), or majority of shares voted (RMBCA §11.04(e))	**Yes**, if "all or substantially all" assets are being sold (DGCL §271(a)) or no "significant continuing business activity" (RMBCA §12.02(a))
A Voting Rights	**Yes, unless** <20% shares being issued (DGCL §251(f), RMBCA §11.04(g))	**No** (though stock exchange rules might require vote to issue new shares)
Appraisal Rights	**Yes, unless** market-out exception (DGCL §262, RMBCA §13.02)	**No** in Delaware, **unless** provided in charter (DGCL §262(c)); **Yes** under RMBCA if T shareholders vote, **unless** market-out exception (RMBCA §13.02(a)(3));

12.8.1 History and Theory

Appraisal Process (DGCL §262)

- Shareholders get notice of appraisal right at least 20 days before shareholder meeting (§262(d)(1)).
- Shareholder submits written demand for appraisal before shareholder vote, and then votes against (or at least refrains from voting for) the merger (§262(d)(1)).
- If merger is approved, shareholder files a petition in Chancery Court within 120 days after merger becomes effective demanding appraisal (§262(e)).
- Court holds valuation proceeding to "determine [the shares'] fair value exclusive of any element of value arising from the accomplishment or expectation of the merger." (§262(h)).
- No class action device available, but Chancery Court can apportion fees among plaintiffs as equity may require ((§ 262(j))

12.8.2 The Appraisal Alternative in Interested Mergers

Most arm's length mergers achieve something close to market price and remaining disagreements about value are usually too small to justify the costs of seeking valuation. However, a minority shareholder ought not to be at the mercy of a shareholder vote that is either controlled or potentially manipulated by an interested party, as in a parent-subsidiary merger or even a management sponsored buyout – appraisal makes sense in these cases.

12.8.3 The Market-Out Rule

- **§262(b):** get appraisal rights in a statutory merger.
- **BUT (§262(b)(1)):** don't get appraisal rights if your shares are market-traded, or company has 2,000 shareholders; or shareholders not required to vote on the merger.
- **HOWEVER (§262(b)(2)):** do get appraisal rights if your merger consideration is anything other than shares in surviving corporation or shares in third company that is exchange-traded or has 2,000 shareholders (with *de minimis* exception for cash in lieu of fractional shares).

12.8.4 The Nature of "Fair Value"

In re Vision Hardware Group, 669 A.2d 671 (Del. Ch. 1995)

– Vision was on verge of bankruptcy, when TCW came in to buy it. Dispute over value of cash-out of shares revolved around whether debt should be valued at face or market value. The Court should appraise a company as a going concern, but as a going concern company was headed for bankruptcy and liquidation and debt should be valued at dollar value of the legal claim the debt represented.

– The proposal by the creditor was a beneficial one because it prevented the company from having to declare bankruptcy, which would have given the shareholders less money, if any, than what the merger proposed. The shareholders' stock had essentially no financial value at the time of the merger and that the offer presented as part of the merger exceeded the fair market value of the stock.

How to Value? Delaware Block Method (look at Weinberger)

1. **Market Value of Shares:** share price, if shares are traded.
2. **Earnings Value:** last three years of earnings, capitalized using a price-to-earnings ratio.
3. **Asset Value:** net assets, valued at liquidation value.

What is to be valued? Three Approaches (increasing desirability as you go down for dissenting shareholders):

(1) value as minority shares, that is, apply a minority discount;
(2) value as pro rata claim on going concern value, that is, no minority discount but no claim on the benefits of the deal; or
(3) value as pro rata claim on going concern value, including the benefits from the deal.

12.9 The De Facto Merger Doctrine

A self-identified sale of assets that results in exactly the same economic consequences as a merger will nonetheless be governed by the (lesser) shareholder protections associated with a sale of assets, and not the full panoply of merger protections.

Hariton v. Arco Electronics, Inc., 182 A.2d 22 (Del. Ch. 1962)
The right of appraisal accorded to a dissenting stockholder by the merger statutes is in compensation for the right which he had at common law to prevent a merger. At common law a single dissenting stockholder could also prevent a sale of all of the assets of a corporation. The legislatures of many states have seen fit to grant the appraisal right to a dissenting stockholder not only under the merger statutes but as well under the sale of assets statutes. The Delaware Legislature has seen fit to expressly grant the appraisal right only under the merger statutes.

12.10 The Duty of Loyalty in Controlled Mergers

12.10.1 Cash Mergers or Freeze-Outs

Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983)

– When directors of a Delaware corporation are on both sides of transaction, they are required to demonstrate utmost good faith and most scrupulous inherent fairness of bargain.
– **The concept of fairness has two basic aspects: fair dealing and fair price.** The former embraces questions of when a merger transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.
– However, the test for fairness is not a bifurcated one as between fair dealing and price. **All aspects of the issue must be examined as a whole.** However, in a non-fraudulent transaction, price may be the preponderant consideration outweighing other features of the merger.
– Part of fair dealing is the obvious duty of candor. **One possessing superior knowledge may not mislead any stockholder by use of corporate information to which the latter is not privy.** Delaware imposes this duty even upon persons who are not corporate officers or directors, but who nonetheless are privy to matters of interest or significance to their company.
– ***DGCL § 262(h)* mandates the determination of fair value based upon all relevant factors.** Only speculative elements of value that may arise from the accomplishment or expectation of the merger are excluded. Elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered.

Rabkin v. Phillip A. Hunt Chem.
"*Weinberger* makes clear that appraisal is not necessarily a stockholder's sole remedy. . . . 'The appraisal remedy we approve may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved.'"

Cede v. Technicolor (Cede IV)
Only speculative elements of value that may arise from merger are excluded – a very narrow exception. "In a two step merger, to the extent that value has been added following a change in majority control before cash-out, it is still value attributable to the going concern."

12.10.2 What Constitutes Control and Exercise of Control

Kahn v. Lynch Communication Sys., 638 A.2d 1110 (Del. 1994)

- A shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation. A shareholder who owns less than 50 percent of a corporation's outstanding stocks does not, without more, become a controlling shareholder of that corporation, with a concomitant fiduciary status.
- A controlling or dominating shareholder standing on both sides of a merger transaction, as in a parent-subsidiary context, bears the burden of proving its entire fairness. A showing that an action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that a merger transaction meets the test of fairness.
- The **exclusive standard of judicial** review in examining the propriety of an **interested cash-out merger** transaction by a controlling or dominating shareholder **is entire fairness**. The **initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction**. However, an **approval** of the transaction **by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof** on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff. Nevertheless, even when an interested cash-out merger transaction receives the informed approval of a majority of minority stockholders or an independent committee of disinterested directors, an entire fairness analysis is the only proper standard of judicial review.

12.10.3 Special Committees of Independent Directors in Controlled Mergers

The same policy rationale which requires judicial review of interested cash-out mergers exclusively for entire fairness also mandates careful judicial scrutiny of a special committee's real bargaining power before shifting the burden of proof on the issue of entire fairness. A two-part test for determining whether burden shifting is appropriate in an interested merger transaction. **The mere existence of an independent special committee does not itself shift the burden. At least two factors are required.** First, the majority shareholder must not dictate the terms of the merger. Second, the special committee must have real bargaining power that it can exercise with the majority shareholder on an arms length basis. Kahn v. Lynch

12.10.4 Controlling Shareholder Fiduciary Duty on the First Step of a Two-Step Tender Offer

As long as an offer is not coercive – as, for example, it would be if the controller threatened to discontinue paying dividends – entering such a transaction is voluntary on the part of the minority shareholders. If the shareholders do not like the price offered, they can remain shareholders in the company and force the controller to cash them out, in which event they will have the protections of both an appraisal action and an entire fairness fiduciary claim.

In re Pure Resources S'Holders Litig., 808 A.2d 421 (Del. Ch. 2002)

- Because no consent or involvement of the target board is statutorily mandated for tender offers, Delaware courts have recognized that **in the case of totally voluntary tender offers courts do not impose any right of the shareholders to receive a particular price**. Delaware law recognizes that, as to allegedly voluntary tender offers (in contrast to cash-out mergers), the determinative factors as to voluntariness are whether coercion is present, or whether there are materially false or misleading disclosures made to stockholders in connection with the offer.
- Delaware law does not impose a duty of entire fairness on controlling stockholders making a non-coercive tender or exchange offer to acquire shares directly from the minority holders. A short-form merger is not reviewable in an action claiming unfair dealing, and absent fraud or misleading or inadequate disclosures, can be contested only in an appraisal proceeding that focused solely on the adequacy of the price paid.
- Delaware law should consider **an acquisition tender offer by a controlling stockholder non-coercive only when:** (1) it is subject to a non-waivable majority of the minority tender condition; (2) the controlling stockholder promises to consummate a prompt *Del. Code Ann. tit. 8, § 253* merger at the same price if it obtains more than 90 percent of the shares; and (3) the controlling stockholder has made

no retributive threats. Those protections minimize the distorting influence of the tendering process on voluntary choice. They also recognize the adverse conditions that confront stockholders who find themselves owning what have become very thinly traded shares. These conditions also provide a partial cure to the disaggregation problem, by providing a realistic non-tendering goal the minority can achieve to prevent the offer from proceeding altogether.

- **Full disclosure** must contain the information that a reasonable investor would consider important in tendering his stock. In order for undisclosed information to be material, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable stockholder as having significantly altered the "total mix" of information made available, in a stock tender offer.

Self-Dealing Transactions - Legal Standards

(Burden of proof)	**Interested Director**	**Interested Controller**
1. Disclosed and disinterested directors authorize	**BJR (P):** Cooke	**Entire Fairness:** Cookies (Iowa)(D) Kahn v. Lynch (Del.)(P)
2. Disclosed and shareholders ratify	**Waste/BJR (P):** Lewis/Wheelabrator	**Entire Fairness (P):** Wheelabrator (dicta)
Neither 1 nor 2	**Entire Fairness (D)**: Hayes Oyster (Wash)	**Entire Fairness (D):** Sinclair (dicta)

Controller Freeze Outs

	Cash Out Merger Lynch Comm.	**Tender Offer/SF Merger Pure Resources**
Judicial standard:	Entire Fairness	Non-Coercive TO
What to look for:	Approval by valid IC negotiating at arm's length. Affirmative vote by maj. of min. SH.	Maj. of min. TO condition. SF merger at same price as TO. No controller threats.
Effect:	Shifts entire fairness burden to P.	No duty to pay a fair price.

13. PUBLIC CONTESTS FOR CORPORATE CONTROL

13.1 Introduction

13.2 Defending Against Hostile Tender Offers

Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985)

- The business judgment rule is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be attributed to any rational business purpose.
- When corporate board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. There is an **enhanced duty** which calls for judicial examination at the threshold before the protections of the BJR may be conferred.
- Directors **must show** that they had **reasonable grounds for believing that a danger to corporate policy and effectiveness existed** because of another person's stock ownership. If a **defensive measure** is to come within the ambit of the business judgment rule, it **must be reasonable in relation to the threat posed**.
- The restriction placed upon a selective stock repurchase is that the directors may not have acted solely or primarily out of a desire to perpetuate themselves in office. A defensive measure to thwart or impede a takeover must be motivated by a good faith concern for the welfare of the corporation and its stockholders

13.3 Private Law Innovation: The Poison Pill

- Rights to buy stock at a discount are distributed to shareholders, the rights are triggered only if someone acquires a percentage of outstanding stock without the board's permission
- The person who triggers the exercise of the rights is excluded from buying discounted stock; this causes the dilution of their position.

Types of Poison Pills

"Flip Over" Pill: Gives target shareholders other than the bidder the right to buy shares of the *bidder* at a substantially discounted price.
"Flip In" Pill: Gives target shareholders other than the bidder the right to buy shares of the *target* at a substantially discounted price.
"Dead Hand" Pill*: Pill that may not be redeemed by the insurgent directors. (*Carmody v. Toll Bros*.)
"Slow Hand" Pill*: Pill that may not be redeemed for a specified period of time after a change in board composition. (*Mentor Graphics*.)
"No Hand" Pill*: Pill that may not be redeemed by current or future boards for the life of the pill (usually ten years).
*** Illegal in Delaware but legal in Maryland and Georgia.**

Implementing a "Flip In" Poison Pill

- Step 1: Rights plan adopted by board vote. No shareholder vote is necessary.
- Step 2: Rights are distributed by dividend and remain "embedded" in the shares. Rights are redeemable by the company.
- Step 3: Triggering event occurs (it never does) when prospective acquirer buys > 10% of outstanding shares. Rights are no longer redeemable by the company and soon become exercisable.
- Step 4: Rights are exercised. All rights holders are entitled to buy stock at half price – except the acquirer, whose right cancelled.

Importance of Proxy Contest Route for Hostile Bids

<u>After the pill</u> (1985-present): board control is a *prerequisite to* buying a majority of the shares:

1. Bidder launches a proxy contest to replace the target's board over one (no SB) or two (SB) annual elections.
2. Once in office, the new directors redeem the pill, thus clearing the way for the hostile bidder to proceed with its bid.

Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985)

- Pre-planning for the contingency of a hostile takeover might reduce the risk that, under the pressure of a takeover bid, management will fail to exercise reasonable judgment. Therefore, in reviewing a pre-planned defensive mechanism it is even more appropriate to apply the business judgment rule. The inherent powers of the Board conferred by *DGCL §141(a)* concerning the management of the corporation's "business and affairs," provides the Board additional authority upon which to enact a "rights plan."
- When the business judgment rule applies to adoption of a defensive mechanism, the initial burden will lie with the directors. The directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed. They satisfy that burden by showing good faith and reasonable investigation. In addition, the directors must show that the defensive mechanism was reasonable in relation to the threat posed. Moreover, that proof is materially enhanced where a majority of the board favoring the proposal consisted of outside independent directors who have acted in accordance with the foregoing standards. Then the burden shifts back to the plaintiffs who have the ultimate burden of persuasion to show a breach of the directors' fiduciary duties.

Forced Pill Redemptions

- **Moran v. Household Intl (Del. 1985):** "The Rights Plan [I.e., poison pill] is not absolute. When the Household Board of Directors is faced with a tender offer and a request to redeem the Rights, *they will not be able to arbitrarily reject the offer*. . . . The ultimate response to an actual takeover bid must be judged by the Directors' actions at that time, and nothing we say here relieves them of their fundamental duties to the corporation and its stockholders." (emphasis added)

- **City Capital Associates Ltd. Partnership v. Interco (Del. Ch. 1988):** Chancery Court requires target board to redeem a stock rights plan that the company used to protect its recapitalization alternative to a hostile, all-cash, all-shares tender offer.
- **Grand Metropolitan Pub. Ltd. Co. v. Pillsbury (Del. Ch. 1988):** Chancery Court required Pillsbury to redeem its poison pill after concluding that Pillsbury's own restructuring proposal was not as good as a hostile all-cash offer from Grand Met.

13.4 Choosing a Merger or Buyout Partner: Revlon, Its Sequels, and Its Prequels

Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)
The business judgment rule is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Thus, the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one.

Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986)

- Favoritism for a white night, to the total exclusion of a hostile bidder, might be justifiable when the latter's offer adversely affects shareholder interests, but **when bidders make relatively similar offers, or dissolution of the company becomes inevitable**, the directors cannot fulfill their enhanced duties by playing favorites with the contending factions. **Market forces must be allowed to operate freely to bring the target's shareholders the best price available for their equity.**
- Bidding war for Revlon emerged between Perelman and Forstmann. Revlon had adopted a poison pill and sold Notes to purchase stock. The Notes limited Revlon's ability to acquire debt, sell assets or pay dividend. Forstmann came in as white knight, he was given a lock-up, no-shop provision, cancellation fee, Rights were redeemed by board and Note tenants were waived for him. In doing this, Revlon showed a preference for noteholders over shareholders; it could not in good faith support this. The merger with Forstmann did not meet *Unocal* standard. The lock-up ended the bidding war. **The directors allowed considerations other than the maximization of shareholder profit to affect their judgment and followed a course of action that ended the auction for Revlon to the ultimate detriment of its shareholders and the board was not entitled to deference of the business judgment rule.**

Revlon Duties

When a "sale" or "breakup" of the company becomes "inevitable," "the directors' role [is] changed from defenders of the corporate bastion to *auctioneers* charged with getting the best price for the stockholders at a sale of the company. . . . The directors' role remains an active one, changed only in the respect that they are charged with the duty of *selling the company at the highest price attainable* for the stockholders' benefit."

Revlon Duties Clarified (Barkan v. Amsted Industries, Inc.)

- **Level Playing Field Among Bidders:** "[W]hen several suitors are actively bidding for control of a corporation, the directors may not use defensive tactics that destroy the auction process. . . . When multiple bidders are competing for control . . . fairness forbids directors from using defensive mechanisms to thwart an auction or to favor one bidder over another."
- **Market Check Required:** "When the board is considering a single offer and has no reliable grounds upon which to judge its adequacy . . . fairness demands a canvas of the marketplace to determine if higher bids may be elicited."
- **Exemption Allowed in (Very) Limited Circumstances:** "When . . . the directors possess a body of reliable evidence with which to evaluate the fairness of a transaction, they may approve the transaction without conducting an active survey of the marketplace."

13.5 Pulling Together Unocal and Revlon

Lockup Agreements

- **Asset Lockup**: gives the acquirer the right to buy specified assets of the target at a specified price. Extremely rare in the 90s.
- **Stock option lockup**: gives the acquirer the right to buy a specified number of shares of the target (typically 19.9%) at specified price. Appeared in 24% of deals in '99.
- **Breakup fee**: gives the acquirer a cash payment in the event of non-consummation. Breakup fees appeared in approximately 50% of deals in '99.

Structural Defenses (a.k.a. "Shark Repellents") – More potent as you go down this list.

- **Golden Parachutes:** Large payments to management team and sometimes to employees (tin parachutes) in the event of a takeover.
- **Anti-Greenmail provision:** Prohibits the board from buying back a stake from a large-blockholder at a premium price.
- **Supermajority Voting Provisions:** Requires super-majority vote (e.g., 80%) to approve certain business combinations, e.g., sale of assets, liquidation, freeze-out, often with a "fair price" out.
- **Poison Pill:** Dilutes the acquirer's stake after hitting a certain trigger threshold of ownership (typically 10-25%).
- **Staggered Board:** Allows only a fraction of directors (typically 1/3) to stand for election each year.
- **Dual Class Stock:** Two classes of stock, with different voting rights, e.g., voting and non-voting stock, e.g., Google.

Paramount Communications v. Time, Inc., 571 A.2d 1140 (Del. 1989)

- Under Delaware law there are, generally speaking and without excluding other possibilities, **two circumstances which may implicate duties under Revlon**. The first, and clearer one, is **when a corporation initiates an active bidding process** seeking to sell itself or to effect a business reorganization **involving a clear break-up** of the company. However, Revlon duties may also be triggered **where**, in response to a bidder's offer, a **target abandons its long-term strategy and seeks an alternative transaction also involving** the **breakup** of the company.
- If a corporate board of director's reaction to a hostile tender offer is found to constitute only a defensive response and not an abandonment of the corporation's continued existence, duties under Revlon are not triggered, though duties under Unocal do attach.
- Directors satisfy the first part of the test in Unocal by demonstrating good faith and reasonable investigation. The Delaware Supreme Court has stated that the refusal to entertain an offer may comport with a valid exercise of a board's business judgment.

Paramount Communications v. QVC Network, 637 A.2d 34 (Del. 1994)

- Board action in a sale or change of control transaction is subject to enhanced scrutiny. Such scrutiny is mandated by: (a) the threatened diminution of the current stockholders' voting power; (b) the fact that an asset belonging to public stockholders - a control premium - is being sold and may never be available again: and (c) the traditional concern of Delaware courts for actions which impair or impede stockholder voting rights.
- In the sale of control context, the directors must focus on one primary objective--to secure the transaction offering the best value reasonably available for the stockholders--and they must exercise their fiduciary duties to further that end.
- **When a corporation undertakes a transaction which will cause: (a) a change in corporate control; or (b) a break-up of the corporate entity, the directors' obligation is to seek the best value reasonably available to the stockholders.**
- **Contractual devices, like no-shop provisions**, whether or not they are presumptively valid in the abstract, **may not validly define or limit the directors' fiduciary duties** under Delaware law or prevent the directors from carrying out their fiduciary duties under Delaware law. To the extent such provisions are inconsistent with those duties, they are invalid and unenforceable.

13.6 State Anti-Takeover Devices

2nd and 3rd Generation AT Statutes

Acquiring a Control Block	Second-Step Freeze-Out

Control share acquisition statutes (27 states): prevent a bidder from voting its shares beyond a specific threshold (20-50%) unless a majority of disinterested shareholders vote to approve the stake.

Other constituency statutes (31 states): allow the board to consider non-shareholder constituencies.

Pill validation statutes (25 states): endorse the use of a poison pill against a hostile bidder.

Business combination (freeze-out) statutes (33 states): prevent a bidder from merging with the target for either three or five years after gaining a controlling stake unless takeover pre-approved by the target's board.

Fair price statutes (27 states): set procedural criteria to determine a fair price in freeze-outs.

Delaware

- DGCL § 203 bars business combinations between acquiror and target for a period of three years after the acquiror passes the 15% threshold unless:
  - **§ 203 (a)(1):** takeover is approved by target board before the bid occurs; or
  - **§ 203 (a)(2):** acquiror gains more than 85% of shares in a single offer (i.e., moves from below 15% to above 85%), excluding inside directors' shares; or
  - **§ 203 (a)(3):** acquiror gets board approval and 2/3 vote of approval from disinterested shareholders (i.e., minority who remain after the takeover).

13.7 Proxy Contests for Corporate Control

13.7.1 Reimbursement of Expenses

13.7.2 Manipulation of the Proxy Contest

Schnell v. Chris-Craft Industries, Inc., 285 A.2d 437 (Del. 1971)

- The advancement by directors of the by-law date of a stockholders' meeting, for inequitable purposes, contrary to established principles of corporate democracy, may not be permitted to stand.
- When the by-laws of a corporation designate the date of the annual meeting of stockholders, it is to be expected that those who intend to contest the reelection of incumbent management will gear their campaign to the by-law date. It is not to be expected that management will attempt to advance that date in order to obtain an inequitable advantage in the contest.

Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988)

- The board of directors of a corporation, as a general matter, is under no fiduciary obligation to suspend its active management of the firm while the consent solicitation process goes forward.
- It is established that a board may take certain steps -- such as the purchase by the corporation of its own stock -- that have the effect of defeating a threatened change in corporate control, when those steps are taken advisedly, in good faith pursuit of a corporate interest, and are reasonable in relation to a threat to legitimate corporate interests posed by the proposed change in control.
- **The board requires a very powerful justification to thwart shareholder franchise for an extended period.** Where board delays a shareholder vote for a week or two, a less compelling justification may suffice (See Stahl v. Apply Bancorp).
- Review under **Unocal is less demanding than review under Blasius**. Under Unocal, the action must be reasonable in light of a threat that the action is directed against. Under Blasius, the justification for that action must be deemed compelling in light of the threat the action is directed against.

[Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361 (Del. 1995)]

- A board of directors' duty of care extends to protecting the corporation and its stockholders from perceived harm whether a threat originates from third parties or other shareholders, but such powers are not absolute. Specifically, the board does not have unbridled discretion to defeat any perceived threat by any Draconian (either preclusive or coercive) means available, and the directors may not have acted solely or primarily out of a desire to perpetuate themselves in office, and, further, that a stock repurchase plan must not be inequitable.
- A limited nondiscriminatory self-tender, like some other defensive measures, may thwart a current hostile bid, but is not inherently coercive. Moreover, it does not necessarily preclude future bids or proxy contests by stockholders who decline to participate in the repurchase
- **A court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision.** If a board selected one of several reasonable alternatives, a court should not second guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.

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14. TRADING IN THE CORPORATION'S SECRUITIES

14.1 Common Law of Directors' Duties When Trading in the Corporation's Stock

14.2 Skipped

14.3 Exchange Act §16(b) and Rule 16

Section 16 -- Summary of Provisions

- **§ 16(a):** Statutory "insiders" (**directors, officers, and 10% shareholders**) must file public reports of all trades in the corporation's securities (within 2 days of the trade under Sarbanes-Oxley).
    - "Officer" status defined as access to non-public information in the course of employment.
- **§ 16(b)** ("short-swing trading rule"): statutory insiders may be required to disgorge profits on purchases and sales within any 6 month period.
    - Exemption for "unorthodox" transactions, e.g., short-swing profits in takeovers, if no evidence of inside information.
    - **Basic Rule:** Match any transactions that produce a profit. Gratz v. Claughton

14.4 Exchange Act §10(b) and Rule 10b-5

Exchange Act Section 10(b)

"It shall be unlawful … –

(b) To use or employ, in connection with the purchase and sale of any security registered on a national securities exchange or a security not so registered,… any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors…."

Exchange Act Rule 10b-5

"It shall be **unlawful**…,

(a) To employ any device, scheme, or artifice to defraud,

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

(c) **To engage in any act, practice, or course of business which operates or would operate as a fraud** or deceit upon any person,

in connection with the purchase or sale of any security."

14.4.1 Evolution of Private Right of Action Under §10

- Since Rule 10b-5 proscribes any or contrivance that acts as a fraud, the elements of an implied cause of action must resemble those of common law fraud.
- **Common Law Fraud Claim – Elements**
  1. False or misleading statement
  2. of material fact
  3. made with intent to deceive.
  4. Reasonable reliance by plaintiff, and
  5. Damages.

14.4.2 Elements of a 10b-5 Claim

- **Elements of a Typical Rule 10b-5 Action**
  - **Duty to Abstain or Disclose**: *Chiarella, Dirks, O'Hagan*
  - **Materiality**: what a reasonable shareholder would consider important; probability x magnitude test. (*Basic v. Levinson*).
  - **Scienter**: specific intent to deceive, manipulate, or defraud, though may be inferred from reckless or grossly negligent behavior. (*Ernst & Ernst*).
  - **Standing**: P must be a contemporaneous purchaser/seller of securities (*Blue Chip Stamp*)…holding stock isn't enough.
  - **Reliance/Causation:** rebuttable presumption of reliance on the integrity of market price (*Basic*)…misleading statement must have been made in connection with sale.
  - **Injury/Damages**: countertraders recover losses, but limited to insiders' profits (*Elkind*).

14.4.2.1 False or Misleading Statement or Omission

SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968)

- Anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.
- The basic test of materiality is whether a reasonable man would attach importance in determining his choice of action in the transaction in question.
- *17 C.F.R. § 240.10b-5* is violated whenever assertions are made in a manner reasonably calculated to influence the investing public if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes. However, if corporate management demonstrates that it was diligent in ascertaining that the information it published was the whole truth and that such diligently obtained information was disseminated in good faith, Rule 10b-5 would not have been violated.

Restatement (Second) of Torts § 551. Liability For Nondisclosure

(1) One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, **if, but only if, he is under a duty** to the other to exercise reasonable care to disclose the matter in question.

(2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated,
(a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them; ….

14.4.2.2 The Equal Access Theory

Matter of Cady, Roberts - "Disclose or Abstain Rule"

- "[I]nsiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction….

– Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access … to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."

SEC Equal Access Rules

Rule 10b-5 equal access rule is gone following *Chiarella*, but its spirit lives on:

- SEC Reg. FD ("Fair Disclosure"): forbids issuers from making selective disclosures to securities analysts. Requires simultaneous public disclosures and prompt correction of unintentional disclosures.
- SEC Rule 14e-3: mini equal access rule for tender offers. Imposes duty on *anyone* who obtains inside information about a tender offer that originates with A or T to disclose or abstain.

'34 Act § 14(e). Untrue statement of material fact or omission of fact with respect to tender offer

"It shall be unlawful for any person to make any untrue statement of a material fact … or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer…. The [SEC] shall … by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."

Rule 14e-3

(a) It is a violation of the '34 Act § 14(e) to purchase or sell securities on the basis of information that the possessor knows, or has reason to know, is non-public and originates with the tender offeror or the target or their officers.

14.4.2.3 The Fiduciary Duty Theory

Chiarella v. United States, 445 U.S. 222 (1980)

– Chiarella made money from inside information he gained as printer of corporate documents.

– **Silence** in connection with the purchase or sale of securities **may operate as a fraud** actionable under § 10 (b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. However, **such liability is premised upon a duty to disclose** (such as that of a corporate insider to shareholders of his corporation) arising from a relationship of trust and confidence between parties to a transaction.

– Petitioner had no affirmative duty to disclose the information as to the plans of the acquiring companies. He was not a corporate insider, and he received no confidential information from the target companies. Nor could any duty arise from petitioner's relationship with the sellers of the target companies' securities, for he had no prior dealings with them, was not their agent, was not a fiduciary, and was not a person in whom the sellers had placed their trust and confidence. **A duty to disclose under § 10 (b) does not arise from the mere possession of nonpublic market information.**

– This Court need not decide whether petitioner's conviction can be supported on the alternative theory that he breached a duty to the acquiring corporation, since such theory was not submitted to the jury.

Dirks v. SEC, 463 U.S. 646 (1983)

– In order to establish a violation of 10b5, the **existence of a relationship affording access to inside information** intended to be available only for a corporate purpose, and the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure **must be shown.**

– There is no general duty to disclose before trading on material nonpublic information, and a duty to disclose under 17 C.F.R. § 240.10(b) does not arise from the mere possession of nonpublic market information. **Such a duty arises rather from the existence of a fiduciary relationship.**

– There must also be manipulation or deception. In an inside-trading case this fraud derives from the inherent unfairness involved where one takes advantage of information intended to be available only for a corporate purpose and not for the personal benefit of anyone.

– Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these **outsiders may become fiduciaries of the shareholders.** The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are **given access to information solely for corporate purposes**. When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee. For such a duty to be imposed, however, the

corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.

- Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, **but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain**. Similarly, the transactions of those who knowingly participate with the fiduciary in such a breach are as forbidden as transactions on behalf of the trustee himself. Thus, the tippee's duty to disclose or abstain is derivative from that of the insider's duty. Tippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information.
- In determining whether a tippee is under an obligation to disclose or abstain from using inside information, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders.
- To determine whether a disclosure itself deceives, manipulates, or defrauds shareholders, the initial inquiry is whether there has been a breach of duty by the insider. This requires courts to **focus on whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings**.

<u>The Dirks Standard</u>

"In determining whether a tippee is under an obligation to disclose or abstain, it is . . . necessary to determine whether the insider's "tip" constitutes a breach of . . . fiduciary duty. All disclosures of confidential corporate information are not inconsistent with the [insider's] duty . . . **[T]he test is whether the insider personally will benefit . . . from his disclosure**. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach [when a tippee trades]."

<u>United States v. O'Hagan, 521 U.S. 642 (1997)</u>

- Under the traditional or classical theory of insider trading liability, Rule 10b-5 violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a deceptive device under § 10(b) because a relationship of trust and confidence exists between the shareholders of a corporation and the corporate insiders. <u>Chiarella v. United States</u> That relationship gives rise to a duty to disclose or to abstain from trading. The classical theory applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation. <u>Dirks v. SEC</u>
- **The misappropriation theory holds that a person commits fraud in connection with a securities transaction,** and thereby violates Rule 10b-5, **when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.** Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, **defrauds the principal of the exclusive use of that information.**

<u>Theories for 10b-5 Liability</u>

- **Equal Access Theory:** All traders owe a duty to the market to disclose or refrain from trading on non-public corporate information. (*Cady Roberts*, *Texas Gulf Sulphur*). <u>Note</u>: Defunct now after Chiarella.
- **Fiduciary Duty Theory:** An insider violates 10b-5 by breaching a duty to abstain or disclose if there is a specific, pre-existing relationship of trust and confidence between the insider and the counterparty/corporation. (*Chiarella*, *Dirks*)
- **Misappropriation Theory:** A person "violates Rule 10b-5 when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." (*O'Hagan*)

<u>ITSA (1984) and ITSFEA (1988) Amendments to the 1934 Act</u>

- **§ 20A:** creates a private right of action for any trader opposite an insider trader, with damages limited to profit gained or losses avoided.
- **§ 21A(a)(2):** allows civil penalties up to three times the profit gained or loss avoided.
- **§ 21A(a)(1)(B):** "controlling person" may be liable too, if the controlling person "knew or recklessly disregarded" the likelihood of insider trading and failed to take preventive steps.
- **§ 21A(e): "**bounty hunter" provision, which allows SEC to provide 10% of recovery to those who inform on insider traders.