CORPORATIONS – STATUTORY OUTLINE

1. Economic & Legal Aspects of the Firm
   1. Basic Concepts
      1. What is a firm?
         1. **Cosean Theory**: market operates by the “invisible hand”; in a firm, resources are allocated pursuant to conscious order or directions from the ER to her EEs; “firm” = set of relations that arise when resources are allocated by the entrepreneur via commands to her EEs rather than a set of relations that arise when an entrepreneur allocates resources via contracts with outsiders.
         2. **Firm as a nexus of contracts**: Firm is a web of explicit and implicit Ks b/w claimants to a share of the gross profits generated by the business (b/w ERs, EEs, suppliers, distributors, etc.)
      2. Sole Proprietorship v. Business Association
         1. **Sole P.**  = one individual makes all business decisions
         2. **Business Assoc.** = more than one person splits the functions of a classic owner. [CB says = any jointly owned firm whether it is operated as a corporation, partnership, LLC, etc.]
            1. Problem: adds complexity; need to protect the reasonable expectations of individuals who jointly own a firm
            2. Issues: how should profits be divided, risk be allocated, authority and responsibility be allocated, how long should business and responsibilities last, how should the parties be able to change or end their relationship, should the issues be decided at the beginning, or addressed later?
      3. **Corporations Law** (the law of business relationships) saves people from bargaining costs. However, in some circumstances it is necessary to have highly detailed agreements.
         1. Protects the reasonable expectations of the individuals who jointly own a firm
         2. The larger the firm, the greater likelihood that passive investors will not be able to stay apprised of the firm’s business
         3. The K between the owners has to have sophisticated rules allocating powers to the active owners. The Board of Directors protects the more passive investors.
         4. The absence of a complicated, detailed agreement may be acceptable to some owners b/c creating one may be expensive
   2. Organizing the Firm: Selecting a Value-Maximizing Governance Structure
      1. **Role of the Corporate Lawyer**: planner; assist in adapting organization as required; transaction-cost engineer; minimize the expected cost of future opportunistic behavior of disputes rather than resort to litigation and judicially-imposed solutions
      2. Transaction Cost Factors
         1. **Bounded Rationality** = there are limits on the ability to act rationally. These bounds limit the accuracy of judgments
         2. **Opportunism** = self-interest seeking with guile; individuals take advantage of the information deficits of those with whom they deal
            1. **Response**: negotiate and execute a K

**Discrete Contracting**: no preexisting obligations; after K, nothing is left to be worked out in the future

This is best when the expected duration is short and number of exchanges is few

**Relational Contracting**: parties do not attempt to provide an answer to all contingencies. Instead they build a governance structure that will allow them to solve problems when, and if, they arise.

* + - 1. **Team-Specific Investment** = when a person or asset has a higher value in its current team use than its value in its next best use
    1. State-Provided Governance Structures
       1. Most off-the-rack rules found in each state are “enabling” and may be modified or changed by the parties. Some are immutable and cannot be trumped by private ordering
       2. Tailored, majoritarian, and penalty default rules
          1. **Tailored rules:** give K parties the exact rule that they would choose if they were able to bargain costlessly over the matter in dispute
          2. **Majoritarian rules:** the result that most similarly situated parties would prefer
          3. **Penalty default rules:** designed to motivate one or more contracting parties to contract around the default. Goal is to force the parties to specify their own rules ex ante
  1. The Firm and the Law of Agency
     1. RS 3d of Agency
        1. §§ 1.01, 1.02, 1.03
        2. §§ 2.01-2.06, 3.01, 3.03
        3. §§ 8.01-8.15
           1. See w.r.t. ***Blackburn***
     2. Stat. supp. pp. 558-61
     3. Introduction
        1. **Agency Law** = set of standard from rules that provide a backdrop for contract or market transactions among team members. Basis for fiduciary duties of all important actors within corps. This protects principals from agents’ opportunism.
           1. Fiduciary duty principles will answer many questions that we would otherwise have to work out via a negotiated K

Fiduciary duty can be thought of as a gap filler

If parties negotiate in advance, courts will enforce that agreement

* + - * 1. Examples:

Sole proprietorship & EEs

Fortune 500 company and its officers

Among partners of a partnership

* + - 1. **Sole Proprietorship Form**
         1. Principal = the unified ownership and control
         2. Agents = other team members that agree to serve as EEs
         3. The agent is subject to the principal’s control w.r.t. the services that the agent has agreed to perform
         4. The law of agency imposes a fiduciary duty on agents, and the law of K imposes some limits on the principal’s right to discharge an EE
    1. **Fiduciary Limits on Agent’s Right of Action** 
       1. ***Community Counselling Services, Inc. v. Reilly*** (1963)
          1. **F**: Reilly was employed by CCS as a regional sales rep. Reilly was very successful and decided to start his own fundraising business. Before Reilly’s resignation became effective, Reilly solicited business of three parishes for himself instead of his ER. CCS claimed that this violated Reilly’s fiduciary duty to CCS.

Reilly’s argument: does CCS expect him to walk out of work with no work/clients?

PROF: YES- this is what the law requires (loyalty until the last day)

* + - * 1. **H**: For CCS; Reilly’s conduct was inappropriate b/c he competed with CCS while he was still employed there. Reilly violated his fiduciary duty of loyalty.

Reilly could have competed the day he left, but he was still CCS’s agent when he was looking to feather his own post-EE nest

Courts use fiduciary duty to settle conflicts of competition, etc. w/o existence of a negotiated K

CCS gets the benefit of the default rule that says that an EE must act loyally

Courts use this to reduce transaction costs

When Reilly became a CCS agent, the nature of the relationship contained these fiduciary duties

But some courts reject this transactional cost view of what FD is all about

* + - * 1. **Rule:** until the employment relationship is finally severed, the EE must prefer the interests of his ER to his own.
        2. **Rule**: EE should be candid with his ER and should withhold no information that would be useful to the ER in the protection and promotion of its interests.

Employment as a sales rep necessitates the highest duty of loyalty

* + - * 1. Agency costs = the costs associated w/ having agents

Contractual vehicles: may be used to minimize or reduce agency costs (these align the agent’s interest w/ the owner’s)

* + - * 1. Why CCS hired EEs like Reilly:

Upsides:

Owners can be everything and do everything, so they hire agents to market and sell the services (other group of EEs actually engage in the charity drives)

Taking on EEs increases pool to effectuate owner’s business plan

Downsides:

Agents can damage principal’s reputation (they are out there holding up your banner)

FIX: training, contract that adheres EE to a script

Possibly creating a competitor

FIX: non-compete agreements

Vicarious liability (for torts, etc.)

“Shirking”

ie. EE plays golf rather than being diligent in work (and it might take a lot of golf games until this is detected)

FIX: require EES to do their work on-premises; computer use stipulations

Other types of self-interested behavior

Using company property for personal purposes; embezzlement

ER/owners incur some costs to monitor their agents

Owner has the power to give agents enough flexibility to get the job done, but owners and agents may have conflicting interests

“Agency costs” = cost of having agents

Corporate law tries to minimize these costs (aka the risks of having agents)

* + - * 1. PROF: ER may not contract to alleviate all of the risks ahead of time b/c they want flexibility and there are the gap fillers of law of agency/fiduciary duty if there is later disagreement. If things are left vague, ER can later argue for a restrictive interpretation w.r.t. what an agent can do and agent can argue a broad view.
      1. NOTE: **Law of Fiduciary Duty**
         1. Some say that it is approximating the bargain that parties would have struck if they had negotiated

Avoid shirking, opportunism (because no one would agree to contract an allowance of these things)

* + - * 1. But some courts reject this idea and say that there is a real concern about fundamental fairness going on (not so much a convo of what a principal would bargain with an agent—it is more aspirational than that)
      1. ***Hamburger v. Hamburger*** (1995)
         1. **F**: 2 brothers, Joseph and Ted, owned and operated Ace Wire. David, Joseph’s son, worked, his way up from warehouseman to general manager of the wire business. Ted resented David, and their relationship turned sour. When David felt that his job would end at his father’s death, David had a meeting with one of Ace’s suppliers. David secured funding to start his own business. David subsequently quit his job at Ace and then began soliciting Ace customers for his own business.
         2. **H**: **Arranging financing and leasing space while still an EE is not illegal. Solicitation of Ace customers did not commence, in any significant way, prior to D’s resignation. David’s behavior did not violate agency rules.**
         3. **Rule:** Agent is entitled to use is general knowledge, experience, memory and skill in establishing a new company, including **“remembered information.”** ERs should use non-competition agreements should they wish to restrict their EEs post-employment competitive activities. **Customer lists are not trade secrets** (use of these lists isn’t a misappropriation if the info can be gleaned from directories/other sources, etc.)**.**

More EEs (other than the ER’s bookkeeper that David later hired) leaving en masse would cut against David more here

* + - * 1. **Compared to Reilly in CCS case**

Both David and Reilly were trained by the ER and left to start a competitor, but the biggest difference is that Reilly was actually trying to divert customers while he was still wearing CCS hat

David waited until he was no longer employed by the ER

Nature of employment relationships

Reilly was contractually obligated to give 30 days notice before quitting

Put Reilly in a pickle

David could quit and leave the next day w/ no notice (this made things easier for David)

COURT: David was the only person who cared about this business and the arguing b/w the brothers ruined the business

David was loyal for as long as the law obligated him to act loyally

* + - * 1. Related HYPO:

If David began soliciting ER’s customers as he was preparing to leave and Uncle Ted was treating David terribly

Court would find for Uncle Ted b/c of David’s competitive behavior

**The relationship of loyalty is not reciprocal**—the EE has a duty to ER, but the ER has NO similar duty of loyalty under the law/agency principles to the EE

PROF: if David had engaged in direct competition during his employment, court would have held for Uncle Ted notwithstanding bad treatment

Rationale for non-reciprocal treatment of ER v. EE duties (ie. why less legal protection for EE)?

Principal/ER is the residual claimant (takes out profits last and puts her assets at risk)

Some argue: Econ incentive to invest in a firm is that you have all of these protections against the downside risks of hiring agents

Others argue: ERs have naturally correct economic incentives to make the right decisions (& EEs don’t)

\*The stake that the ER has in the firm is the reason this is not a two-way street

* + 1. Non-Compete Agreements
       1. Courts balance the legitimate interests of the ER in protecting her business against the legitimate interests of the EE in seeking to redeploy her human capital. Such covenants will not be enforced if the EE has no ability to seize team-specific value to which the ER has a fair claim. “The efficiency and skills which an EE develops through his work belong to him and not to his former ER.”
    2. Limits on the Firm’s Right to Discharge an EE At-Will
       1. Generally
          1. Some courts and legislatures have created exceptions to the at-will doctrine in order to protect EEs from irrational or opportunistic discharge
          2. **At-will employment doctrine**: absent an agreement to the contrary, an EE/ER relationship may be ended at any time. However, there are statutory limitations in Fed. and state law (discrimination on sex, age, race, etc.)
          3. **Unlawful discharge:** provides a cause of action for persons discharged in violation of public policy. Varies from state to state. Many states require that the discharge be in violation of a statute or the state Constitution in order to be wrongful.
       2. ***Foley v. Interactive Data Corp.*** (CA 1988)
          1. SUM: erosion of the employment-at-will doctrine, & common law concept of unlawful discharge

Take-away: few limits on ER’s opportunity to act on opportunistic firing of EE (but may see limits with whistleblower laws)

* + - * 1. **F:**  P worked for D for more than 6 years, working his way up from assistant product manager to branch manager. P learned that D hired Kuhne to replace P’s immediate supervisor. P notified his supervisor that Kuhne was being investigated by the FBI for embezzlement from Kuhne’s former ER. P’s supervisor then informed P that P was being replaced and that a transfer to another division was available, or P could be placed on a “performance plan.” P’s employment was then terminated with neither being presented. P brings suit for damages after he is discharged.
        2. **P’s Arguments**:

Tortious Discharge in Contravention of Public Policy

PROF: most important part of the case

Would entitle P to tort damages (as opposed to K damages)

P claims that he was essentially fired for doing his legally required fiduciary duties of loyalty and care to his ER

But **court** says this is NOT a violation of public policy b/c agency duties P undertook were of private interest to ER and were not protecting the public

Courts trad. consider SH injury another type of **private** injury

It **would** be a violation of public policy & this COA would work here if EE was fired b/c ER refused to violate a building code

Tort damages would have been more $$ than K damages (K damages would have been expectation, and P would have had to mitigate them)

Breach of Implied Employment K

Oral K

Court is sympathetic that the company essentially promised that it would only dismiss for cause

P relied on the personnel policies that HE had to follow in firing other people below him

Court needs more facts, but doesn’t dismiss b/c P pleaded prima facie

Breach of Implied Covenant of Good Faith and Fair Dealing

P analogizes to tort damages in insurance cases

Court distinguishes b/c insurance companies provide protection that is a quasi-public good

Insureds don’t have anywhere to turn after a breach (insurance companies have much more power)

Tort actions are meant to vindicate social/public policy—Employment Ks are matter of private interest

* + - * 1. **H:** P’s K claim can go further, but dismisses tort claim. No answer on whether there is a statutory duty for an EE to report information relevant to his ER’s interest. There is not substantial public policy prohibiting an ER from discharging an EE for performing that supposed duty.
        2. **R: There is a presumption of an employment-at-will relationship unless there is evidence to the contrary to rebut the presumption (a relationship of infinite duration).** The court looks at the totality of the circumstances—specifically the duration of employment and “termination guidelines.”
        3. **R:** In the employment context, **factors apart from consideration and express terms may be used to ascertain the existence and content of an employment agreement**, including: personnel policies or practices of the ER, the EE’s longevity of service, actions of communications by the ER reflecting assurances of continued employment, and the practices of the industry in which the EE is engaged. The totality of the circumstances determines the nature of the implied K.
        4. The court takes a narrow view and says that **wrongful discharge is meant for the protection of the public interest. Whistleblower laws protect those who protect public interest. Most states do not protect EEs at private companies**. The companies have enough incentive to try to prevent fraud.
        5. Related HYPO

If Foley had shared info **not** involved in FBI investigation of past financial fraud and instead had evidence that Kuhne may have been embezzling from the ER itself—if Foley had been fired for reporting this info to his company, this court would likely have held that tort of wrongful discharge would have protected Foley in CA. [whistleblower laws; but CA has always been more protective in the tort context. Sarbanes Oxley would have protected Foley under federal law]

1988- most states didn’t protect EEs from discharge for expressing concerns about fraud or waste, b/c these were seen as concerns that the private ER would have adequate incentive to monitor and the public at large was not affected (just SHs).

* + - 1. Sarbanes-Oxley & Whistleblower law
         1. Congress came in to encourage reporting of illegal activity and fraudulent conduct b/c wanted to prevent Enron, etc.—shows Congress’ support of whistleblowers
         2. EEs of companies that are publicly traded

Prohibits retaliation against an EE who in good faith reports to any government official or any supervisor any information that is evidence of fraud.

This is a private cause of action

* + - * 1. Criminal penalties on any individual who knowingly with intent to retaliate takes an action harmful to a person w.r.t. lawful employment

EE must have reported information to any law enforcement official about illegal activity

Applies to public **and** private companies

* + - * 1. Audit committees are required for public companies as a mechanism for anonymous reporting

This would have helped Foley

* + - 1. Exceptions to the at-will doctrine that protect EEs:
         1. Discharges in violation of public policy
         2. Discharges in violation of EE handbooks which constitute a unilateral contract
         3. In every K there exists an implied covenant of good faith and fair dealing
    1. Agency Law & Relations with Creditors
       1. Generally
          1. Agency law allocates the risk of loss from the unauthorized actions of agents

Creditors and other 3rd parties can rely on these form Ks that come from agency law

* + - * 1. The agent’s actions will bind the principal only if the principal has manifested his or its assent to such actions

**Actual Authority**

Principal manifests his consent directly to the agent

Expressed (written or oral); or

Implied from conduct of the principal

Implied Authority is the type of authority considered to be held by the agent by virtue of being reasonably necessary to carry out express authority. As such, it can be inferred by virtue of a position held by an agent, e.g. partners have authority to bind the other partners in the firm, their liability being J/S, and in a corporation, all execs and senior EEs with decision-making authority by virtue of their position have authority to bind the corp.

**Apparent Authority** (aka “ostensible authority”)

Arises when an agent is w/out actual authority, but the principal manifests his consent directly to the 3rd party who is dealing with the agent

Expressed

Implied

Principal is bound only if 3rd party reasonably believed that the agent was authorized

**Inherent Authority**

Springs from a desire to protect the reasonable expectations of outsiders who deal with an agent (like an implied term in a K b/w principal and customers who work with agents)

Such authority held by the agent who exceeds the scope of express authority by a minimal amount and in a manner that is inherently similar to the action expressly authorized.

E.g. an agent empowered to rent a van for $500 who then, in fact, rents a van for his principal for $600, nonetheless binds the principal in relation to the 3rd party b/c of inherent authority, though the agent may be liable to the principal for the excess.

* + - 1. ***Blackburn v. Witter*** (CA Appeal, 1962)
         1. APPARENT AUTHORITY
         2. **F:** Long was an investment advisor for respondent. Pet. was an elderly woman. Long, while still employed by company, persuaded Mrs. Blackburn to invest in a non-existent company.
         3. The following facts encourage the belief that Long’s actions were supported by the Firm:

Dean Witter knew that customers rely on their EEs for advice, guidance, and consultation.

Witter sent out these EEs to assist customers on the company’s behalf

Long represented that there was a research dept that was assisting the brokers

Communications came on Witter stationery

* + - * 1. **H**: The agent (Long) has **apparent authority**. Affirmed TC b/c there was substantial evidence to support the finding of the TC.

Court forgives pet. b/c Long lied to her after she notices the discrepancies (Def. Witter argued that Pet. was negligent in believing Long b/c there were red flags)

* + - * 1. **Rule:** A principal is bound by acts of his agent, under a merely ostensible/apparent authority, to those persons only who have in good faith, and without want of ordinary care, incurred a liability or parted with value, upon the faith thereof
        2. **Rule:** A principal who puts his agent in a position that enables the agent, while apparently acting within his authority, to commit fraud upon 3rd parties is subject to liability to such 3rd persons for the fraud.
        3. Contrast with how the 7th Cir. deals with ***Sennott***
    1. ***Sennott v. Rodman & Renshaw*** (7th Cir.)
       1. **H:** rejects Sennott’s (Pet.) claim for damages; declines to use agency principles to hold the brokerage firm liable for the actions of the son of a partner who was once associated with the firm
          1. Court has no patience for Sennott’s claim that he exercised ordinary care
          2. Explains why there are no parallels b/w this case and ***Blackburn***:

Blackburn asked questions and was a widow, etc.

Sennott was waiving red flags that were more severe that should have alerted him that there was something amiss

The brokerage firm tried to get Sennott to talk to them about the red flags and he told them that it was none of their business

1. Comparison of General Partnerships, Corporations, and Limited Partnerships
   1. Comparison of Corporations and Partnerships

|  |  |  |
| --- | --- | --- |
|  | **General Partnership** | **Corporation** |
| *Formation* | 1. Do not need a writing; any expression of will to enter into association as co-owners of a business 2. A handshake or less can manifest this type of agreement | 1. Requires formality in the formation; 2. Filing certain documents with the Sec. of State in the state in which the corporation is being formed |
| *Governing Rule* | General partnership law will govern the partner’s rights and duties. This law will fill in the gaps where the parties do not contract. Partnership law does not vary much from state to state | The state’s corporation laws will be the default laws, unless the parties have contracted differently |
| *Management & Ownership* | 1. Owners = partners 2. Ownership & management are shared [& no separation of ownership and control] 3. No person may become a partner unless all partners agree 4. Default rule = equal management by all of the partners 5. Ordinary matters are resolved by maj rule; extraordinary decisions must be made unanimously | Centralized management:   1. Separation of ownership and control 2. Owners = SHs [fill the role of partners in partnership law; put the money in and are the claimants of last resort in dissolution] 3. Management/control = Board of directors who empower the officers to run the corp day-to-day 4. NOTE: some corps (like closely held) often don’t separate ownership from control |
| *Duration* | 1. Can be ended at any time 2. A “new” partnership when any partner withdraws, unless agreement specifies otherwise (ex. No dissolution when there is a withdrawal) 3. \*This ensures that partners can adapt to new circumstances, but also opens up the possibility of opportunistic withdrawal (leverage for bargaining) | 1. Perpetual life 2. When individual SHs sell shares, the corporation does not become a new legal entity |
| *Structure* | 1. Partners owe one another a fiduciary duty [CL fid duties come into play] 2. Partners are the agent of the partnership/co. 3. Any act by one partner binds the entire partnership | 1. Board of Directors and officers are agents of the SHs & owe fiduciary duties to the corp. 2. SHs are the principals 3. Directors & officers are the agents of the SH principals |
| *Liability* | Partners are fully personally liable for losses caused by other partners [ex: $5mm tort judgment, 5 partners = each partner liable for $1mm] | 1. Limited liability 2. Corporate SHs can only lose the assets that they have invested in the organization |
| *Taxes* | 1. Not treated as a separate entity for tax purposes 2. All profits and losses are passed through to the partners, and each partner pays taxes individually | 1. Corporation as an entity pays income taxes on its profits 2. Corporation then distributes profits to SHs as dividends, then SHs pay taxes on received dividends 3. DOUBLE taxation |
| *Transfer of Interest* | Partners cannot transfer their ownership interest (as a general matter) | 1. Ownership interests are freely transferrable 2. SH buys, sells, or trades stock |

* 1. Limited Partnership
     1. Formation
        1. Formal steps have to be taken
        2. One general partner has to be named and file the paperwork
     2. Limited features
        1. Limited partners do not participate in the management of the firm (this is the job of the general partner)
        2. Limited partners enjoy limited liability, only to the extent that they do not participate in the management of the firm

1. The Corporate Form and the Specialized Roles of SHs, Directors, and Officers
   1. The Corporate Form
      1. MBCA §§ 2.06, 8.01, 8.40, 10.01-10.04, 10.20
      2. DE §§ 109, 141(a), 142, 242
      3. Attributes of a Corporation
         1. Formality of formation
         2. Centralized management
         3. Perpetual life
         4. Limited liability
         5. Transferable ownership interests (in most instances)
      4. Overview
         1. **“Default Rules”**: state corp. law provides a set of standard form, off-the-rack rules for persons wishing to own and operate a firm
         2. **DE § 102- Articles of Incorporation** (aka Certificate of Incorporation; charter): **the basic constitution of a corporation** 
            1. State law requires certain provisions:

No provision can conflict with a mandatory provision in state corporate law

* + - * 1. This is a public document

This is what is filed with the state official

* + - * 1. Only directors may propose amendments to articles of incorporation (per DE and MBCA), but SHs must vote on the amendments
        2. In DE, Articles can extend bylaw-amending power to the Directors of the corp.
      1. **DE § 109- Bylaws**: internal set of rules for the governance of the corporation
         1. Nothing can be inconsistent with the articles of incorporation
         2. No provision may conflict with any mandatory provision in state corporate laws
         3. Often includes:

Elections

Officers

Size of board

(May contain any provision “relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its SHs, directors, officers, or EEs” - **§ 109**)

* + - * 1. SHs have the ability to propose amendments to the bylaws (unlike the Articles)
        2. SHs vote on amendments to the bylaws; however, in many states the directors must also approve the amendment to the bylaw

Directors’ power, however, cannot supersede the SHs

* + - 1. Archetypical corp. separation: directors, officers, and SHs
         1. **SHs** provide capital and elect directors

No direct management

* + - * 1. **Directors** make major policy decisions
        2. **Officers** execute those policies and provide day-to-day management
        3. Separation of these functions is not required
      1. By statute, all corporate powers are exercised by, or under the authority of, a centralized group – the Board of Directors
      2. A corporation will be granted the **same** **legal rights and responsibilities as any person**
      3. Potential of perpetual duration
    1. **Directors** [DE **§ 141**]
       1. “Business Judgment Rule”- a judicial presumption that directors acted properly
       2. DE **§ 141(a)**: Board is the locus of all legal power and authority exercised by the corporation; directors manage the corporate business & affairs
          1. This provision [141(a)] is the principle obstacle for SH control of the corp.

Courts have interpreted this to mean that SHs have no direct management control unless there is a provision in the Articles of Incorporation that states otherwise

DE prevents initiation of amendments to the Art. of Incorp. to be made by the SHs

* + - 1. DE **§ 142**: Directors may choose officers and set terms in accordance with the bylaws
      2. DE **§ 170**: Directors may declare and pay dividends
      3. DE **§ 242(b)**: Directors shall propose amendments to the Cert. of Incorporation at the annual mtg.
         1. An amendment to the articles may be initiated only by the directors—normal corporate law
      4. DE **§ 251**: Directors may adopt resolutions proposing to merge
         1. Even if maj of SHs want to merge, they have to get this to the Directors in order to actually make the proposal
      5. DE **§ 271**: Directors propose to sell all or substantially all of the assets of a corporation
      6. DE **§ 275**: Dissolution can only be started by a director resolution
         1. But have to eventually be put up for SH votes
      7. Entitled to compensation for services, but do not share in firm’s residual profits
      8. Management power must be exercised collectively and by majority rule
      9. Law imposes a fiduciary duty on the directors to the corporation and its SHs
      10. Usually comprised of the major SHs
      11. Inside and outside directors now perform de facto specialized roles
          1. **Inside directors** are those who are also officers of the corp.

Ex: CEO, CFO

Why would we not want the Chairman of the Board to also serve as the CEO?

Monitoring function: this would allow for greater detached oversight that an outside director would provide.

Sometimes have to disclose why if you have one person for both jobs

* + - * 1. **Outside directors**

Except for board membership, they don’t have any other relation to the company

If they have no other financial relationship with the company, they are also termed “**Independent directors”**

Ie. an attorney who serves as outside counsel is an indep. director if no substantial fin connection

Can have stock ownership and still be an outside independent director

* + - 1. Boards typically meet 4-10x a year, are usually nominated and usually supportive of inside management
      2. Sarbanes-Oxley pushed for more outside directors
         1. Downsides: outside directors may not be as familiar with the corporation’s business, personnel, and markets
         2. Upsides: outside indep. directors are often thought to be better monitors and better able to identify conflicts of interest among the inside directors (ie. executive compensation)
      3. NYSE & NASDAQ listing requires that maj of board is outside directors
      4. Not liable for the debts of the corp.
    1. **Officers** [DE **§ 142**]
       1. Most statutes are silent about specifying duties for officers
          1. DE **§ 142(a)** doesn’t state much. Basically says look to the bylaws

**(a)** Officers have the powers/titles/duties that the bylaws give them or by the resolutions by the Board

**(b)** Officers shall be chosen in such manner and shall hold their offices in such terms as prescribed in the bylaws or determined by the Board

* + - * 1. CEO is not specifically mentioned
      1. Hold effective power in that they make hiring decisions
         1. Statutory model doesn’t match reality in certain ways

In large PTCs, officers hold the real power (esp. the CEO) even though the statutes make it seem like the Board has most of the power

The bigger the corporation, the more discretion the officers have

Board nominates new Directors, so in a sense it is self perpetuating, **but** often it is the CEO who mentions to the Board who he thinks should be nominated

Board recommends the slate; officers have a role in who the Board’s nominating committee is considering (this is power)

The statute doesn’t necessarily contemplate this, but it is often the reality

* + - 1. Officers are the symbolic/public face of the company
         1. This is why the Board is willing to pay CEO high salaries
      2. Corporate law treats officers as agents and corporation as principal
      3. Sarbanes & Oxley requires that the CEO and CFO certify the financial reports of the corporation that are made pursuant to disclosure rules of the federal securities laws
      4. Receive compensation for services, but do not share in residual profit unless they also own shares
      5. Per **§ 142,** the only required officer is one to be responsible for keeping and verifying corporate records (usually “corporate secretary”)
      6. Not liable for the debts of the corporation
    1. **Shareholders**
       1. **SHs may (1) vote; (2) sell; or (3) sue**
          1. SHs may have voting rights, but it is the directors that initiate the possible amendments, resolutions to merge, dissolve, etc. (which are then voted on by the SHs)

SH voting rights are circumscribed to the big important matters (ie. if someone gets to be a director, selling substantial assets, dissolving)

* + - 1. Under DE **§ 242(b)**, if the Board of Directors proposes an amendment to the articles of incorporation, the SHs get to vote
      2. SHs vote on dissolution
      3. SHs elect their Directors
      4. DE **§ 212(a)**: 1 share = 1 vote (but other shares may have different voting rights)
      5. DE **§ 211**: SHs meet annually and elect directors at that mtg
      6. DE **§ 228**: SHs may act by written consent (so don’t all have to come together in a physical mtg)
      7. DE **§ 109**: gives SHs the right to amend bylaws and initiate bylaw amendments
      8. DE **§ 251**: SH vote on merger proposals
      9. DE **§ 271**: SHs vote on proposals for the sale of all or substantially all of assets
      10. DE **§ 275**: SHs vote on proposals to resolve
      11. SHs are the owners of the corporation, but have very little actual control over the operation of the corporation
      12. Shares entitle the holder to a pro rata share of the firm’s profits and net assets if the corporation dissolves
      13. SHs may get distribution of profits (dividends)
      14. SHs are risk-bearers and residual claimants
      15. Individually—very limited rights/power to participate directly in the management or operation of the corporation’s business
          1. SHs only exercise control through the election of Directors and through confirmation of mergers, dissolution, etc. …
      16. Shares are freely transferable, and voting rights transfer with the share
      17. SH has no obligation or liability to the corporation or its creditors beyond the amount she paid for the shares
      18. Most states DO allow SH to initiate a change in the corporation’s bylaws
          1. However, SHs may not amend to make ordinary business decisions or to establish corporate policies. This power belongs to Directors and may only be taken away in the articles of incorporation
      19. **Have the right to suggest that the directors take a particular action or adopt a new policy**
    1. **Prob. 3-2**
       1. May Joan make the following proposals? [She was formerly a member of the corporation’s senior management. Now the issue is whether she has the power to suggest management idea at SH’s mtg.]. NOTE- Joan can’t make any of (a)-(f) as amendments to the **Articles**, but see below re: **Bylaws**
          1. Locate the banking operations in Timber City? NO (bylaws); SHs may not make proposals to amend the bylaws as to managerial decisions. **SHs may propose bylaw amendments as long as they are a proper subject for bylaw amendments. This is not a proper subject b/c deciding how a corporation may satisfy its banking needs is a management decision. The director’s power may be supplanted by a provision in the Articles [141(a)]. However, only directors may propose amendments to the Articles.**

What can Joan do?

She can threaten to withhold her vote on her renomination of the directors

She could sell her shares

She could sue if the new banking operation creates a conflict of interest

She could ask that the substance of her proposal be discussed at the SH mtg. A **“precatory proposal.”** SHs should be allowed to discuss matters that are important to them.

She could try to encourage other SHs to withhold their votes

She could buy more than 50% of the company; then she would be in control as the maj SH. She could also solicit proxies of the other SHs if she gets more than 50% total of the shares.

* + - * 1. Propose that the purpose of corporation is to conduct lawful business for a profit but with due consideration for forest management and long-term profitability?

NO (bylaws); this attempts to restrict director’s management authority & change the nature of the purpose, which can only be done via provisions in the Articles per DE **§ 102(a)(3)**

Curtailing the decisions of a corporation are in the managerial realm

Purpose of the corporation must be contained in the Articles (but allows a purpose to be phrased in a very vague way)

This could be argued to be an indirect way to change what is in the Articles

* + - * 1. Proposal that the Articles or Bylaws be amended to create the office of the VP for Ecology? New officer position.

YES (bylaws); via introduction as a bylaw amendment, she can suggest that the Board make this new officer position

DE **§ 142(a)**: corporation shall have the officers with such titles and duties as shall be stated in the bylaws

DE **§ 109**: SHs can amend the bylaws

She could submit this to a SH vote, but if management/directors don’t like this resolution, it is not likely that Joan will succeed

If this was a hot debate with management, Joan could solicit proxies

DE law: combo of **§ 102** and **§ 142(a)** would be a vehicle for adding this VP

* + - * 1. Propose that the Articles or Bylaws be amended to provide for annual election by the SHs of all corporate officers?

YES (bylaws); per **§ 142(b)** this is a proper subject for SH consideration b/c it provides that officers shall be chosen in the manner and shall hold their offices for such terms as prescribed in the bylaws. The SHs may elect officers.

However, management would campaign against this

NOTE: the **MBCA** would not allow this b/c the appointment of officers is given to the Directors

**§ 8.40(a)**: bylaws describe the offices (does NOT mention office terms)

SHs can specify which officers there are, but how long/how they are operated falls under managerial/director decision

Could not have a SH vote on an officer term

* + - * 1. Propose that the corporation pay dividends of X dollars?

NO (bylaws); this is a management decision made by the Board of Directors under **§ 170(a)**

* + - * 1. Propose that the corporation merge with a firm?

NO (bylaws); this is a management decision.

Per **§ 251(b)** this is a decision to be made by the Board

* + - 1. Answers would change if corporation was incorporated in MBCA jurisdiction b/c DE has not adopted the MBCA
      2. NOTE: despite her ownership, Joan does not have much power to push through the changes she wants without 40% +1 other SHs
    1. Views of the Corporation
       1. **“SH Primacy”** View
          1. Corp. should be managed primarily/exclusively for the benefit of its SHs.

An implication of this view of the purpose of the corp. is that the principle function of corporate law should be to protect SHs from officers and directors’ misuse of power

* + - 1. **“Director Primacy”** View
         1. Directors are duly elected and run the show

They have their own obligations and fiduciary duty law is the check that makes sure they are not self-serving

Different views of balance of power b/w SHs and directors

* + - 1. **“Other Constituency”** View
         1. Sometimes the general public may have an interest in consuming the product, which justifies other regulatory schemes/protection under corporate law (ie. utility companies)

EEs of the corporation, who may deserve state law protection

Government/TPs

Government bail-out (ended up with company stock)

Environment

Suppliers of raw materials

**Creditors**

* + - * 1. SH primacy may be slightly diminished, here

But could argue that taking into account these other constituencies will lead to maximum profits

* + - * 1. **DE has NOT enacted a provision permitting the Board to consider the interests of other constituencies when considering what is in the best interests of the corporation**

Others have (ie. CT doesn’t assign weight to the interests, but the expectation is that directors are going to consider some of these other constituencies in making decisions)

* + - 1. NOTE: these views show the different POVs re: whether a director complies with its fiduciary duties when it says no to a merger
  1. The Formation of the Corporation & the Governance Expectations of the Initial Participants
     1. Where to Incorporate, Formation, Shares
        1. **“Internal Affairs Doctrine”**- courts look to the laws of the incorporating state to determine the basic rights and duties applicable to a particular corporation [even if all of the corporation’s investors, factories, etc. are outside of this state—a corp. can be HQ’d in one state and incorporated in another state]
           1. This makes it possible for states to compete with other states for incorporating companies
           2. “Race to the bottom”- legislatures’ attempt to bribe by fashioning corporation codes that give directors and officers more discretion and less liability

People who criticize this may prefer a uniform federal corporate law

* + - 1. Other reasons why companies go to DE
         1. Once there is a critical mass of corporations in DE, other corporations will follow suit
         2. The legislature/DE courts/judges are more experienced in corporate law. This makes it easier for litigators, too.

This also causes greater certainty in the law

* + - * 1. Argument that DE corporate law achieves an appropriate balance of the interests, and this is why companies prefer to incorporate there (not the race to the bottom)

Some evidence that companies that reincorporate in DE have positive stock market effects—the market is valuing the DE decision

SHs have the power to choose their investments

* + - 1. ND’s “Race to the Top”
         1. Hoping to compete with DE
         2. Adopted what it heralded as the most SH friendly corporate law in the USA

Provides for maj voting in director elections

Gives SHs a say on pay

* + - * 1. Goal was that SH activists would seek to reincorporate in ND

Directors propose reincorporation b/c it is in the Articles, but SHs vote on it

* + - 1. Federal law affecting corporations
         1. Congress can use commerce clause power to regulate corporations directly if it believes that state law is not sufficiently protective of national interest [esp. governance of PTCs]
         2. Congress will warn state legislatures and judiciaries (esp. DE) that if they continue to make it seem like the decks are stacked against SHs, Congress can step in with securities regulations/federal law that re-divvies up the rights and responsibilities of the SHs/directors/officers
      2. **Prob. 3.3** [Applies MBCA 2.02]
         1. F: soft drink association looking to change its state of incorporation from DE to an MBCA state

The decision to reincorporate would require an amendment to the Articles (proposed by the Directors and voted on by the SHs)

* + - * 1. Art. 1: need to change the name to include “corporation,” “incorporated,” or “limited,” or an abbreviation of one of these words

Currently in compliance with DE § 102(a)(1) b/c uses the word “association”

MBCA § 2.02(a)(1), which points to § 4.01

**Policy**: MBCA wants corporations to be readily identifiable; wants words that signal limited liability to the public (association is a more “squishy” word)

This is an easy change to make

* + - * 1. Art. 2: the registered agent and location will have to be updated to the new state of incorporation

DE § 102(a)(2)- this address needs the county in which the agent resides (missing)

DE would prob. require an agent IN DE

MBCA § 2.02(a)(3) requires street address and name of registered agent (in compliance here)

**Reasons**: for the purpose of receipt of process

* + - * 1. Art. 3: The Purpose – this is satisfactory for both

DE § 102(a)(3) – Articles MUST specify the purpose (can be general—“anything that’s legal”)

MBCA § 3.01- default rule that a corp. may engage in any lawful business (if Articles say nothing about the purpose, this § enters in)

MBCA § 2.02(b)(2)(i)- purpose **may** be set out in the articles

Company here would not have to change its provision

* + - * 1. Art. 4: Issuing Share

DE § 102(a)(4)- In the Articles, corp. must set forth the total # of shares it is authorized to issue and must either set forth its par value or a statement that he shares are to be w/o par value

Par value at one time represented the price at which the shares of the corporation were to be issued. It is now outdated—just an arbitrary amount assigned to a share by the Articles (usually shares are issued for higher amounts than the par value of the share). This may be used to judge the minimum capitalization

DE requires a mention of par value, but can say that it is $1 (antiquated approach)

MBCA § 2.02(b)(2)(iv)- eliminates requirement of par value—however, this § allows a corp to specify a par value

No change necessary (can leave it in)

* + - * 1. Art. 5: Director liability

DE § 102(b)(7)- this specifically authorizes this provision to be included in the Articles—can eliminate/limit personal liability for certain types of breaches of fiduciary duty as a director.

**May not limit liability for**: breach of duty of loyalty, acts or omissions not in good faith, or transactions for improper benefit (unlawful payment of dividends), etc.

**May have** an exculpation provision for a breach of the duty of care

MBCA § 2.02(b)(4)- this also approves an **exculpation provision**. Exclusion list does not forbid exculpation for breach of duty of care, so may include this provision.

This is actually more generous toward directors than DE. This allows exculpation of liability for breach of duty of loyalty.

* + 1. Formation: Articles of Incorporation
       1. MBCA §§ 2.01-2.06
       2. DE §§ 101, 102
       3. NOTE: some things **must** be in the Articles and some things **may** be in them
       4. **Process:** complete the Articles and file them with the appropriate state official in the chosen state.
       5. Includes:
          1. Corporation’s name
          2. Registered office and agent for service of process
          3. Number of shares it is authorized to issue
    2. Determining Shares to Issue
       1. MBCA § 6.01
       2. DE § 151
       3. **Capital structure = combo of claims that the corp. sells** 
          1. NOTE: choose how to organize this after choosing the state in which to incorporate
          2. **(1) Equity**: usually stock, dividends, etc.

**DE § 151** largely governs the issuance of stock in DE

Connotes power to control, usually by voting, and right to receive the fruits of the business through dividends, distributions and liquidation

Market capitalization = amount of shares outstanding (x) price per share

MBCA & DE require the corp to state in the Articles the # of shares it is qualified to issue

If corp decides to issue more stock, this needs to be reflected in the Articles, too

If Articles authorizes more than one class of shares, then the Articles must prescribe the classes, # of shares in each class, and rights of each

* + - * 1. **(2) Debt**: this is some fixed contractual obligation of repayment that is independent of the success or failure of the corporation

These terms are laid out in Ks b/w the corp. and the lenders, whereas the terms in equity are laid out in the Articles and DE § 151

K will specify term, interest rate, etc.

Not generally prescribed in the Articles

Sometimes this is orchestrated through private lending, from corps., other times via public lending like bonds

Corporate lenders can exert influence over the corporation’s decision making by using the loan agreement terms to extract concessions

E.g. debt to equity ratios, monitoring, seeing executive compensation agreements, etc.

* + - 1. **DE § 151**: may have several types or classes of shares
         1. All shares of a given class are fungible (they have identical rights, preferences, and limitations)

Investors are normally entitled to assume that there is no fundamental difference in common stock from corporation to corporation w.r.t. rights and privileges

* + - 1. Must have a class that carries authority to elect directors and exercise all other SH voting rights
      2. **DE § 151(d):** Must have a class that entitles the bearer to receive the corporation’s net assets upon dissolution
      3. **“Common Shares”**: both residual claimant status and voting rights
      4. **“Preferred Shares”:** have a dividend or liquidation preference over common shares, usually coupled with limitation or denial of voting rights
         1. Need to research—cannot assume equality between P&G v. GE
      5. **Articles of Incorp**. determines the amount of shares to be issued and the classes that will be provided
         1. **DE § 102(a)(4), 151**: Must give the distinguishing characteristics and rights b/w classes
      6. Most corps just issue a single class of common stock
         1. Common stock has residual claim status: right to have a claim to corp’s assets after all other debts have been paid during a liquidation
      7. Corps may also issue other types of stock to convince a different group of investors with different risk preferences to invest in the enterprise
         1. Grant different voting rights among different classes of stock
         2. Preferred share—dividend of liquidation preferences over common shares

These are not fungible across corps like common shares are

* + 1. Determining Voting Rights: Using Articles & Bylaws to Change Legal Norms
       1. MBCA §§ 8.04, 7.21, 7.28
       2. DE §§ 141(d), 212(a), 214, 216
       3. NOTE: **Articles** are public documents that can be changed only by action of the corporation’s directors and SHs. **Bylaws** often can be changed by the directors alone and are not publicly filed documents.
       4. **Default Rules**
          1. DE § 212(a)- One share = one vote
          2. DE § 211- All seats on the Board are up for election 1x a year at the annual mtg
          3. DE § 212(a)- Each SH has one vote for a each seat up for election
          4. DE § 216(3)- Plurality will win

Default for Directors only

For all other voting, must command the maj of shares

Some corporations have used private ordering to require majority for director election (this would avoid the problem of unliked person winning when the # of directors running = # of seats, but could lead to a failed election if each “winner” didn’t win a maj of votes)

DE § 216- recent sub-provision saying that a bylaw amendment specifying the vote necessary for the election of a director shall not be further amended or repealed by the directors

* + - 1. *Overview of Normal Rules of SH Voting for Election of Directors:* ***Straight Voting****- this is the default rule in DE, but* **§ 214** *allows the Articles to have cumulative voting*
         1. Directors are annually elected by a plurality vote (one vote/one share)
         2. Cast votes equal to number of shares for each of X candidates

SH with 51% of the votes will be able to elect 100% of the Board

The top vote earners win (even if they don’t win a maj of the votes)

* + - * 1. SHs may change the bylaws and therefore adjust the votes that are necessary for the election of the Board

The Articles may also be changed to adjust the votes required for the election of the Board

Such as changing to requiring a maj of votes instead of a plurality of votes

* + - * 1. **Implications**

Most states specify plurality rule

No failed elections. No vacant seats

Presidential elections are also plurality

In an uncontested election, the Director may be elected by only a single vote from a single SH

Management effectively chooses the directors through the selection program. SHs are essentially stuck with the directors

* + - * 1. Example: Straight Voting

Total shares = 10

Maxine = 6 shares, so 6 votes per seat

Frank = 4 shares, so 4 votes per seat

3 board seats

If straight voting, then a SH that has more than 50% of the stock may choose all of the directors

Ie. if 6 people run for director and Maxine puts all 6 of her votes for each of 3 of them and Frank puts all of his 4 votes for each of the OTHER three, then ALL 3 of Maxine’s people will win (Frank will get no representation)

Solutions:

Cumulative voting in Articles (DE 214); or

Provide for different classes of stock in the Articles to give voting preference to some class(es)

Shares could reflect their capital contributions (same liquidation and dividend preference for both—difference only in voting rights; could even be director-only voting rights)

But what if Frank quits his job and opts to work for the corp. at a very low pay? Maxine continues to work outside. What could we do for Frank to give him equal representation on the Board?

Could expand to 4 directors and keep the classes of stock

Maxine will still get more dividends b/c she has more money invested

Allow M & F to each get two directors

Dual Class Common Stock

See below

* + - 1. ***Cumulative Voting***
         1. Authorized under DE § 214

Corps. who chose it manifest an intent to guarantee non-majority SHs at least some potential power in that corp.

* + - * 1. A SH can cast a total # of votes equal to the number of shares multiplied by the # of positions to be filled

Can be spread out or concentrated as desired

Example: 100 shares, 3 candidates = 300 votes. May cast 300 votes for one candidate. Straight voting would only allow 100 votes for each of the 3 candidates.

* + - * 1. Purpose: permit some minority SHs to have a place on the board
        2. **Maximum voting power of a given block of shares**:

To elect **X** # of directors, a SH must have more than SX/(D+1) shares.

Where **S** = # of outstanding shares voting; **D** = # of directors

Frank & Maxine example

Maxine has 18 votes; Frank has 12 votes

Frank has 4 shares, but only needs more than 2.5 shares to be guaranteed one director

M is guaranteed 2 seats & F is guaranteed 1 seat

(10)(1)/4 = 2.5 shares [Frank]

(10)(2)/4 = 5 shares (Maxine)

* + - * 1. Cumulative voting is more common for **private** corps. b/c people will not put forward up to 50% of the equity in a corp unless they have some representation

This will allow for at least one seat of representation. That investor can at least participate in the discussion.

* + - 1. ***Class Voting, Including Dual-Class Voting Schemes***
         1. Articles may divide shares into classes and permit each class to select a specified # of Directors
         2. One class may be given more votes per share than another class
         3. These have been disfavored by the SEC and curtailed by stock exchange rules, but are permitted in DE
         4. **Dual Class Common Stock**

Another way to ensure board representation to non-maj SHs if you provide for this in Articles

One class has disproportionate voting power as compared to their capital contribution

From above example:

Maxine would have 6 class A shares (1 vote per share)

Frank would have 4 class B shares (1.5 votes per share)

This would satisfy Frank and achieve equal board representation

See this mostly in close corps

SEC and stock exchanges disfavor this b/c it undermines the ability to compare b/w corporations (fungibility)

Enables SH with relatively low equity participation to have disproportionate power and influence w.r.t. things like director elections

* + - 1. ***Classified Board with Staggered Terms*** *– Adaptability v. Stability* 
         1. MBCA § 8.06
         2. DE §141(d)
         3. **This may be enacted in either the Articles or the bylaws**

If the staggered board provision is in the Articles:

Only the directors may propose a change

THIS IS MOST COMMON

If staggered board provision is in the bylaws:

Provision may be more easily changed

New maj SH may propose to change the bylaws and then use the voting power to effectuate that change

* + - * 1. If divided into two groups, each director serves a 2-year term
        2. If divided into three groups, each director serves a 3-year term
        3. Benefits:

Staggered terms theoretically ensure that a corp. will always have experienced directors in office

Management likes that they will keep their jobs longer

* + - * 1. Drawbacks:

Staggered terms means that two separate annual mtgs would be required to replace a maj of the board

**Limits the ability to change**: this operates as a constraint on the maj of SHs’ ability to adapt to changed circumstances by quickly naming new directors

* + - * 1. What does staggered terms do to voting?

It reduces the # of directors up for election each year, and therefore **increases the # of shares that the minority needs to successfully seat a person on the Board**

* + - 1. **Prob. 3-5**
         1. F: Protein Corp. has 6 mm shares. 2 mm are held by the Cabal. Upcoming election of 9 board members. Remaining shares are held by a diverse group, none of them owns more than 1% of Protein’s shares. Cabal has a slate of directors that will run against management’s nominees. Assume cum. voting. What is the max # of directors Cabal can be sure of electing if:

Under straight voting, Cabal is not guaranteed ANY directors

Cabal’s 1/3 voting power is fruitless if the other 2/3 voting power favors the 9 mgmt nominees

Under cum voting, if mgmt has proxies for the rest of the 4 mm shares? Cabal can be sure of electing as many as 3 directors [with its 2 mm shares]

(6,000,000 x 1) / (9 + 1) = 600,000 [+1] shares

Cabal would need 600,000 + 1 shares to be guaranteed to elect one director

Management is guaranteed 6 directors with its 4 million votes

Under cum voting, if 3 mm non-Cabal owned shares submit proxies in favor of management’s nominees, and the remaining 1 mm shares are not voted? Cabal is still assured of only electing three directors (is just one share short of electing 4)

If Cabal decides to engage management in a contest for control/outstanding 1 mm shares, Cabal must obtain proxies from 500,001 of the outstanding 1 mm shares to gain control of the corp. (ie. get 5 directors)

Cabal can overthrow management if successfully solicits the proxies

Interestingly: cum voting would protect management, here, b/c with straight voting the Cabal would have ALL 9 seats (b/c Cabal would have 2,500,001 shares out of 5 mm voting shares)

* + - 1. **Prob. 3-6**
         1. F: Micro has 5 mm outstanding shares currently held by 24 sophisticated investors and newly hired CEO, Jan Stark (who owns 1,000 shares). Micro is negotiating with investor Bill Door. Door is willing to purchase 3 mm Micro shares (additional shares that are to be issued by Micro in exchange for the new funds) if he is given the ability to elect four of the nine members of the board. Stark has told the board that she favors the deal but will quit unless the board gives her 1/3 of the voting power in the election of the board maj.
         2. Issue: how can the board (which has the full support of the SHs) satisfy Door and Stark, while protecting the interests of the corp. and its other SHs?
         3. Analysis

Under **straight voting**: if Door owned 3 mm out of 8 mm outstanding shares, and if all 8 mm shares are voted at an election, Door would not be guaranteed any seats (if mgmt. has the proxy)

**Cum voting** would **not** help Door with his 4 directors, either

Door would need more than 3 mill to elect 4 directors

Would need 3,200,001

**Answer**: split stocks into A, B, and C classes to accommodate Door, Stark, and the rest of the SHs

**Door**: use private ordering allowed under DE § 151(a) & 141(d) [authorize more than one class of shares]

Amend Articles for two classes of common shares

Both would have same liquidation and dividend rights

Those already outstanding can be Class A

Exclusive right to elect 5 directors

Door’s shares can be Class B

Exclusive right to elect 4 directors

This change would have to be in the Articles, so would have to prepare a resolution and have the Directors propose this to SHs and have the SHs vote

Presumably they all agree, here, though, b/c they want Door to invest

**Stark**

Not contributing as much money as Door, but perhaps she has more working capital

Currently has negligible voting power, but wants 1/3 voting power in Board

(A) Could issue Stark 2.5 million shares of Class A

Not practical b/c other SHs would be mad b/c this would dilute their equity interest in the corp.

\*(B) Could issue Stark Class C shares in the corp

These shares don’t have to have any liquidation rights—could be defined as having 1/3 of the voting power in the election of the 5 board members

Current SHs would have to vote on this

Tax considerations prob. drive the decision making in these situations

* + - * 1. Take-away: we have default rules under DE law, but these rules may be changed

**Three ways to vary default rules for SH voting in director elections:**

Cumulative voting by inserting provision in Articles (§ 214)

Adopt class voting for directors (§ 151(a))

Each class has rights to vote for certain directors

Staggered board/classified board of Directors

This would vary the DE § 212(a) default rule

But one set of terms would have to be up for election each year

DE § 141(d) allows staggered terms if such provision is in Articles **or** in a SH adopted bylaw

Board would be divided into 2 or 3 groups in as equal a size as possible

If the staggered board provision is in the Articles, then the new maj SH can’t propose to get rid of it—the Board has to make the proposal

Regarded as an anti-takeover device

Trend in PTCs to eliminate classified boards at SH request—because want the corp to be able to adapt to change

* + 1. SH Action After Electing Directors
       1. Annual Mtg & Other Forums for SH Action
          1. MBCA §§ 7.01-7.07, 7.21
          2. DE §§ 211-213, 216, 222, 228
          3. Decisions w.r.t. the annual mtg may be provided in the **Articles** or **bylaws**
          4. **DE § 211**

**(a)(1)**- provides location of the mtg

Can be held within our outside of the state in a manner designated in the Articles or bylaws

If both are silent, the where and when of the mtg is determined by the Board

**(b)-** Directors are elected at the annual meeting

**(c)**- grace period. If there is a failure to hold the annual mtg in 13 month window, the Court of Chancery may order a mtg to be held at the application of the SH or a director

**(d)**- **only directors may call special mtgs unless the Articles or the bylaws state otherwise**. Unless Articles or bylaws specifically state otherwise (this makes change more difficult, b/c many changes may only be done by SHs by a vote at the annual mtg; this effectively blocks SH mtgs to oppose the current board & slows things down)

Most states also allow SHs to call a special SHs mtgs to discuss issues specifically mentioned in the mtg notice.

**MBCA § 7.02**: SHs owning 10% or more of stock may demand that the directors hold a special SHs mtg.

* + - * 1. Directors may act strategically to try to hold the annual mtg in such a way in that it is advantageous to them

Directors do have the discretion to choose an inconvenient time and an inconvenient place

Courts are reluctant to interfere with the Board as long as there is notice—unless it is specified otherwise in the Articles or the bylaws

* + - * 1. **Action by written consent in lieu of mtg**—DE actually has a broad/more flexible provision

**DE § 228(a)**- allows SHs to act w/o prior notice & w/o a vote if written consents to the proposed action are signed by SHs holding the voting power for such action. **Maj of SHs would have to act by written consent for it to work.**

Can use this to amend the bylaws; or remove/elect directors if it would be permissible to do at the mtg.

This is the only exception to the otherwise immutable right of SHs to have an annual mtg (b/c if there is no need to elect directors at the mtg, then the mtg’s statutory purpose has already been achieved and the expense of the mtg would outweigh the policy reasons for having it)

**MBCA § 7.04**: allows SHs to act without a mtg only by unanimous consent

* + - * 1. Another way to amend the bylaws is to propose a resolution at the annual mtg and have it voted on by the SHs, including the possibility of soliciting proxies in advance
      1. Removal of Directors & Other Midstream Private Ordering
         1. MBCA §§ 8.08-8.10
         2. DE §§ 141(k), 223
         3. **General Rule:** when non-classified (no staggering of terms) Board is elected by a single class of SHs by straight voting, those SHs may remove those directors with or w/out cause.

**In DE**, the removal of directors is much more limited. See DE § 141(k)

* + - * 1. When we have cum voting, staggered terms, or class elections, we will have special limitations w.r.t. removing directors w/ or w/out cause
        2. **DE § 141(k)**: Default rule- “any director may be removed, w/ or w/out cause, by the holders of a majority of the shares …”

**Exceptions** to general rule of freedom to remove**:**

Classified/staggered board

DE § 141(k)(1)- board members may only be removed for cause (statutory right to hold onto their seat)

But exception if the Articles say that even classified members can be removed without cause

For cum voting: may not remove w/out cause if the votes against such director’s removal would be sufficient to elect such directors if then cum voted at an election of the entire Board—what can get her in can block from getting her out

Cum voting is an impediment but not a complete bar. There is no way short of actually taking the vote, until we know. The threshold number is that which would guarantee a seat on the board.

**Exception**: if there is cum voting in place, SH can remove the entire board w/o cause

There is no general presumption that a director is entitled to serve out his term

This is a change of the CL presumption that directors had a vested right to serve out their full term

Last para of DE § 141(k): Where different classes of shares are used to elect different directors, then we look only to that class of shares for that director’s removal. We do not look at all the shares for removal w/out cause.

**If you have cause, then you only need a maj of the SHs to vote for removal**

Even with staggered/cum voting/different classes

The above limitations kick in for removal **without** cause

***Campbell v. Loew***—shows that SHs have a long road to travel to prove cause for removal. The preferable route is a vote for removal w/o cause

**Are the directors in classes? YES 🡪** then removal only for cause per DE § 141(k)

(**NO)** 

**Is there cumulative voting? NO 🡪**  no problem, can remove w/out cause

**(YES)** 

**Is there less than the entire board being removed? NO 🡪**  no problem

**(YES)** 

No removal w/out cause if votes cast against removal would have been sufficient to elect such director if then cumulatively voted at an election of the entire board

|  |  |  |
| --- | --- | --- |
|  | **Classified Board** | **Non-Classified Board** |
| **Cum Voting** | For cause: only remove with majority—DE § 141(k)(1) | For cause: only remove with majority—DE § 141(k)(1)  Without cause: if less than the entire board is being removed, no removal if the votes cast against such D’s removal would be sufficient to elect such director at an election of the entire board of directors—DE § 141(k)(2) |
| **Straight Voting** | For cause only: only remove with majority—DE § 141(k)(1) | For cause: majority of shares  Without cause: majority of shares |

* + - * 1. **Prob. 3-8**

**F:** Biotech has 10 mm shares of common stock. 9-member board, divided into 3 equal classes. Cumulative voting. Largest SH is Robbins (Board member and CEO), who owns 2mm shares. Powers owns 3 mm shares. On March 10, 2006, Biotech fired CEO Robbins in response to concerns expressed by the Powers. In late March, new CEO Hall called a special board mtg and informed the board that she uncovered evidence that Robbins lied to the Board. Board wishes to remove Robbins as a director (but this is a SH decision).

**Problems:** they are in classes, so § 141(k)(1) allows removal only for cause; cumulative voting

**Suggestions:**

Board would need to look to determine what “for cause” means. This is not in the statute, so look at case law. See ***Campbell v. Loew’s***

Harassment, disclosing corp trade secrets, actions done to harm the corp are likely to be viewed by a court as sufficient cause

It is not a trial that takes place unless the person who is being ousted decides to make a case of it

Lack of cooperation is not a sufficient basis for removal for cause

Power struggles and good faith arguments about a vision are not for cause

It appears that they could remove Robbins for cause

Lying to the Board would appear to be done to harm the corp (but depends on how the corp was damaged by the lies—lies have to be material)

Procedural requirements for “for cause” removal:

There must be a fair procedure for removal (***Campbell***):

Send a letter to Robbins, explaining that they are seeking removal, tell him why he is being removed, and give him a chance to respond

The Board may solicit proxies only after the accused directors are afforded an opportunity to present their case to SHs. This opportunity to be heard must accompany or precede the initial solicitation of the proxies seeking authority to vote for the removal of such director. [expensive for corp]

“Service of specific charges, adequate notice and full opportunity of meeting the accusation”

Other possibilities to avoid “for cause”

Biotech could call a special SH mtg proposing an amendment to the Articles which would allow removal of classified board members w/o cause by majority vote [141(K)(1)]. This would be an exception to the exception in 141(k)(1)

Board could propose a bylaw amendment to change the classification of the board since the staggering was set forth in the bylaws

How to avoid the cum voting issue:

Remove the entire board, then nominate the new slate of directors (8 incumbents and then a new member). If you remove the entire board, 141(k)(2) does not apply

If all 10 MM shares vote: to keep his seat, Robbins would need more than 2.5 mm shares & board would need 2.5 mm +1 to remove him (so Robbins would only need to find 500k proxies or votes in favor of him)

If 8 mm shares vote, then Robbins only needs 1 more share to keep his seat

* + - * 1. ***Adlerstein v. Wertheimer***

Background: Board mtg that occurred w/o any notice to the director that the board was trying to remove. If there is a for cause removal recommendation, board would have to notify the director of this

F: Adlerstein (CEO, director, and maj SH) was kept in the dark by the other 2 directors. At this board mtg., these directors issued a new class of super voting stock to Reich using their director power. This allowed Reich to use his power under DE § 228 to remove Adlerstein from the board (corporate coup).

H: Holds for Adlerstein and nullifies the actions at the mtg. Other 2 directors owed Adlerstein a duty of candor stemming from Adlerstein’s combined status as director AND controlling SH. Unfairness here b/c had Adlerstein known what was going on, he could have used his control prior to the mtg to get rid of one or both of the other directors. **Do NOT take from this that controlling SH or director has to be given advance notice of mtg agenda**.

NOTE: a corp board may want to meet initially to discuss and not inform the director they want to remove, but the board would want to have the later mtg after notifying that director

This director would not get the same protection as Adlerstein b/c he was just a director (not a maj SH)

* + - 1. Protecting minorities’ ability to get some voice on the board
         1. Frank (min SH) could protect cum voting from deletion from the Articles by Maxine (maj SH)’s maj of directors by:

Amend bylaws (not a good idea) or Articles to specify that in their corp. directors can only act by unanimity

This would ensure that the directors would not be able to set the wheels in motion for getting cum voting out of the Articles unless Frank is on board with it

* + - * 1. Super majority voting –could also say that SH action (other than director elections) needs more than 2/3 votes

This would also protect Frank

Under DE law, when super maj provisions are in the articles, you need a super maj to repeal that super maj (that’s what keeps it in motion)

Per DE § 242(b)(4)

Not the case for bylaws, though

* + 1. Initial Issuance of Securities
       1. Securities Act of 1933 §§ 3(a)(11), 5, 11, 12, 17
       2. SEC Rules 147, 501-508
       3. \*Applies to all corps/business entities (even non-PTCs)
       4. **(1) Registration Requirements in Securities Laws**
          1. § 5 of Securities Act

Prohibits the offer and sale of any securities through the means of ISC unless a registration statement has been filed with the SEC for that security; OR

Unless the issuance of the security is exempt from the registration provision

* + - * 1. EX: Bakery that you want to convert to a corp. You issues shares to 5 persons, including yourself.

There is an ISC trigger, but this nexus is triggered by using the MEANS of ISC (ie. mailing something via USPS is enough; using a cell phone that beams to another state, etc.]

If you don’t want to file a registration statement, need to figure out your transactional exemption

Private placement type exemptions

Limited offering exemptions (raising less than 1 mm or 5 mm pursuant to different rules)

Intrastate offering exemption

Bakery will likely be fine w/o a registration statement

But will likely need a lawyer b/c could do something that could blow up your opportunity to claim an exemption

* + - * 1. § 5 requires comprehensive registration statements from corps seeking to raise a LOT of money with widely dispersed investors (part. from companies who have never had a public offering before)

**Form S-1 Registration Statement**

Gives insight into corporate governance structure

* + - 1. **(2) Anti-Fraud Provisions in § 10(b) and Rule 10b-5 of Exchange Act**
         1. Rule 10b-5 prohibits fraud in connection with the sale of purchase of a security

This would become a federal cause of action even in the bakery example

SH that you liked to, DOJ, etc., can bring the suit

* + - 1. Definition of securities in 2(a)(1) & 3(a)(10) is incredibly broad
         1. Stock, bonds, notes, debentures, but also esoteric investments (could also include real estate/condo money pooling)
    1. NOTE: DE code provisions we have discussed apply to all corps, whether PTC or closely held
  1. Publicly Held Corporations & the Impact of Federal Law
     1. **How Publicly Held Corporations are Different**
        1. SEC Reg. S-K
        2. Secondary market for trading
           1. Securities that were once sold directly by the cop can also be traded between and among the investors
           2. Trad distinctions b/w stock exchanges [NYSE & NASDAQ] and the rest of the decentralized OTC market have dropped out

Stock exchanges have gone more electronic

To list in stock exchanges, corps have to meet certain listing criteria (min. levels of net worth; outstanding shares; outside directors, etc.) – stock exchanges serve as pseudo regulators, as well

But PTCs with lower market capitalizations can be traded in the OTC market

* + - * 1. **Securities markets serve 3 important benefits to PTCs:**

Liquidity

Valuation

Instant calculation of value of shares by looking at trading price

Monitoring type device

Possibility of corporate takeovers (due to ease of buying shares) motivates managers to efficiently operate their corp with an eye to maximizing SH value (so SHs will want to stick with the current managers)

Wall Street Rule: people who are dissatisfied with management will sell their stock and therefore depress the market price

A raider may just want to stir things up enough to just vote new directors (but this also puts the current management on guard)

Managers can diminish the effect of monitoring by saving a Super Class B Voting Stock during an IPO (this would ensure that the company cannot be taken over—via private ordering)

* + - 1. Presence of institutional investors
         1. Ie. mutual funds, pension funds, insurance cos.
         2. This impacts the governance structure of the PTC
      2. Proxy voting
         1. This is how SH action/voting is typically accomplished b/c of the large # of SHs
         2. Generally conducted by the corp/board, but sometimes SHs seek proxies if they are battling the corp/board
      3. SEC reporting & other obligations under federal securities laws
         1. Require PTCs to file form **10-K annual reports** and form **10-Q quarterly reports** (in addition to the above 2 requirements that apply to ALL corps, whether PTC or not)
         2. Must engage in proxy solicitations
    1. Efficient Market Hypothesis
       1. States the relationship b/w a change in a security’s price and the disclosure of specific information (KEY: relationship b/w price and info)
       2. **Weak form**: you can’t develop a trading strategy based on the use of past prices that will enable you to beat the market return
          1. Stock prices move in a “random walk”—past prices give no info as to what prices will be in the future b/c the info is already present in the price of the stock
       3. **\*Semi-strong form**: stock price will quickly reflect all publicly available info, but not private/secret info. I can’t develop a trading strategy that will beat the market by using publicly available info relevant to the value of traded stocks. **The market will be efficient in incorporating such info before you trade on it.** This is what we believe our securities markets are.
          1. No such thing as overpriced or underpriced stock

No sense in ordinary traders doing independent research to gain info (b/c there are faster people who have already heard this info and the stock price reflects this info)

Note: these professional investors don’t follow every stock. There are also reasons to doubt that the markets are performing efficiently in a semi-strong form (ex: the 500 point swings in the market indicators)

* + - * 1. Can be dominated by noise traders
        2. If this form is right (ie. if info is as quickly impounded into price), why do research analysts research PTCs?

Can’t systematically profit, but doesn’t mean that you can’t profit sometimes

Analysts can earn their keep if clients profit enough times to warrant the cost of their research

Ironic b/c these professionals who root out the info and make trading decisions based on this info are what makes the market efficient

If most of these analysts stopped working, then the market is not going to be efficient and the analysts who don’t stop would be wildly successful

* + - 1. **Strong form**: a stock price will quickly reflect all publicly available info **and** all secret info. Even if your trading strategy were based on non-public info, **you would not be able to beat the market**
         1. But if this were true, we would not have any laws against insider trading & press releases would not affect stock price like they do
      2. **Prob. 3-9**
         1. F: RRIP has been increasing its investment in Argona. Argona is traded over NASDAQ and average daily trading volume is approx. 10k shares. RRIP owns 60k shares of Argona, representing 6% of the outstanding stock. Nanette works for RRIP, and she learned from her brother that Surf, Inc. may devastate Argona. Argona market price has already dropped 25% in two weeks. Should Argona sell RRIP’s shares immediately?

This depends on theory of the efficient market hypothesis

**Under semi-strong**: assuming Surf’s beta testing and potential ability to wipe out Argona’s market is public info, the market price has already incorporated such info before Nanette can effectively trade on it. The price of the shares already reflects this impact from Surf. **I would not recommend selling** b/c RRIP will lose money on the transaction costs.

Assuming Surf’s beta testing is not public info, then the market value of Argona shares does not reflect this info, and N should sell some shares immediately.

N needs to look into how her brother came to this info. If her brother learned this info under confidentiality, then she should not act on it

Also, N needs to be careful not to cause panic in Argona stock. If N sold all of her shares, it would 6x the daily trading volume and 6% of all the stock. As she continues to try to sell all the stock, the price will continue to drop and she will lose more and more money. She could hurt herself and her portfolio trying to sell so many shares so rapidly.

**Under strong form**: it would not matter whether the info is public or not. A strong form hypothesis states that even if your trading strategy was based on nonpublic info, you would not be able to beat the market. This hypothesis believes that the market price would have already taken the info into account before it was announced.

* + 1. The SH Census – The Emergence of Institutional Investors
       1. Typical SH’s lack of interest in corporate governance was seen as a product of **“rational apathy”**
          1. Separation of ownership from control means that officers, not SHs, exercise control over the corp.

Burles & Means argue that sep of ownership and control is a practical reality due to rational apathy – thus, SHs often rubber stamp current management or sell their shares

* + - * 1. Wall street rule (easier for SHs to just sell their shares if they don’t like the way things are going)

Rational SHs will not take the lead in opposing management (no mechanism for forcing other SHs to share in the cost of research efforts)

* + - 1. SH apathy may negatively affect the accountability of directors and managers
         1. May not fear losing their seats even if they are asleep at the wheel; directors may make decisions tilted toward management b/c want to keep their jobs as directors—even if not in SHs’ best interests
      2. Large **institutional investors** 
         1. Separation of ownership and control does not necessarily pan out when it comes to these institutional investors b/c it is less rational for them to be as apathetic as ordinary investors (stakes are different)
         2. Use their large shareholdings for trad SH responsibilities, but also to engage and influence corp management

Cost of coordinating with other major institutional SHs to create a maj is easier and cheaper

* + - * 1. Institutions are likely to be more knowledgeable than individual investors: less expensive access to info; lines of communication; more resources; research costs their incur can help them across their portfolio
        2. Equity ownership is concentrated in the largest institutional investors

Top 25 account holders account for 30% of all publicly held stock

This shows where the power is concentrated

* + - * 1. **SUM:** institutional investors have more incentives to be active. However, pragmatically, institutional investors don’t always take on mgmt. even though they have a stronger theoretical case for doing so—there are legal and political barriers to participation in governance. Fund managers may fear that they will be replaced if they actively challenge the mgmt of a certain company

Less than 50 SH-initiated proxy contests in all of the 1000s of PTCs

CALPERS & NYCERS: pension funds whose managers will sometimes engage corp mgmt. in effecting change.

Sometimes changes are captioned as “social policy” type changes (ie. don’t want actual control of the corp.)

Institutional investors will try for “good governance” type matters, too (Rule 14a-8)

Many times, just the mere threat of a battle with mgmt. will lead to a consensual resolution with the corp.

* + - 1. **Other Investors** who affect collective behavior
         1. “Arbitrageurs”- seek out companies whose stock is in play and seek to encourage the trends that will make them money
         2. “Value investors”- those who actively seek to influence corporate management so as to produce higher share value from underperforming companies
         3. “Relational investors”- purchase large blocks in particular companies and seek a long-term relationship with management
         4. “Social investors”- give explicit priority to social needs in guiding investment decisions
    1. Proxy Regulation in General
       1. **Proxy Voting**
          1. “Proxy”- authorization given from a SH to another person, to vote the SH’s shares; may also describe the person who is given the power to vote; may be used to describe the tangible document used to evidence that granted authority
          2. SH proxies are sought by the existing Board
          3. Relationship in which one party is given the power to vote the shares of another
          4. May create an agency relationship
          5. Process:

Almost all important discussion takes place before the vote (proxy solicitation)

Competing solicitations turn into the proxy contest

Battle prior to the mtg to get the most cards

It is generally state corp law that identifies the issues that SHs may or must vote.

Federal law sets out the procedures by which voting occurs and the info that must be provided to the SHs before they vote

**Securities Act of 1933**: regulates the offering of securities

**Exchange Act of 1934:** regulates purchases and sales of securities between and among investors

Also created the SEC

Congress gives the SEC substantial rule-making power

**(this statute is what we will be focusing on)**

* 1. **Role of Federal Law for PTCs**
     1. Disclosure as the Dominant Approach
        1. Fed. law requires disclosure in 5 contexts:
           1. Issuing securities
           2. Periodic reporting
           3. Proxy solicitation

Federal role is ancillary to the state role, requiring disclosure only when state law requires or permits SHs to act

* + - * 1. Tender offers

This is a form of corporate take-over

* + - * 1. Insider trading
      1. Fed. law makes extensive use of state law, often deferring to the primary role of state law, but also enlists the role of self-regulatory orgs (SROs – ex: NYSE, NASDAQ)
         1. NYSE & NASDAQ have listing requirements/thresholds

Many deal with corporate governance, ex: listed companies must have at least 50% of its board being outside directors

* + 1. Periodic Reporting
       1. Disclosure required outside of SH voting or outside of stock transactions with the corporation
          1. Sometimes disclosure is an effort to change the substance of behavior by an officer or director (ex: code of ethics)
          2. Also reveals critical info that a potential investor or any SH would want to know in connection with making/having an investment
    2. Disclosure Triggered by Proxy Solicitation & SH Voting
       1. 1934 Exchange Act Rules 14a-3, 14a-4, 14a-5, 14a-9
       2. **1934 Securities Exchange Act**- SEC authority to regulate the proxy or consent solicitation process of a corp required to register securities with the SEC
       3. **Corp is required to register securities with SEC if:**
          1. Securities are listed on national exchange (**Exchange Act § 12b**); OR
          2. Equity securities (e.g. stock) held by more than 500 SHs AND corp has assets of $10 mm or more (**§ 12g** & **Rule 12g-1**)

This is different than registering a transaction for an IPO (aka “going public”) under **§ 5**

EX: Facebook decided to go public b/c it was close to surpassing 500 SHs

It would have to open its books anyway, so may as well raise some money in the process by going public

* + - 1. Once you are a registered 12b or 12g security **🡪 § 13(a)**: **Must file Form 10-k** (annual report) and **Form 10-Qs** (quarterly reports), **Form 8K** (special events).
         1. These corps are known as “reporting corps”, interchangeable with “publicly held corps”
         2. Analysts study these reports; this close following contributes to the quick way markets respond to new info
      2. **§ 14(a): Proxy solicitation for corps w/ SEC registration pursuant to § 12**
         1. **§ 14** is Congress’s requirement that persons comply with the SEC’s rules and regs.

Proxy rules only apply to those that fall under (iii)(3)(a) or (b) above.

Doesn’t really say much about the process—just says that it is unlawful to violate an SEC rule (if SEC didn’t actually issue proxy rules (below), then 14(a) would be an empty vessel

* + 1. Disclosure Related to SH Voting
       1. Securities Exchange Act of 1934 §§ 14(a), 27
       2. SEC Rules 14a-1 through 14a-15 & Schedule 14A
       3. *See* **SEA § 14(a)** above
       4. Rules Primarily Affecting **Solicitation of Proxies,** whether by management or SHs
          1. **Rule 14a-3**: Info to be furnished to security holders

Cornerstone of SEC rule making under its proxy authority

**Must file with the SEC a proxy statement** containing info set forth in Schedule 14A

Requires this info to be provided to the SH prior to the proxy solicitation

Includes basic facts that informed voters would presumably possess (Schedule 14A)

Time, date, and place of mtg to which the solicitation relates, solicitor’s info, basic info about candidates for director

**Proxy statement shall be accompanied by an annual report** in prescribed form (if mgmt. is sending a proxy statement in connection with an annual mtg)

This annual report is similar, but NOT the same as the 10-K

Applies to both corp and individuals seeking proxies

SEC has allowed more and more electronic delivery of proxy materials

PURPOSE: to provide true and accurate info to SHs so they can make informed choices

* + - * 1. **Rule 14a-4**: Requirements as to proxy

Regulates the form of the proxy (e.g. rectangular card)

Requires boxes to indicate whether SHs approve or disapprove

Must give SHs a way to withhold authority

Ensures that SHs are given an opportunity to do more than grant the authority requested by the solicitor

If choice is not specified, the proxy will state in bold-face type how it will vote

PURPOSES: if we didn’t have these requirements, the SHs would have less choice than they would have otherwise

**Prob. 3-11**

Proxy card on CB page 222

Error #4- “if no direction is made, this proxy will be made for proposals 1 & 2 and against proposal 3”

**Rule 14a-4(b)(1)**: how it intends to vote if no direction is made must be in **bold**

* + - * 1. **Rule 14a-5**: Presentation of info in proxy statement

Regulates the form of the proxy statement (readability, type, font size, subject matter, headings, etc.)

* + - * 1. **Rule 14a-9**: False or misleading statements

Catch-all anti-fraud provision

Prohibits the making of false of misleading statements as to any material fact, or the misleading omission of a material face in connection with a proxy solicitation

There is an implied private right of action for violation of this rule. SHs may sue in federal court seeking damages against the company or the proxy solicitor

The SEC may also bring enforcement actions for proxy fraud

* + - 1. Rules Primarily Regulating SH Access to Effective **Means of Communication** w/ Other SHs
         1. These rules provide SHs an affirmative right to communicate with other SHs in a corp. (fosters SH democracy)
         2. **Rule 14a-7**: Obligations of registrants to provide a list of SHs’ addresses or mail SH’s soliciting material to security holders

Requires a corp that is itself soliciting SHs in connection with an annual or special mtg to provide specific proxy solicitation assistance to requesting SHs

Corp must either (**at the SH’s expense**):

Provide the requesting SH with an accurate list of those SHs and financial intermediaries from whom the corp intends to solicit a proxy (SH must defray the cost of postage and handling); OR

To directly mail the requesting SH’s proxy material to SHs and financial intermediaries (SH must defray the cost of postage and handling)

Who would prefer this to 14a-8?

Institutional investors who want more than 500 words to explain

Someone who is battling the company for control

Can exclude a SH proposal under 14a-8 if it relates to board elections (so would have to use 14a-7)

If SH wishes to includes more than one proposal up for discussion (14a-8 only allows one)

* + - * 1. **Rule 14a-8**: SH Proposals

**This is where the socially significant proposals are advanced**

“Qualifying SH” may require corp to include a “SH proposal” and an accompanying support statement in the company’s proxy statement in the company’s proxy material (not to exceed 500 words)

Essentially a motion at the SH’s mtg

**“Qualifying SH”** = 14a-8b at least ($2k in mkt value or 1% of the company’s stock) for at least one year by the date the SH makes the proposal, and continuously owns such stock through the date of the mtg.

Limited to only one proposal per mtg

**SH bears no expense**

**14a-8(i)(1)-(13) EXCEPTIONS**

There are **13 reasons** that allow companies to exclude the proposal

Corporate counsel would work through this for each proposal

Corps may exclude proposals that are “not a proper subject for SH action under state law”

Most SHs opt for this type of inclusion (over 14a-7 type inclusion) b/c it is free

Written in Q&A form

***Lovenheim***: when a qualifying SH complies with these requirements, management must include it in the proxy statement unless it has valid grounds to exclude that proposal

* + - * 1. **Prob. 3-2** [Exceptions]

Q: SH proposed bylaw amendments 🡪 under 14a-8, would Northwest be required to include Joan’s statement?

14a-8 applies to Northwest b/c Northwest is on a national stock exchange and is registered with the SEC

Joan is a qualifying SH b/c she holds 10% of stock

How could the company exclude this proposal to **relocate banking operations**?

14a-8(i)(1)—improper under state law [DE **§ 141** states that unless the Articles specify otherwise, the corp shall be managed by its Board]

14a-8(i)(7)—banking deals with matters relating to the company’s ordinary business operations/management functions

BUT SEC reads a **social policy exception**  into this exclusion—even if the proposal does fall under business operations, the SEC will not deem it ordinary if it is socially significant (will allow the proposal to go through)

Joan could get around an exclusion under 14a-8(i)(1) by requesting that the Board propose/consider feasibility of **keeping banking operations in Timber City**. It should be phrased as an opportunity for SH voice and not a command for the directors to act

However, this may not help her under the 14a-8(i)(7) exclusion

What if Joan submitted a proposal for an **alternative candidate for the Board**?

The company may reject under 14a-8(i)(8), “if the proposal relates to a nomination of an election of membership on the company’s board …”

What if Joan submitted a precatory proposal seeking to expand the **health care options of retirees** of the business?

14a-8(i)(7)- company could argue ordinary business operations

14a-8(i)(4)- personal grievance; special interest. “Designed to result in a benefit to you”

ex: labor unions may also fall under this if they are a qualified SH

“Special interest” does NOT mean a SH who is active in PETA (this SH would need to get a bonus from PETA for how many PTCs he got proposals in for this to be a special interest that would get kicked out)

14a-8(i)(12)—resubmissions: if the proposal has been proposed before

**Sustainable forests**: although this is an ordinary business function, could qualify within the social/political importance exception to the ordinary business exclusion

**$5 in dividends**

14a-8(i)(13): may exclude a proposal that relates to specific amounts in stock dividends

14a-8(i)(8)- **relating to elections**

Proposals that seek to include info in the proxy materials re: specific people to run for the board are excluded

14a-8(c)- SH can only have one proposal per SH mtg

If there is a defect in the proposal that is correctable, per 14a-8(f) the issuer has 14 days to notify Joan of her procedural deficiency and Joan can correct it and choose which of her proposals to advance

14a-8(j): **if the company decides that it is going to exclude a SH proposal**, it has to let the SH (Joan) know and also has to let the SEC staff of corporate finance know

Company can ask for a “no action letter” from the SEC

Non-binding; if SH took company to court, it would be up to the court whether to defer to the letter

Proponent whose proposal is rejected can file a claim with the SEC re: why it disagrees w/ management’s rejection of its proposal

SEC would then have two briefs before it

* + 1. SH Proposals
       1. 1934 Exchange Act Rule 14a-8
       2. NOTE: corporate counsels to PTCs often spend lots of time on the excludability of SH proposals at this time every year b/c a lot of PTCs hold their annual mtgs in the spring (the clock starts for proxy proposals typically in the fall)
       3. **Socially Significant SH Proposals**
          1. To exclude these statements from the proxy statement, directors may use the “**economic irrelevance**” test under rule 14a-8(i)(5) and the “**ordinary business**” exclusion under 14a-8(i)(7)
          2. ***Lovenheim v. Iroquois Brands, Ltd.***

F: SH proposed resolution to study and report on the procedure used to force-feed geese for production of pate de foie gras in France. Iroquois refused to include the proposal in the proxy materials

This issue was related to NO earnings

Corp. wanted it excluded b/c didn’t want controversial/insignificant topics taking up time at the board mtg

Note: even if Lovenheim gets SH support, the Board can decide not to follow the resolution. Mgmt may also be concerned about the advertisement of method of feeding the geese. Mgmt sees these types of proposals to be nuisances

This proposal may be excluded under the **objective economic test** [14a-8(i)(5)], but Lovenheim argues that proposals may not be excluded even if they do not meet the economic or 5% test b/c of the societal importance

**H: The meaning of “significantly related” to issuer’s business needs is not limited to economic significance**

Political, social, etc. significance may be sufficient

**The court allowed the proposal to be admitted**

Judge ruled against SEC’s no action advice

How could Lovenheim have **linked his proposal to the company**?

Ex: Association with these feeding practices could be detrimental to the image and perception of the company. There is a risk of consumer backlash.

Ex: He could look to analogous products that are manufactured or produced that the public finds offensive.

Ex. In 2006, Chicago City Council banned the sale of pate. Lovenheim could use this info in chain of inferences to show that consumers take this seriously.

Alternative purpose of the SH proposal:

To advertise this issue to the SHs

To try and signal to the Board

To start a discussion

Question as to whether these proposals have a sufficient nexus to make them a proper subject for SH proposals

NOTE: Wendy’s could not exclude a cage-free hen proposal from PETA under the ordinary business exception under 14a-8. After this, Denny’s decided to negotiate with the humane society to change its practices (SH then withdrew their societal issue proposals)

* + - * 1. Directors remain free to ignore even winning SH proposals and in most cases they do
        2. Yet, these proposals are a potent way by which institutional SHs communicate with boards
        3. SH has to show how his proposal and the ramifications of his proposal ties back to the company

Not just ANY social issue can come in

Sometimes decision-making is over-inclusive, and sometimes under-inclusive re: the importance of these social issues

* + - * 1. **Policy** w.r.t. SH’s legal right to raise social issue proposals:

Argument against social issue exclusion from exemptions under 14a-8: people buy stocks to make money, so social issues should be relegated to writing to your Congressman (don’t cost the corp/district it from its business)

Argument for keeping the social issue exclusion: these issues have SOME relationship to the bottom line of the corp (b/c they could be excluded if they didn’t)

The SHs care about these things and they are part owners in the company

Consumer boycotts DO have an effect on the bottom line

Money & lawyer time spent deciding whether the proposal falls within an exception; then time spent at SEC when company asks for a no-action letter

* + - * 1. **Prob. 3-12**

**14a-8 ordinary business exclusion analysis**

F: Trylon is a public company whose business involves genetic research and sale of resulting products. Trylon donates less than 1% of net income annually. SH proposes that the corp refrain from making charitable contributions to organizations that perform abortions.

DE **§ 122(9)** grants corps the right to make contributions for the public welfare or for charitable purposes

**How to approach the issue**: Make sure that the proposal is made by a qualified SH and that it fulfills the other procedural requirements. Then look to SEC no action letters on the same subject matter (these are publicly available). Then try to reason by analogy.

Remember that these are non-binding. There is a slight risk to lawyers relying on these letters.

Trylon may try to exclude this proposal under **14a-8(i)(5)** arguing that this donation (1% of net income) is below the 5% threshold.

Trylon may also try to exclude under 14a-8(i)(7) arguing that this is a decision that should be left to the management that is NOT trumped by social concerns. The corp is not directly involved in what the SHs say will damage the corp—aka the abortion services.

But one could argue that abortion is not a mundane business decision that the SEC intended to be included in 14a-8(i)(7) or that there is a socially significant policy reason for kicking this out of the ordinary business exception. Abortion is a hotly debated topic—social arguments re: how abortions affect this particular corp.

SH proponent would argue that this does affect the company (not mundane and routine), and thus can’t get kicked out. Also would tie it to the company’s welfare (this is arguably what this is all about)

Argue that abortion may bother consumers, who may boycott

**Can SH even propose this?** Probably yes—if the charity donations by the business are laid out in the bylaws, then a SH may propose an amendment

**Answer**: mgmt. would likely be able to properly omit this proposal from the proxy materials.

The charitable contributions don’t meet the econ criteria of 14a-8(i)(5), and the contributions are not **“significantly related to the issuer’s business**.” Trylon is in the business of genetic research, and abortions are tangentially related to genetics. However, this relationship is not as direct as the relationship in the Lovenheim case

**There needs to be a nexus b/w the proposal and the company’s business.** This situation doesn’t appear to be a sufficient nexus to kick the SH proposal’s goal out of purely mgmt. functions.

**NOTE:** if this company was actually manufacturing an abortion drug, this would be more like Lovenheim b/c there would more of a threat of a boycott

* + - 1. **Governance-Related Proposals**
         1. Designed to change the status quo by giving SHs more power and control

Viewed as a threat to mgmt. AND a pain in the neck

These are a backlash from investors who think that corporate managers may be using private ordering tools give to them by state law to overly insulate themselves from the discipline of the market

* + - * 1. Proposals are often phrased in terms of a SH movement to amend the bylaws
        2. DE **§ 211(b)**- yearly elections unless bylaws or articles say otherwise

DE **§ 141(d)**- allows board to be staggered by either an amendment to the articles or amendment to the bylaws

SH could propose a bylaw amendment to be voted on at the annual mtg that would provide for a staggered board

A proper subject for bylaw action would be a proper subject for binding proposal (if voted yes)?

* + - * 1. Dodd Frank Act 2010: relates to a broader corporate governance debate
        2. ***CA v. AFSCME***

Pension fund put forth a bylaw proposal through rule 14a-8 rights under federal law

NOT precatory b/c would have amended the bylaws

DE SC says that

* + - * 1. **Prob. 3-13 [double check answer]**

F: SH proposal re: cap on CEO compensation at this NYSE traded co.

Proposal is phrased as a request, so SHs can get it bulletproofed vis a vis the exception company would try to use under **14a-8(i)(1)**

Language re: not violating any current Ks or obligations is added b/c company could arguably exclude the proposal otherwise under **14a-8(i)(6) or (i)(3)**

**(i)(3)**- proponents always have to be careful that the issuer is going to try to exclude by saying that the proposal was misleading [if the proposal were to pass, and thought to take effect immediately notwithstanding the current K with the CEO—could be misleading]

**Answer**: prob NOT excludable

Corp. may be able to exclude this proposal under **14a-8(i)(7)** b/c pay of EEs is the textbook example of a management function

BUT we have to research SEC opinions—we would find that SEC views executive/CEO compensation as NOT in the realm or ordinary business

**So this proposal would NOT be excludable under (i)(7)**

**Exchange Act § 14A: SH approval of exec compensation**

If the company already has a “say on pay” provision in its proxy statement that gives SH advisory vote on officers’ compensation [Dodd Frank Act gives SHs a federal right to this every three years], is there anything that the company could try to use to exclude this proposal, which is trying to place a cap on exec compensation?

**14a-8(i)(10)** “substantially implemented” [PROF says not excludable under this, though]

**14(c)(4)**: rule of construction—the vote shall not restrict or limit the ability of SHs to make proposals for inclusion re: exec compensation [Congress is saying that company can’t exclude a proposal like this under (i)(10)]

But even if the proposal is added to the proxy statement:

The Board can advise that everyone vote no; and

Even if the SHs vote yes, the Board doesn’t have to enforce the cap b/c it is just a request [but may make the board more sensitive to the exec compensation issue]

* + - * 1. **Exchange Act Sec. 14A & Say on Pay** (continued)

**Golden parachute (14A)**: SHs have to have a non-binding advisory opinion on CEO retirement packages (ie. compensation packages for CEOs who are fired for underperformance)

State law and private ordering could have dealt with **“say on pay”**—so why is federal law needed?

Congress thought this should be a federal right b/c of federal bail-outs

Exec compensation led to excessive risks being taken by CEOs who were motivated by short term gain (over the long term stability that was good for SHs and the general public)

SHs supported this b/c it is good corporate governance

SHs can express their views in a non-binding vote and if Board members want to keep their seats, they may take some action

**14A(d)**: Disclosure of votes

Not telling managers of institutional investors how to vote, just shedding light on how they voted

**Opponents** to this say that the free market will regulate itself; and

Federalism argument: this is a states’ rights issue b/c corp governance has trad been a state issue—state law should require a mandatory say on pay votes if it wants

* + - * 1. **Prob. 3-14**

F: precatory proposal shifts the state of corp from Oregon to ND.

ND Corporation Act’s default rules:

Maj voting in election of directors

Advisory SH votes on compensation reports

Proxy access to 5% SHs who have held shares for at least two years

**“Proxy access”** would allow some SHs, as long as they are proposing one or two directors, to have their nominees included in the corp’s proxy statement (SHs owning certain amounts of stock wouldn’t have to fund the campaign themselves)

**BUT** proxy access is not a federal law [Rule 14a-11 was shut down]

Reimbursement for successful proxy contests proportional to success

Separation of the roles of Board Chairperson and CEO

Can company seek to exclude this SH proposal?

Methodology: go through 14a-8 and look for a basis for exclusion

PROF: companies have not been successful in getting these types of proposals excluded under 14a-8 if they are phrased as requests

Answer: this proposal would probably need to be included

But some of ND law has already been enacted in the federal securities law

* + - * 1. CEO/Chairperson Debate

Congress considered writing **§ 14(B)** as a required separation

Couldn’t develop the consensus that this is good

Tries disclosure as a different tack

Congress requires the company to disclose the reason why it has chosen the same person to be CEO and Chairman

This is a kind of “**comply or explain**” provision

Makes company at least think about separating the rules and express its reasoning (even though the combo is permissible

For monitoring purposes, makes sense to have the Chief and CEO separated

But there are reasons why the roles should be combined, too

NOW, the trend is to separate the roles due to the catalyst of **14(B)**

* + 1. Using SH Authority to Change the By-Laws
       1. DE §§ 109, 112, 113, 141
       2. MBCA §§ 2.06, 8.01, 10.20
       3. Largely a state law issue, but can’t leave 14a-8 to the side
       4. ***CA, Inc. v. AFSCME Employees Pension Plan***
          1. SEE ABOVE for 1st part of case

Litigation began in the context of a Rule 14a-8 proposal not submitted as a precatory request

* + - * 1. F: AFSCME set forth a proposed amendment to CA’s bylaws that would have been discussed and voted on at the annual mtg

**Proposal**: bylaws should provide that the Board must reimburse reasonable fees for successful proxy contests in connection with contested director elections

**Justification for corp reimbursing these expenses (ie. why this proposal is aimed to improve corporate governance)**: increases competition within the director process

Elections cost money; reimbursement will incentivize SHs to run candidates against the status quo—which will be good b/c current directors will feel less entrenched and will pay more attention to their SHs

* + - * 1. CA doesn’t like this proposal; says that it can always reimburse expenses if it wishes to, but doesn’t want their hands tied by this bylaw

**Under 14a-8, CA has to come up with one of the 13 exclusions to get what it wants**

Improper under state law [14a-8(i)(1)]

Even if it is proper under state law, it would result in a violation of state law [14a-8(i)(2)]

CA asks SEC for a no-action letter

Includes legal opinion saying that this proposal would limit mgmt. power and any limit on mgmt. power would have to be in the Articles. Even if the proposal can be deemed a proper proposal, it is excludable b/c it would violate state law b/c it would rob directors of discretion to reimburse, which might be a problem in cases where reimbursement would violate directors’ fiduciary duties

**BUT SHs** get another legal opinion for THEIR proposition

SEC certifies the Q to the DE SC

* + - * 1. DE SC:

**Held**—bylaw reimbursement provision is a proper subject for SHs to include in the bylaws under state law [makes SHs happy]; BUT says that this particular reimbursement proposal is worded in a way that would cause the company to violate state law essentially b/c the worded proposal doesn’t include a “fiduciary out” (ie. “unless such action would violate directors’ fiduciary duty”)

This proposal would probably be ok if it had such a clause

Rationale: the function of corporate bylaws is not to mandate how the board shall decide substantive business decisions. The purpose of bylaws is to decide the **process and procedures** by which those substantive decisions are made

The Q of whether a corp should reimburse is a proper subject of SH action b/c it is essentially a process/procedure type Q

The right to cast a ballot in director elections is meaningless if SHs don’t have a role in the selection of contestants

DE gives SH an explicit right to a free and effective exercise of voting rights

SHs have the right to amend bylaws to provide for reimbursement

BUT DE **§ 109(b)** says that a bylaw may not be inconsistent with state law 🡪 this includes not only the code provisions but also the body of judicial precedents developed AND CL rules and precepts

Court argues that this proposed bylaw could be regarded as a contractual arrangement that would commit the board to a course of action that would preclude it from fully discharging its fiduciary duties

Ie. Board would be bound to reimburse even if a proxy contest had illegitimate motivations

PROF: this is a far fetched fear; and is unlikely b/c to get reimbursement, this “evil” director would have to actually be elected

* + - 1. NOTES after this case
         1. DE **§ 112**: bylaws CAN include provisions that require proxy access to SHs if it chooses (ie. including blurb about candidates other than those slated)

This would be private ordering to allow for proxy access (one reason why 14a-8(11) was invalidated)

* + - * 1. DE **§ 113**: provisions for reimbursement of successful proxy contests may be made in the bylaws

BUT use magic words “as long as reimbursement is consistent with the fiduciary duties of the directors …”

* + - 1. ***Kistefos AS v. Trico Marine Services, Inc.***
         1. F: PTC’s bylaws provide for maj voting

**“Pfizer” proposal in place**, which says that incumbent directors who receives only a plurality vote can continue to serve as a holdover director until a successor is elected, etc.

**Proposed bylaw** wants to put teeth in maj voting, so that directors who don’t get a maj vote MUST resign and create a vacancy

* + - * 1. Corp: says that this bylaw would be inconsistent with state law and Articles
        2. Court: doesn’t even have to rule on the substance b/c the corp’s Articles requires 2/3 vote to amend the bylaws and the bylaw doesn’t reach this
        3. **Tension re: maj voting**—this does make director elections more uncertain, and to the extent that directors have to spend time and money campaigning for their seat, it is a distraction

Maj voting is slowly becoming the norm b/c corps have agreed to set a different set of default rules through private ordering

Possible that as more and more corps change their rules by private ordering (ie. **give SHs the ability to “just say no”),** states mat follow and make maj voting the maj rule

The **MBCA still maintains plurality as the rule for director elections (most states do too)**

* + - 1. **Proxy Access**
         1. What would the world look like if PTCs were required to include in their proxy statements the candidates that SHs reaching certain thresholds of power wish to run against the incumbent board?

After a decade of debate over proxy access, SEC did adopt **Rule 14a-11** that essentially provides this proxy access

A legal challenge to this rule was filed in the DC Circuit; said that it violated the 1st am, federal law b/c exceeded SEC authority; didn’t comply with cost/benefit analysis

But by the time court decided this, Congress had already weighed in via the Dodd Frank Act, giving the SEC this authority [but 1st am and cost/benefit analysis argument persisted]

* + - * 1. ***Business Roundtable v. SEC*** (2011)

DC Cir invalidated Rule 14a-11 (proxy access)

SH activists are campaigning for SEC to come up with a new and improved proxy access rule

If corps voluntarily work with SHs on this right, the fight for federal law on the issue may subside

* + - 1. **Prob. 3-15**
         1. F: Directors in a DE corp pass a bylaw that requires a SH to hold $1k of stock for a full year in order to present a proposal for action at the annual mtg

Are these limitations permissible interferences with SH rights to meaningfully participate in the SH mtg?

* + - * 1. Issue: can directors amend the bylaws to regulate the threshold amount of stock required to bring a proposal?

Board has the burden to justify why it felt it had a really good/strict-scrutiny type reason for this $1k figure

A threshold may survive strict scrutiny if the **PTC** has tons of SHs-- $1k would not be overly burdensome & allowing all SHs who buy one share to bring a proposal is too burdensome on annual SH mtgs. But if it is a **closely held** corp, threshold may not survive b/c what is the worst that can happen in allowing all of the few # of SHs to bring proposals?

* + - * 1. Issue: can directors amend the bylaws mandating 60 days advanced notice?

Probably wouldn’t be too onerous in large PTC context

But for closely held corps, 60 days may be viewed as interfering with SHs too much w/o a really good reason to do so

NOTE: if this was in connection with director elections only, it may look suspicious and like entrenchment (which is bad)

* + - * 1. ***CA*** case, FN 12: **whenever a director action interferes with SH voting at annual mtgs, it requires strict scrutiny (higher level of justification for this interference b/c the right at stake is so fundamental to the small rights that DE gives SHs)**
    1. Corporate Records and SH Lists
       1. MBCA §§ 7.20. 16.01-16.04, 16.20
       2. DE §§ 219, 220
       3. 1934 Securities Exchange Act Rule 14a-7
       4. Federal law: SH may inform the corp in writing of the planned solicitation and ask the corp to provide “14a-7 assistance”
          1. Management must supply the requestor with either a SH list, or mail out the materials at the cost of the requestor
          2. Most corps choose to mail out the materials
       5. **Most SHs choose 14a-8 route b/c they don’t have to bear the cost. However, SHs will use 14a-7 if they have more than one proposal, want to engage in a proxy contest, or want to include more than 500 words and don’t mind using their own funds.**
       6. State law [DE **§ 219 & 220**]
          1. Gives SH documents a range of documents (federal law is more narrow)

Not limited to just SH lists like in 14a-7

DE **§ 219**: examination of lists

* + - * 1. SHs may make proposals for any **proper purposes** and are not limited to proxy solicitation
      1. ***Conservation Caucus v. Chevron Corp.***
         1. F: SH wants to communicate with other SHs re: the econ risks of doing business in Angola

Corp’s argument **not** to turn over the SH list:

Purpose is to harass the corp

Interests were solely political

Board has the power to manage the business affairs

SHs are entitled to privacy and should not be subject to pressure from groups whose only interest is to assert opposition to a range of issues

Court **rejects** the corp’s arguments looking at DE **§ 220**

* + - * 1. **Held:** Chevron had to give the SH list; Chevron did not prove an improper purpose

DE **§ 220(c)-** Burden of proof is on the corp to show that the request for SH list is for an improper purpose

DE has shifting burdens based on what the SH is requesting

When SHs are requesting other docs, SH has to show the proper purpose

SH only needs one proper purpose to pass

Rationale:

Political interest is not improper purpose

This is not harassment

It is a proper subject for SH action such that it is a validly submitted SH proposal

No privacy concern of one more letter in the SHs’ mailboxes

* + - * 1. Legacy: It is very tough for any DE corp to refuse a request for a SH list
      1. **Prob. 3-16**
         1. F: RIIP (pension fund) is the requester; wants various records. Also wants a proposal to phase out tobacco sales to minors in developing countries (would have to precatory b/c this is a mgmt. decision)

This request would be more costly to the corp than a SH list

Corp could ask RIIP to compromise on what they are asking for

* + - * 1. Entitlement to “other books & records” -- **DE § 220: doesn’t provide a bright line re: what a SH may or may not inspect. Each must be judged on its own particular facts re: a proper purpose. Burden flips to SH to show proper purpose b/c this is something other than a SH list**
        2. How could RIIP demonstrate proper purpose?

Health/social issues in 3rd world could lead to consumer boycott in US (would affect stock price)

Legit litigation risk here, b/c sales of tobacco to minors is illegal in the US and this company is unloading cigs on minors abroad

SHs would have to show the judge product liability suits in the US against Marlboro (document that their proper purpose is to prevent the company from risking huge liability verdicts)

If there was a statute in one of these countries preventing tobacco sales to minors and SHs sought records b/c they thought the corp was flagrantly violating these laws, they would phrase the proper purpose as looking to file a derivative action against the directors who were violating the law

* + - 1. ***City of Westland Police & Fire Retirement System v. Axcelis Technologies, Inc.***
         1. When SHs claim they are entitled to a **§ 220** book & records b/c of suspicions of corporate wrongdoing, DE courts require these SHs to show credible evidence via pleadings
         2. “Credible basis” is the lowest standard of evidence

Don’t have to prove that the wrongdoing occurred—just a credible basis that it occurred [this could also apply to Prob. 3-16]

* + - * 1. But plaintiffs here did **not** show a credible basis for wrongdoing

PROF: **balancing**—CL courts recognized that doc requests are burdensome on the corp and realize that there is a risk in giving out books and records (so CL and then codified that SHs have to have a good reason)

A mere fishing expedition is not a sufficient basis to get the corp to incur these costs/risks

Is there a ½-way point b/w a fishing expedition and a legit basis of inquiry that doesn’t rise to the level of credible evidence of wrongdoing?

This “**minimal pleading burden**” is difficult and bars SHs from exercising their DE **§ 220** rights

* + - * 1. Catch-22 that plaintiffs need docs to substantiate their suspicions

SHs will have to be creative re: how to plead their complaint

Maybe show a proper purpose by positing that you are trying to initiate a corporate conversation

* + - 1. NOTE: DE **§ 220 gives the right, but DE courts have sometimes set a higher pleading standard**
         1. Argument that the failure of states to provide adequate disclosure to SHs led Congress to authorize a disclosure system for PTCs [ie. disclosure provisions under Federal Exch Act are a direct response to the race to the bottom in state law]
      2. ***Disney*** – plaintiffs had complaint dismissed w/o prejudice and used DE **§ 220** rights to beef up their complaint to survive dismissal
  1. Non-Corporate Business Entities – Partnerships, LLCs, LLPs
     1. Omit statutory material

1. Fiduciary Duty, SH Litigation, and the Business Judgment Rule
   1. Introduction
      1. MBCA §§ 8.01, 8.31, 8.32, 8.41, 8.42
      2. Overview
         1. Concerned with econ efficiency with both voting and suing
            1. Voting: corp could not function effectively if every business decision was put to a SH vote

State corp law only puts matters of monumental importance to SH vote

* + - * 1. Suing: corp can’t function efficiently if every time directors make a decision that displeases SHs it can be hauled into court to explain its decision making

Determine the proper level of SH control via ex post litigation—but need a system to make that the SHs can sue, but to an excessive amount

Managing fiduciary duty through litigation would be costly and inefficient

* + - 1. **Fiduciary Duty of Loyalty** operates to constrain directors and officers in their pursuit of self-interest
         1. Wrong for an officer or director to compete with her corp or divert to personal use assets or opportunities belonging to her corp
      2. **Fiduciary Duty of Care** holds directors to the standard of care that an ordinary prudent director would exercise in a similar situation
         1. Centralized mgmt. is value enhancing – more so than it would be if SHs made business decisions
         2. DE **§ 141(e)** – protects Ds who rely in good faith on certain corporate info
      3. **Business Judgment Rule**
         1. Judicially created (rebuttable) presumption that directors acted w/o self-dealing or personal interest, that they exercised reasonable diligence, and acted with good faith. One gets this presumption by virtue of being a director.

Policy

This presumption deters frivolous lawsuits

However, meritorious actions may be screened out. But at least boards know that every decision will not be 2nd guessed

Prevents access to discovery

Avoids judicial interference where judges have no particular expertise

Encourages directors to serve b/c limits exposure to liability

Judicial efficiency

Discourages directors from being risk averse

\*When SHs invest in a corp, they are recognizing the rules of the game (ie, maj SHs have more power)

BJR is fair b/c if SHs don’t like it, they don’t have to invest in stock (this can’t be said for the medical malpractice area, etc.)

Purpose:

Provides directors with broad discretion to manage the corp’s business

May promote some risk taking

Gives the Board the freedom to make mistakes (frees them from personal liability)

Consequences to this presumption:

Insulates Board decisions from judicial review

BJR protects directors and officers from personal liability

But have we set the standard of proof so high that directors feel that they can make any decision they wish?

**Only if the P’s pierce the presumption will a court review the substance of a transaction for fairness**

Heightened pleading requirement

Complaint has to do something other than make mere allegations that a decision was bad

The SH bears the burden of rebutting this BJR presumption

**To overcome the presumption, Ps must plead facts that, if true, show a breach of a duty of loyalty, or a breach of a duty of care, or actions of bad faith**

If SHs do pierce this shield, the burden is then on the director defendants to show that despite their breach of fid. duty, the action they took was fair

* + - 1. In **some** circumstances, directors’ fid. duty is owed directly to the SHs
         1. E.g. duty of candor when making recommendations
         2. Enforcement: individual action by SH against director, or class action
      2. In **most** circumstances, director or officer owes fid. duties to the corp. and to the SHs collectively
         1. Enforcement-- SH vehicles to sue one of two ways:

**“Direct” Action** (aka class action). SHs are alleging that they themselves are owed some type of duty that was breached. (ie. duty of disclosure/candor)

**Money obtained through litigation goes to SHs directly**

**“Derivative” Action** brought on behalf of the corp by one or more SHs. There is not a direct harm to the SH; the SH stands in the shoes of the corp for the harm to the corp itself.

Only allowed when court is convinced that the managers are unable to impartially and in good faith control a particular lawsuit

**Money goes into the corporate treasury (minus attorneys’ fees) if the directors are found to be liable**

* + - * 1. A decision whether to sue is a business decision that receives protection of the BJR
    1. **Discretion to Determine General Business Policies**
       1. ***Shlensky v. Wrigley***
          1. F: Min. SHs bring derivative action against Cubs Corp. board, alleging that the board acted negligently and mismanaged the corp b/c failed to instal lights at Wrigley stadium for Cubs night games
          2. H: Decision was protected by BJR; “It cannot be said that directors, even those of corps that are losing money, must follow the lead of other corps in the field”

Dismissed on the pleadings for failure to state a claim

PROF: there is no statement by Mr. Wrigley saying that he is opposed to the lights no matter how much the corp loses (unlike Mr. Ford); this would have shown selfish self interest at the expense of minority SHs

* + - * 1. This case had a narrow view of what it takes to rebut the presumption of the BJR

The court says that **negligent conduct standing alone is not enough to pierce the protection of the BJR**

* + - * 1. **To pierce the BJR:** this court wants to see something that touches on **“fraud, illegality, or conflict of interest”**

**TODAY**: gross negligence/breach of duty of care could get SHs through the BJR shield, too

* + 1. Discretion to Consider Interests of Non-SH Constituencies
       1. Overview
          1. Directors may consider the interests of other constituencies if there is “some rationally related benefit accruing to the SHs,” or if so doing “bears some reasonable relation to general SH interests”
          2. “Other constituency” statutes: in determining the best interest of the corp, directors may consider the interests of suppliers, EEs, customers, and affected communities
       2. ***Dodge v. Ford Motor Co.***
          1. **This case shows the level of particularity requires to pierce the BJR**
          2. F: action by min. SHs suing Henry Ford and the directors alleging that the decisions were a benefit to the working class at the investors’ expense. The Dodge bros are complaining that Ford is not paying dividends, but instead cut the price of cars. They accused Henry Ford of running this business to provide vehicles to the working class. Dodge Bros also wanted to stop Ford’s planned expansion and decrease in car price.
          3. H: Court upheld the ruling ordering Ford to pay a dividend. BUT the court reversed the lower court’s decision to enjoin the planned expansion. **The expansion of the business is a decision to be made by the mgmt.. However, there is no reason why the corp should be sitting on so much money w/o awarding its investors.**

Hoarding this cash w/o distribution is bad faith

SHs were able to pierce the BJR shield re: the payment of dividends, but not re: the decision to expand/lower car price

* + - * 1. Dodge Bros had to put facts in the complaint that rebutted the BJR. **They pierced the “shield.”** They were able to do this by showing year after year of dividends **and using Ford’s statements that he wanted to provide a low cost car to the working class.**
        2. **“A business corp is organized and carried on primarily for the profit of the SHs. The powers of the directors are to be employed to that end.”**

The directors can only change the means to this end (profits to SHs); can’t change the end itself

* + - * 1. NOTE: there may have been an issue of min oppression b/c the Dodge bros wanted their dividends so they could compete with Ford
      1. **Prob. 4-1**
         1. Context: talking about the BJR and role of corp social responsibility in director decision making

Loosely based on Nike and manufacturing in developing countries

* + - * 1. F: Board takes expenditures to better work environments abroad. SHs seek to enjoin this (don’t want the company to gratuitously bring the plants abroad in accordance with US standards)
        2. I am counsel for the corp and receive this complaint:

File mtn to dismiss based on BJR (sprinkle with legit reasons even though the law doesn’t require it)

Counsel board members to not make statements like “this will lower our earnings”

Look for evidence that this decision was made in the interest of long term profits

* + - * 1. SHs have to show a breach of duty of loyalty/care or lack of good faith to pierce the BJR

Evidence: SHs can point to the spokesperson admission that this will have a negative impact on earnings over BOTH the short and long term [compelling evidence that corp. is diverting/gifting $2mm in profits—should be declaring a dividend if has this much profit]

* + - * 1. If this complaint survives

Discovery follows, then typically SJ motions

SJ stage is where we will see corp’s arguments for why they are doing this (ie. better press will lead to more profits)

Court would then have to decide whether there are general issues of material fact in dispute

The trial may be just on the issue of whether the BJR has been pierced

* 1. **NOTE: In DE, fiduciary rules governing directors are solely the result of case law [Exception: DE § 144 governing conflict of interest transactions]**
  2. Fiduciary Duty of Loyalty – the Corporate Opportunity Doctrine
     1. ALI Principles of Corporate Governance §§ 5.05
     2. MBCA § 8.70
     3. **Duty of Loyalty** – Overview
        1. Described as “performing a contractual gap filling function”; parties contract with the thought that fid. duty provides ex post standards
           1. Fid duty law tries to replicate what the bargain would have been face-to-face
        2. Two classic settings:
           1. **Director personally takes an opportunity that the corp later asserts rightfully belonged to it; and**
           2. **Transactions b/w the corp and the director, commonly called “conflicting interest transaction”**
        3. **DUTY**: the director must favor the corp’s interests over her own whenever those interests conflict
           1. There is also a **duty of candor**, so courts will ask whether the director has been completely candid with the corp and its SHs
     4. **Corporate Opportunity Doctrine**
        1. This is **theft**
        2. ALI Approach
           1. ***Northeast Harbor Golf Club, Inc. v. Harris*** (Maine 1995)

F: Harris was president of the golf club and purchased and developed property abutting the golf course. Harris was contacted b/c of her position with the club; she immediately agreed to purchase the property, and did not disclose her plans to the club’s board prior to the purchase.

Lower Court: held that there was no breach of duty b/c “the acquisition of real estate was not in the club’s line of business. Moreover, the corp lacked the financial ability to purchase the real estate at issue.”

Applied the **line of business test** – **DE also applies the line of business test**

Issue: this test doesn’t allow the corp the right to change its business

We don’t want the corp’s financial hurdles to restrain it

H: Maine SC reversed the lower court and held that the ALI test is appropriate. The purchase of these properties is a corp opportunity b/c ALI defines it broadly but with specificity. Harris should have brought this to the board before she did anything.

Not happy with the ***Guth*** test b/c it is too amorphous and discretionary

Adopts the **ALI Principles of Corp Governance** in its entirety

This requires full disclosure to the board, and requires the corp to accept or decline an opportunity

“If the opportunity is not offered to the corp, the director or senior executive will not have satisfied § 5.05(a).” “Full disclosure to the appropriate corp body is … an absolute condition precedent to the validity of any forthcoming rejection as well as to the availability to the director or principal senior executive of the defense of fairness.”

* + - * 1. **ALI § 5.05** Taking if Corp Opportunities by Directors or Senior Execs

(a) General Rule. A director or senior exec may not take advantage of a corp opportunity UNLESS:

(1) the director or senior exec **first offers the corp opportunity to the corp and makes disclosure** concerning the conflict of interest and the corp opportunity;

(2) the corp **opportunity is rejected by the corp**; AND

(3) either:

(A) the rejection of the opportunity is fair to the corp; or

(B) the rejection is authorized in advance following such disclosure by **disinterested directors**, or, in the case of a senior exec who is not a director, authorized in advance by a disinterested superior, in a manner that satisfied the standards of the BJR; or

(C) the rejection is authorized in advance or ratified following such disclosure, by **disinterested SHs**, and the rejection is not equivalent to a **waste of corp assets**

(b) **Definition of a Corp Opportunity.**

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

(A) in connection with the performance of functions as a director or senior exec, or under circumstances that should reasonably lead the director or senior exec to believe that the person offering the opportunity expects it to be offered to the corp.; or

(B) through the use of corp information or property, if the resulting opportunity is one that the director or senior exec should reasonably be expected to believe would be of interest to the corp; or

(2) any opportunity to engage in a business activity of which a senior exec becomes aware and knows is **closely related to a business in which the corp is engaged or expects to engage**

* + - 1. DE Approach
         1. DE § 122(17)

Recognizes that often, directors serve two masters

* + - * 1. ***Broz v. Cellular Information Systems, Inc.*** (DE 1996)

Takes DE approach

F: Broz sat on the board of two telecom competitors (RBG & CIS). Broz used RBG to acquire *Michigan 2,* which is a license for service area adjacent to RBG’s service area. Tri Cellular (TC) was looking into buying *Michigan 2*and CIS, but before TC purchased CIS, Broz purchased *Michigan 2*. The new board of CIS that TC put into place is the one bringing the suit against Broz.

Lower Court: ruled in favor of the plaintiff & against Broz

Broz failed to make a formal presentation to the board (directors weren’t able to deliberate with each other)

\*This court would have added an additional prong to the corp opportunity doctrine (requirement of a formal get together to enhance the formalism of board decision)

Once the 3rd party (TC) started hovering around, Broz should have taken into account the interests of the potential owners

SC: rejects both of the lower court’s reasonings; relied on ***Guth v. Loft***

**Disclosure to the board is a safe harbor, but it is not required. Failure to disclose to the full board does not by itself constitute a breach of loyalty**

If you make full disclosure, then you don’t have to worry about the balancing test (“full disclosure” means all material facts are disclosed)

A director’s right to “appropriate [an] … opportunity depends on the circumstances existing **at the time it presented itself** to him without regard to subsequent events

***Guth* Four Factors** that state that a corp officer or director **MAY NOT** take a business opportunity as his own:

The corp is financially able to exploit the opportunity;

The opportunity is within the corp’s line of business;

The corp has an interest or expectancy in the opportunity; and

By taking the opportunity for his own, the corp fiduciary will thereby be placed in a position inimical (‘harmful or at odds’) to his duties to the corp

***Guth* Four Factors** that state that a corp officer or director **MAY** take a business opportunity as his own:

The opportunity is presented to the director or officer in his individual and not his corp capacity;

The opportunity is not essential to the corp;

The corp holds no interest or expectancy in the opportunity; and

The director or officer has not wrongfully employed the resources of the corp in pursuing or exploiting the opportunity

**SC only finds the 2nd factor from the 1st *Guth* set against Broz. The court finds all four *Guth* factors from the 2nd set that are in Broz’s favor.**

Some other factors that probably should count:

Disclosure (amount of disclosure)

Concealment

NOTE: how the info comes in is crucial—if the only reason Broz heard about *Michigan-2* was from his position on the Board of CIS, the equities shift

* + - 1. Differences b/w ***Broz*** & ***Harris*** 
         1. Harris took action on her own. Broz discussed the purchase with other directors at CIS.
         2. Broz owed duties to 2 corps. Harris only had one corp. and only one loyalty
         3. Harris was an EE of the corp (President). EE may owe a higher duty to your ER than would an outside director.
         4. Harris’s interest was personal (would help her own pocket)

But could argue that benefits would go in Broz’s pockets, too, b/c he was the President of RFBC

* + - * 1. Different corp ability to take advantage of the opportunity:

Broz: CIS was getting rid of its licenses & BK put restrictions on acquiring others

Harris: board could have raised money to buy the property/gone to the zoning board, etc., but never got the chance to act

* + - 1. Differences b/w ALI Approach & DE Approach
         1. **Individual who has taken the opportunity will prefer the DE approach. SHs and directors would probably prefer the ALI approach** b/c it would require full disclosure of corp opportunities to the corp.

|  |  |
| --- | --- |
| **ALI Approach [bright-line rule]** | **DE Approach** |
| Requires disclosure to the board  The way the opportunity comes is enough to violate the doctrine (rigid and no discretion) | Disclosure to the board is a “safe harbor” but is not required on one’s defense |
| Must meet the definition of “corp opportunity” and requires the corp. to accept or decline the opportunity | Uses four factors that director MAY take the opportunity and four factors that director MAY NOT take the opportunity |

* + - 1. **Prob. 4-2 (1)**
         1. F: E conducts an interview for VP of her company (NW). The interviewee tells E that she is trying to get funding for her restaurant. E decides to invest in the restaurant and becomes a director of the restaurant co. NW then loses this potential VP b/c she stays at her restaurant
         2. Issue: is the fast food restaurant a “corp opportunity”?

Under **ALI** approach?

YES. §5.05(b)(1) says that it is a “corp opportunity” if you become aware “in connection with the performance or functions as a director or senior exec.” **This is a breach of fid duty of loyalty** to NW even though the fast food restaurant is not “closely related to the business in which the corp is engaged or expects to engage.”

This is a rigid requirement—no discretion

Under ***Guth v. Loft***

NO breach of fid duty of loyalty to NW

This is taking away from corp resources b/c this interviewee could have been a potential EE/VP

No basis for expectancy, though

No line of business problem, b/c this is not currently what company is doing

This may not interfere with E’s role at NW if she is just a passive investor in the restaurant

* + - * 1. The opportunity coming in a particular way is enough to violate the doctrine under ALI principles

DE is more mushy

* + - * 1. Advice: provide full and complete disclosure and get enough support and consent as you can re: the corp opportunity
      1. **Prob. 4.2 (2)**
         1. (A)

F: E learns that NFL needs charter transportation services. She contracts with another company re: this opportunity w/o telling NW.

**ALI approach**

This is a corporate opportunity under § 5.05(b) b/c E hears of it while she is doing her official duties and acting on behalf of NW

Financial ability to take advantage of the opportunity is irrelevant

So doesn’t matter that NW is in a lot of debt

Notice doesn’t matter

**DE**

Could argue that this is within the realm of reasonable expectancy

Takes into account the corp’s financial ability to take advantage of the opportunity

If E is resigning from NW, she won’t have an inimical position after 60 days

* + - * 1. (C)

F: NFL initiated discussions with E at a private dinner re: doing business with her new company (and in no event would want to do business with NW)

**ALI**: NW paid for E’s trip out there, E’s status at NW got her the initial mtg with the NFL (think about how the opportunity came to her)

* + - * 1. (D)

F: E is a director but not an officer at NW. She is also a CEO of another company.

**ALI:** Executives are held to a higher standard than directors, so ALI section 5.05(b)(2) would not apply here

**DE:** her being the director cuts against this being a corp opportunity

* 1. Loyalty Continued – **Conflicting Interest Transactions**
     1. **Overview**
        1. Conflict of interest transactions are not necessarily theft
           1. May actually get a good price; interested person may have unique assets, so fair CITs should be allowable
        2. Primary Concern: director may benefit financially at the expense of the corp.
           1. Ie. if X is on both sides of the transaction (self dealing)

Can be between a director and the corp or anyone in a fid capacity to the corp (both would be subject to these rules)

* + - 1. **Old CL:** duty of loyalty used to be applied very strictly
         1. In conflicts of interests, all transactions were void or voidable at the option of the corp

This put a chilling effect on ALL CITs, even those that were objectively fair to the corp.

* + - 1. **Now**: most states have passed statutes that define conflicts of interests and that they are NOT per se void or voidable. Specific procedures to make sure that the K is fair and has been put in place appropriately w/o the insider taking advantage [**DE** **§ 144** is a prototypical example]
    1. **DE § 144**
       1. **(a)** Interested director transactions **not** void or voidable solely b/c of conflict, if: [THE FOLLOWING ARE SAFE HARBORS]
          1. **(1) Majority disinterested & independent** (aka “not beholden to or dominated by another party”) **director approval** (good faith) **OR**

What is the benefit of approval? Approval under a1 or a2 will sanitize the transaction/restore the protection of the BJR. Any SH suit will be subject to the BJR. Reminder: this is a rebuttable presumption saying that the directors acted w/o self dealing--the plaintiff must rebut by stating facts in the complaint that show a breach of loyalty, breach of duty of care, or lack of good faith.

* + - * 1. **(2) Approval by SHs in good faith; OR**
        2. **(3) Fair to corporation**

Court asks to questions:

Fair dealing?

Timing, how it is structured, negotiated

Fair price?

Economic and financial considerations of the particular transaction

\*Use a3 to this fairness showing to sanitize the transaction if you can’t get BJR presumption restored via disclosure

Fair price and fair dealing components of “fairness” come from ***Weinberger v. UOP***

* + 1. MBCA §§ 8.60-8.63
    2. ***Shapiro v. Greenfield*** (MD 2000)
       1. SUM: Familial relationship does not in and of itself make one an interested director under DE § 144(a)
          1. This MD statute is very similar to DE 144, so can compare
       2. F: Greenfields (SHs) bring a derivative action claiming breach of duty of loyalty against College Park (Corp.), its officers & directors
          1. It is a family corp—3 directors (Charles Shapiro, Shapiro’s son and Shapiro’s sister)
          2. SHs complain about a transaction that is actually working out pretty well for the corp. Transaction:

C. Shapiro sets up a joint venture (Clinton Crossings Limited Partnership) to develop a mall on College Park’s property [Greenfields are SHs in the 50% of CCLP that College Park owns)

College Park Corp, couldn’t afford to develop this mall on its own

* + - * 1. C. Shapiro took steps to make sure that this transaction was approved by others who didn’t share his conflict of interest (b/c he was doing business with his own corp)

(1) Vote passes at SH mtg

C. Shapiro and his son are both SHs but both have conflicts

Shapiro’s sister is a SH and votes yes (but she is also a family member—conflict?)

Greenfields would have likely voted no, but they weren’t at the mtg

(2) Ratified at director mtg

But these directors are all family members

* + - 1. TC: agrees with SHs that defendent directors breached their duty of loyalty b/c they usurped a corp opportunity
      2. HELD- CoA: no definitive answer to this case—Q of fact w.r.t. whether Shapiro’s sister was independent and disinterested while wearing director and SH hat
         1. This case raises interested director transaction issues, NOT corp. opportunity doctrine [these are different]. **Remands** the case so the transaction can be analyzed under MD 2-419 (similar to DE 144)

C. Shapiro bore the risk in this transaction (he put his own financial and human capital into the enterprise and guaranteed the loans personally)

But College Park Corp DID part with title on the building

All of the analysis boils down to Shapiro’s sister

She is the only person who could be seen as a disinterested independent director and good faith SH capable of voting and cleansing the transaction (w/o having to go to the Q of whether this transaction was fair to the corp.)

TC assumed that sister was as conflicted as C. Shapiro and his son, but CoA doesn’t know why it assumed this

* + - 1. One difference b/w DE 144 and MD 2-419
         1. MD 2-419 (b)(1)(ii)- restores BJR protection if a maj of votes cast by SH (other than shares held by interested director)

Specifically excludes the votes of SHs who have the conflict

Ie. C. Shapiro and his son’s votes wouldn’t count

* + - * 1. DE 144(a)(2)- doesn’t specifically say that you factor out the shares of the directors who have the conflict (but this idea is packed into the idea of good faith)

So same type of vote would cleanse in both DE and MD

* + 1. **Prob. 4-5**
       1. F: Diversity owns commercial office bldg. that needs repair. Diversify has 4 directors. Board received appraisal for the bldg. (appraisal of $12-15 mm and offers fell between $8-11 mm and were rejected by the Board as insufficient). Two years later, directors themselves form a company (BNNN) and enter into a K that has Diversify selling the bldg. to BNNN for $11 mm without SH approval. Later, new directors of Diversity seek a suit against old directors wanting damages or the bldg. back (rescission).
       2. Analysis: assuming Diversify is a director corp., this is obviously a **conflicted interest transaction** under DE law b/c BNNN is wholly owned by the Diversify directors. This would also be a **self dealing trans** b/c by selling the bldg., these directors are getting a benefit that no other SHs are getting.
       3. Advising BNNN:
          1. DE 144(a)(1) is impossible to use b/c can’t get director approval here b/c the 4 directors are on the other side of the trans, too (NO disinterested directors)
          2. If the transaction is approved by the SHs after full disclosure, court would have to see if the material facts as to BNNN and its interest were disclosed or known by the SHs and whether SHs approved in good faith (in order to dismiss suit on 144(a)(2) grounds and restore BJR)

BUT b/c directors did not seek SH approval here, DE 144 analysis would boil down to whether the sale was **fair** to the corp

Four old directors have the burden to show that there was a fair price and fair dealing

Defendant directors would argue:

They put the bldg. up for sale and solicited offers. Argue that the appraisal was inflated and BNNN did a “market test” and then matched the highest bid ($11 mm)

BNNN’s offer was more attractive and thus fair dealing b/c would have been friendlier to Diversify re: moving out, etc.

No one stepped in offering to pay more than $11 mm

New Diversity board would argue:

No fair dealing or fair price

BNNN offered an amount that Baron had at one point deemed insufficient

The appraisal is old

No real estate broker involved here to market the property to other buyers

* + 1. Directors’ “Self-Compensation”
       1. DE §§ 141(h), 157
       2. MBCA §§ 6.24, 8.11
       3. “Directorial self-compensation decisions lie outside the BJR’s presumptive protection”
          1. Solutions:

Seek SH ratification

Place the compensation decision in the hands of the board of members who are independent and disinterested

* 1. **Fiduciary Duties of Care**
     1. Overview
        1. DE: scope of duty of care is set by case law
           1. Case law also defines the bounds of potential liability for failing to adhere to the requisite standard
        2. Many states: Standard of care is supplemented by a statutory formulation
           1. Pre-1988 MBCA **§ 8.30**

Requires a director to carry out her duties “with the care an ordinarily prudent person in a like position would exercise under similar circumstances”

This only applied in egregious circumstances

* + - * 1. Later, MBCA sharpened this via **§ 8.30(b)**

Need courts to interpret this confusing language

* + - * 1. \*DE doesn’t even try to reduce it to statutory provision
    1. Presumptions that attach to BJR:
       1. Directors act loyally in good faith
       2. Directors make decisions with the requisite level of diligence and care
    2. Policy Arguments for Limiting the Reach of the Duty of Care
       1. MBCA § 8.30(b) & official cmt to § 8.30
       2. Fiduciary duties of care & good faith
          1. ***Joy v. North***

SUM: A corporate officer who makes a mistake in judgment will rarely be found liable for damages suffered by the corp.

**Reasons for BJR**:

SHs voluntarily undertake the risk of bad business judgment

Best way for SHs to protect themselves from the downside risks of bad business decisions is to diversify

Courts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions

B/c potential profit often corresponds to the potential risk, it is very much in the interest of SHs that the law not create incentives for overly cautious corporate decisions

A rule that penalizes the choice of seemingly riskier alternatives thus may not be in the interest of the SHs generally

TNOTE: BJR only extends as far as the reasons that justify its existence.

* + 1. Duty of Care in Decisional Setting
       1. MBCA §§ 8.30, 8.31
       2. **Importance of Outside Directors**
          1. Much of the detailed info necessary to determine an appropriate course of action may be possessed by directors or other mgmt. personnel who are clearly committed to a particular course of action
          2. Outside directors are competent business execs or are otherwise familiar with the dynamics of the type of transaction being contemplated by the corp
          3. Informed about the corp’s business
       3. ***Smith v. Van Gorkom*** (DE SC 1985)
          1. SUM: pierced the BJR with gross negligence
          2. F: Van Gorkom (CEO) assembled a proposed per share price for sale of the company and a financing structure by which to accomplish the sale. Gorkom did so w/out consulting either his board or any members of Senior mgmt.. except one. Ds approved and passed the merger agreement w/o even reading or seeing the agreement. 5 months later, SHs vote in favor of the merger. Trans Union was merged into New T, a subsidiary of Marmon Group owned by Jay Pritzker. SHs received a $17 premium over the market price at the time. This is NOT a derivative suit—Smith is suing for damages or rescission (but rescission was not really an option)

Trans Union pursued the merger b/c its tax bill was not sufficient to make full use of all of its available investment tax credits—so it bailed out and sold Trans Union to a larger shell that already owned a lot of corps

* + - * 1. Issues:

Did Trans Union directors act with due care re: selling out to Marmon Group?

Did directors fulfill their fiduciary duties in setting the terms of the transaction? (esp. the sale price and adequate disclosure to the Trans Union SHs in seeking their approval)

* + - * 1. **DE § 251(b)** specifies that directors of each **corp proposing to merge must adopt an agreement to merge.** This also specifies specific details that must be contained in the merger agreement. This must include the considerations received by the SHs (cash or new security).

**DE § 251(c)** states that the **merger agreement must be distributed to the SHs of BOTH corps** for voting upon that merger proposal. 251(c) also specifies that at this SH mtg to approve the merger, there is a vote, **and for a merger to be approved a maj of the outstanding stock must vote in favor of it**

If merger is approved by a maj, those who vote against the merger have no choice but to surrender their shares for the agreed upon consideration—**but** they have another option: they can demand to have their shares purchased at fair value and then seek appraisal in Chancery Court if can’t agree on what fair value is

P here did **not** seek appraisal—he filed this suit

NOTE: here, Trans Union was an empty shell, but Trans Union had real SHs who were owed real disclosure before they acted on the resolution and voted on the merger

* + - * 1. **BJR**: “a presumption that in making a business decision, the directors of a corp 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”

Directors tried to use this as a defense

**Trial Court determined that enough allegations about breach of the duty of care were pled in the complaint to justify discovery** (the complaint had to have specific facts to justify that)

TC: trial focused on the duty of care and whether it pierced the BJR. Judge found that Ps failed to pierce the BJR and held for defendants

* + - * 1. **RULE FOR DUTY OF CARE**: director liability is predicated upon concepts of gross negligence. However, if there is an exculpation clause, then P’s must show bad faith.

**Mere gross negligence is NOT bad faith**

* + - * 1. Determined only upon the basis of the information then reasonable available to the directors and relevant to their decision
        2. **H: SC finds for plaintiffs; Board breached duty of care & acted with gross negligence for selling the stock w/o adequate info [couldn’t withstand the fair price/fair dealing analysis]**

Held that the directors were personally liable for the difference b/w what the shares were worth and what the SHs received (remanded to settled Q of damages)

PROF: court skipped a step, b/c once you pierce the BJR, should allow Ds the change to defend their actions as fair to the corp. Would expect SC to remand to the TC to see if it was fair to the corp and **then** if not determine damages

***Cinerama***: fairness = fair price/dealing. The facts that show gross negligence show a lack of fair dealing, so the court made an implicit finding of fairness or lack there of

Rationale: Board didn’t know how the $17 premium figure came to be and didn’t ask about it. It was based on the feasibility and not the value of the company (didn’t know the value of the company). There was no exigency—this was rushed unnecessarily

SH ratification did not cleanse the transaction b/c board wasn’t completely candid with SHs (should have told SHs the things that the board itself didn’t know)

The Board argument that no one else had offered to buy the corp isn’t enough b/c there was no true test of the market. There was no evidence of an auction b/c there was a condition that prohibited the company from soliciting bids.

But Van Gorkom was **not** disloyal

* + - * 1. Lockup: Pritzker expressed interest, but Van Gorkom wanted Trans Union to be free to accept any better offer that may come out of the woodwork due to Pritzker’s bid. In exchange, Trans Union promised Pritzker 1 mm shares at $38 a share. **Courts allow lockups** b/c serve as a quasi sales commission to compensate the losing bidder for getting the process going. The lockup only has meaning as long as someone else outbid Pritzker.
        2. What types of things **Van Gorkom should have done differently**

Tell the board what the mtg is about, and give it documentation to prepare for the board mtg (less secretive)

Van Gorkom should have been discussing with the board about approaching Pritzker about the offer of $55 a share

Van Gorkom should have sought an evaluation for the value of the company, not how much an acquisition would cost in terms of price per share to be able to pay off loans

* + - * 1. Why doesn’t trading price (x) number of shares outstanding give us a **proper valuation of the company?**

This is the value of the minority share in the company. Majority SH has more power and thus the shares are worth more.

The market price is only what a share in the market is worth. This is just what someone is willing to pay for the voting right and the equity interest associated with that share. The company itself is, hopefully, worth more than the value of the stock

Also, there are unutilized tax credits through the investment tax credit

However, one may argue that a company may be worth how much someone is willing to pay for it

Perhaps at an auction

* + - * 1. Leveraged buy-out

Trans Union mgmt. wanted to borrow enough money to buy out its outstanding shares

Mgmt.. has a conflict when it tried to buy the company from its SHs it is trying to get the lowest price possible [Van Gorkom owns a lot of stock; other senior mgrs. own very little stock]

Very conflicted if the mgrs. propose a sale to a company that they put together

* + - * 1. Why might Van Gorkom’s interest as a SH be different than other SHs (even though he had an incentive to get a high price as a substantial equity owner)?

Unless some sale of the company takes place, then Van Gorkom is unable to realize the value of his investment and retire

* + - * 1. **The transaction with the Board**:

**BJR itself “is a presumption that in making a business decision, the directors of a corp 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”**

What could one use to **pierce this rule?**

**P’s could show a failure of the Board to adequately inform themselves of all material info. The standard for directors is “gross negligence”**

* + - * 1. What facts didn’t the Board know that a Board should know?

Board didn’t know the value of the company

Board didn’t know what kind of negotiation came out of the $55 price

Board members only had a 20-minute presentation. They did not have a merger agreement in their hands. The CFO then said that he thought this was at the bottom of the fair price

The Trans Union board only spent 2 hours on the mtg

There was an absence of bids from other potential buyers

There was an argument that there was not gross negligence b/c they didn’t have any other bids by which one would normally compare Pritzker’s bid to. The Board could say that the terms of the agreement prevented the company from soliciting other bidders.

* + - * 1. Corporate counseling lessons:

Make sure you have a valuation study

Higher an investment banker

Directors should carefully look at the merger agreement

Directors must actively participate in questioning insiders who propose mergers or other significant transactions

E.g. how did the $55 price come up in the negotiation

Directors should insist on getting accurate info, taking recesses if necessary, and calling experts if necessary. Not rushing to a decision.

A real market test, not a sham test (advisable, but not required)

You don’t want to inhibit your ability to talk to other bidders

**DE §141(e) provides that directors are fully protected in relying on good faith reports by officers**

Not clear whether Roman’s statements and Van Gorkom’s presentation was a report, but even if it was, cannot blindly rely (here, blindly relied b/c Board didn’t ask any questions)

Also, a at a min the report must be pertinent to what the mtg is called for

The 2009 **§ 141(e)** is not as limited as back in Van Gorkom’s time. **§ 141(e)** includes protection of directors’ reliance on opinions by officer (see this in the ***Disney*** litigation).

* + - * 1. SH ratification is not sufficient to insulate the directors if the SHs were not adequately informed (e.g. the directors breach their duty of candor)
        2. In the directors’ defense of a fast decision, the DISSENT points to the experience of the directors and that their decision was not the victim of a “fast shuffle”
      1. **Once the P rebuts the presumption of the BJR, then the D must show that the transaction was intrinsically fair to the corp.**
      2. **The burden will also shift when the Ps show that there was a violation of duty of care (pierce the BJR by gross negligence), then the Ds must show that the transaction was intrinsically fair to the corp.**
    1. Statutory Exculpation Provisions
       1. MBCA §§ 2.02(b)(4)
       2. **DE §§ 102(b)(7)**
          1. This provision limits director liability
          2. **This MAY be included in the corp’s Articles**
          3. This limits of eliminates the personal liability of directors
          4. This does allow **exculpation of breach of a duty of care**, but **does not allow exculpation** for breach of the **duty of loyalty,** acts or omissions **not in good faith**, acts involving intentional misconduct, or unlawful payment of dividends or improper personal benefits. Also can’t have monetary liability eliminated.
          5. This is the legislature’s reaction to ***Smith v. Gorkom***

**Policy:**

Many scholars felt that the DC SC got the decision wrong re: what the SHs would have wanted (exposed directors to excessive risk of liability)

So encourage the use of exculpation provision to protect directors

Once state law allowed corps to amend their Articles to include an exculpation clause, directors wasted no time in voting to put this amendment to a SH vote and recommend that they vote yes (it was up to SHs)

Virtually all PTCs now have exculpation clauses in their Articles

* + - 1. ***Malpiede v. Townson*** (SC DE 2001)
         1. Practical effect of **§ 102(b)(7)**
         2. F: Frederick’s (F) was searching for a buyer for a merger. Knightsbridge made an offer to purchase all outstanding Class A and B stock and F’s agreed. Two months later, F’s received a fully financed, unsolicited cash offer for more money from Milton. A few days later, an even higher fully financed unsolicited cash offer came from Veritas. Knightsbridge increased its bid but on the condition that the board accept a variety of terms designed to restrict its ability to pursue superior offers. Veritas increased its offer to $9 per share. The board rejected the bid relying on the (1) “no talk” provision, (2) Knightsbridge’s intention to vote against the bids, and (3) Veritas’ request for an option to dilute Knightsbridge’s interest.

Unlike ***Van Gorkom***, there was an actual bidding war here

* + - * 1. Claim: SHs sued for breach of fiduciary duty of care for the directors ending the bidding too early
        2. **HELD: Effect of exculpation clause** 🡪 Defendants get immediate judgment as a matter of law

Even if Ps were able to prove gross negligence for the breach of the duty of care (and damages) and Ds were unable to prove that the transaction was fair, then the Ps would still not be able to get damages b/c of the exculpation clause

* + - * 1. **Cannot exculpate for a breach of fiduciary duty of loyalty or lack of good faith**

If the Ps had claimed a breach of the fiduciary duty of loyalty or a lack of good faith, then the court would not have been able to enact the exculpation clause

But the court in this case says that the Ps pled insufficient facts for these two claims

* + - * 1. **Duty of due care**

**Gross negligence will breach the duty of due care** (unless exculpation clause, then you need bad faith)

Ex: failing to implement a routine defensive strategy that could enable the board to negotiate for a higher bid or otherwise create a tactical advantage to enhance the SH value

Liability shield- **DE § 102(b)(7)**

The purpose of this statute was to permit SHs to adopt a provision in the Articles to free directors from personal liability in damages for due care violations, **but not** for duty of loyalty violations, bad faith claims, or certain other conduct.

In short, it freed directors to take business risks w/o worrying about negligence lawsuits

* + - * 1. Policy

If you assume that it is good policy that SHs are able to decide whether their corp directors should be exculpated from breaches of the duty of care, should DE have gone ever further with **§ 102(b)(7)** and allowed SHs to vote for exculpation for breaches of other duties?

**MBCA 2.02(b)(4)** does go further than DE

Articles may limit liability for directors except for … [doesn’t use loyalty/good faith type language]

DE: directors probably think that they can spot loyalty issues earlier than care & diligence type issues (breaches of loyalty are more ascertainable in advance than gross negligence)

* 1. Intersection of Care & Loyalty – Duty of Good Faith
     1. Care, Good Faith, & Directors’ **Oversight/Monitoring Responsibilities**
        1. MBCA §§ 8.30, 8.42
        2. Overview
           1. Duty to monitor activities EEs in a corp
           2. It is not efficient for directors to try to prevent every unfortunate event

**DE § 141(a)** provides that a corp’s business and affairs shall be managed by a Board

It is unthinkable that the board will make **every** decision – the board sets major policies and the maj of day to day decisions will be made by people don’t have a remote connection to the board

* + - 1. ***In re Caremark International, Inc. Derivative Litigation*** (1996)
         1. SUM: shows how difficult it is for courts to make decisions re: directors’ liability for preventing illegal activities, particularly when the corp is benefitting from the illegal activities until it is caught and has to pay

CAREMARK STANDARD OF CONDUCT: affirmative obligation to set up a reporting mechanism and take compliance-related steps

* + - * 1. TEST: Director liability for a breach of the **duty to exercise appropriate attention** may, in theory, arise in two distinct contexts:

(1) Such liability may be said to follow **from a board decision** that results in a loss b/c that decision was ill-advised or “negligent”

The substance of the decision is irrelevant. **What matters is the PROCESS**. That the directors had a well-informed and good faith process for making these decisions.

**Where the directors in fact exercises good faith to be informed and to exercise appropriate judgment, he or she should be deemed to satisfy fully the duty of attention**

**BJR** will end these cases unless SHs can show facts that evidence gross negligence

**But** where there is an exculpation clause, SHs have to show bad faith for personal liability to apply

Generally, even if this results in a loss to the company, BJR analysis will apply

**HELD**: the court finds that the settlement is reasonable. The directors didn’t intentionally violate any law, and it appears that they did the conduct that was required of them. It doesn’t appear that the board members were approving or assisting with illegal activity. So, the directors were not liable for the decision they made.

(2) Liability to the corp for a loss may be said to arise from an **unconsidered failure of the board to act** in circumstances in which due attention would, arguably, have prevented the loss. **This falls under duty of loyalty**.

The BJR does **not** protect this situation b/c the directors have **not** made a judgment. You cannot presume that decision was made carefully and thoughtfully.

Standard of Oversight from ***Graham v. Allis-Chalmers***:

OVERSIGHT PROCEDURES

MONITORING PROCEDURES

INTERNAL CONTROLS

Directors must assure themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior mgmt. and to the board itself timely, accurate info sufficient to allow mgmt. and the board, each within its scope, to reach informed judgments concerning both the corp’s compliance with the law and its business performance. **Waiting for red flags to pop up is not enough.**

Standard of Liability**:**

**Bad faith**

“Only a sustained or systematic failure of the board to exercise oversight –such an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith”

What do Ps have to prove:

(1a) **That directors knew or (1b) should have known** that violations of law were occurring and, in either event

(2) That **directors took no steps in a good faith effort to prevent or remedy that situation, AND**

(3) **That such failure proximately resulted in the losses complained of**

* + - * 1. **F**: ARPL said that Caremark couldn’t legally pay doctors to refer patients to the drug companies. But caremark put out money to doctors for “consulting & research.” To help ensure compliance with the ARPL, Caremark held internal audits, etc. Directors may have encouraged the proliferation of consulting agreements at a time when the government did not explicitly make this illegal, but Caremark changed its instructions as the federal gov’t changed its instructions.

Caremark settled with the gov’t for $250mm after being prosecuted for illegal referral kickbacks

During this settlement with the gov’t, SHs filed derivative actions alleging fiduciary duty breaches re: directors allowing the corp to violate the ARPL

Settlement b/w SHs & directors: directors don’t pay, but promise to adopt certain remedial measures

SHs’ attorneys as for $1mm in fees

**Issue:** court has to sign off on these settlements; **Chancellor Allen has to decide whether the attorneys fees are justified here**

* + - * 1. **Held:** court approves the settlement but reduces the attorneys’ fees to $870k.

The SH settlement was reasonable b/c the directors hadn’t intentionally violated any law and tried to fix it via audits, etc.

Caremark also increased the oversight and procedures for compliance

Exchange of attorneys fees for the consideration of these “beefed up” procedures

Even though the procedures set forth by the company were not tough enough

Very demanding test for oversight liability 🡪 lack of good faith as evidenced by sustained or systematic failure of the board to exercise oversight

* + - * 1. NOTE: see ***Stone v. Ritter*** (below)
        2. Legacy:

This case created a lot of work for lawyers b/c directors actually had affirmative duties; lawyers came in to advise boards on their ***Caremark***responsibilities

But directors took solace in the fact that liability turned on good faith and that lack of good faith could only be shown by sustained and systematic lack of oversight

Plaintiffs’ attorneys’ reactions

These attorneys turned directors’ lack of care in oversight (where Ps could show gross negligence) into a non-exculpable claim based on the lack of good faith (ie. raise the claim to the level of bad faith b/c there was no money in gross negligence)

***Caremark*** didn’t elaborate on what is a lack of good faith, so Ps’s lawyers could try to convert lack of care claims into bad faith claims

Some parts of ***Caremark*** seem to suggest that a sustained utter lack of oversight is enough to satisfy bad faith, but Chancellor leaves it hanging

* + - 1. **Prob. 4-8**
         1. F: Tyron Company; EEs began overcharging the VA by providing fraudulent price lists that resulted in illegally obtained profits. In 1994, after possibilities of illegalities are raised by the VA Inspector’s Office, CEO reports that she suspected that there had been isolated incidents of fraud, but that they were not widespread. In 1988, EEs are indicted (there is a quote in the record about fudging the #s; reflected that directors knew in 1988 that these practices are rampant in the industry).
         2. Claim: SHs claim a breach of the directors’ duty of care
         3. Analysis

Assuming there is an exculpation clause in the articles:

It is unlikely that the SH derivative suit will allege solely a breach of the duty of care

Complaint will probably allege lack of care in that there was grossly negligent oversight AND well-pleaded allegations that this lack of oversight constituted bad faith actions (which essentially amounts to a breach of the duty of loyalty)

Different from ***Caremark***

*See* ***Stone v. Ritter***: imposition of liability requires that the directors knew that they were not discharging their fiduciary duties

Tyron board **knew** that its own company had issues as early as 1994

Only sent a memo to their mgmt. to remedy the fraud (does this count as a “system of controls” under a ***Ritter*** interpretation of ***Caremark***?

Facts that might show that directors should have known about the fraud despite their “attempt” at oversight:

If the revenue #s had remained the same or increased after their letter of warning

If there was an internal whistleblower

If this person told a P’s attorney that the board talked about what they should do and then did the opposite (this is proof positive of conscious disregard for what should be done, under ***Ritter***)

* + 1. **DUTY OF LOYALTY**
       1. **If there is a failure of the board to act, then there is a breach of duty of loyalty if:**
          1. **No good faith, and**
          2. **Insufficient oversight procedures**

Insufficient monitoring procedures

Insufficient internal controls

**To recover, P must show bad faith**

***Caremark***- “only a sustained or systematic failure of the board to exercise oversight –such as an utter failure to attempt to assure a reasonable information reporting system exists – will establish the lack of good faith”

***Disney***- “intentional dereliction of duty”

What example facts would prove this?

Director says, “I resigned b/c I told my fellow directors that other companies are guilty of fraud, and the same could be occurring at our company. However, the other directors just dismissed me w/o consideration”

May require a whistleblower

A memo in the file that says “I am concerned about what is going on in the industry. Other companies have violated, and so could we”

* + - * 1. **No acts constituting waste**

“An exchange that is so one-sided that no business person of ordinary, sound judgment could conclude that the corp had received adequate consideration.

* + - 1. If you are a director: hire outside law firms to make sure that companies you manage are law-abiding
    1. The Role & Nature of Substantive Rules
       1. ***Brehm v. Eisner***
          1. H: affirmed decision to dismiss SHs’ initial complaint, but gave SHs a chance to re-plead

No discovery had taken place, so SHs needed a way to get particularized facts to substantiate their claims 🡪 use **books & records request** under **DE § 220**

* + - * 1. F: Eisner (CEO and Chair of Disney) decides to hire Ovitz as Disney’s President (Board approves). Ovitz had experience negotiating with talent, and go to get him to leave his old job at CAA, Disney knew it would have to pay Ovitz a lot.

Contract:

Ovitz could be terminated during the 5 years for cause, which meant clearly improper conduct (ie. malfeasance or gross negligence)

If Ovitz was terminated without cause, then Ovitz would be entitled to the present value of the remainder of his salary, a $10mm severance payment, 7.5 mm for each year in remaining on the K, and the A stock options that would immediately vest (3 mm shares)--- these are the dominos that would fall

Ovitz has been at Disney for only 14 months when it was plain that his hiring had been a mistake

Eisner couldn’t get along with him and wanted him out; decided that Disney would fire Ovitz w/o cause. This then triggered the other dominos.

The result was that Ovitz wound up with cash payments of $40 mm and stock options worth close to $100 mm

Disney SHs then brought derivative suits against the **old board who approved the initial K AND the new board that approved Ovitz’s no fault termination**

* + - * 1. 2 groups of claims in 1st SH suit:

Old board violated duty of care and committed waste in 1995 when it approved the compensation package and employment K for Ovitz

New board violated its duty of care and committed waste in 1996 when it approved a no fault termination with respect to Ovitz’s separation from that company

* + - * 1. SHs’ alleged facts to support that OLD BOARD didn’t consider the cost of the compensation package:

Board members didn’t calculate the #s

Was done in a hurried manner that didn’t satisfy due care

Two public statements by compensation consultant, Crystal, which form the basis of the allegation that the board didn’t consider the cost of the severance package

But court says that this didn’t create a reasonable doubt of gross negligence b/c these statements were made **after** Ovitz was fired (so this doesn’t go to what the board was doing or thinking)

* + - * 1. SH’s waste argument:

Court has a hard standard re: whether a board decision can be classified as “waste”

**TEST**: an exchange that is so one-sided that no business person of ordinary sound judgment could conclude that the corp received adequate consideration

The deal has to be extraordinarily bad for the corp [court essentially says that a lot more zeroes would have to be added to the $$ here for his to be waste]

Complaint fails to show particular facts to meet the waste test (mere conclusory statements are not enough)

* + - * 1. SH’s claim re: NEW BOARD’s alleged violation of duty of care and waste:

SHs say that Ovitz should have been fired FOR cause

But court says that SHs show no concrete facts that this was an ill-informed decision

* + 1. Directors’ Duty of Good Faith Explicated
       1. ***In re Walt Disney Company Derivative Litigation***
          1. SUM: To show bad faith, SC says that gross negligence is NOT enough (need something else)

Aka **gross negligence does NOT equal bad faith**

* + - * 1. Background: 1st complaint was dismissed b/c the P didn’t satisfy the pleading standards. MUST PLEAD FACTS WITH PARTICULARITY. Also, the 1st complaint accused the board of a breach of its duty of care. Because there was an exculpatory clause, the complaint was dismissed b/c there was no bad faith or showing of waste.
        2. **NEW Facts** [raised reasonable doubts about the duties of care and good faith]:

Old Board (2nd complaint):

Correspondence was b/w Eisner & Ovitz

Not b/w the board or compensation committee and Ovitz

Spent less than an hour reviewing Ovitz’s possible hiring (this is similar to ***Van Gorkom***. It was a rushed and uninformed process)

Did not review the actual draft employment agreement

Did not evaluate the details of Ovitz’s salary or his severance provision

\*Survived motion to dismiss AND SJ process. Chancellor ruled that it was strong enough to necessitate a trial

New Board (1st complaint):

Refused to explore any alternatives to a no fault termination

Did not request a meeting

Left it up to Eisner to negotiate the termination

Failed to ask questions re: relationship with Ovitz

Didn’t seek expert advice

\*Didn’t survive def’s motion to dismiss

* + - * 1. **Chancellor concludes** that SHs have met their pleading burden; directors didn’t fulfill any of their responsibilities re: becoming informed of the compensation package and the option for firing Ovitz for fault; but ultimately that directors were entitled to BJR protection

SHs have shown an argument for gross negligence AND that the facts rise to a level of bad faith

SHs should be able to proceed to discovery re: bad faith

**Formula for bad faith** = deliberate indifference and inaction in the face of a duty to act

* + - * 1. **Held [DC SC]:** agrees with Chancellor that the directors were protected by the BJR b/c the Ps could not show that the directors acted with gross negligence, that they acted in bad faith, or that they acted with waste

In the 8 yrs, **no** court made a determination re: whether the $140 mm severance package was fair to the corp. (fairness was never before the court thanks to the BJR)

Neither the severance package nor the decision to grant Ovitz a no-fault termination constituted waste

Establishes “**best practices”**

Says that the directors could have saved all the parties a lot of time if they had used best practices [below are ideas from PROF?]

Committee members should have received a spreadsheet that calculated all the foreseeable circumstances (would become an exhibit to the minutes of the compensation committee mtg)

Document that Disney got good legal advice that Ovtiz probably couldn’t be fired for cause

Show that Eisner and Ovitz were not as good of friends as the record showed

But at trial it was shown that the board and compensation committee were informed “adequately”

Even if bad faith can be shown by some type of showing of gross negligence [which it can’t], SHs didn’t even show gross negligence

* + - * 1. LEGACY:

After this case: care, loyalty, AND good faith, **OR** just care and loyalty?

Case doesn’t come right out and say where the duty of good faith fits into the greater picture

***Stone v. Ritter*** answers this Q

**Says that good faith is just a subset of the duty of loyalty**

**If you show bad faith, you have essentially shown a breach of the duty of loyalty**

By subsuming ***Caremark*** into good faith, the court makes a violation of the ***Caremark*** duties non-exculpable (potential for ***Stone***to expand director liability)

MISC NOTE: When you show bad faith alone, you pierce the BJR. If you show that this bad faith resulted in an unfair transaction to the corp. then you would be entitled to damages (the showing of bad faith would be the heavy lifting for the Ps)

* + - 1. LEGAL STANDARDS FROM DISNEY
         1. **“A failure to act in good faith may be shown, for instance,**

Where the fiduciary **intentionally** acts with a purpose other than that of advancing the best interest of the corp.

Where the fiduciary acts with the **intent** to violate applicable positive law, or

Where the fiduciary **intentionally** fails to act in the face of a known duty to act, demonstrating a **conscious** disregard for his duties”

This is what the P alleges in ***Disney***

This was also present in the ***Caremark*** case

* + - * 1. There are **three distinct categories that might be bad faith**. The following would rebut the presumption of good faith.

**(1) “Subjective bad faith”**

“Fiduciary conduct motivated by an actual intent to do harm.”

Also includes preferring the adverse self interest of the fiduciary or of a related person to the interests of the corp

This is bad faith, no question

**\*(2) “Lack of due care”/gross negligence** [this gets knocked off the list]

“Fiduciary action taken solely by reason of gross negligence and without any malevolent intent”

**“Grossly negligent conduct** [including a failure to inform oneself in material facts available]**, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith**”

If there is not an exculpation clause, then gross negligence on the part of directors may make them liable

SHs beg the court to recognize this as bad faith

But court says that gross negligence and bad faith have to mean two different things, otherwise **DE § 102(b)(7)** would be a nullity (b/c allows exculpation for gross negligence but not bad faith)

**DE § 145**: allows corps to indemnify directors for certain conduct, including **gross negligence**, but not for **bad faith.**

**(3) “Intentional dereliction of duty”**

“A conscious disregard for one’s responsibilities”

Reckless, NOT negligent

This is conduct that **would** show bad faith

This is conduct that more culpable than inattention or failure to be informed, but less than disloyalty

* + - 1. **The bar for bad faith is VERY HIGH. “Intentional dereliction of duty.”**
      2. **Excessive executive compensation is often phrased as waste**
         1. In Disney, the P argues that $140 mm for 14 months is waste, but the court had sympathy for the directors b/c they had to persuade Ovitz to leave his successful job
         2. If Ps show that directors created waste, then the act cannot be exculpated b/c waste is a bad faith act
  1. Special Aspects of Derivative & Direct Litigation
     1. Derivative Litigation & Demand Requirements
        1. MBCA §§ 7.42, 7.44
        2. ALI, Principles of Corporate Governance § 7.03
        3. Overview
           1. **DE requires a SH to make pre-suit demand on the board, explaining the claims that he wishes investigated and remedied [unless demand would be futile]. PROCESS 🡪**

Demand is usually a letter setting out the wrong that was allegedly perpetrated and demanding that the board commence a suit against the responsible person to recoup the losses

The board then has to seriously consider the allegations and relief requested b/c it has a fiduciary duty to look into the raised facts

If the board concludes that litigation has merit but wouldn’t be worth it, it would set up BJR protection for the business decision **not** to go forward with the lawsuit

The very fact that the board would be suing itself does NOT make a conflicted board. Would have to have more- aka would be conflicted if directors would be personally liable (would be suing themselves and would lose)

If the board comes to a business judgment not to file a lawsuit, SHs can then file a derivative lawsuit. Now the SHs have two claims in complaint:

(1) Claim against board for allegedly acting wrongly in not brining the lawsuit (aka rejecting the demand); and

(2) Initial substantive claim against the directors who chose to pay the bonus

The board would then likely file a motion to dismiss based on BJR shield.

In a demand refusal case, the fight is typically over whether the board’s decision to reject the demand was made in good faith after careful deliberation

Idea is that the directors are the best people to manage the litigation. The demand also serves as a dispute mechanism for disgruntles SHS (they have to exhaust their intra-corp remedies first)

In DE, demands are actually rarely made

The fight in DE would be whether or not SHs were entitled to file a suit w/o first making a demand

Ie. ***Disney***: SHs didn’t begin with a demand; pled that demand should be excused (court ok’d this)

* + - * 1. DE Chancery Rule 23.1

Complaint shall allege with particularity that P made a demand **OR** state with particularity the reasons for not making a demand (ie. why the demand is excused b/c it would be futile)

**“Demand futility exception”:** DE and some other jurisdictions excuse SH from making pre-suit demand in circumstances where demand would be futile, for example, when the directors lack the independence to impartially consider a demand

* + - * 1. **MBCA** has a universal demand requirement

The fight is then almost always whether the demand was wrongfully refused by the board

* + - * 1. Tension b/w the need for derivative litigation as a tool to enforce against management and the concern re: abusive litigation by SHs

Litigation rules (ie. demand requirement) try to avoid this abusive litigation

* + - * 1. When harm is done to the corp., individual SHs have little incentive to sue b/c recoveries go to the corp. and not the individual SHs

If it weren’t for potentially high attorneys fees, derivative litigation may never be brought

* + - * 1. **“Strike Suit”**: even in a case w/ absolutely no merit, corp. may be pressured to settle just to make the SH to away
      1. ***Aronson v. Lewis*** (DE SC 1984)
         1. F: Board approved an employment agreement for a 5-year term w/ provision for auto renewal each year thereafter, indefinitely. $150k per year + bonus, Fink could terminate at any time, but the company had to give 6 months notice. At termination, Fink would become a consultant at $150k for the 1st three years, $125k for the next 3 years, and $100k thereafter for life. Company also made loans to Fink for $225k. Fink would be compensated even if he were disabled.

Fink owns 47% of company’s outstanding stock. Fink also “personally selected” each of the company’s directors

* + - * 1. Issue: was a pre-suit demand on the board excused as futile?
        2. Rule: **“In determining demand futility, the court must decide whether, under the particularized facts alleged, a reasonable doubt is created that:**

**(1) the directors are disinterested and independent OR**

**(2) the challenged transaction was otherwise the product of a valid exercise of business judgment”**

* + - * 1. Claim: Ps claim the employment K was waste. However, the P doesn’t show waste until the Ps have shown that demand was excused because it was futile
        2. **Chancery**: to show demand futility, SH must plead facts that raise a “reasonable inference” that the directors’ action at the base of the suit was unprotected by the BJR

**DE SC** says that this test is too easy

The complaint meets the reasonable inference standard, but not the reasonable doubt standard required by the SC. [both sides could show a reasonable inference]

Complaint also did not allege “particularized facts indicating that the agreement is a waste of corporate assets”

* + - * 1. **Held [DE SC]**: demand is excused only where facts are alleged with particularity that create a **reasonable doubt** that the board actions were entitled to the protection of the BJR [more protective of corps and directors than the Chancery court]

The fact that Fink owned 47% of outstanding stock and “personally selected” each of the directors does not support that the directors lack independence

“In the **demand-futile context**, a P charging dominion and control of one or more directors must allege particularized facts manifesting ‘a direction of corporate conduct in such a way as to comport with the wishes or interests of the corp (or persons) doing the controlling’”

* + - * 1. How to find the necessary particularized facts:

Relevant books and records of the corp under DE § 220

* + - 1. **DE Chancery Rule 23.1 / ARONSON TEST FOR DEMAND FUTILITY**
         1. Complaint shall allege with particularity the:
         2. **(1) Efforts, if any, made by the P obtain the action desired** **OR**

Demand made and was refused -- wrongfully

Example of wrongfully refusing if the directors just threw the letter in the trash

* + - * 1. **\*\*(2) The reasons for not making the effort**

Demand excused b/c it is futile

**Demand is excused when Ps allege particularized facts creating a reasonable doubt that either:**

**(a)(1)** The majority of directors are disinterested and independent **OR**

The board would then have to show beyond a reasonable doubt that they are disinterested and independent

SHs want to show that a connection PLUS a reason as to why the board is beholden to someone. A connection by itself is insufficient

**(b)(2)** The challenged transaction was otherwise the product of a valid business judgment

In ***Aronson***, SHs want to show that the K is wasteful. The standard for waste is very high –“that no reasonable person would have agreed to this K”

* + - 1. WHAT FACTS DO WE WANT:
         1. Particularized facts that might create a reasonable doubt
         2. **Prong 1 (disinterested & independent):**

SHs want to show that the board is beholden to Fink. **We want a connection PLUS a reason. A connection by itself is not sufficient.**

Ex: personal relationships (more than just neighbors or frat brothers)

Ex: family relationships (***Greenfield*** case—the fact that the sister was on the board didn’t show that she lacked independence, would have to show more)

Ex: Children. Could show that they have an indirect interest in the employment K b/c they will eventually inherit Fink’s money, or at the very least, it will save them the expense of caring for their father

Ex: if some of the board members were indebted to Fink and he was going to forgive their loans, then this might show a reasonable doubt if independence

* + - * 1. **Prong 2 (business judgment):**

SHs want to claim that this was wasteful

If Fink truly couldn’t do any valuable work to the corp (ie. if he were already incapacitated or senile)

Employing someone who can do absolutely nothing for the company would be a particularized fact that shows proof beyond a reasonable doubt

* + - 1. ***Disney*** SHs were not able to hurdle the Aronson test on the 1st try. Met the pleading standard of DE Chancery Rule 23.1 in their 2nd complaint
      2. NOTE: Rule 23.1 ***Aronson*** test for demand futility is a higher burden for the Ps to meet than 12(b)(6)
    1. Fiduciary Duty & ***Aronson’s*** First Prong
       1. ***In re The Limited, Inc. Shareholders Litigation***
          1. F: buyback of stock and cancellation of redemption agreement
          2. Issue: how does a P raise allegations that show that a director is interested such that he can’t be counted in the majority, or that he isn’t independent
          3. R: Directorial interest occurs when a directors gets something that no one else is getting
          4. R: To establish lack of director independence, must show that directors are either beholden to controlling SH or so under its interest that their discretion is sterilized
          5. H: Gilman & Trust were kicked out
    2. Demand Futility Under ***Aronson’s*** Second Prong or Under the ***Rales*** Test
       1. ***Ryan v. Gifford***
          1. What types of **other** allegations (outside of interestedness or independence) can satisfy pleading standard
    3. When ***Aronson*** two-prong test is **NOT appropriate**:
       1. **(A)** If there was NO decision or transaction, can’t ask if it is protected by BJR;
       2. **(B)** When the majority of the board has been replaced since the challenged decision; OR
       3. **(C)** Decision being challenged was made by the board of a different corporation
          1. Ie. the decision was made by a subsidiary’s board and the parent company’s board has to make the decision re: the litigation

Picking off the directors would be irrelevant if the litigation decisions are made by a completely different board

* + - 1. 🡪 This is when you use the ***Rales v. Blasband***TEST
         1. Answered the Q: is demand automatically excused in oversight cases b/c there is no business judgment to which to apply the BJR?
         2. F: Ps brought derivative suit on behalf of parent corp. for actions taken by a wholly-owned subsidiary corp. B/c the suit didn’t challenge a decision by the parent corp.’s board, the court held that the ***Aronson*** standard didn’t apply
         3. **Test: W.r.t. demand futility, court must determine whether the particularized facts in the complaint create a reasonable doubt that the board could have properly exercised its independent and disinterested business judgment in responding to a demand.**

**Examine whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations**

Shifts the inquiry—now picking off people b/c they can’t fairly evaluate the decision or whether or not to bring the lawsuit

* + - * 1. **(A), (B), and (C) above come from the court in this case**
        2. NOTE: see this in ***Stone v. Ritter***
    1. **Prob. 4-4 (changed facts)**
       1. Facts:
          1. Diversified’s directors:

Norris owns all of BNNN

Nancy is BNNN’s CEO

Nick is BNNN’s lawyer

Baron is Norris’ first cousin

* + - * 1. Diversified sold tower to BNNN. Ps charge that this was a hastily organized conflicting interest transaction at an unfair price. Ps want the tower back. P sues alleging breach of fiduciary duty, breach of care, and breach of loyalty. P also claims that demand is excused. So, P tried to plead with particularity that demand is excused. P claims that this board is incapable of making an impartial decision as to whether to sue.
      1. Analysis:
         1. D will likely seek dismissal on two grounds: (1) the Ps have failed to state a claim under which relief may be granted [12(b)(6)]; and (2) the Ps have failed to plead demand futility within the requirements of Rule 23.1
         2. Ps will fight the dismissal by showing particularized facts creating a reasonable doubt that either:

A majority of the directors are disinterested and independent OR

The challenged transaction was otherwise the product of a valid exercise of business judgment

* + - 1. **Aronson PRONG 1**
         1. Facts to show a reasonable doubt that the majority of the board are disinterested and independent
         2. **Norris**: argue that there is a **RD that he is** **disinterested** and **independent** b/c he is the owner of BNNN, so he has a financial interest/he is self-dealing
         3. **Nancy:** we don’t know if she has a financial interest in BNNN, so she is **probably disinterested**. Nancy is CEO of BNNN, so she serves at the pleasure of BNNN’s board (which is controlled 100% by Norris). So Nancy is beholden to Norris enough to create a reasonable doubt about her ability to act with **independence**.
         4. **\***2 board members are enough to show that there is not a maj of this board who are disinterested and independent beyond a reasonable doubt—but keep going for argument’s sake
         5. **Nick:** If Nick is a solo practitioner that has 100% of his business coming from BNNN, we would question his **independence**

But if he has dozens of clients, then we have not created a reasonable doubt that Nick is not disinterested or independent

* + - * 1. **Barron:** his family tie to Norris is not enough to rise to the level of reasonable doubt. But if we show that Barron’s house is a courtesy of Norris and Norris has loaned Barron money, then we would have a reasonable doubt to show that he was not **disinterested or independent**
      1. **Aronson PRONG 2**
         1. Facts to pierce the reasonable doubt that the transaction was otherwise the product of a valid exercise of business judgment
         2. **Duty of care**

This board was relying on a previous proposal. There was a failure to obtain a real estate agent, the board was questionably not informed

* + - * 1. **Duty of loyalty**

This was a conflicting interest transaction. A sale of a building to one of Diversified’s director’s companies

There is no automatic protection under DE 144(a)(1) b/c there is not a maj of the directors who could vote who are independent/disinterested.

* + - * 1. **Waste claim**

Diversified got $11 mm. Even if the building was worth $13 mm it might not be so that no reasonable person would have sold at $11 mm. This would be a very difficult argument.

* + - 1. **SHs pass the demand futility requirement (b/c win on Prong 1 of Aronson), which means that SHs pass the pleading requirements for particularity**
    1. **Prob. 4-10**
       1. Assume that Ps clear 23.1 hurdle and establish for purposes of pleading that demand is futile
       2. A subsequently filed 12(b)(6) motion would be dismissed b/c 23.1 standard is higher. Ps have clearly stated a claim upon which relief can be granted for purposes of pleading and moving on to discovery phase of the litigation
       3. **The 1st prong of Aronson is dressed up like a pleading of breach of loyalty type claim**
    2. Demand Futility in the Contest of ***Caremark*** Claims
       1. ***Stone v. Ritter*** (2006)
          1. F: SHs suing directors for failure to establish adequate controls (***Caremark***-type claim, but in the banking industry)

Involved banking and internal controls that followed the money

The board can’t claim protection of BJR b/c it is being criticized for its unconsidered failure to stop EEs from stealing money, etc. (No business decision made that gets BJR protection)

* + - * 1. **C. R. 23.1**-- To show that board is unable to evaluate the merits of the litigation (ie. for demand to be excused), would have to show that your facts would have the directors suing themselves **AND** that there was a substantial likelihood that directors would be liable for your claim

**Ps are not able to do this in this case**

* + - * 1. H: DE SC reaffirms ***Caremark*** standard of conduct (ie. directors must actually do something re: compliance-related functions at the corp.); **BUT directors did put in checks, and even if they weren’t ideal, SHs didn’t establish demand futility**
        2. **Test** for liability for lack of oversight is a **conscious disregard**

Ie. Directors knows what he should be doing but says that he is not going to do it

* + 1. Dismissal of Derivative Litigation at the Request of an **Independent/Special Litigation Committee** of the Board
       1. MBCA § 7.44
       2. Overview
          1. **When there is a finding of demand futility, it essentially means that the board would not be entitled to BJR presumption if demand were made and the board refused to commence the litigation**
       3. ***Zapata Corp. v. Maldonado*** (DE SC)
          1. F: Conflicted board convened a special litigation committee composed of disinterested directors to run the litigation, and this committee decided that the litigation is not in the best interests of the company
          2. Issue: how should the court evaluate the special lit comm’s business judgment?
          3. DE answer is different from NY (***Auerback*** case) and IA (***Miller*** case)

[DE tried to strike a balance b/w the two—see the rules below in **prob. 4-11**]

* + - * 1. “The final substantive judgment whether a particular lawsuit should be maintained requires a balance of many factors ethical, commercial, promotional, public relations, EE relations, fiscal as well as legal”
        2. H: demand was **excused** b/c the maj of the board was either interested or beholden.
        3. **Two-Step TEST:**

For how courts should decide what to do with the recommendation of the special litigation committee

**1st part**

***Zapata*** says **every** court in this situation must take:

**Special lit. comm. must prove its independence, good faith, and reasonableness**

Emphasis on written record—wants a committee report re: what its decision-making was. Make sure it substantiates the disinterestedness and good faith of the committee

**2nd part**

Court **may** move on to this step [use its own business judgment/discretion to look at whether this suit should go forward]

[This is somewhat surprising given DE’s history of deference to board decision-making]

A court may be motivated to step in to provide for the maintenance of a continued litigation notwithstanding the special lit committee’s good faith determination that it should be dismissed as not in the best interests of the corp. after looking to matters of law and public policy

3rd party consequences

If the Board thinks that what went wrong in the corp. may be endemic to a greater problem that may justify going through P’s allegations further

* + - 1. **Prob. 4-11**
         1. Facts: BNNN. Assume that the derivative suit survives mtn to dismiss for lack of demand and case proceeds. Shortly after, Diversified replaces Nick and Nancy with 2 new directors on Diversified’s board (Mike and Michelle). M & M are on the special litigation committee and find that this proposed litigation would harm the corp (also that these losses far outweigh the possible benefits of the derivative action against Nick, Norris, Nancy and Barron.
         2. Outcome of Special Committee’s mtn to dismiss the derivative action as not in Diversified’s best interests:

Depends on jurisdiction:

NY (***Auerback v. Bennett***)

If M & M (corp.) show the court that they are independent and disinterested and have conducted a good faith determination using reasonable procedures, then their decision will control

High deference

This is a showing that the corp. has to make—different than the reg. BJR

Corp. could meet this burden by showing that they had a process of considering the allegations and reaching a conclusion

Iowa (***Miller v. Reg. Tribune***)

If demand would have been futile with the old board, then court won’t treat any special litigation committee with any extra deference (even if it has squeaky clean directors)

Focuses on structural bias

Why should we give deference to this committee that was hand-picked by the old board?

DE strikes a middle ground in ***Zapata***

* + 1. Federal Securities Law & Fid Duty/SH Litigation
       1. Fed. Sec. law provides another type of oversight obligations at least on boards of PTCs (on the **audit** committees of PTCs)
          1. Congress gave SEC power to direct oversight procedures
       2. This government enforcement (by SEC & DOJ) will run alongside private Sh litigation

1. Close Corporations
   1. Introduction
      1. **The power to sell shares is limited in a close corps.**
         1. Perhaps the buyers are limited, or there may be restrictions on transfer (you may have to sell the shares back to the corp.)
         2. **Illiquidity** provides the likely situation of oppression of minority SHs (the minorities cannot sell their shares and get out)
            1. Ex: ***Dodge v. Ford***- the maj, SH, Ford, was denying the Dodge Bros. a return on their investment
            2. **Contracting** may be used to avoid/reduce minority oppression in close corps
      2. **Other Differences** b/w Close Corps and PTCs
         1. **PTCs**
            1. SHs don’t have relationships with one another

Investors are looking to sell their shares at a higher price than they purchased them for, or they want to receive dividends

* + - * 1. SHs elect directors who manage the corp. through delegation of day-to-day business to officers
        2. The separation of function and maj rule is typically what makes a PTC successful
      1. **Close Corps**
         1. Typically a small, tight-knit group of participants

SHs typically have relationships with one another

SHs are typically looking to be employed by the corp.

* + - * 1. There is very active participation of the SHs. Not only by EEs, but by those who hold officer positions. Participants often look to the corp. for their livelihoods.
        2. The trade-offs from a PTC usually raise the risk of minority oppression

Considerations that create adaptability create too much risk to min SHs, here

Desired balance of adaptability and exposure to opportunism

Do we decide rights/responsibilities before or after the fact? Should the parties, judges, legislature decide these?

* + 1. **DE Sub Chapter 14**
       1. §§ 350, 351, 354
       2. Most important collection of DE statutes w.r.t. close corps
       3. Corp. does not automatically get to avail itself of these provisions—has to **specifically elect to be a DE close corp**. [this election is very important]
       4. **§ 341**: applies to all close corps as defined in § 342
       5. **§ 342**: have to choose to have the characteristics of a close corp [ie. less than 30 SHs, never had a IPO, etc] **AND** follow the directions of Sub Ch. 14 to **elect to be a DE close corp.**
          1. Articles have to contain a statement that the corp. wants to be a close corp.
       6. Once a corp. is in the door to Sub Ch. 14, there are specific statutes that reverse the determinations in ***McQuade, Clark, and Benintendi***
          1. **DE § 350**: under certain circumstances, SHs and SHs who are serving as directors **can** tie their hands in advance by enforceable K if the other requirements in the section are met (aka **can sterilize** director decision making if corp is a DE close corp. that has elected this status)

**Agreement has to be in writing among a maj of outstanding stock entitled to vote**

* + - 1. **§ 354**: if SHs in a close corp determine that they wish to run the corp like a **partnership** and they memorialize this in the Articles or bylaws, courts will not view this agreement as void
         1. **DE courts** will not take it upon themselves to voluntarily take this partnership analogy for close corps, but will respect private ordering doing so
         2. SHs may want to contract to gain the fiduciary duties that come with the partnership
  1. Contracting as a Device to Limit the Majority’s Discretion
     1. **As to Director Decisions**
        1. **DE § 141(a) and (b), § 350-354**
        2. **Today**: statutes allow you to vary the extent of director management and the shares required for a vote (unanimous, majority, etc…)
        3. ***Zion v. Kurtz*** (NY CoA 1980) ---MODERN APPROACH
           1. NOTE: this NY court is interpreting DE law b/c this is a DE corp.
           2. F: Zion & Kurtz were the only SHs of Lumbard-Wall Group. Z & K agreed in writing that any business decision or activity will require Zion’s consent. Despite the agreement, Kurtz made a decision w/o Zion’s approval. (AKA a SH agreement seeking to confine director decision making)
           3. **Rule: “A written agreement b/w the holders of a maj of such a corp’s stock” is not invalid, as between the parties to the agreement, on the ground that it so relates to the conduct of the business and affairs of the corp as to restrict or interfere with the discretion or powers of the Board”**

The theory of **DE §** **350** is to declare unequivocally, as a matter of public policy, that SH agreements of this character are not invalid.

**DE § 351** recognizes a special sub-class of close corps which operate by direct SH management and it should be liberally construed to authorize all sorts of internal agreements and arrangements which are not affirmatively improper, or more particularly, injurious to 3rd parties

* + - * 1. Held: enforces the K against Kurtz as a matter of equity; these sorts of agreements are not necessarily void for being against public policy

Why can’t the court just say that Kurtz has to follow the agreement?

Kurtz didn’t file the appropriate paperwork under **DE § 344**, so it didn’t become a close corp., so Q as to whether **§ 350** applies here

Had Kurtz filed this paperwork, then this agreement would certainly be enforceable (filing this paperwork is not hard to do).

Says that it would be unfair to allow Kurtz to evade responsibility for this agreement when it was Kurtz’s responsibility to file the papers

**So the court doesn’t look just to § 350. Also looks to changes to DE § 141(a) and says that it reflects that agreements that tie directors’ hands are no longer flat or void against public policy**

Don’t have the same usual chill w.r.t. the feeling that there is a legislative presumption against these Ks

* + - * 1. Dissent

There may be other SHs that could be hurt. SHs have a reasonable expectation that director decisions are going to be unfettered. However, if the corp. were a close corp., then the SH would be on notice that this corp. is subject to **Subchapter 14** (and thus notice that these special provisions apply)

Dissent is also worried about creditors. Creditors will not know that this corp. falls under **Subchapter 14** if it is not listed as a close corp.

3rd parties doing business with the corp. don’t even know that they have to be careful b/c there is nothing in the corp. Articles that put anyone on notice that it is a close corp.

Maj: but it is not clear that there are actually any 3rd parties being hurt by this

* + - 1. **Two contractual agreements that close corps may use:**
         1. **Agreements restricting discretion of directors**

Ex: SHs enter into a K and one of the SHs takes actions that is inconsistent with the K. The other SH sues to enforce the K

The K doesn’t always make explicitly clear whether the parties are acting as SHs or directors, but courts care about this.

State corp. law at one point drew a line b/c contracts w.r.t. directors duties with those that limited SH discretion when acting as SHs

* + - * 1. **SH Voting/Pooling agreements**

Not in the close corp sub chapter

Written SH **pooling agreement** [**DE § 218(c)**]. This protects parties’ (SHs) agreements on how their shares will be voted. This is most often used by the SHs holding a maj of the voting stock. The parties in the agreement will agree to vote ALL of their combined stock in accordance with the maj vote of such parties to such agreement.

Ex: if S, B, and M are in the agreement, if just two vote in favor then ALL the stock of the 3 parties will be voted in favor. These agreements are used so that the parties in the agreement hold enough stock to have a controlling vote.

Has to be in writing

Allows further pooling arrangements/procedures so long as they are part of a written agreement

SHs may wish to pre-commit w.r.t. how they elect directors

Sometimes creditors will only lend money if SHs work out in advance how they are going to cast their votes [and wants to know that courts will enforce these agreements]

**When SH promises to vote in a certain way, it is enforceable under CL and under DE § 218**

* + - * 1. NOTE: don’t see a ton of these agreements b/c SHs think they can rely on personal relationships; don’t want to set up suspicion from the beginning
      1. NY cases – good for comparison b/c came before statutory regimes
         1. ***McQuade v. Stoneham*** (1919 NY)

F: Stoneham induces McQuade and McGraw to purchase stock for $50k. The 3 friends execute a K as part of the deal. Pursuant to the K, they agree that each would use his best efforts to continue McQuade and McGraw as officers with stated salary. The arrangement continues until there is a falling out. Stoneham then causes the board to discharge McQuade (for no reason) and vote him off the board.

TC: awards McQuade damages for Stoneham’s breach of the K

CoA: held that the agreement was unenforceable & void as against public policy b/c of the sterilization of director decision making

B/c the controlling statute at the time said that the affairs of the corp. shall be managed by a board of directors (no clause saying “unless otherwise provided …”)

This private agreement improperly interfered with this statutory precept calling for director management of the corp.

Rationale: court didn’t have a problem with Stoneham’s K to vote his shares as a **SH** to keep McQuade as a director

Court separated the promise that Stoneham made as a **director** to use his power to keep McQuade as an officer (which violated public policy)

* + - * 1. ***Clark v. Dodge***

F: agreement b/w min and maj SH [only 2 SHs of the corp.]

Purpose of the agreement was to protect the min SH (Clark) from post-investment opportunism by Dodge

Clark had a secret formula that was key to the success of the corp., so he was afraid to divulge it w/o this protection

Agreement guaranteed Clark ¼ of corp’s net profits and employment

There was a falling out and Clark sued

NY CoA: SH agreement was **valid**

Reasoned that since the agreement was unanimous, it could harm no one but the particular parties, and wasn’t harmful to the parties b/c just required them to do what was in their best interests.

Maybe this is different from ***McQuade*** b/c here there are only 2 SHs, so no other SHs would be affected by the sterilization of director decision making

* + - * 1. ***Benintendi***

NY court: this bylaw is unworkable and unenforceable

Pays homage to the CL rule of director decision making

* + - * 1. Director decision making my maj rule is no longer an immutable rule in most jurisdictions

Instead, SH and/or directors maj rule is usually phrased in default terms [ie. DE 141(a)- “except as otherwise provided in the Articles …”]

Aka not a **mandatory** rule

**DE §** **141(a)** & **(b)-** maj voting rule can be varied for director vote

**DE §** **216**- maj voting rule can be varied for SH vote, too

* + - 1. **Prob. 5-1**
         1. Facts:

Agreement between people wearing their “director” hats

ProBall has 4 SHs: JJ, RJ, SJ, and BB [all contribute $5 mm and receive ¼ of the corp.’s shares]

They are all directors, too. The first 3 are CEOs of **other** PTCs, which means that they are making management decisions for ProBall but also have other full-time jobs. BB is the one director who is ProBall’s CEO. The agreement is that SHs make assurances to BB to get her on board b/c she knows something about bball.

* + - * 1. Issue: is this SH agreement enforceable in DE?
        2. (a) Written agreement to continue BB as CEO and coach for ten years at X salary per year.

If ProBall **elected** to be a Sub. Ch. 14 close corp, then BB would win

§ 350 says that this type of agreement is enforceable

If ProBall **didn’t elect**, back to ***Zion v. Kurtz*** and weigh the equities

Ask if this would impermissibly tie directors’ decision making

The other 3 directors don’t seem to benefit from their own negligence (like in ***Zion***)

Good for BB w.r.t. fairness that all 4 SHs were party to the agreement [no other SHs]

But still potentially concerned about prospective SHs and creditors

But a court could say that it won’t get worked up over this as long as BB is doing a good job here

* + - * 1. (b) Oral agreement

Assume the corp elected

**DE § 350** does **not apply**, b/c says that it needs to be a written agreement

Doesn’t need to be officially notarized, etc., just needs to be in writing my a maj of outstanding stock entitled to vote

* + - * 1. (c) What if JJ didn’t sign, but RJ, SJ, and BB signed?

Assume the corp elected

Enforceable under **DE § 350** b/c it is a maj of votes

* + - * 1. (d) What if only BB and SJ were party to the agreement?

**DE §350** will not give protection b/c this is 50% (not a maj)

Court would not enforce this on the equities b/c would worry about the effect on the two other SHs who didn’t agree

* 1. Fiduciary Duty and the Threat of Dissolution
     1. **Traditional Judicial Deference to Majority’s Discretion**
        1. Corp. law provides 2 principal avenues for min. SHs’ suits:
           1. Petition for involuntary dissolution
           2. Direct or derivative suit for breach of fiduciary duty
        2. Directors normally owe fiduciary duties of care and loyalty to the corp. but not to individual SHs
        3. SHs may sue in their own right to challenge unfair dividend policies, to protect voting or contractual rights, and to protect other rights owed directly to them by the corp.
        4. ***Zidell v. Zidell*** (Oregon SC 1977)
           1. **There is a presumption against bad faith**
           2. F: Arnold Zidell entered the family business. There was bad blood b/w Arnold and the other 2 partners. Arnold points to several facts to support **his claim that** **“dividends are unreasonably small and were not set in good faith”** [had to make a claim of bad faith, otherwise BJR would protect the D]
           3. Held: refuses to protect Arnold by ordering an increase in the dividend

The other 2 SHs are protected by the BJR

Corp was able to come up with some legitimate business reasons for not paying out dividends—needed the cash to grow, etc.

* + - * 1. **RULE:** those in control of corporate affairs have fiduciary duties of good faith and fair dealing toward the min SHs. Insofar as dividend policy is concerned, however, that duty is discharged if the decision is made in good faith and reflects legitimate business purposes rather than the private interests of those in control

**The essential test of bad faith** is to determine whether the policy of the directors is dictated by their personal interests rather than the corporate welfare

**If there are plausible business reasons** supportive of the decision of the board, and such reasons can be given credence, a court will not interfere with a board’s right to make that decision. If it not the court’s function to referee every corporate squabble or disagreement

**Aka bad faith must MOTIVATE OR CAUSE the money to be tied up in the corp rather than being paid out in dividends. There really must be no other reasonable explanation for keeping that much money in the company** (see Dodge v. Ford)

* + - * 1. Following facts are relevant to the issue of bad faith:

Intense hostility of the controlling faction against the min;

Exclusion of the min. from employment by the corp.;

High salaries, or bonuses or corp loans made to the officers in control;

The fact that the maj group may be subject to high personal income taxes if substantial dividends are paid;

The existence of a desire by the controlling directors to acquire the min stock interests as cheaply as possible;

The accumulation of an unreasonably large cash reserve – a reserve that can only be explained by the controlling maj’s bad faith (see Dodge v. Ford);

**Written evidence of animus** (ex: X is not going to pay dividends b/c Y is gay)

* + - * 1. **NOTE:** Arnold would have been in a better situation had he lived in Mass (see ***Wilkes***)
      1. **The plaintiff has the burden of proving bad faith on the part of the directors in determining the amount of corporate dividends**
      2. **Routes to breach the BJR:**
         1. Bad faith
         2. Self dealing
         3. Conflict of interest
         4. Lack of procedural care

Lack of care, or lack of decision making in an informed manner

This is very difficult

* + - 1. **Prob. 5-2 (A)**
         1. What if **partnership law** applies to ***Zidell v. Zidell***?

If salary decisions were made by everyone, then the salary friction would not have existed (we can’t explain the lifestyle friction b/c we don’t know what it was)

Arnold may withdraw his shares and dissolve the partnership. If Emery wanted to continue, he would have to deal with Arnold more fairly or Emery could work out an arrangement with Arnold.

Being a partner gives Arnold more power and options than just being a SH in a corp. He would not find himself in a passive investment

**DE § 18(e) and (h)** – participants in a partnerships would have a statutory expectation to participate in the mgmt.. and take equal share of profits unless varied by the partnership terms

* + - 1. ***Donahue v. Rodd Electrotype Co.*** (MA)
         1. F: Donahue (widow) is the oppressed min who wanted a forced repurchase of her shares
         2. H: for Donahue; court forces the repurchase b/c finds that the typical close corp. is strikingly similar to a general partnership

Rationale: unlike minority **partner**, min **SH** does not have a right to dissolve the corp. We need to feel bad for Donahue b/c there is no ready market for Donahue’s shares (he is trapped in a disadvantageous situation)

**MA law**: SHs in close corp owe each other essentially the same duties as partners owe each other in a partnership

Holds this by analogy, not based on a statute

**Maj’s SHs’ fiduciary duty could only be satisfied by buying Donahue’s (min SH) shares**

* + - * 1. Differs from ***Zidell***

MA steps away from this case in ***Wilkes***

* + - 1. ***SEE* DE § 354** – partnership norms
    1. ***Wilkes v. Springside Nursing Home, Inc.*** (Mass. SC 1976)
       1. WARM & FUZZY APPROACH
       2. F: Wilkes, with 3 other SHs, owns the Springside Corp. The other 3 directors discharge Wilkes from his salary position. They then fail to elect Wilkes as a director. Wilkes sues for damages in the amount of the salary he would have received
          1. The original understanding was that each would be a director of Springside and each would participate actively in the mgmt.. and decision making involved in operating the corp.
       3. H: Maj SHs breached their fid duty that they owed to Wilkes
          1. Court found that at all times relevant Wilkes was willing and able to fill his obligations. The court found that Wilkes was fired/frozen out b/c there was bad blood b/w Wilkes and the other SHs [bad blood was the motivation]

Even if maj SHs could show that there were legit business reasons, the min SH could come in with a different showing and potentially still get relief

Min SH could show that an alternative course of action would have satisfied the legit business purpose

* + - 1. Wilkes puts forth a framework that is more favorable to min SHs b/c puts the burden on the maj to come forward with legitimate business reasons for its actions
    1. **Prob. 5-2 (B)**
       1. Issue: what is the result if we apply the ***Wilkes*** approach to the facts of ***Zidell***?
       2. Analysis:
          1. Under ***Wilkes***, the burden is placed on the majority

**The other two SHs (Jay and Emery) would have to show that their actions were legitimate business reasons for refusing to pay a high dividend**

J & E would probably meet this burden b/c they said that the corp. could be in need of money, there may be a relocation of the plant, they had two good years, etc. … these seem like legitimate business reasons

**Even if the maj shows a legitimate business purpose,**

The minority may prevail of they show that the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority’s interest

Arnold could show that the legitimate business reason could be achieved in another way other than keeping large amounts of cash on hand. A way which would not starve Arnold of his investment. Ex: insurance, line of credit, loans. These may be more costly, but they are not unreasonably costly.

* + 1. **RULE for close corporations [2 parts]:**
       1. The maj must be allowed to establish that its action demonstrate a legitimate business purpose (the burden is on the maj)
       2. Even if the maj meets this burden, the min may prevail if they show that the same legitimate objective could have been achieved through an alternative course of action less harmful to the min’s interest
          1. The maj must consider the interests of the min and make sure that its legitimate needs are least harmful to the min
    2. **Hetherington & Dooley**
       1. **RULE: They propose** that min SHs be given an **immutable statutory right** that is waivable for no more than 2 years at a time to have all of their shares redeemed by the corp. for any reason. If 90 days pass and the corp. has not purchased the shares, the court will dissolve the corp.
       2. Partnerships and close corps are functionally equivalent organizations having the same functional means
       3. All newly formed corps would operate under this mandatory buy-out
       4. **Rationale for waiver:**
          1. Flexibility. Sometimes may be in the min’s best interest to waive this right to buyout or dissolution. Creditors might insist on such a waiver as a condition for extending credit, or parties might want a guarantee of a period of stability in order to facilitate long-range planning.
          2. Rationale for 2-years: majority is powerful, and if maj. had a right to extract a waiver, maybe a min SH like Arnold might give it indefinitely and taken advantage of
       5. **Benefits of this proposal:**
          1. Min SHs can’t be locked in indefinitely to the maj’s decision making and can get their inheritances/money out
          2. Availability of dissolution provides the min with bargaining power to protect their interests
       6. **Downside of this proposal**:
          1. There is no showing required for dissolution

Ie. doesn’t turn on oppression/bad treatment by the maj

Comes with uncertainty that might make corporate planning difficult

Esp. if corp can’t afford to buy back the shares (even over a 5-year installment plan if banks aren’t lending)

* + - * 1. People may not be as careful about their investment into close corps if they back out so easily
        2. The view that the illiquidity problem in close corps is the principal problem may be too narrow

The min SHs’ hopes and dreams that they also have tied up are not spoken to, here

In ***Zidell***, Arnold would have been happy b/c he wanted to get his inheritance out (it was tied up in the corp.)

Oregon wasn’t sympathetic to this

H&D would have helped Arnold here but not some of the others we have talked about

* + - 1. NOTE: many state legislatures, although have not adopted this proposal wholesale, have taken the idea and massaged it into some type of statutory remedy that is equitable
         1. This is a paternalistic approach to min SHs
    1. **Prob. 5-2 (C)**
       1. Issue: what is the result if we apply the H&D approach to the ***Zidell*** facts?
       2. Analysis:
          1. Arnold could say that, as a min SH who has held his shares for 2 years, he wishes to take advantage of a statute that basically orders big brother Emery to buy out his shares

Arnold would have to demand a complete buy-out (can’t demand a **partial buyout**)

* + - * 1. If Emery convinced Arnold to waive his statutory right to this buy-out, the waiver is only allowed for 2 years (after 2 years, Arnold could demand the purchase)
        2. If Emery/corp. says no to the buyback, H&D proposal says that the court would be required to order for the corp. to be dissolved (after 90 days)

Arnold would then get his money out this way

* + - * 1. If the corp. can’t afford the buy back but doesn’t want to see the corp. dissolved, under H&D, the corp. can structure a buy-back over time with a plan (ie. 5-year installment plan)

Court wouldn’t have to order dissolution if Emery/corp. can make this showing

* + 1. **Determining fair value**: harder to determine value of a close corp.’s shares b/c by definition can’t look to the value that the market puts on a share (instead, there is sometimes a difference of opinion)
       1. Courts will have to determine the fair value of the stock a lot of time
       2. But these proposals are pegged on this concept of “fair value” of shares, which is a different calculation to make
    2. **SUM: APPROACHES to Minority Oppression in Close Corps** 
       1. ZIDELL V. ZIDELL
          1. Court applied a traditional business judgment analysis where the burden is on the P
       2. WILKES
          1. Ds have to show that there is a legitimate business purpose. Even if the maj does show a legit business purpose, the min will still have the opportunity to show an alternative
       3. DELAWARE
          1. **SUM**: prefers private contracting in the close corp context. In the absence of K, unless the min SH can prove bad faith, the BJR will protect the maj’s decision

This would match very closely the ***Zidell*** except with great deference to private contracting (otherwise deference to maj and burden on the P to show that the decisions were selfishly motivated)

* + - * 1. DE courts are generally not willing to interpret fiduciary duties owed from the maj to the min SHs in the warm and fuzzy way that MA would

Ie. if SHs choose NOT to vary the terms via private K, they live with the consequences

Unless the min SH can prove bad faith in the traditional DE sense, the protections of the BJR will protect the maj’s decisions

* + - * 1. Why DE doesn’t adopt the kinder and gentler approach to the min oppression problem?

**DE Judiciary’s motivation:** keep dockets clear; DE’s dominance in Corp. law means that it has a ton of PTCs (not looking to attract the charters of close corps.)

If anything, **DE is less attractive for close corps**

Wants to keep their corp law precedents clear; doesn’t want to confuse corp law by having one body of law warm and fuzzy (for close corps) and another body for PTCs (robust BJR)

**If close corps don’t like this, Sub Ch 14 says that they can vary the default rules by K**

**BUT** DE courts have allowed Min SHs to state a direct claim rather than requiring breaches of fiduciary duty action through derivative litigation only

**DE legislature’s motivation:**  DE has **not** followed the trend of 2/3 of the other states in adopting special statutory provisions that allow for **involuntary dissolution**

* 1. Involuntary Dissolution in the Case of Oppressed Min SHs
     1. Statutory
        1. **MBCA 14.30**
           1. Provides that SHs in close corps have a statutory right to seek dissolution upon a showing of **deadlock** (can’t make decisions) or **illegality**, **oppression** and/or **fraud**

Requires the P to show something

* + - * 1. (a)(2)(ii): sets forth what the petitioning SH will have to show

That the directors have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent

* + - * 1. NOTE: 35 states have adopted some form of this
      1. **MBCA 14.34**
         1. Provides for a buy-out alternative in lieu of dissolution

Allows the maj. (or corp.) to step in and ask not to be dissolved even though they were oppressive, etc.; that they wish to buy out the petitioning SHs for **fair market value**

This is made available by the petition made under **14.30**

* + - * 1. Some states couple this with **14.34**
      1. NOTE:
         1. Even in jurisdictions that have only adopted **14.30**, states that provide for statutory dissolution often allow the maj to come in and buy out the shares of the petitioning SH even though it is not authorized by statute (as part of equitable jurisdiction/equitable relief, court may do this so avoid dissolution)
         2. Often, the litigation in states that have analogs to **14.30** and **14.34** centers around defining that it is that constitutes oppressive conduct for the purposes of the statute
      2. **DE does not offer this sort of statutory alternative** (ie. involuntary dissolution for close corps)
         1. In DE, either contract these rights or adhere to fiduciary duty rules
    1. ***Kemp v. Beatley*** (NY CoA 1984)
       1. IMPORTANT b/c defines OPPRESSIVE CONDUCT
       2. This NY statute is close to the MBCA
       3. F: Pet. Dissen had been employed by the company for 42 years before retirement. Dissen had acquired 200 shares of stock. Pet. Gardstein had worked for the company for 35 years before his employment was terminated by the company. Gardstein owns 105 shares of stock.
       4. Held: under NY law, dissolution was the only way that the two petitioners could receive a reasonable return on their investment
          1. Their reasonable expectations had been defeated (they had expected to have input into management, etc.)
       5. Reasoning
          1. **Oppressive conduct = conduct that substantially defeats the (objectively viewed) reasonable expectations held by minority SHs in committing their capital to the particular enterprise**

Ex: when others in the corp seek to defeat those expectations and there exists no effective means of salvaging the investment

* + 1. ***Gimpel v. Bolstein*** (NY SC 1984)
       1. COMPARE WITH KEMP
       2. F: Family corp. Roberts owned stock by gift and bequest. Robert was employed by the corp. but was discharged b/c he embezzled money (he never denied it). Since the embezzlement, Roberts received no benefits from his ownership position. The company never paid dividends. Other owners received substantial sums as salary, benefits, and perquisites. Roberts has also been excluded from all managerial decisions.
       3. Reasoning:
          1. **Two types of “oppression”:**

**(1) Violation by the maj of the “reasonable expectations” of the minority**

**(2) “Oppressive conduct” = “burdensome, harsh and wrongful conduct; a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members; or a visible departure from the standards of fair dealing, and a violation of fair play on which every SH who entrusts his money to a company is entitled to rely”**

* + - * 1. Type (1) oppression doesn’t apply here b/c all present holders of the corp.’s voting shares are two generations removed from the adoption of the corp. form

It cannot be fairly said that these SHs entered into the business with the same “reasonable expectations” as partners do

* + - 1. Held: uses equitable jurisdiction to create a fair remedy (make an effort to pay dividends or buy out the embezzler for his fair share)
         1. Robert can’t forever be compelled to remain an outcast. The other SHs need not allow him to return to employment with the corp., but they must by some means allow him to share in the profits

**Even just cause termination may not be sufficient to subvert the court’s power to order a dissolution**

NY law would allow this court to dissolve the corp., allow maj to exercise the buy out right, or allow maj. to come up with some other type of accommodation so that Roberts could get some kind of fin return commensurate with his investment in the firm

* + 1. **Prob. 5-3**
       1. F: SHs (G, H, and R) formed a close corp. Each serves as a director. R puts in life savings, quits his job to set up the video stores and takes a lower income to be President of Video, Inc. R’s employment ends after a year. Instead of paying dividends, profits are reinvested. Thus, two actions were taken by the board: (1) ending R’s employment; and (2) shutting R out of dividends
       2. **(a)** What if R was fired after meritorious sexual harassment allegations were made against him. Firm refuses to pay dividends.
          1. If jurisdiction has a dissolution remedy for oppression:

The reasonable expectation argument goes both ways – board expected R to not sexually harass people, but R expected to gain from his investment/get his investment out

Locking R out for life (w/o allowing him to get his investment out) would look oppressive (even in spite of his status as a harasser)

Compared with Kemp: R WAS at the formation of the corp.

Would be better facts for R if the corp. had a history of paying dividends and stopped when it fired R (but the corp. had **not** been paying dividends)

* + - * 1. If Rift files for dissolution under **14.30**, G & H could opt to buy-back his shares under **14.34**

G & H could take a calculated risk

May let the dissolution petition go forward and hope that it will be denied b/c R can’t show oppression under the statute

If G&H pass up their **14.34** rights, they risk that the court won’t allow them to buy out the shares later on

**14.34** required 90 day window unless court allows more

* + - * 1. NOTE: courts will work hard to use its equitable power to not use dissolution powers

But could use availability of dissolution to put pressure on the corp.

* + - 1. **(b)** R was fired for not supporting G’s daughter’s run for school board
         1. Makes this look more oppressive

**British test for oppression**

* + - * 1. R’s reasonable expectations—he wouldn’t expect that he could sexually harass worker, BUT he could have reasonable expected that as long as he did good work for the firm that he wouldn’t be fired

**Objective test** for these reasonable expectations

The fact that he is fired for reasons completely unrelated to the firm makes it looks more burdensome, unjust, etc.

* + - * 1. **14.34** will still kick in w.r.t to R’s petition for dissolution under **14.30**
      1. **(c)** R resigned in order to accept a higher paying job at a competitor firm
         1. Now R can’t complain that he was separated from the firm
         2. Concern is whether R’s two co-venturors will be able to lock R in forever to the initial investment that he made

There will be a time when G&H’s failure to adjust their dividend policy will become oppressive to R

* + - 1. **(d)** R terminated his employment by mutual agreement with G&H. since then, R’s wife has become ill and R wants to “cash in” his investment in the Firm to pay for his wife’s needed medical care.
         1. In fighting the dissolution petition, G&H would argue that it is not reasonable for the firm to take a huge hit for R’s personal needs

Should the corp/G&H have to suffer b/c of the changed circumstances that if R had been reasonable, he would have known that bad things can happen if he locks up his assets in an investment like this?

* + - * 1. ***Goode v. Ryan***

Passive SH sought to sell stock as part of estate that she inherited. She was locked in.

Court said that it is not the proper role of the court to reallocate the risk of stock ownership based on corporate maj misconduct/oppression

* + - * 1. The immediacy of R’s need for cash shouldn’t affect whether the maj’s conduct is oppressive **at this point in time**

**Passage of time is important**—It may come to a point in time that the lack of dividends to R IS oppressive

If the reasonable expectation is that all 3 partners would operate the firm together (thus liquidity restrictions on R’s shares), this may lead the court to give R more wiggle room

1. Piercing the Corporate Veil
   1. Overview
      1. **This is used to disregard the corporate form in order to impose personal liability on SHs for corporate debt**
         1. “The separateness of the corp. entity is normally to be respected. However, a corp’s veil will be pierced whenever corporate form is employed to evade an existing obligation, circumvent a statute, perpetrate fraud, commit a crime, or work an injustice”
      2. **General Rule of Limited Liability**
         1. SH’s financial risk is limited to the amount of capital they put into the corp.
         2. SHs are immune from corporate obligations
      3. Public policy **in favor** of limited liability:
         1. Encourages passive investment b/c places a known cap on the loss that investors may incur
         2. Promotes efficiency b/c allows the managers to manage b/c SHs are not as concerned about their liability in the corp. Limited liability helps SHs t trust managers.
      4. Public policy **against** limited liability
         1. Managers may take excessive risks
   2. **Three-Part Alter Ego TEST**
      1. PIERCE THE CORPORATE VEIL WHEN:
      2. **(1) The defendant SH/parent corp. has complete control and domination over the corp.;**
         1. Essentially corp. had no “mind of its own”
      3. **(2) The defendant used his control over the corp. in a way that was unjust, fraudulent, or wrongful toward the plaintiff; and**
         1. “Undercapitalization” at the time of formation is an example of satisfying this prong
      4. **(3) Plaintiff actually suffered some harm as a result**
   3. **Three central factors that may affect the likelihood that veil piercing will occur (per THOMPSON):**
      1. **(1)** Distinction b/w plaintiffs suing to enforce contract claims and those suing to enforce tort claims
         1. Courts are more reluctant to pierce the veil in K claims than in tort cases. This is b/c the parties in K claims have consented to this sort of risk.
         2. Veil piercing is more likely to occur in the tort realm b/c the tort victim has not consented to the tortious conduct
         3. **BUT NOTE**: empirically, court is more likely to pierce the veil in K cases
      2. **(2)** The identity of the person behind the veil
         1. More willing to pierce the veil of a corp to reach other (parent) corps
         2. **BUT NOTE:** empirically, court is more likely to pierce the veil to reach individuals
      3. **(3)** Distinction b/w closely held and PTCs
         1. More likely to pierce the veil in closely held corps
         2. **NOTE:** this conventional wisdom matches the empirical evidence (veil piercing does NOT happen in PTCs b/c SHs are diverse, etc.)
   4. **CONTRACT CASES**
      1. Think: what is the benefit of the 3-prong inquiry. Why don’t we just ask, “what is fair?” Wouldn’t that be simpler and get us the same result?
      2. When courts consider whether to adhere to the general principle of limited liability for K claims, sometimes look to what the parties would have contracted for if they could have done so in advance under a veil of ignorance
         1. Much more difficult to do this in the tort context
      3. ***Consumer’s Co-Op v. Olsen*** (WI SC 1988)
         1. UNDERCAPITALIZATION
         2. F: Business with 2 parents (Olsen) and their son. They all invested in starting a corp. Extensive care was taken to do all corp. business under the corp’s name. There was no evidence to indicate that corp. funds were used to pay personal expenses. There was, however, ample evidence that substantial personal assets were used to subsidize the operation of the corp. in the form of unprofitable leasing agreements and foregone salaries and rent.
            1. Creditor tried to pierce the corp. veil in an effort to hold Olsen personally liable for the corp. debt (to do an end run around the BK)
         3. H: **no piercing of the veil to reach into Olsen’s pocket**; creditor is estopped from making a claim
            1. No fraud here
            2. Uses the 3-prong test

(1) Olsen’s control/domination was not demonstrated well enough. **Court says that by control, it means complete domination** (aka failure to follow corp. formalities, treating corp. as a personal ATM). No evidence that other SHs lacked minds of their own, here.

PROF: this is a strange prong in the close corp context

(2) Undercapitalization is not enough of an injustice to pierce the veil

How can we judge re: what is undercapitalized when the corp. only had one client when it was formed?

(3) Not clear that this “control” even caused the creditor’s injury

It is the creditor’s own fault that it is owed money b/c it continued to extend credit to this corp. in violation of the creditor’s own policies

* + - 1. **Undercapitalization:** “if the capital is illusory or trifling compared with the business to be done and risks of loss”
         1. **Measured as of the time of the formation of the corp.**
         2. Undercap. is only a single example of how the **unfairness** prong of the piercing test may be satisfied. The errant party need not have willfully wronged the other party, nor need he have engaged in anything amounting to fraud in their relationship.

The essence of the **fairness** test is simply that an individual businessman can’t hide from the normal consequences of carefree entrepreneuring by doing so through the corporate shell

* + - * 1. **Undercap. is not an independently sufficient ground to pierce the corporate veil**

One must show additional evidence of failure to follow corp. formalities or other evidence of pervasive control must be shown

* + 1. ***KC Roofing Center v. On Top Roofing*** (MO CoA 1991)
       1. F: Nugent, a roofer, had 5 different corporate names over 5 years. He would start a new corp every time the prior corp accrued a lot of debt, and he would sell all of the assets from the old corp. to the new corp.
       2. H: court allowed the corp. veil to be pierced and for Nugent to be held personally liable for the debts owed to the plaintiffs
          1. These were, in substance, illegal dividends that Nugent took (ie. salary)—the result of which he is not paying for goods that he is buying
          2. Russell should be **estopped** from denying any claim that he owed
          3. Nugent’s conduct proximately caused the creditors’ loss

Creditors have not assumed the risk of this kind of loss

Nugent was in total control of the corp., so he was the corp’s “alter ego”

* + - 1. Rule: **to pierce the corp. veil or disregard the corp. entity, a P must show:**
         1. **(1) Control**, ie. complete dominion such that the corp. entity as to this transaction had at the time no separate mind, will, or existence of its own;
         2. **(2)** Such control must have been **used by the D to commit fraud or wrong**, to perpetrate the violation of a statutory or other positive legal duty, or dishonest and unjust act in contravention of P’s legal rights, **and**
         3. **(3)** Aforesaid control and breach of duty must **proximately cause the injury or unjust loss complained of**
      2. “Where the corp. is used for an improper purpose and to perpetrate injustice by which it avoids its legal obligations, ‘equity will step in, pierce the corp. veil and grant appropriate relief’”
      3. Differences from ***Consumer’s Co-Op v. Olsen***
         1. Nugent did this repeatedly
         2. Nugent and his wife were paid substantial salaries and rent, whereas Olsen deferred salary for his corp.
         3. Lumberman (plaintiff creditor) did not do business with On-Top, it did business with a successor corp. Nugent argues that Lumberman sued the wrong defendant. Lumberman was not estopped b/c the name on the trucks and business had not changed although it was under a different corp.
  1. **TORT CASES**
     1. Overview
        1. **Uses the same three-part test as the contract cases** 
           1. **However, the proximate cause and injustice factors are a little more important**
        2. Tort cases are different in part b/c the corporate form has never provided insulation for an **individual committing a tortious act** even if the individual purported to be acting as an officer or otherwise in the name of the corp.
           1. Piercing the corp. veil is not necessary to reach such individuals; they are liable as a result of agency law (or negligence, vicarious liability, etc.). There has been an increase of statutory provisions, such as those in the environmental or pensions area, imposing similar direct liability for an individual’s own wrongful acts even if purportedly taken in a corporate capacity
           2. Courts will try to use these other tools (vicarious liability, etc.) FIRST in an effort to not pierce the corp. veil and respect limited liability
        3. NOTE: we want to be able to pierce the corp. veil in the case of tortious claims b/c we are concerned that the corp. will run out of money and then leave the injured party w/o compensation
        4. **The corporate veil was never intended to protect EEs, directors, of officers for torts they commit even while acting under their employment/in the name of the corp.**
     2. ***Western Rock Co. v. Davis*** (TX CoA 1968)
        1. F: Western Rock operated a rock quarry and blasting site. Corp. was owned 50% by Stroud and wife and Fuller owned the other 50%. Stroud began to learn of complaints of damages being sustained by the people near the site by reason of the blasting activity being carried on, under his supervision, by the corp. A lawsuit was filed against the corp., and a significant time later, Stroud informed Fuller that complaints had been received and that a suit had been filed. Fuller and Stroud continued with such blasting activities, even though they found out that there wouldn’t be any insurance coverage.
        2. H: the court allowed the Ps to pierce the corp. veil and support a judgment that Fuller and Stroud were legally responsible
           1. Even though this case doesn’t state the test clearly, gives facts to fir the 3-prong formula
           2. Uses the corp veil to shift the unreasonable risk of loss away from the outsiders
           3. Unclear whether the court did this b/c Fuller was a manager or SH
           4. Result: Fuller has to pay substantial amount of money for the damages to the homes
        3. Reasoning:
           1. We see complete dominion

Fuller takes all the assets out of the corp. [he owned all of the corp. equipment and leased it back to the corp.]

* + - * 1. Injustice

None of the SHs put capital into the corp.

Their own tests revealed that blasting would cause damage to the surrounding area (creation of debts that they knew the corp would not be able to pay)

* + - * 1. Control + injustice proximate cause of P’s loss

F&S purposely left the corp. with little money to compensate injured Ps

* + 1. ***Baatz v. Arrow Bar*** (SD SC 1990)
       1. F: H & W are injured by a drunken, uninsured judgment-proof motorist. Before the accident, the drunk driver was drinking at Arrow Bar (there was a witness who observed the already intoxicated driver being served at the bar before the accident). Arrow Bar was operated by Arrow Bar, Inc., a corp. formed and owned by the Neuroths.
          1. Plaintiffs feel they are justified in bringing this action b/c of two cases decided subsequent to the Dram Shop Law that say that a tort cause of action based on this criminal statute can be retroactive
          2. The bar doesn’t have assets to cover this tort action, so plaintiffs try to reach into the pockets of the Neuroths
       2. H: **no piercing of the corp. veil**. The court doesn’t see injustice or control in this case
       3. Reasoning:
          1. This was a real corp; no evidence of undercapitalization; when the corp as incorporated, there was no tort for violation of this criminal Dram Shop Law

It was reasonable that Neuroths didn’t have dram shop insurance b/c at the time (in 1980), tort liability was not recognized

* + - 1. **Factors** that indicate injustices and inequitable consequences and allow a court to pierce the corp. veil are:
         1. Fraudulent representation by corp. directors;
         2. Undercapitalization;

SHs must equip a corp. with a reasonable amount of capital for the nature of the business involved

* + - * 1. Failure to observe corp. formalities;
        2. Absence of corp. records;
        3. Payment by the corp. of individual obligations; or
        4. Use of the corp. to promote fraud, injustice, or illegalities …
    1. **HYPO:** If Arrow Bar is in BK and at the start of its venture, the owners (Neuroths) lent the bar $145l for the equipment and land. Neuroths took a SI in the bar itself for this $145k.
       1. Could the court give the Neuroths’ access to the $145k loan that they have secured to at least pay the tort victims for their medical bills?
          1. **Equitable Subordination**

Put these tort victims above the SC/Neuroths re: priority b/c the SC is involved in how the corp. incurred this debt

\*Even though the court won’t pierce the veil

Courts may prefer this b/c it at least gives SHs a more limited risk than piercing the corp. veil (limited to the quantifiable amount SC loaned)

* + 1. **Piercing the Corporate Veil to Reach Incorporated SHs**
       1. Court looks at the parent’s control.
          1. Is the subsidiary run as a mere department? (intermingling funds, intermingling personnel, EEs?)
       2. ***Craig v. Lakes Asbestos*** (3rd Cir. 1988) [applying NJ law]
          1. F: Ps brought suit for personal injuries resulting from exposure to asbestos. NAAC sold fiber in the US. Cape engaged in mining asbestos in South Africa and wholly owned NAAC. Charter held 67.3% of Cape’s outstanding shares. Charters maintained 3 directors on Cape’s board of 10-14 directors.

**Charters, 67% of stock in🡪 Cape, wholly owns🡪 NAAC (converted into CRC)**

CRC is created as a way for Cape to still get asbestos into the US

To get at Charters’ assets in the US, would have to pierce TWO veils

(1) Veil b/w Cape and NAAC/CPC, **then**

Easy b/c Charters admits that Cape was NAAC’s alter ego AND the dissolution scheme makes the NAAC/CPC relationship look like an injustice

(2) Veil b/w Cape and Charters

doesn’t pierce the veil b/c no evidence that Charter actually DID dominate even though it could have

* + - * 1. H: **potential control is not enough. Corporate veil b/w Cape and Charters is not pierced.**

There is a grave injustice (b/c the scheme of closing NAAC and using CPC instead was a scheme to defraud creditors), but there is not control, so the veil is not pierced.

* + - * 1. Reasoning:

**In NJ, the corp veil may be pierced only where:**

The parent so dominated the subsidiary that it had no separate existence but was merely a conduit for the parent; AND

The parent has abused the privilege of incorporation by using the subsidiary to perpetrate a fraud or injustice, or otherwise to circumvent the law

These are separate companies, separate management, & separate bank accounts. Charter can theoretically use its control, but the facts show that Charters does NOT control Cape. Charter chooses only 3 of the 10-14 directors.

* + - * 1. **Factors for consideration:**

Gross undercapitalization

Failure to observe corp formalities

Nonpayment of dividends

The insolvency of the debtor corp at the time

Siphoning of funds of the corp. by the dominant SH

Non-functioning of other officers or directors

Absence of corp. records; and

Fact that the corp is merely a façade for the operations of the dominant SH(s)

* + - * 1. **Constant involvement is not enough. There must be “dominance”**

**Test if how much control is exercised**

* + - * 1. Without control, we could have an injustice (we just won’t hold the SHs personally liable)

1. Insider Trading
   1. **GENERALLY: describes the purchase or sale of securities on the basis of material, non-public information**
      1. But term is a bit of a misnomer, b/c the person doesn’t have to be an “insider” to be found in violation of this prohibition
         1. Others (ie. not officers or directors of the corp., etc.) with access to this material non-public info, even if not an insider, can get into trouble if not scrupulous with how they handle confidential info when they seek to use info that rightfully doesn’t belong to them
            1. Ex: attorneys representing Alpha Corp. can be considered temporary insiders of Alpha
            2. Ex: attorneys representing Alpha Corp. can also learn info about Beta Corp. and be an “outsider” of Beta – and be subject to these rules
      2. No place in federal securities law that directly prohibits the offense of insider trading
         1. We have SEC Rule 10b-5 instead
   2. **Rule 10b-5**
      1. **Prohibits fraud in connection with the purchase or sale of any security** 
         1. Broad anti-fraud prohibition that doesn’t mention insider trading specifically
            1. The trick is to make sure that insider trading is fraud

It is only fraudulent **some** of the time

* + 1. **Notes**
       1. Not all insider trading is actually illegal
          1. Some things may be unfair but not necessarily illegal
       2. Even congressman have to abide by this rule
  1. **Policy reasons** for prevention of insider trading:
     1. **We believe in the semi-strong market hypothesis**
        1. This info can impact the price of the stock and the decisions of the investors
     2. Investor confidence: effect on everyday, ordinary investors (& incentives to go into the market to buy securities)
        1. People w/o inside access would go with alternative, safe savings options if the system is rigged toward those with inside access
     3. Market integrity: linked with investor confidence
        1. **Market efficiency**: while we would all like to know corp. secrets before we buy stocks, the fact that trading on these secrets is illegal makes people feel better about not knowing everything
     4. May be bad for the corp. itself
     5. Can encourage perverse behavior
        1. Market efficiency is best the fewer secrets there are
           1. Insider trading incentivizes corps keeping more secrets that they can trade on
           2. Ban on insider trading incentivizes getting the info out quickly so insiders can trade within their own market
     6. Insiders of a corp. can profit on good news, as well as bad news
        1. No ban would create scary incentives for insiders to make bad things happen (insiders could make money betting on a fall)
        2. Do we want EEs to keep secrets from their own managers?
           1. More efficient to give incentives to EEs to share with managers immediately
     7. Property rights
        1. Corp. info is property and we should ban people from stealing/misappropriating material, non-public corp. info
        2. We want to create incentives to create info
  2. **Arguments for** **allowing** insider trading [& thus not using Rule 10b-5 in this manner]:
     1. If one believes in the strong market hypothesis (secret info is already accounted for in price)
     2. Some would argue that allowing insider trading would help to creep the stock price up to the **true/accurate value** of the stock
        1. Accurately priced stock is more efficient and good things happen when securities trade at an efficient price
           1. But this comes at a huge cost (costs outweigh this benefit)
     3. Could argue that insider trading is an efficient way to compensate entrepreneurs and managers
        1. BUT there are other ways to encourage them to develop new formulas (ie. bonuses, higher salary, etc.)
           1. Insider trading would essentially allow secret compensation, which brings other problems
  3. Federal Securities Laws: **History**
     1. From the beginning (1933), Congress viewed insider trading as a harm to securities markets
     2. **First** sought to address the harm indirectly:
        1. **Sec. 16b of Exchange Act**
           1. Develops a cause of action against officers, directors, or large SHs from profiting from “short swings” [buys and sells within 6 month window]
           2. **This has NOT been an effective vehicle in policing insider trading**

**Over-inclusive:** regulates those who do not even have access to insider info. The virtue of the fact that you traded w/in the 6 month time period triggers the rule. The corp. is then allowed to go after those profits.

**Under-inclusive**: this does not prohibit insider trading by an official who had been at the corp for a long time. As long as you hold the stock for more than 6 months, you are in the clear even if you traded on that inside information.

This also doesn’t account for the insider who purchases stock at a low price knowing of material information that will likely cause the price to increase

* + - 1. **IT was also viewed as actionable in some states under the CL**
         1. But cause of action was not recognized when securities were traded over a market/stock exchange

Only applied to **face-to-face transactions**

Silence/not disclosing good news was fraud

* + - * 1. Problem: most securities transactions do NOT occur face-to-face and NO jurisdictions recognized cause of action for fraud of Exchanges

And most states didn’t even recognize the face-to-face cause of action

* + 1. 1960s: SEC took an old rule (Rule 10b-5) to sanction insider trading as a type of fraud that would violate 10b-5
       1. SEC has success with this on an administrative level, and SEC then litigates this in ***Texas Gulf Sulfur***, where the 2nd Circuit embraces it
  1. **“PARITY OF INFO” THEORY – INSIDER TRADING**
     1. ***SEC v. Texas Gulf Sulfur*** (2nd Cir. 1968)
        1. PARITY OF INFO THEORY
           1. No longer good law; rejected by SCOTUS in ***Chiarella***
        2. F: When the first ore info came out, the stock price was $17. Then upon the announcement of the discovery, the stock price was $36. Defendants bought stock in the corp. based on the secret news that the corp. may have struck valuable ore and minerals in the land that it owned.
        3. **BROAD RULE**: Court interprets **10b-5** to prohibit individuals from remaining silent about secret info. Anyone in possession of material non public info either needs to **(1)** disclose that info, or **(2)** refrain from any trading relating to that info
           1. **This applies to anyone**

This rule would also apply to anyone who overheard info b/c they were in the right place at the right time

[This rule is old law—it is the **anyone** part that ***Chiarella*** takes issue with**]**

* + - 1. **Corp. tried to keep news of this possible ore strike secret from the public b/c**:
         1. It was still looking to purchase more land

Trying to keep the buying price of adjacent property down

Corp was operating under the idea that silence is golden in real estate transactions (ie. that the corp. couldn’t **lie** to these adjacent property owners, but if the Q was never asked it would not be fraud in buying the real estate w/o disclosing the material non-public corp info)

Argue that real estate transactions are different than securities transactions b/c sec trans are based on info, while real estate/jewelry, etc. can be appraised

* + - 1. **10b-5 definitions**
         1. **Materiality of Info --- STILL GOOD LAW**

The basic test of materiality is whether a reasonable man would attach importance in determining his choice of action in the transaction in question. (has to be objectively important)

Whether the facts are material will depend on the balancing of the probability that the event will occur and the anticipated magnitude of the event

In this case, the probability **and** the magnitude were high

It is important what insiders do when they hear about the info. Aberrations of trading patterns will show that the defendants thought that the info was material

Here, the fact that the defs bought a lot more stock and call options pointed to the fact that they thought this info was material

* + - * 1. **Non-Public Info --- STILL GOOD LAW**

Before insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to ensure its availability to the investing public

In this case, one of the defendants waited to buy more stock until there was a press release (but court said that even though there was a press release, at the time the def made his trade, the info was non-public b/c had not been absorbed by the investing public)

But today, with the internet, this info would probably be absorbed within minutes of the press release

* 1. **“CLASSICAL THEORY” – INSIDER TRADING**
     1. ***Chiarella*** (SCOTUS 1980)
        1. SCOTUS states that the 2nd circuit’s test that **anyone** must disclose is too broad.
           1. However, under the ***Chiarella*** test, the outcome in ***Texas Gulf Sulfur*** would be the same
        2. **Classical Theory**
           1. **Officers, directors, and EEs of a company have a fiduciary-like duty to speak, to disclose info to the other party in a securities transaction**
           2. **This focuses on the fiduciary’s deception of the shareholders on the other side of the transaction**
           3. **Relationship: between the tipper and those with whom the tipper is trading**
           4. **Fraud = fiduciary’s deception and breach of duty to SHs on the other side of the transaction**
           5. *Chiarella* & *Dirks* apply this theory
        3. F: Markup man at a printer received announcements of corporate takeover bids. Chiarella was able to deduce the names of the target companies before the final printing and without disclosing his knowledge, he purchased stock in the target companies and sold the shares immediately after the takeover attempts were made public.
           1. A **tender offer** is a public offer to buy all or some of the shares of a public company. This is often done to make a company private. These offers are also made at a premium over the stock price. Confidentiality is important for the company willing to launch the tender offer.

If confidentiality is breached: The bidder will have to pay more money for those shares b/c the premium will go up. The target company may also be surprised by the offer, so the target company may try to thwart the offer.

* + - 1. Issue: gov’t accused Chiarella of defrauding the investors with whom he was trading
      2. **Rule:** when an allegation of fraud is based upon nondisclosure, there can be **no fraud absent a duty to speak**. We hold that a duty to disclose under 10b-5 does not arise from the mere possession of nonpublic market info
         1. **The duty to disclose arises when one party has information that the other party is entitled to know b/c of a fiduciary or other similar relation of trust and confidence between them**
      3. **Held**: Chiarella didn’t have a duty to disclose the information.
         1. Justice Powell (maj) revised the rule to the CL rule for fraud. One can remain silent. One cannot lie, but one is not required to disclose material info unless there is a duty to do so to the people on the other side of the securities transaction (caveat emptor).

Insiders (directors, officers) obviously have this duty b/c they are in a position of trust and confidence with SHs

Courts building on this also say that EEs of the securities issuer also have this duty b/c they are agents

* + - * 1. Chiarella didn’t owe a duty to those target companies or SHs of those target companies (because he was a stranger). SCOTUS says that unfair transactions are not necessarily fraudulent, and 10b-5 only regulates fraud and deceit.

Focuses on relationship b/w Chiarella and the sellers of the target corp stock

* + - 1. Dissent
         1. Proposes that the rule should focus on the **access** to the confidential information, and not the duty to disclose.
      2. NOTE:
         1. If Chiarella had bought stock in the bidding corp, instead, then he would owe agency-type duties to the SHs of the bidding corp b/c he would be regarded as a temp insider of the bidding corp.
         2. If litigated today, Chiarella would have been misappropriating the printing company’s info under the ***O’Hagan*** misappropriation theory
    1. Tippee Liability & Constructive Insiders
       1. ***Dirks v. SEC*** (SCOTUS 1983)
          1. Context: people who receive info from a corporate insider such that they are the beneficiaries through a chain of **tipping**
          2. F: Dirks specialized in providing investment analysis to institutional investors. Secrist, a former officer at Equity Funding, alleged that the assets of Equity Funding were vastly overstated as a result of fraudulent corp practices. Dirks investigated the allegations and openly discussed the info with a number of clients and investors, causing them to sell their holdings. The stock price dropped, the NYSE halted trading, and CA insurance authorities discovered the fraud
          3. **Rule**:

**A tippee assumes a fiduciary duty to the SHs of a corp. not to trade on material nonpublic info only when the insider has breached his fiduciary duty to the SHs by disclosing the info to the tippee and the tippee knows or should know that there has been a breach**

**Whether there has been a breach depends on the purpose of the disclosure. 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 SHs. And absent a breach by the insider, there is no derivative breach.**

* + - * 1. H: Dirks didn’t violate 10b-5 by sharing info about the fraud to his clients. Secrist breached a confidentiality duty he owed**,** but he did not do it for personal benefit. Secrist did not breach a duty of loyalty for personal benefit, so Dirks didn’t derivatively breach the fiduciary duty.

Court didn’t consider the warm-fuzzy feeling that Secrist likely got from exposing this fraud

Financial remuneration is a key indicator of improper motivation

* + - * 1. **Constructive Insiders (FN 14)**: there are times when the abstain or disclose prohibition that is applicable to insiders applies to certain persons other than corp officers, directors, EEs. Court suggests additional categories—temporary or “constructive” insiders (aka underwriters, accountants, lawyers, etc.) who work for the corp. whose securities are traded

Corp. must expect the outsider who is acting as a temporary insider to keep the disclosed info non public AND the relationship at least must imply such a duty (ie. the attorney/client privilege, agency relationship, sometimes an explicit confidentiality agreement)

* + - * 1. Dissent

Securities laws should be protecting these equity funding purchasers who are in the market with Dirks’ knowledgeable clients (who are buying Dirks’ clients shares w/o this knowledge)

Maj responds to this by saying that not everything that is unfair is fraudulent (fraud = silence in the context of a duty to disclose)

* + - * 1. **Distinction: Chiarella stole the info but Dirks was given it?**
      1. **Three-Part Test for Tippee Liability** (from ***Dirks***)
         1. **The insider must disclose material nonpublic information to someone outside**

Constructive insider

Note: there may be temporary insiders (lawyers, accountants, consultants, etc.). These people in effect become fiduciaries to the SHs

* + - * 1. **Insider must directly or indirectly benefit personally from that disclosure**

Personal benefit to the tipper – “pecuniary gain or reputational benefit”

Ex: exchange of info for cash, exchange for reciprocal info, or exchange for other things of value for himself

Ex: warm-fuzzy feeling from giving a gift. If an insider is giving info to a relative, buddy, or friend, they are doing so as a gift

Secrist didn’t have a personal benefit from the disclosure of info to Dirks

* + - * 1. **Tippee needs to know or should know that the insider breached a duty to the SH**
        2. NOTE: If all three elements are established then the tippee is a “co-conspirator” and the tippee assumes the insider’s fiduciary duty
      1. If there is a **long chain of tippees**, ask if each tippee down the chain knew of the original insider’s duty
         1. If the downstream tippee knew that the info came through a nefarious purpose, government can prosecute
  1. **MISAPPROPRIATION THEORY & Rule 14e-3 – INSIDER TRADING** 
     1. Misappropriation Theory
        1. Focus is on the fiduciary’s deception of the source of the info
        2. Relationship: b/w the trader and the source of the info
        3. Fraud = fiduciary’s deception of the source of the info
        4. SCOTUS embraces this
     2. ***US v. O’Hagan*** (SCOTUS 1997)
        1. F: O’Hagan was an attorney at a law firm. The law firm was being used by Grand Met to make a tender offer to buy Pilsbury. O’Hagan used the info to buy stock in Pilsbury (he then sold his stock and options, making $4.3 mm profit). **O’Hagan would not have been found liable under the Classical Theory. That theory would have focused on O’Hagan’s deception to Pilsbury SHs. Since O’Hagan had no duty to the SHs of Pilsbury (he was a stranger to them), he would not be liable under the Classical Theory.**
        2. H: reinstated O’Hagan’s conviction
           1. **Part 1**: the fraud was in connection with the purchase/sale of securities b/c the fraud is on the law firm and the law firm’s client

Law firm and client have a property right in the info, so O’Hagan using the info for his own personal benefit and keeping silent about defrauds them

Rule 10b-5 doesn’t prohibit **theft** of the info, it prohibits **fraud** (so comes in when the fiduciary steals the info and then tricks the principal into thinking that the fiduciary is acting in the principal’s best interest)

The deception is on the source of the info by virtue of the fid relationship

* + - * 1. **Part 2**: 10b-5 “**in connection with**” element is satisfied b/c the fiduciary’s fraud is consummated when, w/o disclosure to the principal, the fiduciary uses the info to **sell the securities**

This links the fraud to the securities transaction and brings it within the realm of 10b-5

This is where the dissent disagrees with the maj

* + - * 1. Ginsberg (maj) suggests that if O’Hagan had simply told his law firm and client that he was using their info, it would negate liability under 10b-5

**Full disclosure to the source of the info means that you don’t commit securities fraud under 10b-5**

BUT you do commit **theft** and breach of the duty of loyalty (and can still go to prison)

This is more of a theoretical loophole only b/c insider traders wouldn’t typically do this (ie. disclose)

* + - 1. Dissent
         1. Agrees that this was fraud, but argues that rule 10b-5 requires the fraud to involve deceit to the actual parties to the security transaction (aka the classical theory is the only game in town)
         2. Difference of interpretation of what is required by the “in connection with” statutory element
      2. Legacy
         1. This case involved a person who owed the fid duty to the source of the info and who directly trades himself.
         2. After this case the **misappropriation theory has been used in tippee cases as well** (ie. can either trade directly or be the tipper)

Aka if O’Hagan had taken this info and gave it to his best friend or sold it to a hedge fund and took a kick back, O’Hagan would still be misappropriating the info

W.r.t. the recipient of this tip, the question would be whether the tippee knew that the tipper had this info in the context of the breach of a duty

* 1. **Rule 10b5-2**
     1. Sets out 3 categories of persons who will be presumed to owe fiduciary duties to the source of the info, so that trading on the basis of info conveyed to them in the course of that relationship will constitute a breach of duty for purposes of **Rule 10b-5**
        1. **Persons who get info by virtue of an agreement to maintain info in confidence**
        2. **Persons who get info in the course of a relationship where there is a history of sharing confidences**
        3. **Certain family members**
           1. Rebuttable presumption that info is given in confidence in the context of family members

Can rebut this presumption by showing that you are a deadbeat and no one in your family would share confidential info with you

* + 1. SEC promulgated this rule after ***O’Hagan***
       1. There was an issue w.r.t. what types of relationships become fiduciary such that we can apply these **presumptions of trust and confidence**
  1. **Prob. 11-5**
     1. F: woman tells her hairdresser that her husband is about to take over a corp. Hairdresser uses this info to buy stock
     2. Issue: does hairdresser violate Rule 10b-5?
        1. NOT under **classical theory** b/c she is a stranger
        2. Under **misappropriation theory**, ask if the hairdresser owes a duty to her client, the source of the info (the wife)
           1. Hairdresser/client doesn’t fall into a hornbook category of fid relationship, but could argue that there was a history of exchanging confidences? (this is a stretch)

Under ***O’Hagan***, gov’t would have to show this type of relationship to prosecute the hairdresser