(3) CORPORATIONS

Corporation

A "legal person" – a legal construct to pool money and labor – typically possessing the following attributes

1. Separate entity
2. Perpetual existence
3. Limited liability
    a. Creditors of the corporation cannot go after the shareholders personally (big difference from "general partnership")
4. Centralized management (in many corporations this means there is a separation of share ownership and control)
5. Divisible ownership (shares of stock)
6. Transferable share and debt obligations (unless limitations imposed, in private companies especially)

Introduction to Corporations

- The founders of a corporation create the corporation by "incorporating" by filing certain docs w/ the appropriate state agency and may choose to do so in any of the states
- Corporate law primarily focuses on the relationship b/t:
    - 1) The stockholder (aka "Shareholders")
    - 2) The board of directors, and
    - 3) The officers (aka "managers" or "executives")
- **Stockholders** = equity investors
    - Their ownership ints. are reflected in the stock of the corporation
    - They elect a board of directors, who in turn select the officers who run the biz
    - Shareholders have a few key rights but they don't participate in managing the corporation's biz or affairs. They cannot act on behalf of the corporation
    - Role = just owning stock and rights & duties that follow from owning stock
- **Board of Directors** = direct the affairs of the corporation
    - Authority to act for (and to bind) the corporation originates in the board as a collective body.
    - Directors have fiduciary duties to the corporation and the body of shareholders
- **Officers** = handle day-to-day management of the corp. and are under the direction of the board
    - The officers are appointed by the board. E.g., CEO, CFO, etc.
    - They are agents of the corporation
- Sources of Law
    - Each state has its own corporation code (statutes), which sets out how to incorporate and the laws governing corporations; courts interpret and apply the state corporation code through case law
    - While there is no fed. law of corporations per se, federal statutes add a significant layer of corporate regulation (e.g., securities law, Sarbanes-Oxley, Dodd-Frank)
    - *Corporate law is BOTH state law and common law.
- **Choice of Law**
    - Once a firm incorporated in a particular state, it is the law of that state that controls as to the matters covered in the corporations code (known as the "**internal affairs doctrine**")
    - [**EX**] Delaware -> DE's code and DE case law and federal overlay on something
- Key corporate docs:
    - **Certificate/articles of incorporation**
        - Terminology:
            - DE uses "cert. of incorporation"
            - CA uses "articles of incorp"
            - Colloquial term = "Charter"
            - *All used interchangeably
        - Must be [1] filed w/ state in order to incorporate, and [2] must meet statutory reqs
            - Typically include basic provisions req'd by the state, such as the corporate name, agent address for service of process, number of authorized shares, etc.
    - **Bylaws**
        - *Not filed w/ the state
        - Sets out the governing details of the corporation

            - Typically longer than the cert. of incorporation and include the governing rules for electing directors, filing director vacancies, notice periods and details for calling and holding meetings of shareholders and directors, etc.

The **Ultra Vires Doctrine**

- Whenever a transaction was beyond the corporation's limited purpose or powers, either party to the K could disaffirm it.
    - At common law, a corporation was limited to the powers enumerated in the purpose clause of its charter.
        - "Purpose clause" = Statement describing the biz the corporation is to conduct
        - The term "corporate powers" refers to methods the corporation may use to achieve its purpose (e.g., power to contract and power to borrow money)
    - Historically, if a corporation engages in conduct that was NOT authorized by its express or implied powers, the conduct was deemed "ultra vires" and void.
    - Over time, courts began to interpret corporate powers more broadly. State legislatures began to allow corporations to specify in their charter that they were formed to engage in "any lawful purpose." Corporations need not specify a single purpose, nor do they need to list their specific powers.
- *TODAY, most modern corporation statutes expressly grant incidental/implied powers. Corporate managers in the absence of express restrictions, have discretionary authority to enter into Ks and transactions reasonably incidental to its biz purpose, which may be broadly defined. (**DGCL §§121, 122**)
    - *This is an equitable doctrine.
    - The modern ultra vires doctrine is narrow. It applies only where the cert. of incorporation states a limitation and there are **3 exclusive means of enforcement** (**DGCL §124**):
        - 1) In a proceeding by a stockholder against the corporation to enjoin a proposed ultra vires act;
        - 2) In a corporate suit against directors and officers for taking unauthorized action (the directors and officers can be enjoined or held personally liable for damages);
        - 3) The state attorney general can seek involuntary judicial dissolution if the corporation has engaged in unauthorized transactions.
    - **An ultra vires act will be enjoined ONLY if equitable to do so**
        - Meaning that an act involving an innocent party (e.g., one who didn't know the action was ultra vires) will not be enjoined
        - *Use of the ultra vires doctrine is VERY RARE; many legal commentators view it as a historical relic.
    - [**HYPO**] A and B incorporate a biz called Island Foods, Inc. ("IF"). IF's cert. of incorporation includes a purpose clause stating that the corporation was formed for the purpose of making and selling traditional Hawaiian food. The biz is successful, and later, in an attempt to expand the biz, A (on behalf of IF) enters into a K w/ C to buy a tour boat. When A tells B about the deal, B is angry and brings an action to enjoin the purchase.
        - The ct. would generally grant and injunction only if C knew that the transaction was beyond IF's purpose clause (b/c ultra vires is an equitable doctrine).

The **Internal Affairs Doctrine**

(A choice of law rule)

- As a general matter, the "internal affairs" of the corp. are governed by the **law of the state of incorporation**.
    - Cts. apply the law of the state of incorp. when adjudicating governance and fiduciary duties that arise w/in the corporation, including the rights of and relations among stockholders, the duties and obligations of the officers and directors, issuance of shares, acquisition procedures, etc.
    - Hence, the act of incorp. also selects the law that will apply to the corporation's internal affairs.
    - [EX] "A Delaware corporation," "a California corporation"
- ***Corporation Code §2115** – CA's long-arm statute
    - Notable departure from the internal affairs doctrine
    - It makes "foreign" corporations w/ half of their taxable income, property, payroll and outstanding voting shares w/in CA **subject to certain provisions of the CA Corporations Code**.
    - Basically, for corporations incorporated in DE that operate primarily in CA, DE law will apply but certain CA Corp. Code provisions)
    - DE thinks 2115 is unconstitutional – this is controversial and has been the subject of recent debate.

Qualification of "Foreign" Corporations to Do Business

- "**Foreign**" = Not incorporated in that state
- A biz incorporated in one state may conduct biz in another if "**qualified**" to do business in the state.
  - To "qualify" the corporation usually has to
    - 1) file a certified copy of its certificate,
    - 2) pay a filing fee, and
    - 3) appoint a local agent to receive service of process in that state.

Why do we study DE law?

- The internal affairs doctrine has made it possible for a dominant body of corporate law principles to exist.
- When incorporating a business, most ppl choose to incorporate in either their home state where their principal place of biz is or in DE
  - Nearly 60% of publicly traded US corporations are incorporate in DE.
  - Nearly 90% of public corporations that re-incorporate do so in DE.
  - Many private companies that wish to grow larger and go public usually incorporate in DE.
- DE has:
  - The largest body of precedent interpreting its corporation code (comprehensive body of corporate law in the US)
  - Relatively stable and modern corporate law.
  - A special ct. for biz matters (the Chancy Court), which has a reputation for excellence and experience in corporate law (as well as the DE Supreme Ct, which is similarly respected)
  - Procedures that facilitate timely decisions (which can be esp. important for some corporate issues like takeovers.)
  - Many lawyers across the country are trained in DE corporate law, esp. biz savvy lawyers.

Partnerships v. Corporations

	General Partnership	**Corporation**
Formation	Informal; UPA, RUPA.	Formalities required; Certificate of incorporation, bylaws, board of directors, minutes, elections, filings, etc.
Limited Liability	No. Unlimited personal liability. But partnership agmt can have indemnity provisions, can buy insurance, and other partnership forms offer limited liability to various extents (LP, LLP, LLLP)	Yes. Limited liability for shareholders. But creditors may seek personal guarantees and there is the veil piercing doctrine.
Free transferability (of interest/ share)	No (default rule). Just the "transferable interest" is personal property that can be transferred; but partners can negotiate and dissociate.	Yes, generally. Can sometimes be restricted.
Continuity	Default is at will. Can agree to continuation agreements. Death of partner – dissociation.	Default is indefinite/perpetual. But can limit. Not tied to human life.
Management	Decentralized (default). Each partner an agent and equal participation in mgmt is default; but can use exec comm. and limit authority by agreement and notice to third parties.	Centralized (default). Directors and officers manage the corporation; not shareholders. Separate and specialized functions.
Cost	Zero. But often good idea to hire a lawyer.	Filing fees, typically lawyer fees, franchise fees, etc.

Default Rules	Extensive.	More extensive.
Flexibility	Very malleable form for carrying on business; most rules are default. Almost all the rules, you can contract around for partnerships.	Not quite as flexible. You can still contract around but not as flexible as partnership default rules
Tax	"Flow-through" (single). Partnership itself doesn't pay taxes. Profits and losses flow thru to individual partners. Losses can be used by partners.	Taxed as entity, so shareholders have double taxation on distributed earnings; losses usable only by corporation. (Corporations pay tax at the entity level – double taxation b/c corporation makes a distribution such as a dividend or if shareholder sells, they are taxed at the individual level as well. [**Exception**: S Corporations]

Public v. Private Corporations

- **"Public" Corporations**
  - Large firms w/ stock traded on public stock markets
  - The shareholders typically don't expect to participate actively in the operation of the biz → they are passive investors.
  - Many Americans also invest directly through mutual funds, etc. (e.g., 401Ks)
  - There is a large amount of federal law that applies to public corporations (securities law, etc.)
- **"Private" Corporations** – aka "close" or "closely held"
  - Not subject to public reporting reqs under federal securities laws
  - Typically private corps. have a small number of shareholders who hold stock that is not publicly traded. The stock is generally less "liquid" and may be subject to shareholder agreements that limit its transferability.
  - Generally, (though not always) private corporations are of relatively modest economic scope, and the people in the top managerial positions may also own a substantial amount of the corporation's stock.

The Incorporation Process

- **Select state** of incorporation.
- Reserve the desired **corporate name** by application to the secretary of state or other designated state office.
- Arrange for a registered office and registered agent.
- Draft, execute, and file the **certificate of incorporation** (aka "charter," "articles of incorporation") with the relevant state agency, according to the requirements of state law (e.g., **DGCL § 102** – let's look at this in detail).
  - Note: The role of incorporators can be purely mechanical. They sign the certificate and arrange for the filing. If the certificate does not name directors, the incorporators select them at the first organizational meeting (to serve until first shareholder meeting). After incorporation, the incorporators can fade away and do not need any continuing interest or role.
  - Filing the certificate is a straightforward task. The DGCL requires state officials to accept certificates for filing if they meet the specifications. **DGCL § 103(c).** Certain filing or organization fees and any franchise tax must be paid.
- Properly filing the certificate brings the corporation into existence. (**DGCL § 106.)** Next step is to **have an organizational meeting** of the incorporators or of the subscribers for shares to elect the directors, if not named in the certificate. (**DGCL § 108**) Also:
  - Appoint officers
  - Adopt bylaws (typically describe rules regarding shareholder and director meetings, shareholder voting, etc.) (**DGCL § 109**)
  - Adopt pre-incorporation promoters' contracts
  - Authorize issuance of shares, stock certificates, corporate seal, corporate account, etc. (use a checklist to be meticulous)
- **Prepare board meeting minutes**, open corporate books and records, issue shares, qualify to do business in states where business will be conducted, obtain any needed permits, taxpayer ID numbers, etc.
- **Plan for shareholder meeting as required**.

Intro to Corporate Management: Board of Directors & Corporate Officers

- **[A] Board of Directors**
  - Management of the corporation is centralized in the board.
    - "**DGCL § 141(a) –** The business and affairs of every corporation . . .shall be managed by or under the direction of a board of directors, except as may be otherwise provided…"
    - *The authority is w/ the board
  - What are the **key functions of the board**?
    - (1) Monitoring and oversight (including hiring and firing of the officers)
    - (2) Strategic focus and vision (includes giving advices to officers and execs)
    - (3) Provide access of network for contacts and resources
  - Some key characteristics:
    - By default, stockholders elect the members of the board (directors) at the annual stockholder meeting.
    - Directors tend to be CEOs or other high-level executives with full-time jobs and responsibilities at other companies. Corporate officers such as the CEO may also be directors. (Recall example of Apple Corp. board).
    - Directors have fiduciary duties (which we'll study in detail).
    - Subject to some limitations, the board has the power to delegate authority (e.g., it can appoint officers to run the day-to-day operations, it can delegate certain authority to committees of the board, etc.).
  - An individual director acting alone generally has no rights or powers.
    - **The board of directors takes action on behalf of the corporation either
      - (1) **At a meeting** at which a "quorum" is present; or
        - **DGCL § 141(b)** – Action at a board meeting:
          - **Quorum** = min. # of people that have to be present for a meeting to occur.
          - "A majority of the total number of directors shall constitute **a quorum** for the transaction of business unless the certificate of incorporation (COI) or the bylaws require a greater number. Unless the COI provides otherwise, the bylaws may provide that a number less than a majority shall constitute a quorum, in no case shall be less than 1/3 of the total number of directors…"
            - Default is majority. Can require less, but can't be less than 1/3.
          - "The **vote of the majority of the directors present** at a meeting which a quorum is present shall be the act of the board of directors…"
      - (2) By **written consent**.
        - **DGCL § 141(f)** – Action by written consent
          - Authorizes a board to act without a meeting by means of **written consent**, but it requires **unanimity.**
- **[B] Officers**
  - Corporate officers run the day-to-day operations of the business.
  - They execute firm strategy. (And in practice, often help devise the strategy too. Most corporate actions are actually taken by corporate officers and subordinate employees pursuant to delegated authority).
  - They are agents of the corporation, and the scope of their power often comes down to agency principles.

Warm-Ups/Review

- When does corporate existence begin? How is a corporation formed?
  - Begins by the articles of incorporation being filed w/ the secretary of state (or corporate division) along with the required filing fees
  - Founders will come up w/ name, register with the name... file the articles of incorporation, get tax payer ID, get qualifications to conduct business in the state, draft and adopt the bylaws ... etc.

- Can you name 6 attributes of the corporate form?
- Corporate law focuses primarily on the relationship between which 3 groups of people?
- Can you name a synonym for certificate of incorporation?
    - article of incorporation; charter
- What are bylaws?
    - Below articles of incorporation
    - Doc that establishes the inter-governance rules
- What does the board of directors do?
- What do the officers do?
- What is the internal affairs doctrine?
- What is the ultra vires doctrine?
- What is the effect of California's long-arm statute, California Code § 2115?
- What are some characteristics of corporations that are different from general partnerships?
- How can the board of directors take an action on behalf of the corporation?

CORPORATIONS – Promoter Liability, Defective Formation, and Capital Structure

PROMOTER LIABILITY

- A "promoter" is a "person, who acting alone or [with others], directly or indirectly takes initiative in founding and organizing the business or enterprise of an issuer."
    - E.g., identify and solicit investors, arrange for space/facilities, hire employees for the entity, enter into contracts.
    - Often referred to as the "founder" or "organizer."
    - Acting on behalf of the corporation that is to be formed in the future
- Contrast with an "incorporator" who has the limited, **mechanical task of preparing** the incorporation **documents** and filing them with the state. Incorporators are often lawyers, paralegals, etc. In contrast to the rules of promoter liability, incorporators are typically not liable for their pre-incorporation acts.
- *Pre-incorporation*:
    - Promoters are liable for contracts entered into on behalf of a future corporation, absent a contrary intent.
        - Contrary intent generally requires showing more than just signing "for a corporation to be formed."
        - Evidence of the parties' intentions must be found in the contract or in the surrounding circumstances—for example, that the parties intended the promoter to be a non-recourse agent, a "best efforts" agent, or as an interim contracting party only until incorporation and the corporation adopts the contract and substitutes in the promoter's place.
- *Post-incorporation*:
    - Rule#1: Corporation is liable on the contract **only if the corporation adopted it**.
        - Can be **express** (e.g., formal board resolution) or **implied** (e.g. if directors or officers knew of and acquiesced in the contract).
        - Adoption is similar to ratification (but in ratification, the principal has to be in existence at the time the contract was entered into)
    - Rule #2: Promoter remains liable unless:
        - 1) Corporation is formed;
        - 2) Corporation adopted the pre-incorporation contract; and
        - 3) The parties agreed to release the promoter from liability (either in the initial contract or through subsequent novation).
    - It's possible for the corporation and the promoter to both be liable on the contract (if the novation is not formed, then the promoter remains liable)

Moneywatch v. Wilbers

- Wilbers (tenant) entered into lease w/ Moneywatch (landlord) as "Jeff Wilbers, dba Golfing Adverntures". Wilbers created an incorporation shortly after, J & J Ventures, Inc. Defaulted on lease. Moneywatch went after Wilbers personally for the unpaid rent.
- Issue #1: Has there been a **novation** that releases Wilbers from liability?
    - Rule: Promoter remains liable to the lease unless the parties agree that the corporation will be liable instead.
    - Holding: No, no clear indication that parties wanted to enter into a novation

- The fact that they changed names in the contract isn't enough to show that there was a release of liability
- PLUS, there is no consideration...

Promoters have Fiduciary Duties

- Promoters of a yet-to-be-formed corporation have some fiduciary duties to the entity, the other promoters, and investors:
  - Promoters must deal with the entity in good faith. This requires promoters to act fairly in transactions they enter into with the corporation.
  - Promoters must disclose relevant information, like opportunities and conflicts vis-a-vis the entity, to other relevant parties. (e.g., no secret profits)

Defective Formation: 2 Doctrines

HYPO – The investors think that they're investing in a legitimate corporation, turns out that it was defective and not recognized by law... and the creditors are now going after them personally... court may recognize a de facto corporation for those poor investors

- De Facto Corporation
  - Elements:
    - Statute for valid incorporation available;
    - Good faith attempt at incorporation; and
    - Good faith use of corporate form in a transaction with a third party.
- Corporation By Estoppel
  - Both parties believed that a corporation existed (no actual knowledge of defective formation)
  - Equitable doctrine applied where court determines it would be unjust for a party to deny corporate existence.
  - Example: *Southern Gulf v. Camcraft*

Southern Gulf Marine v. Camcraft

- Issue? Whether the (P) can estopp (D) from trying to get out of this contract
  - (D) = buyer
  - (P) = seller
  - P entered into K to buy a boat and signed on behalf of corporation that hadn't been incorporated. K stated that the corporation was incorporated in Texas.
- Holding?
  - It didn't matter to the seller at all whether the corporation was incorporated in TX
  - Not a good enough reason to invalidate the contract
- Why did Barrett on May 30, 1979, sign a contract on behalf of Southern-Gulf Marine Co. No. 9, when the corporation had not yet been formed?
- Why did Camcraft want to back out of this contract?
  - Ship became more valuable (increased in price) by the time seller had built it.
  - Wanted to sell to someone else at a higher price
- The appellate court suggested that Barrett might have been able to enforce the contract in his individual capacity. Under what legal theory could Barrett have done this?
  - Agency law ... an agent for a non-existent principal is liable for the contract!!

CORPORATIONS – Capital Structure

(Basic info on stocks. debt, options and dividends)

How do corporations get money ("capital") to run the business?

- Corporations raise money ("capital") to fund their business by (1) issuing debt or (2) equity securities (the "capital formation" process).
  - These securities are long-term contingent claims on the corporation's assets and future earnings, issued pursuant to formal contractual instruments.
- Corporations with existing operations often fund their business "retained earnings" (which just means income retained by the corporation instead of distributed as dividends).

CAPITAL STRUCTURE: DEBT & EQUITY

- Corporations have a "**capital structure**," (whether the company has debt, equity or both types) consisting of 2 basic types of securities:
- **[1] Debt**
  - 3 basic forms: (1) **bonds**, (2) **debentures**, and (3) **notes**.
  - Holders of debt securities are **creditors** of the corporation
  - Debt represents a fixed claim on the corporation's assets and earnings, usually with a specific duration.
  - Pros:
    - Typically, debt holders get periodic **interest payments** and **ultimate repayment of the principal** at maturity date.
    - At liquidation, they would get paid before the stockholders (in a sense, it's less risky)
  - Cons:
    - They have lower rate of returns
  - The relationship between the corporation and its debt holders is essential **contractual**.
  - Directors and officers normally owe **no fiduciary duties** to debt security holders.
- **[2] Equity**
  - A corporation issues equity in the form of shares of stock
  - Equity security holders have the "residual claim" = at liquidation they are entitled to whatever funds are left after all other claims on the corporation have been satisfied
    - If the corporation is hugely successful, they get more funds to claim b/c there's a lot of money left over after debt being paid off. The opposite is true if the corporation is not successful.
  - The law traditionally regards stockholders as "**owners**" **of the corporation** (though many corporate scholars take issue with this characterization – stock represents an economic interest in the corporation with particular rights)
  - The relationship between the corporation and its shareholders is a major focus of corporate law.

STOCK

- Many corporations divide their equity securities into multiple "**classes**" of stock (and there can be "series" within a class).
  - **DGCL § 102(4) –** They must be authorized and set forth in the certificate of incorporation.
- The 2 most basic forms are **common stock** and **preferred stock**.
- Unless otherwise agreed, corporate shares are by **default "common shares"** with **equal voting rights per share** and **equal rights per share to residual claims** of the corporation.

[1] Common Stock

- The most basic of corporate securities. The default.
- All corporations have common shares. Some corporations issue no other kind of security.
- Typically, common shareholders have voting power.
  - The power to vote to elect the board of directors and to vote on other matters that require shareholder approval (e.g., amending COI, mergers if structured in certain ways, etc.).
  - Voting rights can be varied.
- Common stockholders have the "residual claim" on the assets of the corporation (debt and preferred stock would typically have a right to be paid first if the corporation is liquidated).
- Corporations are rarely liquidated, though, so common stock generally represents a permanent or long-term commitment of capital to a corporation. If stockholders want out of their investment they "exit" by selling their stock to someone else who buys it at a price that reflects the corporation's then-current value.

[2] Preferred Stock

- Different type of stock that **not all corporations issue**.
- Comes with certain contractual "preferences" such as
  - **Senior** economic rights,
  - Dividend **preferences** (K would specify that they would get paid before common stock gets paid dividends, or more than how much common stock gets – 5x or 10x, etc.)
  - **Liquidation** rights, etc. (K rights that preferred stock holders have, a right to be paid any portion of the assets remaining after the debt is paid off BEFORE the common stock holders are paid)
- Essentially contractual in nature. Rights must be in the "certificate of incorporation" (COI).

- Sometimes it's referred to as a hybrid because it's a stock but it acts as a debt (b/c of dividend preferences)
- Preferred stock sometimes represents a permanent commitment of capital and sometimes not
  - In the latter event, the shares will be "redeemable" for some specified amount. (Right to redeem may be held by the shareholder or by the corporation or both.)
- Deemed to have voting rights equal to the common shares unless the certificate of incorporation provides otherwise – voting rights can be varied.

DECISIONS ABOUT CAPITAL STRUCTURE

- Different capital structures reflect differing allocations of control, risk, and claims on the corporation's income and assets.
- There is no one-size-fits-all optimal structure.
  - Various considerations, e.g.:
    - Taxes (for example, interest paid on bonds is deductible but $ paid in dividends is not)
    - Leverage (Will the corporation be able to pay the agreed upon interest when it comes due? Leverage can increase potential for additional gain or for bankruptcy depending on corporation's income and what it will do with the borrowed money. "Leverage increases risk—both on the upside and downside.")
    - Market (How much money needs to be raised for the corporation? What will investors buy? On what terms?)

Potential Tension in Capital Structure

- Illustration:
  - *Equity-Linked Investors, L.P. v. Adams*
    - (pages 265-267)
  - Company was on the verge of bankruptcy. Preferred share stockholders had right to liquidate the company. They had first dibs on getting paid back $30 Mil. If they liquidated the company, the common shareholders would get *nothing*. The company secured additional capital to stay in business and the preferred stockholders sued the Board for breach of fiduciary duties – making a bad business decision.
    - Common stock had something to gain if the company made any money
    - The preferred stock holders wanted to get out and $30 Mil to cut their losses.
  - Court concluded: There was nothing in the law that obligated the board to prefer the preferred stock holder's interests... board was acting in good faith to keep company afloat. No violation of fiduciary duties... didn't have to uphold the interests of preferred stock over common stock.

Issuing Stock

- Much of the law governing the issuance of stock is federal and state securities laws.
  - If you take Securities Regulation, you'll learn a lot about this!
  - At the most basic level the idea is that **federal securities laws require issuers of stock to register the issuance with the SEC, unless there is an available exemption. Liability can result from false statements in the registration statement.**
- There is also state corporate law concerning the stock issuance process. That's what we'll focus on (+ basic vocab).
- **DGCL § 152 –** To validly issue shares, the (1) **board must authorize** the issuance of shares and (2) the corporation must **receive appropriate consideration**.
  - **DGCL § 161 –**The corporation, acting through its board, must approve the particular transaction in which the shares are sold.
  - The appropriate number of shares must be authorized in the certificate of incorporation.
  - **DGCL § 152 –**The directors determine the price or consideration for newly issued shares. Their judgment that it is adequate is considered conclusive, in the absence of fraud.

Vocab:

"Subscription Agreement"

- = An offer to purchase shares from a corporation. Subscriptions can be made to existing corporations or corporations to be formed.
  - A subscription does not become a contract until accepted by the corporation. There can be concerns about the enforceability of subscription agreements entered into before incorporation;

DGCL § 165 – the default = they are irrevocable by the subscriber for 6 months from the date of subscription, unless otherwise provided.

"Par value"

- Historical purpose . . . same value per stock. Couldn't be set less than was par value (to make sure that one person wasn't paying more than another)
- Watered stock = if par value of stock was valued at less than its face value, the holder would be liable for the difference.
- Book Page 268.
- Corporation is required to hold certain cushion to protect the holders from creditors.
- Law minimized the importance of the concept of par value.
- **"Par value" = minimum price per share for the value of stock**. Led corporations to set very low par value or no par value to avoid the constraint and sell the stock for more.
- Some corporations still have a par value on their stock

**Authorized, Outstanding, & Treasury Stock

- **Authorized stock/shares**: The maximum number of shares that a corporation is legally permitted to issue, as specified in the certificate of incorporation.
- **Outstanding stock/shares**: shares are outstanding when they have been validly authorized, issued, and are held by someone or some entity other than the corporation itself (aka, "issued stock/shares").
    - These are the shares that are entitled to vote and receive dividends. DGCL §§ 160(c), 170.
- **Treasury stock/shares**: stock that has been previously issued then repurchased by the corporation.

Options

- An option is the right to buy or sell something in the future.
- They are contingent claims: gives the holder the contractual right to buy or sell, but not a contractual obligation.
- "Call option" = the right to buy shares (typically by a certain date at a certain price).
- "Put option" = the right to sell shares (typically by a certain date at a certain price).

Stock Options

- A type of call option – giving the holder the right, but not the obligation, to buy shares of a company.
- Often issued as part of an incentive compensation package.
- Often subject to a "vesting period" in which a certain portion of the stock options vest over time, giving the holder the right then to purchase a certain number of shares at the "strike price"/ "exercise price" before the expiration date.

How can stockholders make money from their investment in a corporation?

- Two ways: (1) dividends (2) selling stock

Dividends

- A dividend is a distribution of cash, stock, or property by the corporation to a class of its shareholders, decided upon by the board of directors.
- Most commonly it is a portion of the profits that is distributed as a dividend. The dividend is often quoted in terms of the dollar amount each share receives (dividends per share).
    - E.g., a corporation with 1 million shares outstanding that decides to distribute $2 million to its shareholders results in a dividend per share of $2 ($2 million dollars divided by 1 million shares).
- The board of directors "may" authorize the corporation to pay dividends. **DGCL § 170(a).**
    - It's within the board's discretion
- What are the *constraints* on the board's discretion to declare a dividend?
    - **"Legal Capitals Test" – DGCL § 160**; concept of "surplus" (taking account of assets and liabilities)
        - The idea = surplus is total assets – total liabilities – legal capital (cushion)...whether the corporation is solvent enough to issue a dividend
        - If you have more assets than liabilities, you're solvent... and then board has discretion to declare a dividend
    - Every state has a version of rules on constraints
- Can shareholders *compel* a corporation to declare a dividend? What happens when shareholders challenge a board decision to issue or not issue dividends?

  - Basic Rule: Courts generally refuse shareholders' decisions to issue dividends
    - It's very hard for shareholders to force/compel board to issue dividends
    - That's just the general rule – whether the board is acting in good faith
  - Case illustrations:
  - *Litle v. Waters* (closely held private corporation and an "interested director" as to the decision not to issue a dividend – entire fairness review)
  - *Kamin v. American Express* (public corporation and board's decision given business judgment rule deference)

Stock Splits

- A stock split is a division of the outstanding shares into more shares.
- It simply divides the pie into more slices. It doesn't change the stockholders' relative ownership interests.
- Why might a board decide to split the stock?
  - Reduce price per share (sometimes the value of the stock becomes SO high that it's too expensive to buy 1 share)
- How are stock splits commonly done?
  - Through a stock dividend of authorized but unissued stock ...
  - Need to check if there's enough unauthorized stock that hasn't been issued yet. If there's enough, you declare a dividend. (You'd be doubling the number of outstanding shares – someone who had held 1 share now holds 2 shares. 2 for 1 share)
  - **Reverse Split*: 1 for 2 – each stockholder would have 1 share instead of 2 (this requires amending the certificate of corporation)
    - Corporation famous for its high stock price. Left the stock of a certain class to increase... It was at $3,500 for one share. If you didn't even have $3.5K, you couldn't buy a single stock. They did a 50 for 1 split → went down to $70 a share
    - The company is worth the same as before, there are just more slices. You can't tell the value of the company just by looking at the stock price. Needs to compare understanding shares and take into the fundamentals (you have to take corporate finance)
- How are stock splits expressed/referred to?

Stock Repurchases

- What are possible reasons why a corporation would repurchase its own stock?
  - 1. May be tax advantageous – you don't get taxed on stock repurchase
    - Instead of issuing money out, you're buying back stock, increasing the value of the company (now that the outstanding shares are worth more)
  - 2. If you're sitting on a giant mountain of cash (like Apple has been doing...) → what's the best use of this cash? To buy back some of our stock (b/c we can't think of anything else better or they are more confident in the value of the company than the market has been)
  - 3. To change corporate capital structure (mix of debt and equity)
    - There is no one optimal capital structure – depends on capital of the company...
    - One way to change the ratio b/c the debt and equity= to change capital structure
  - 4. In a private co. context, some kind of scenario when you want to terminate one shareholder's ownership. They might do a buy back from a disgruntled shareholder.
- Rules on repurchases?
  - **DGCL § 160** – Similar as dividends. Company can't repurchase its shares if doing so will cause impairment of the capital. (Leaves company in such dire strengths that under the law) – must have AT LEAST ONE OUTSTANDING SHARE. Can't buy back all of the stock.
  - Case Illustration: *Klang v. Smith's Food* (in absence of bad faith or fraud on the part of the board, the court defers to the board's determination of surplus)
- Repurchased stock = "**treasury stock**" (authorized, issued, but not outstanding stock that can be re-issued by default rule)

CORPORATIONS – Limited Liability and Piercing the Corporate Veil

Limited Liability – General Default Rule:

- **General Default Rule**: Corporations have limited liability, which means that shareholders are not personally liable for corporate debts or torts. Shareholder losses are limited to the amount invested in the firm.

- It is possible for a shareholder to voluntarily assume liability through a personal guaranty.
- When a company has shareholders, they stand to lose only the money that has been invested into the corporation.

Policy Discussion:

- It is the tort or contract creditor, not the corporation's shareholders, that bears the loss whenever the corporation's resources are insufficient to satisfy the claim.

- Why do shareholders want limited liability? More generally, what are the rationales for limited liability?
  - They want to avoid personal liability.
  - Why do we let those losses fall on contract? → Increases investment
  - Promotes capital formation. Who would want to invest in companies if they were held liable for everything?
  - We care a lot about who else is the other shareholder in the company. Worry about whether other shareholders has deep pockets so that it's not going to be on you
  - Worry about logistics. What if you're the only person that could be reached w/in the jurisdiction?
  - Allow for corporate risk taking that might be valuable. It's better to engage in it if the net value is higher than not doing it. Might be deterred from taking those business risks if they know they're on the hook for it. Diversification possibilities.
    - Diversification – investment in various areas
  - Means there's more liquidity in the stock which is beneficial for the system

- Why would creditors accept limited liability?
  - Contract creditors
    - Can say "if I'm going to enter into an agreement w/ the corporation, I want to know the assets and books to see if they can satisfy the debt to me."
    - If I'm a contract creditor, I can charge a higher interest rate to protect myself or require a personal guarantee of someone involved
  - Tort creditors:
    - The world wouldn't look like it does if we didn't have LL
    - It's enabled huge industrial projects and institutions ...

- Dark side to limited liability:
  - LL encourages corporations to engage in riskier or more damaging activities because shareholders are allowed to externalize the corporation's costs to third parties
  - Tort claimants may be particularly harmed because they may lack means to spread the risk externalized onto them.

Piercing the Corporate Veil (PCV)

- **PCV** = Common law exception to limited liability
  - Exception to the general rule to pierce the limited liability of a corporation to reach the deep pockets of the shareholders
  - Courts are reluctant to pierce this veil. This is an exception to the general rule

- Big Picture of PVC Doctrine
  - Piercing the corporate veil (PCV) is an **equitable doctrine** created by courts to "prevent fraud and achieve justice." It is an exception to the general rule (of limited liability).
  - States vary in their PCV tests. No single test prevails.
  - Fact-specific cases.
  - Nearly all PCV cases involve closely-held corporations (apart from enterprise liability, which we'll discuss soon).
    - Doesn't happen with public companies.
    - In closely-held corporations, shareholders often participate in management and have more to gain by shifting risks. Individual is more likely to dominate a close corporation than a public corporation. Liability increases when an individual has more involvement.

  - Plaintiff
    ↑

Corp
↑
Shareholder

2 prong-test to allow PCV:

- **(1) Unity of interest and ownership b/t corporation and shareholder**
  - Sometimes phrased as "control or domination" or that the corporation was an "alter ego"
  - Frequently discussed factors or considerations:
    - 1. Failure to observe corporate formalities
      - Failure to hold board / shareholder meetings, keep minutes, issue stock, appoint a board, adopt the normal corporate document, keep separate books etc.
    - 2. Comingling business and personal funds or assets
      - Shareholder treated this corporate account as his own
      - The money of the corporation should be separated from personal assets
    - 3. Undercapitalization of the business
      - Deliberate undercapitalization (distinguished from actual legit debt)
      - Look at insurance and whether that counts
      - Look at whether there wasn't even enough put in at the beginning of the corporation, and it wasn't enough to run that business
      - Depends on the scope of the contemplated biz and what liabilities would be foreseeable @ the time of formation
      - Was there money put in for the liabilities that could arise? Doesn't matter that the company now doesn't have money is insolvent...
      - Undercapitalization alone probably isn't enough. If more than one of these factors are met, it's more likely that the court will pierce

- **(2) Refusing to allow PCV would sanction fraud <u>or</u> promote injustice**
  - Deceit or other wrongdoing, some element of unfairness or wrong beyond a creditor's mere inability to collect
  - In all of these cases, the creditor doesn't get paid out by the corporation... There must be some additional wrong!

- *(3) Sometimes, the courts will also require that the 2nd element must have been a **proximate cause** of injury to the Plaintiff

- *Notes:
  - Some courts expressly state the separate prong with sanctioning fraud or promoting injustice; sometimes the analysis ends up being very similar anyway and effectively collapses into analysis of the unity factors or a holistic appraisal.
  - Courts state different factors, but it generally boils down to control (often implicitly), lack of corporate formalities, intermingling funds or assets, undercapitalization. To pierce, you generally need at least 2 of these.
  - Courts sometimes also state that the control or wrongdoing must have proximately caused the injury or loss to plaintiff.

CA Test:

- To invoke alter ego, two conditions must be met:
  - 1) There must be such a **unity of interest and ownership** between the corporation and its equitable owner that the separate personalities of the corporation and the shareholder do not in reality exist; and
  - 2) There must be an **inequitable result** if the acts in question are treated as those of the corporation alone.
  - *F. Hoffman-La Roche*
- CA's Laundry List of PCV Factors:
  - [1] Commingling of funds and other assets, failure to segregate funds of the separate entities, and the unauthorized diversion of corporate funds or assets to other than corporate uses;
  - [2] the treatment by an individual of the assets of the corporation as his own;
  - [3] the failure to obtain authority to issue stock or to subscribe to or issue the same;
  - [4] the holding out by an individual that he is personally liable for the debts of the corporation;

- [5] the failure to maintain minutes or adequate corporate records, and the confusion of the records of the separate entities;
- [6] the identical equitable ownership in the two entities;
- [7] the identification of the equitable owners thereof with the domination and control of the two entities;
- [8] identification of the directors and officers of the two entities in the responsible supervision and management;
- [9] sole ownership of all of the stock in a corporation by one individual or the members of a family;
- [10] the use of the same office or business location;
- [11] the employment of the same employees and/or attorney;
- [12] the failure to adequately capitalize a corporation;
- [13] the total absence of corporate assets and undercapitalization;
- [14] the use of a corporation as a mere shell, instrumentality or conduit for a single venture or the business of an individual or another corporation;
- [15] the concealment and misrepresentation of the identity of the responsible ownership, management and financial interest, or concealment of personal business activities;
- [16] the disregard of legal formalities and the failure to maintain arm's length relationships among related entities;
- [17] the use of the corporate entity to procure labor, services or merchandise for another person or entity;
- [18] the diversion of assets from a corporation by or to a stockholder or other person or entity, to the detriment of creditors, or the manipulation of assets and liabilities between entities so as to concentrate the assets in one and the liabilities in another;
- [19] the contracting with another with intent to avoid performance by use of a corporate entity as a shield against personal liability, or the use of a corporation as a subterfuge of illegal transactions; [20] and the formation and use of a corporation to transfer to it the existing liability of another person or entity.

Tort Cases

Walkovsky v. Carlton (Tort)

- Facts:
  - Carlton owned 10 corporations, each of which owned 2 heavily-mortgaged taxicabs that carried the legally-mandated minimum liability insurance.
  - All of the cabs operate out of the single garage
  - Carlton took $$ regularly
  - One of the cabs owned by Seon Corporations injured the tort victim, Walkovsky. W tries to pierce the corporate veil of Seon to get to Carlton's pockets
- Rule:
  - Court will only pierce the corporate veil "to prevent fraud or achieve equity" ...
  - Court uses the Alter-Ego Doctrine: (P) had to show that Carlton was actually doing biz in individual capacity w/o regard to formality
    - Shareholders must treat the corporation as the alter ego
- Holding:
  - W failed to plead a valid cause of action. We don't know enough based on the complaint... No allegations that Carlton was conducting biz in his individual capacity. Alleged that the separate entities were undercapitalized but didn't add specific evidence as to whether C was doing biz
  - W is being conclusory! Reversed w/ leave to amend
- Dissent:
  - Legislative intent – the minimum liability insurance of $10K isn't to shield individuals who organize corporations intending to shield those individuals who organized corporations

- 2 Options for Tort Victim here:
  - 1. Vertical Piercing (pockets of shareholder)
    - Seon = a dummy for the individual stockholders who are carrying on business for personal gain
    - Where a plaintiff succeeds with a vertical PCV theory, they can reach the shareholders' personal assets.

        - 2. Horizontal Piercing / Enterprise Liability (pockets of affiliated company)
            - Seon = subsidiary of a larger corporation
            - Enterprise liability holds the larger corporate entity financially responsible. Depends on proof that the separate identities of the corporations were not respected. If successful under this theory, the plaintiff could recover from the other corporations but not from the shareholders.

    - *It's not improper to incorporate business for the express purpose of avoiding personal liability
        - This is the part of the deal of what you get when you incorporate

    - It's not improper to split a single biz enterprise into multiple corporations so as to limit the liability exposure of each part of he business?
        - <u>Southern-Gulf Marine</u>: Buyer incorporated to hold the asset and buy boat.
        - Not necessarily improper but look at the facts. In certain circumstances, courts will say that this privilege has been abused.
        - Asset partitioning → conserves the monitoring costs of lenders
            - [EX] A borrowed from different banks to invest in 3 different businesses. By using 3 separate corporations, A allows the banks to worry less about the other corporations. There is some efficiency in structuring this way.

<u>Radaszewski v. Telecom Corp</u> (Tort)

- Facts
    - P got into a motorcycle accident w/ truck driver (employee of Contrux)
    - Contrux = subsidiary of Telecom (parent corp)
    - C had insurance ($1 Mil basic, $10 Mil. excess coverage)
- Rule
    - To pierce corporate veil, (1) Parent must have complete domination of subsidiary (2) such control = used to commit fraud/wrong – undercapitalization (3) control proximately causing P's injury
- Holding
    - Fails prong #2
        - They had insurance and insurance counts toward whether the corporation was undercapitalized.
        - No evidence that they knew that the insurance was going to become insolvent and not available to meet the demands of plaintiffs
        - Doctrine of limited liabilities exists to protect a parent corporation to shield itself from liability in cases just like this. We shouldn't hold parent companies liable simply due to errors of business judgment (e.g., choosing insurance company)
- Dissent
    - Dissenting judge would have remanded case for new trial. Reasoning: why else would a corp. purchase insurance from an insolvent corporation? Cheap way to meet the standards of federal regulations

Contract cases

- Voluntary, and parties can try to ascertain whether there is a recourse corporation and have the opportunity to bargain for a risk premium, a shareholder guarantee, restrictions... etc.

<u>Freeman v. Complex Computing Co.</u> (contracts)

- Facts
    - Glazier co-developed computer software and asked for Columbia U for license for the software.
    - Columbia U licensed to C3 (C3 hired G as an independent contractor, and given an option to buy all of C3's stock).
    - Freeman = sales rep for C3; Glazier = hired by Thompson and bought C3
    - Freeman sues C3 → Glazier for unpaid contract terms
- Rule:
    - Equitable Ownership: If you are exercising enough control over the corporation, you'll be deemed an equitable owner
- Holding:
    - Doesn't matter if you're not even a shareholder, director officer. You're an equitable owner.

        - But no finding of fraud/wrongdoing yet. Remanded for further proceedings
    - Reasoning:
        - Did not have any board meeting minutes
        - President never attended a board meeting
        - Vast majority of funds were going directly back to own bank account

Theberge v. Darbro, Inc. (contracts)
- Facts
- Appeal: Reversed on appeal. No piercing the veil! Context of contractual dispute – more stringent standards apply
- Didn't do anything wrongful and didn't formally do a personal guarantee.

Enterprise Liability – Piercing in Corporate Groups
- PCV claim could arise where there is a parent-subsidiary situation or where there is a corporate group with a parent and multiple subsidiaries that are affiliates of each other (i.e. vertical or horizontal piercing).
- Case illustrations:
    - *Gardemal v. Westin Hotel Co.*
    - *OTR Assocs. v. IBC Services, Inc.*

Gardemal v. Westin Hotel Co.
- FACTS: Wife and husband are on vacation and husband dies while snorkeling.
- No evidence that the parent company so dominated the subsidiary that it could be considered the same business → no piercing the corporate veil
- Nothing shady, all normal business practices b/t a subsidiary and parent corporation
- There are connections through stock ownership, financial arrangements, etc.
- Westin was operating as its own separate entity. Had its own capital, insurance etc.

OTR Assocs. v. IBC Services, Inc.
- Blimpie (parent), IBC Services Inc. (subsidiary formed just for hold a lease)
- Can OTR pierce the corporate veil of IBC to get to Blimplie's pockets?
- YES. There was domination and control of Blimpie over IBC and Blimpie had abused the privilege of corporation to abuse / commit fraud
    - IBC didn't have a business on its own, other than its purpose of holding that lease
    - Did Blimplie use IBC for fraud? Yes b/c the plaintiff was led to believe that it was dealing with Blimpie
- RULE: The corporate veil of a parent corporation may be pierced if the parent: (1) dominates and controls the subsidiary and (2) abuses the privilege of incorporation by using the subsidiary to commit a fraud or injustice.
- REASONING: Here, Blimpie created IBC for the purpose of insulating Blimpie from liability on the lease if the franchisee defaulted. Such purpose was fraudulent and improper. Therefore, the corporate veil was properly pierced. The judgment is affirmed.

Wrap-ups/Review
- What does "limited liability" mean in the context of corporations?
    - **Limited liability** = shareholders don't have personal liability for the liabilities and debts of the corporation
    - When you're forming a corporation, you're creating a separate legal entity, meaning that the shareholders lose only what they invested in stock
- As a policy matter, why might one be more concerned about the impact of limited liability on tort claimants than on contract creditors?
    - Contracts – more informed and higher bargaining power
- What rationales support the policy of limited liability?
    - Promote risk taking and business
    - Liquidity in stock (how we would deal with that logistically)
- We studied the doctrine of PCV, an exception to the general rule of limited liability. States vary in their statement of the test for PCV. Can you state a boiled-down version that sums it up?
    - See above.

[**CORPORATIONS**] – FIDUCIARY DUTY OF CARE + BIZ JUDGMENT RULE

Brief Intro into Fiduciary Duties

- Directors are fiduciaries that shall act in good faith and with conduct reasonably believed to be in the best interests of the corporation.
- They owe a [1] **duty of care** (DOC) and [2] a **duty of loyalty** (DOL) (which includes a duty of good faith) to the corporation and its shareholders.
- Stemming from these duties, directors also have a **duty of disclosure** (aka, a duty of candor).
    - When directors seek shareholder approval, they need to fully, fairly and truthfully disclose all information relevant to the decision making process

Duty of Care

- In General – the duty of care (DOC) requires directors to use the *amount of care* and skill that a *reasonably prudent person would reasonably be expected to* exercise in a like position and under similar circumstances.
    - This is a judge-made doctrine (it's not in the DGCL)
    - In some states, they've put it in their law
    - Breach of duty of care = very rare. Director's conduct must be *egregious* to find liability. Directors very rarely pay out of pocket for the breach of duty of care.
        - Why? B/c courts universally recognize that directors are presumptively are not liable for breach of duty of care when using business judgment

- **MBCA § 8.30(b)** – "Standard of Conduct" (Aspirational)
    - When becoming informed in connection with their decision-making function or devoting attention to their oversight function, [directors] shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under the circumstances."

- **MBCA § 8.31** – "Standard of Liability"
  *Where legal liability may arise if the corp. suffers losses from their breach of duty
    - A director shall not be liable to the corporation or its shareholders unless the challenging party establishes (1) a **corporate charter indemnification** or **cleansing** does not preclude liability; and (2) the conduct was the result of **lack of good faith**; **lack of belief** acting in best interest of corporation; **not being informed**; **lack of independence** (DOL); or **failure to devote ongoing attention** to oversight, or **devote timely attention** when particular facts arise.

BJR (Business Judgment Rule) – In General

- Generally, for *ordinary business decisions*, the relevant fiduciary duty is the duty of care. ***But*** directors are entitled to the protections of the "**business judgment rule**" (BJR).
    - BJR is a presumption that the business decision was made in good faith, in an informed way, in the best interest of the corporation
    - The BJR presumes that the directors' decisions were made "on an informed basis, in good faith and on an honest belief that the action is in the best interest of the corporation."

- When the BJR applies, it is the plaintiff's burden to rebut the presumption (and establish that losses were proximately caused because of the breach).
    - Plaintiff needs to plead facts to show that it wasn't an informed decision / made in good faith
    - Merely asserting that the decision turned out badly doesn't state a cause of action

- Because of the BJR, **courts generally will not second-guess** directors' decisions.
    - The inquiry for the DOC is largely about whether the process that generated the relevant business decisions was unsound
    - e.g., did directors fail to inform themselves before making a decision?

- There is an outer limit or exception to the BJR for substantively egregious decisions:
    - 1. Where there is **no rational business purpose** or what is known as "**corporate waste**."
        - **Waste** = transactions that are so one-sided that no person of sound business judgment could've received adequate consideration / would've done it. Corporate waste claims are exceedingly rare

        - [**<u>EX</u>**] Issuing stock for no consideration
    - 2. **Non-feasance** situations (failure to perform minimal levels of oversight or making a decision at all).

- Policy rationales for the BJR?
    - Boards are better equipped to make business judgments than judges
    - Board has access to information
    - Encourages risk taking – it would chill actions of the board
    - Law shouldn't provide incentives for overly cautious decision making
    - Avoids wasting judicial resources. Everything a business decision goes bad, a shareholder will sue... this would clog up the courts. This also wastes corporation time.

<u>2 Views of BJR</u>
- 1. As an abstention doctrine
    - A judicial "hands off" philosophy or presumption against judicial review of DOC claims.
    - The court abstains from reviewing the substantive merits of the directors' conduct unless the plaintiff can rebut the BJR.
    - Unless the plaintiff can plead facts that the judgment was not informed/in good faith → we can't do anything

- 2. As a standard of review, essentially raising the bar (e.g., from negligence to gross negligence or recklessness).
    - Plaintiffs have to plead more than the fact that the decision turned out to be bad
    - The standard in Van Gorkom was "gross negligence" – no liability unless grossly negligent

<u>The Business Judgment Rule</u>:
When a board decision is challenged, the burden is on the plaintiff to overcome the BJR by proving either:
1. Fraud, bad faith, illegality, or a conflict of interest (DOL)
2. Failure to become informed in decision-making
    a. Focus on process; liability generally based on gross negligence; e.g., *Van Gorkom*
3. Failure to establish a modicum of oversight of the corporation's activities
    a. E.g., *Francis*; *cf.* recent good faith cases regarding oversight, DOL); or
4. Waste (lack of a rational business purpose)

<u>Note</u>:
- *Reliance on Experts
    - In discharging the DOC, directors are encouraged to seek information and advice from officers, employees, as well as outside experts, such as investment bankers, attorneys, and accountants.
        - Experts should be selected w/ reasonable care... their independence should be evaluated, their expertise should be in the area that they are being sought information for
        - Directors shouldn't blindly bind themselves to expert findings
    - Under **DGCL § 141(e)**, directors are entitled to rely on opinions and reports so long as such reliance is reasonable and in good faith.
- In general, **officers owe the same fiduciary duties as directors**.
    - But... There is currently some uncertainty in the law as to whether the same standards (as the directors) apply, however, and there are a few other notes to make about differences, so we'll come back to addressing officers' duties at the end.
- We'll also later discuss how sometimes certain shareholders can owe fiduciary duties.

<u>Kamin v. American Express</u>
- FACTS
    - (D)s = 2 minority shareholders of Amex. Amex acquired DLJ's common stock for $29.9 million but the stock decreased in price to $4Mil.
    - If Amex SOLD the stock → reduce income tax, but would hurt the Amex stock (b/c it looks like their income is low)
    - If Amex DISTRIBUTED the stock as dividends → the stock price wouldn't suffer but no tax benefit (b/c income statement wouldn't be affected)
    - Board of Directors decided to distribute DLJ stock as dividends.

- ISSUE
  - Can the shareholder (P)s compel the Board to rescind the dividend and sell the shares through a court order?
- HOLDING
  - NO. Held for the Board. Didn't breach its duty of care. Board had a special meeting and the BJR applied.
  - Standard? Question of whether or not a dividend should be declared is exclusively a choice for the board members unless the P suggests that the power were used for some illegal, fraudulent, dishonest, or shows that the D directors were acting in bad faith.
- A better decision would've been to take the loss at the corporate level and tax cut. The court still said that even though it wasn't the "best" decision, BJR still applies
- **TAKEAWAY**: Illustrates that the duty of care req for a rational basis doesn't require that the board make the best or most rational decision. Just must be rational, informed, and not wasteful.

Shlensky v. Wrigley
- FACTS
  - Plaintiff shareholder of Chicago Nat'l League Ball Club (owns the Chicago Cubs) sued the director of the club for refusing to install lights for night baseball. Other teams had higher attendance b/c they played at night; the Cubs were losing money.
  - (D) directors refused b/c he was worried that night baseball would be detrimental to the surrounding neighborhood
- HOLDING
  - Directors = entitled to a BJR protection
  - Court will not overrule a business decision made by (D) absent showing of either fraud, illegality or a conflict of interest.
- Rational Basis Test? If there's any rational reason ... then BJR applies and that's it.
- Wrigley didn't have to show that the decision would've benefited the shareholders
- Aftermath – the new owner did install lights

Smith v. Van Gorkom
- Plaintiffs: Shareholders, class action of Trans Union
- Defendants:
  - Jerome W. Van Gorkom – Chairman and CEO of Trans Union, and other board members
- The whole company was being sold, the stakes involves are much higher... and it was selling share for cash
- Action being challenged:
  - Directors' agreement to approve the sale
- Legal Cali:
  - Breach of the fiduciary duty of care
- FACTS
  - The directors of TransUnion wanted to sell the company through a leveraged buyout to the Marmon Group (controlled by Jay Pritzker) @ $55/share.
    - TransUnion = natural candidate for acquisition (it had tax credits that the company couldn't use but another company could use... and also had cash on hand)
    - Leveraged Buyout = where you have an acquisition of all of the company's outstanding shares using funds secured by the assets of the company being acquired
    - Management Buyout = the people who do that are the managers... Shifts the capital structure toward more debt b/c you bought all the outstanding shares using debt. All the public stock being sold is now going to be at the hands of the company achieving the leveraged buyout
    - CFO says it would be good to buy $55/share (it's valued at $38 on New York Stockexchange – this is a minority shareholder)
      - at $55, you get control of the company! So you pay a "control premium" and pay more money to get control of the company
    - Negotiation b/t TU and Marmon for the price of $55 ... If you can get a loan to buy the company for $55/share, you'll have paid it off in 5 years!
    - Pritzker said he wanted to buy 1.75 million shares of the company at $55 so that TU won't shop around to different places
  - Directors had a duty to:

        - Inform themselves of all material information reasonably available to them" before making a decision
    - Plaintiffs have the burden of proof on this issue
        - Must prove "gross negligence" that the directors were *grossly negligent* in failing to inform themselves of all information reasonably available to them
        - Does the court review the substance of the decision? NO. The process issue...
        - Why didn't 141(e) apply here? It wasn't actually a report as defined in the statute. The person who gave you the report was uninformed. The board has a duty of inquiry. You weren't reasonable on your reliance.
        - Court rules that the Ds breached their duty of care
    - Directors very rarely lose on these grounds
    - What steps should boards take in order to avoid liability for effective decision making?
        - This case is amazing as guidance.
        - Don't do it in two hours. Know what the agenda is before hand. Circulate board books beforehand. Get a fairness decision/opinion (lawyer/business banker third party should research whether this deal is fair). Get all the lawyers and business ppl to opine as to how much the stock is worth. etc. etc. all the things that went wrong – do the opposite!
        - Also, get a real market check!
            - B/c of the deal terms, they couldn't shop around. Restricted themselves from getting a market test
    - Company was deprived of the decision process. Shareholder vote to cleanse/cure that problem – the shareholders would've had to been informed of these
    - It's the Plaintiff who bears the burden and a presumption of the BJR
    - Directors can rely on 141E(e) – but only applies on good faith reliance
    - DISSENT
        - The decision to sell the company in an all cash acquisition would've caused the shareholders to no longer have a share in the company. With that huge magnitude decision the board used this really sloppy process. The majority says there has to be a limit to this... even w/ the standard of gross negligence being the bar.

<u>Aftermath of ***Smith v. Van Gorkom***</u>

- D&O insurance rates began to skyrocket
    - PPl were really nervous about having to pay out of pocket → insurance rates began to skyrocket. If you're not insured, didn't want to sit on the board

- ***DGCL §102(b)(7)** – A corporation may include in its charter ... a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for **<u>monetary</u> damages** for **breach of fiduciary duty as a <u>director</u>**, provided that such provision shall **not eliminate** or limit the liability of a director:
    1. For any breach of the director's **duty of loyalty** to the corporation or its stockholders;
    2. For acts or omissions not in **good faith** or which involve **intentional misconduct** or a knowing violation of law; … or
    3. For any transaction from which the director derived an **improper personal benefit**.
- It put into the corporate code a provision that allows a company to choose to basically exculpate directors from certain kinds of liability
- If the company so chooses (amend certificate w/ certificate) directors will not have personal liability for money damages, as long as they don't breach their duty of care. Nowadays, it's extremely rare to find directors personally liable. All of the states, after DE did this

<u>Wrap-Up / Review</u>
- What was the challenged board decision in *Kamin v. American Express*? What did the court rule and why?
    - The board decided to disperse stock to shareholders as a dividend instead of taking a tax benefit, because they didn't want to declare a $25 million dollar loss
    - The court dismissed the case because in the absence of fraud, the decision receives the protection of the BJR

- Same questions as to *Wrigley v. Shlensky*…?

  - Wrigley and the board did not want to install lights to have night games even though all other baseball teams were holding night games. Wrigley didn't like night games but the board was also concerned about the neighborhood.
  - The court ruled that they did not breach their duty of care and affirmed dismissal of the suit because it was a clear exercise of business judgment.
    - BJR applies and plaintiffs failed to rebut it.

- In *Van Gorkom*, what standard did the court apply in concluding that the directors breached their duty of care? Who had the burden of proof on that issue?
  - Standard = gross negligence. Price was based on a rough estimation and did not seek expert opinion. Board members relied on Van Gorkom's 20 minute presentation and Van Gorkom himself hadn't read the K. No real crisis or emergency to justify how quickly the board made this decision.
  - Burden was on the shareholder plaintiffs

- Post-*Van Gorkom*, what would you advise directors in similar circumstances to do to avoid breaching their fiduciary duty of care?
  - Get a fairness opinion/report (opinion by an expert, paid by the board) and have a meeting where documents are circulated beforehand so that the directors can inform themselves and prepare questions. Also, block off a sufficient amount of time for substantial deliberations and questioning.

- What does **DGCL § 102(b)(7)** provide? **(need to know the number of the provision)**
  - It allows a corporation it eliminate or limit the liability (from monetary damages) of a director to the corporation or its stockholders for breach of fiduciary duty as long as its not the duty of loyalty or acts that are not in good faith, involve intentional misconduct, or a transaction in which the director derived an improper personal benefit.
  - Must be in the certificate: directors, monetary damages, duty of care, blah di blah.

- Bananas Corporation has been earning record revenues from its popular gadgets and has accumulated an uncommonly large amount of retained earnings. The board of directors of Bananas Corporation discusses what should be done with this money and considers declaring a stock repurchase or a dividend. The board decides to do nothing for now and to revisit the issue at the next board meeting.
  - Is this protected by the BJR? Yes. Making an informed decision, to not take an action, is still a decision entitled to BJR.

A Very Brief intro to Fiduciary Duties

- Directors are fiduciaries that shall act in good faith and with conduct reasonably believed to be in the best interests of the corporation.
- They owe a **duty of care** (DOC) and a **duty of loyalty** (DOL) (which includes a duty of good faith as a subset) to the corporation and its shareholders.
- Stemming from these duties, directors also have a duty of disclosure (aka, a duty of candor).

Duty of Care

- **Duty of care (DOC)** = requires directors to use the amount of care and skill that a reasonably prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

The BJR

- When a board decision is challenged, the burden is on the plaintiff to overcome the BJR by proving either:
- (1) Fraud, bad faith, illegality, or a conflict of interest (DOL);
- (2) Failure to become informed in decisionmaking (focus on process; liability generally based on gross negligence; e.g., *Van Gorkom*);
- (3) Failure to establish a modicum of oversight of the corporation's activities (e.g., *Francis*; *cf.* recent good faith cases regarding oversight, DOL); or
- (4) The lack of a rational business purpose (or "waste").

[**CORPORATIONS**] – CORPORATE PURPOSE, SOCIAL RESPONSIBILITY, CHARITABLE GIVING AND POITICAL ACTIVITY

PURPOSE

Questions:

- What does the law of fiduciary duty require directors to have as their goal?
- To whom should the directors owe their duties?
- What is the directors' duty to shareholders?
- What about social responsibilities to other stakeholders?

SOCIAL RESPONSIBILITY

Dodge v. Ford Motor Co.

- FACTS
  - Ford was making a crazy amount of money and the few shareholders were giving out millions of dollars worth of dividends and still sitting on $50 mil cash. Ford decided that the company was not giving special dividends and use the money to expand the plant and cut the price of cars
- HOLDING
  - Must pay dividends? YES
    - "A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits or to the non-distribution of profits among stockholders in order to devote them to other purposes."
    - The refusal to issue dividends was "arbitrary" and not in "good faith." Primary reason was humanitarian. Doubling employee wages, lowering price of cars... We can't even get out of making profits! This decision was not in good faith.
  - Enjoining the building of the plant? NO
    - B/c there's a legitimate rationale for expanding the business. There wasn't clear testimony that suggested that it wasn't for a business decision.
    - Build more cars, lower costs of production etc.
    - Applies the business judgment rule here and upholds the discretion of the directors
- Henry Ford's testimony was that he was running the corporation almost as a charitable, non-profit organization. Courts won't do so if the refusal to pay dividends was arbitrary and not in good faith.
- CLASS NOTES:
  - This case is a little odd; not paying dividends *is* a business decision, although courts will generally defer to a board's business decision, it will not do so if the refusal to issue dividends is arbitrary/not in good faith. Ford's testimony seemed like he was running the company as a charitable organization rather than a profit-making corporation, so BJR did apply, but the court believed that his decision re: dividends was arbitrary/not in good faith.
  - If he would have made different statements during his testimony, the court would have probably applied BJR in his favor.

Note: "Constituency Statutes"

- A majority of states have "constituency" statutes that expressly allow (but do not require) a corporation to consider stakeholders' and other constituencies' interests alongside shareholders' interests.
  - Statute says "may consider" → permissive

    - Companies that are incorporated in states w/ constituency statutes to consider the interest of the employees / constituents in making decisions
- DE and CA do not have constituency statutes.

CORPORATE CHARITABLE GIVING

- All 50 states have statutes providing for corporate authority to make charitable contributions.
- There are different formulations.
- We'll look at DE and CA.

Delaware Corporate Law Statute on Corporate Charitable Donations

- **DGCL § 122 (9)** – "Every corporation created under this chapter shall have power to: . . . **Make donations for the public welfare** or for **charitable**, scientific or educational **purposes**, and **in time of war** or other national emergency in aid thereof;"
- *Note the language of the DGCL doesn't expressly dispense with the requirement of a corporate benefit.
- Only refers to the POWER of the corporations to do this. It doesn't address whether this is supposed to benefit the corporation in some way or another

California Corporate Law Statute on Corporate Charitable Donations

- **California Corporations Code § 207:**
    - "Subject to any limitations contained in the articles and to compliance with other provisions of this division and any other applicable laws, a corporation shall have all of the powers of a natural person in carrying out its business activities, including, without limitation, the power to: . . ."
    - "(e) Make donations, regardless of specific corporate benefit, for the public welfare or for community fund, hospital, charitable, educational, scientific, civic, or similar purposes."
- *They have the POWER to do it, regardless of specific corporate benefit (unclear as to what exactly is "specific corporate benefit"
- The donation still can be challenge and subject to judicial review, where the court will apply a standard

Theodora Holding Corp. v. Henderson

- FACTS
    - Girard = controlling shareholder of AD Inc, wanted corporation to donate to a charity he founded. Ex-wife's daughter (who was sitting on an AD board) opposed → he got rid of her → ex-wife shareholder sued for breach of duty of care
- RULE:
    - Test the court uses: If it's REASONABLE, then BJR (it's within the director's discretion)
- HOLDING
    - It was only a small percentage of the company earnings → it seems reasonable
    - The small loss in immediate income (but reduce tax) outweighed the benefit of giving rehab + education to young people in need (this is good!)
- Corporate Charitable Donations
    - The most eloquent and elucidating opinion on corporate charitable contributions is in *A. P. Smith Manufacturing Company v. Barlow.*
        - At issue was the propriety of a $1500 gift to the trustees of Princeton University. The plaintiff shareholder challenged the gift as a waste of corporate assets since it resulted in no direct economic benefit to the corporation.
    - Corporation's Justifications: (1) Fosters good will; (2) Provides properly trained employees; (3) acknowledgment of corporate responsibility; and (4) Capitalism depends on well educated employees

    - Holding - The court first traced the history of corporations, concluding that the corporate entity has always had a role to play as a responsible societal member. The court validated the gift not only as a donation to society but also as in furtherance of the free enterprise system on which the corporation's success was dependent.
        - *Can't be a pet charity (giving to yourself, or your sister)
    - The Barlow case is especially significant because it upheld the gift as a matter of common law. The holding has won legislative confirmation as evidence by the Model Business Corporation Act's express recognition of the corporate power "[t]o make donations for the public welfare or for charitable, scientific or educational purpose. Even under such express statutory authority, however, charitable gifts are subject to challenge if *clearly unconnected to the corporation's present or prospective welfare*.
- The Delaware counterpart of the Model Business Corporation Act's provision was scrutinized in *Theodora Holding Corporation v. Henderson*, wherein a shareholder challenged a corporate charitable contribution in excess of $525,000. The Delaware Court of Chancery upheld the validity of the contribution, relying on both the state corporation statute and the parameters of permissible charitable deductions as established by the federal tax code. In a more recent decision, the Delaware Supreme Court reaffirmed its view that reasonable charitable gifts are proper and that the tax code provides the guide of reasonableness. These guidelines in turn support giving corporate directors great leeway in making charitable contributions.

What is the purpose of a corporation?

- 1. Shareholder Primacy
    - Purpose = to maximize shareholders wealth. Fiduciary duties are owed to shareholders to serve that purpose.
    - The social responsibility of business = to increase profits Other constituents have their own contractual rights and other legal protections and we should look to those things when we're worried about sustainability / employees (should be regulated @ govn't level)
    - This idea gives a very clear set of guidelines for directors to make decisions. You can't always maximize multiple metrics.
    - Often uses a conceptual framework of thinking about shareholders as PRINCIPALS and directors as AGENTS.
        - All of corporate law is about trying to minimize agency costs
- 2. Stakeholder Theory
    - Think more broadly and take into account constituents (Community, shareholders, employees, customers etc.)
    - What do you do when there are competing interests?

Citizens United v. FEC

- Citizens United is a political advocacy non-profit group that made a movie called "Hillary" in 2008. The film was political advocacy against Hillary Clinton. CU was worried about this movie violating law prohibiting corporations from political speech w/in a certain time period before the primary election
    - Sought declaratory relief to say this campaign doesn't fall into 2 USC 441 (Tillman Act – prohibited corporations from spending treasury funds on campaign contributions advocating the election or defeat of a clearly identified candidate)
- Ruling = Corporations can make unlimited corporate expenditures.
- *Citizens United was NOT the first decision that recognized as having a right to political speech
    - Independent political expenditures = not coordinated w/ the candidate's campaign. Campaign contributions are still not allowed.
    - Corps of any type can give as much as they want to independent political expenditures that don't directly coordinate w/ candidates.
- Government says there are 3 reasons why this statute is constitutional:
    - 1. Anti-corruption – Contribution in exchange for favor to corporation
        - Majority response? NOPE. Independent expenditures aren't given directly to the candidate and asking for something. Not quid-pro-quo

- 2. Anti-distortion – Corporations spending money in politics distorts the national conversation. Corporations have limited liability to amass great amounts of money to distort the marketplace of ideas / public conversation
    - Majority response? Another individual may do that. There is no difference b/t an individual doing that vs. someone w/ a lot of money doing that.
    - If we buy this argument, that would allow Congress to ban media corporations ...
- 3. Shareholder protection – When a corporation gives money to spend on politics, some of the shareholders investing in the corporation will have their money used to support a candidate they don't support. There is no remedy!
    - Majority response? Then you can have a situation where a media corporation does this and get away with it
    - They have the procedures of corporate democracy! Fiduciary duties, shareholder derivative suits, etc.

- DISSENT
  - It's not about equalizing voices but understanding the need to confront of the distinctive corporate...who's even speaking when a corporation places an ad or endorses a candidate? Is anybody's expressive value truly impinged?
  - Anti-corruption. Undue influence is very corruptive ... citizens will get the impression that corporations dominate our democracy
  - The procedure of the corporate democracy don't work. Most people own stock through their 401Ks so they can't even sell their stock and leave the company at will.

Charitable contribution v. Independent Corporate Expenditure

- If a shareholder found out about a board decision about a political expenditure what standard would apply in reviewing that challenge?
  - It's an ordinary business decision. Under basic corporate law, it's treated the same as any other ordinary biz decision and receives BJR. Plaintiff needs to rebut that presumption.

Wrap-Up Questions:

- Can a corporation choose to offer only daytime baseball games? *Yes*
- Can a corporation give to charity? *Yes (some statutes says yes, regardless of corporate benefit) – as long as reasonable and it's not a pet charity in which there is a conflict of interest*
- Can a corporation retain earnings despite shareholder wishes otherwise? *Yes. In most cases, that's what happens*
- Can a corporation choose to make an independent political expenditure? *Yes. It's an ordinary business decision and enjoys the presumption of BJR*
- What are the underlying principles?
  -
- Does the law dictate a particular view of the objectives of management?

[**CORPORATIONS**] – FIDUCIARY DUTIES: THE DUTY OF LOYALTY

Overview of "Duty of Loyalty"

- Duty of care = about decision-making and implicates all the members of the board
- Duty of loyalty = misconduct by a single / few directors
- **RMBCA § 8.30(a)(2) –** Requires that directors and officers act "in a manner the director reasonably believes to be in the best interests of the corporation."
- We'll be studying DOL in the context of:
  – Interested Director Transactions (aka "self-dealing," "conflicts of interest")
  – Corporate Opportunities
  – Good Faith, which Delaware courts have recently classified as a subset of the DOL
  – Controlling Shareholders

INTERESTED DIRECTOR TRANSACTIONS

- Aka "Self-dealing" or "Conflict of Interest"
- Director's loyalty is divided b/t some kind of personal interest and the corporate interest
  - [**EX**] Direct - A director / officer contracts directly w/ the corporation. This is a conflict of interest.

- [**EX**] Indirect - A person/entity in which the director has an interest (spouse/family member or significant financial interest in that entity) has a transaction w/ the corporation
- @ Early common law, the corp/shareholders could void a conflicted interest K, regardless of the fairness of the K or approval by the board/shareholders
  - Less risk that a director would act adverse to corporation's interests
  - Downsides of this strict rule:
    - Small corporations need to take advantage of these transactions and this would deter the directors from engaging in these deals
      - If a director is willing to make a loan, why can't they do that?
      - If a director is willing to sell a piece of land that they need, why can't they do so?

Interested Director Statutes

- Modern Common Law Rule:
  - Transaction is upheld, so long as the director proves it was **fair** to the corporation (CA and DE)

- Statutes, in addition to modern common law rules:
  - **DGCL § 144** (and California has a similar provision under its corporate code, § 310).
  - The statute doesn't preempt common law, but instead overturns the old common law cases deeming conflicted interest transactions voidable per se and **provides a procedure by which to "cleanse" interested transactions.**

Bayer v. Beran

- *Fairness standard when it smells like conflict of interest (don't get presumption of BJR)
- FACTS
  - Company deals with Celanese, which is a product similar to rayon. Corporation doesn't want the two products to be labeled the same → sought advertising/marketing to make the distinction. One director (who is also the president) suggested an increase in the advertising budget to pursue a $1 mil radio campaign that will star his wife, Ms. Tennyson → Board approve
  - Board also approves an employment agreement for Ms. Tennyson's brother, Dr. Henri who is a co-founder of the technology behind the company's products. The agreement prevents him from working elsewhere.
  - Shareholders sued the board of directors—including the husband—for negligent, wasteful spending on advertising/radio. This is like self-dealing... there is a conflict of interest. Duty of loyalty claim!
- ISSUE
  - Did the board breach their fiduciary duty of loyalty by approving the radio deal and employee contract?
- RULE
  - Personal transactions of directors tend to produce a conflict b/t self-interested and fiduciary obligation are, when challenged, examined w/ the most scrupulous care
  - If there is any evidence of improvidence/oppression, any indication of unfairness/undue advantage... → transaction will be voided
- HOLDING
  - Defendants win. The deal was fair to the corporation, so even if there is a conflict of interest
- TAKEAWAY
  - W/ duty of CARE → BJR is automatically there.
  - W/ duty of LOYALTY → You don't start w/ the BJR.
    - In this claim, the **standard is "fairness"** – you don't start w/ BJR
    - **Plaintiff initially bears the burden of proving the conflict.**
    - **The burden then shifts to the defendant to show "FAIRNESS"**
      - Procedural fairness
        - They negotiated through her agent
        - They used a form contract
      - **Substantive fairness**
        - Cost paid was the industry standard (didn't pay more b/c she's the wife)

        - Cost v. Company Revenues (How much was the company spending on advertising? Does the amount suggest that they're using more money than necessary? No – they've spent lots of $ on advertising
        - This seemed to be a successful ad campaign!

__Remillard Brick Co. v. Remillard-Dandini Co.__ (CA CASE)

- *Just b/c transaction was disclosed+approved doesn't mean it's automatically validated.
- FACTS
    - 2 companies – one is a sales corporation and the other is a manufacturing company. Two majority shareholders and directors of the manufacturing corporation = also majority shareholders & directors of the sales corporation. They kept allowing the manufacturing company to also perform sales & contracts → stripping the sales corporation of its function. The profit made from sales are then transferred to the Sales Corp. The 2 shareholders stand on both sides of the deal.
- ISSUE
    - Did the board of directors breach their fiduciary duties?
- HOLDING
    - CA Interested Director Statute – Doesn't automatically validate a transaction simply b/c it was disclosed and approved by disinterested shareholders. Still OK to review
    - Yes – the BJR doesn't automatically validate a transaction b/c it was approved by a majority of the stockholders. A director cannot obtain an unfair advantage/profit @ the expense of the corporation.

__DE's Interested Director Statute__

- Interested transaction is not per se voidable

- **DGCL §144(a):**
    - An interested transaction **shall not be "void or voidable solely" b/c of the conflict** or "solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose," **provided at least 1 of 3 conditions are satisfied**

    - **DGCL §144(a)(1)**
        - **Approval by "a majority of the disinterested directors"** provided there has been **full disclosure** of the material facts relating to both the transaction and to the director's conflict of interest
            - Even if the disinterested directors = less than the quorum (the majority need not be present)
            - [**__EX__**] Corporation has 5 directors. 1 is interested. Leaves 4 disinterested. You'd need 3 of those disinterested board.
            - You have a board meeting and you inform them and you get it documented in the board of director meeting's minutes so that it goes in the corporate record.
    - **DGCL §144(a)(2)**
        - **Approval "in good faith by vote of the [disinterested] shareholders,"** with **full disclosure** of the material facts relating to both the transaction and to the director's conflict of interest
        - *Even though § 144(a)(2) doesn't say "disinterested" SH approval – that is what is required for § 144(a)(2) to have a cleansing effect.
    - **DGCL §144(a)(3)**
        - A transaction that is **"fair as to the corporation as of the time it is authorized**, approved or ratified, by the board of directors, a committee or the shareholders"
        - If there is some flaw by which (a)(1) or (a)(2) were not met, __then the defendants have the burden of showing that the transaction was fair.__

__Analysis/Effect of DGCL §144__

- Just need to satisfy 1 of 3 prongs
- What **standard of review** does the court reply? Need to look @ case law for that.
- Depending on the process, it may end up getting BJR or a stricter scrutiny.
    - **§ 144(a)(1) satisfied → BJR**

        - *BOT v. Benihana*
    - **§ 144 (a)(2) satisfied → BJR**
        - *Fliegler v. Lawrence* note (p. 615-616),
        - *Lewis v. Vogelstein*
        - *Harbor Finance Partners v. Huizenga*
    - **If not either (a)(1) or (a)(2) → you HAVE to satisfy (a)(3) w/ stricter scrutiny**
        - Fairness analysis illustrated by old case *Bayer v. Beran*

Remedies for an Improper Interested Director Transaction

1. Enjoining the transaction
2. If it's already happened → Setting aside the transaction
3. Damages

BOT v. Benihana

- FACTS
    - Due to financial problems, the directors of Benihana, Inc. decided to pursue a Renovation Program and needed to finance this. They hired an outside investment banker who said that the best option is to issue convertible stock to a potential buyer. The potential buyer = a company called BFC repped by one of the directors (Abdo). The director didn't disclose that he had negotiated this deal on behalf of BFC, but disclosed that the director was a principal of BFC. Benihana Tokyo owner disapproved this sale.
    - Abdo was on the board of Benihana but was also on the other side of the Benihana → source of conflict.
    - Cleansed transaction by getting the approval of the majority of the informed directors. This shifted the burden to the plaintiffs to overcome the BJR.
- ISSUE
    - Did the board breach its duty of loyalty by issuing this stock?
- HOLDING
    - No. The directors knew all the material facts of the director's relationship/interest and even if they didn't know that the director negotiated the deal on behalf of BFC, they knew by the time the approved it. Directors spent significant time in making their decision and the transaction was fair → it was covered by BJR.
- EFFECT of DGCL §144(a)(1) → BJR
    - The standard applied after the Defendant shows that they satisfied 144(a)(1) is BJR
    - If it's met, then BJR applies.

Fliegler v. Lawrence

- **DGCL §144(a)(2)** – Shareholder ratification
- This case establishes that this statutes means "disinterested" shareholders approval

Lewis v. Vogelstein

- **DGCL §144(a)(2)** – Shareholder ratification
- FACTS
    - Stock option compensation plan for the directors of Mattel, Inc. approved by the shareholders of the annual meeting. This was a clear interested transaction (the board of directors adopted a plan for their own compensation). Shareholders = informed of the material facts, uncoerced and they did.
- TAKEAWAY:
    - What does the court say is the effect of § 144(a)(2)?
        - In other words, under what standard will a court review a breach of DOL claim where there was "informed, uncoerced, disinterested SH ratification of a transaction in which corporate directors have a material conflict of ifnterest"?
    - This cleanses it. Shareholder ratification, under 144(a)(2) – if it's met, has the effect of shifting the burden of proof for the complaining party to show that the transaction was so unequal that is similar to waste.
    - Conflict of interest → Party shows that there was shareholder ratification → Burden shifts to opposing party to show that the transaction was equal to waste. If not, BJR.

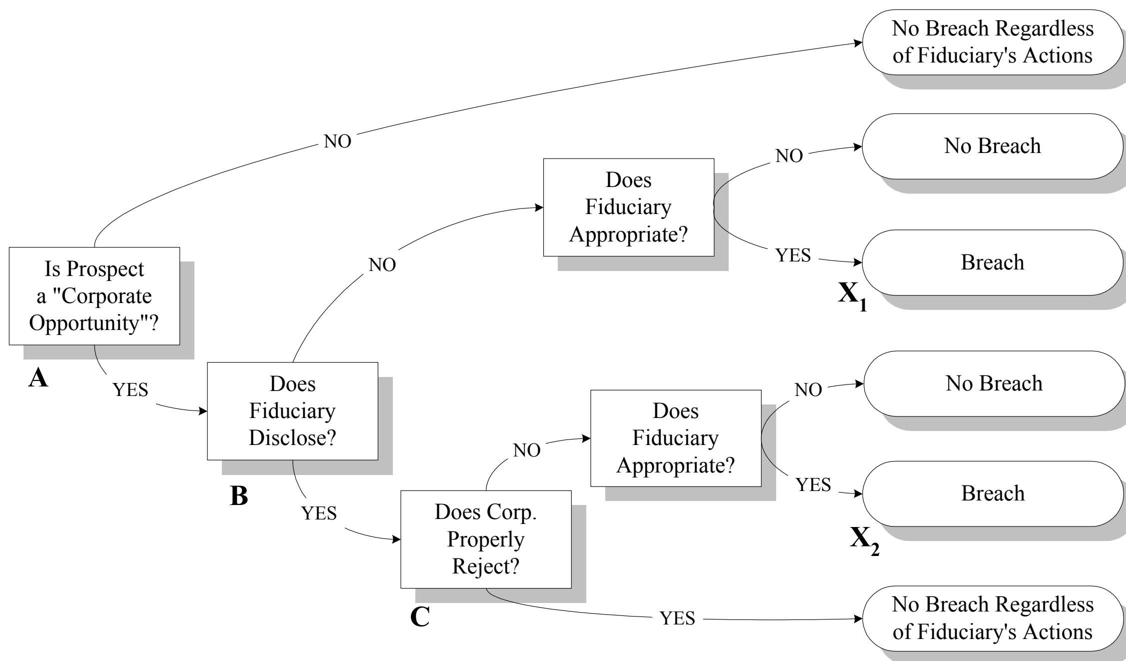
Harbor Finance Partners v. Huizeng

- **DGCL §144(a)(2)** – Shareholder ratification
- FACTS
    - Directors of Republic Industries owned a lot of stock in the company that it acquired. The complaining shareholders said that the terms were unfair and procured by a misleading statement. There was a conflict of interest and the disclosure that was made was flawed and you don't' get to count it as them having shareholder approval.
    - Should this case get dismissed for failure to state a claim?
- HOLDING
    - This is a duty of loyalty issue. The Defendant first has to show that it was cleansed in order for them to get BJR. Was it a fair, uncoerced and fully informed vote of the disinterested shareholders? It's hard to show at the pleading stage and it might need a trial...
    - If they succeeded, BJR!
    - Yes this was informed and coerced. 144(a)(2) was met and as a result, the BJR is invoked and the merge is only attacked if wasteful.
        - Admittedly, it's very difficult for a plaintiff to show that a fully informed, fair, and uncoerced decision amounted to waste (so one-sided that no ordinary person of business judgment would've done it). How would a plaintiff win at that point? It seems logically almost impossible.
        - However, a long line of case law shows that even this does not extinguish a case of waste. If you want to extinguish a waste claim, it has to be unanimous.

THE CORPORATE OPPORTUNITY DOCTRINE

- Corporate Opportunity Doctrine forbids a director, officer, or managerial employee from diverting to himself any biz opp. that "belongs" to a corporation
    - To apply this doctrine, one must balance corp's expansion potential and economic interests against corporate manager's personal entrepreneurial interests.
- Objective:
    - To deter appropriations of new business prospects "belonging to" the corporation
- Applies to...
    - Directors and officers of corporation
    - Dominant shareholders who take an active role in managing firm

Flowchart of a Corporate Opportunity Dispute



***Faber v. Servan Land Co.* (Skipped)**

- TAKEAWAY – What constitutes a corporate opportunity
- FACTS
  - Investors started a company called Servan Land Co to build and operate a golf course and country club. The company initially bought 160 acres of land an then an additional 20 acres from Farquahar.
  - 1968 annual SH meeting – a DR+SH said Farquahar was willing to sell another 160 acres of land abutting the golf course → SHs took no action
  - 1969 – Serianni and Savin (majority stock owners and principal officers of Servan) bought the 160 acres of land from Farquahar in their individual capacities
  - 1970 – SHs learned of the purchase; dispute as to whether the purchase was ratified
  - 1973 – Serianni and Savin sell tract and company assets to a 3rd party purchaser. Of the final sale price, $5 Mil → the corporation; $3.3 Mil → the individuals
  - Faber, one of the SHs sued, claiming that the purchase by Serianni and Savin was a taking of corporate opportunity and that he wanted an appraisal to determine whether the corporation should've received a larger portion of the sale price
- ISSUE
  - Court notes 4 issues:
    - 1. Did corporate opportunity exist?
    - 2. Did the SHs decline the opp. for failing to act?
    - 3. Did SHs ratify the purchase?
    - 4. Does the subsequent benefit rectify the wrong, if any?
- HOLDING
  - Corporation is entitled to the profits of Serianni and Savin's subsequent sale of the 160 acres.
  - Corp. Opp:
    - Corporate Opportunity = Business opp. in which the corp. has an interest for a "valid and significant corporate purpose.
      - The opp. need not be of "utmost importance" – just "fit into the present activities of the corp or fit into an established corp. policy which the opportunity would move forward"
    - YES b/c evidence;
      - SHs frequently discussed acquisition of land @ meetings
      - SHs discussed this particular matter at the last meeting
      - SHs indicated a "sense of approval"
      - Corporation needed the land on the perimeter of the course
      - Corp. had bought addt'l land from Farquhar in the past
  - Decline Opp?
    - Failure to vote to commit the funds to purchase the property does NOT indicate a decision to refrain from pursuing the opp.
    - SHs lacked specific info and it would've been illogical to make commitment of funds at the time

            - Serianni was the president and active director and his personal inaction cannot be used to show rejection of the opportunity
    - Ratification?
        - Can't rely on credibility of the corporate minutes
        - But even if the ratification vote did take place, it cannot prohibit Farber's derivative action b/c FL courts have not indicated whether SHs are capable of ratifying a director/ officer's breach of fiduciary duty.
            - Plus, Serianni and Savin constituted a majority of the votes and their votes cannot be counted toward ratifying their own inappropriate acts

<u>DE's Factors/Balancing Test to Determine if Corporate Opportunity</u>

1. Is corporation **financially able** to take the opportunity?
2. Is the opportunity in the corporation's **line of business** (now or reasonable in the future)?
3. Does the corporation have an **interest or expectancy** in the opportunity?
    - Interest – something in which the company already has a right in. [EX] When an officer bought land to which the corporation had al
    - In which in the ordinary course of things, the corporation would've gotten it. [EX] When officer took renewal rights, the corporation had an expectancy to believe that if a renewal came up, they would get it. Or if an officer took a contract with the corporation's long time customer.
4. Would taking the opportunity **result in a conflict between the director's self-interest** and that of the corporation?

- *If result of balancing test is that it is not a corp opportunity, then director can pursue it without offering it to the corporation first.
- ***<u>Note</u>:** variations on this balancing test exist (see casebook pages 651-655). The corp. opportunity doctrine requires a particularized analysis of the circumstances.

<u>Broz v. Cellular Information Systems, Inc. (CIS)</u>

- Illustration/application of DE's balancing test of corporate opportunity – who's opportunity *is it?!*
- FACTS
    - RFBC and CIS were competitors in the cellular service business.
    - Broz was the Prez and sole stockholder of RFBC; he was also a director of CIS
    - Broz was contacted by a 3rd party, Mackinac, for RFBC's possible purchase of a license to Michigan-2. CIS was not being considered by Mackinac at the time b/c of its recent financial troubles and the fact that CIS had been divesting itself of licenses.
    - Broz spoke with CIS's CEO who told him that CIS was not interested in Michigan-02. He also contacted another CIS director who also indicated that CIS had neither the resources nor the inclination to purchase the license.
    - PriCellular was undergoing an acquisition of CIS which was delayed due to financing difficulties. Meanwhile, PriCellular obtained an option to purchase the Michigan-2 license from (M), under the condition that the option was not transferable to any party other than a PriCellular subsidiary and that (M) was free to sell to another party willing to exceed the exercise price by at least $500K.
    - Broz, on behalf of RFBC, offered $7.2 mil and the license went to RFBC b/c it exceeded PriCellular's exercise price.
- HOLDING/REASONING
    - Broz did not breach his fiduciary duties to CIS in usurping a corporate opportunity.
    - CIS was not financially able to undertake this opportunity – had just declared bankruptcy
    - Although this was in the line of CIS's business, CIS did not have an interest/expectancy in the license b/c CIS was actively engaged in the process of divesting its cellular license holdings
    - Broz is not required to formally present the matter to the CIS board – if the director or officer believes that the corp. is not entitled to the opportunity, he may take it for himself.
    - Broz is also under no duty to consider PriCelluar's interests b/c at that time, it had not yet acquired CIS.
- [**<u>HYPO</u>**] RFBC and CIS both have interest in Michigan-2. What should Broz do?
    - Present the offer to both parties
    - Recuse himself from one company or even resign.
- [**<u>HYPO</u>**] Broz was an officer and director of CIS.

- In the case, Broz was an outside director. The capacity in which he learned of the M-2 license was as a RFBC director.
- Outside v. inside director doesn't come up in the 4-factor test but it's indicative of whether the way the person heard of the opportunity was through the corporation or as an individual... If they came to him as an inside director – it makes his case less viable b/c it makes it more likely that (M) came to him as a rep of CIS. This is relevant but not dispositive.

In re eBay, Inc. Shareholder Litigation

- eBay hired Goldman Sachs to handle its shares.
- Investment bank was flipping IPO shares. Goldman Sachs allocated IPO shares to their "friends" who were directors+officers of Ebay.
  - There was great value in being able to access initial public offerings in high tech shares (bankers choose the initial price based on what they think the market will bear).
  - IPOs are generally under-priced so that the price will shoot up in the first day.
  - Investment banks have the ability to allocate shares to their customers.
- Did these directors take a corporate opportunity in the profits they made on their Ebay stock?
  - Yes – this was a corporate opportunity
  - Ebay did have a business of investing
  - This opportunity came to these people because of their corporate office (This was like a bribe for these officers to keep using Goldman Sachs).

DGCL 122(17)

"Every corporation created under this chapter shall have the power to…**Renounce**, in its certificate of incorporation or by action of its board of directors, **any interest or expectancy of the corporation in**, or in being offered **an opportuni**ty to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or one or more of its officers, directors or stockholders."

- ^ DE amended the corporate statute to allow specific carve-outs / categories that will not constitute corporate opportunity.

BOARD OF DIRECTORS' DUTY OF OVERSIGHT / DUTY OF CARE IN NON-FEASANCE

Francis v. United Jersey Bank

*This case illustrates a "duty of care" claim where BJR does not apply. And how non-feasance or lack of oversight can plead as a duty of care claim or lack of good faith.

- FACTS
  - P&B = reinsurance broker (arranged Ks b/t insurance companies and reinsurance companies & earned profits from commission)
  - One dominant director, Charles Pritchard stepped down from his position and his two sons took over. When he died, his wife, Mrs. Pritchard also became P&B's director.
  - Sons began taking personal loans out of the company's account until it became bankrupt.
  - The trustees and the bank sued Mrs. Pritchard for breaching her duty to her clients as a director, proximately causing their losses
- ISSUE
  - Can Mrs. P be held liable even though she was old and sick? No b/c she was still competent to act and she never made the effort to discharge her responsibilities as a director of P&B
  - Did Mrs. P breach her duty of oversight? Yes
- RULE
  - What a reasonable person would do if they understand that there is a duty to oversight
  - As a general rule, a director should acquire **at least a rudimentary understanding of the corporation's business**. If he has insufficient experience, he should either acquire the knowledge or refuse to act.
  - Directors are under a continuing obligation to keep informed about the activities of the corporation.
    - This does not require a detailed inspection of day-to-day activities, but a general monitoring, attending board meeting regularly (not every day but as a matter of practice – depending on the type of business), maintain familiarity w/ corporation's financial status
  - Sometimes requires even more than oversight/resignation:

        - Take reasonable means to prevent illegal conduct by co-directs, etc.
        - Investigate/check other possible wrongdoings of other co-directs if there's a red flag or some suspicion...
        - If no reasonable suspicion, then the director can just reply on the directors...
    - *"Dummy director" is not a defense.
- HOLDING/REASONING
    - 1. Duty of care issue, BJR doesn't apply here.
        - *Why doesn't BJR apply here? Because it was non-feasance. No active decision to do/not do something. IT doesn't apply where there's just a complete failure to do ANYTHING.
        - BJR didn't apply. Apply reasonable person standard. Once it determines the breach, it asks whether the breach is the proximate cause of the injury. You have to make a Business Judgment in order to have BJR apply!

    - 2. Applies the <u>reasonable person standard</u> to determine breach.
        - She didn't act as a reasonable person in the normal course of business... all she would've had to do was look at the numbers and ask "why is there a $10mil loan when we're supposed to be holding the money in trust?"
        - → Breach!

    - 3. Asks whether the breach is the proximate cause of the injury.
        - It was clear fraud. Had she looked at ANY of the reports, she would've been on notice of the wrongdoing.

    - Mrs. P should've known how the company was making money
    - Should've obtained and read the annual statements of financial condition
    - And should've realized, from those statements that her sons were misappropriating funds
- TAKEAWAY
    - Incompetence is NOT a defense
    - Complete non-feasance does not get the BJR presumption

EVOLUTION OF "GOOD FAITH"

<u>In General</u>
The concept of good faith pervades Delaware's corporate law:
- Courts often refer to the **BJR** as "a **presumption**"
    - That the directors or officers of a corporation acted on an informed basis, in *<u>good faith</u>*, and in the honest belief that the action taken was in the best interests of the company
- **DGCL § 141(e)**
    - "A member of the board of directors, or a member of any committee designated by the board of directors, shall … be fully protected in relying in *<u>good faith</u>* upon [specified documents and persons]
- **DGCL § 102(b)(7)**
    - Can, in its articles of incorporation, eliminate/limit director's personal liability BUT NOT for acts/omissions in *<u>good faith</u>*
- **DGCL § 145(a) and (b)**
    - Authorize **indemnification** of a director or officer who "acted in *<u>good faith</u>*."

<u>The Evolution of Good Faith in DE</u>
- Does the "duty of good faith" attach to the "duty of care" or "duty of loyalty"?
    - Despite the pervasiveness of the concept, it has been essentially undefined until recently. In addition, whether it is an independent fiduciary duty or subsumed in the DOC or DOL has been unclear.

- In ***<u>Cede & Co. v. Technicolor, Inc</u>***. (Del. 1993), the Delaware Supreme Court stated:
    - "To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty or due care."

- Since ***Cede***, the Court has further clarified the meaning and status of good faith in *Walt **Disney Co. Deriv. Litig**.* (2006) and ***Stone v. Ritter*** (2006)

In re The Walt Disney Company Derivative Litigation ("Disney III")

- FACTS
    - CEO Michael Eisner asks Michael Ovitz (Hollywood's leading talent agent/consultant) to join Disney
    - Ovitz negotiates an employment contract that offers Ovitz stock options on top of annual salary. If fired without cause, (non-fault payment - NFT), Ovitz would receive salary + unaccrued bonuses + immediate vesting of 3 million options + $10 million for remaining options.
    - Ovitz is fired without cause after 14 months. As part of his severance package, he was given $140 million.
    - Shareholders a derivative lawsuit against Disney executives for agreeing to pay Ovitz a ridiculous amount of money
        - Argued that Eisner breached his fiduciary duties by agreeing to pay so much and for not consulting the board of directors before firing Ovitz
- PROCEDURE
    - Trial Court found for Eisner on summary judgment – a large severance package alone is not enough to show a lack of due are / to constitute waste
    - DE Supreme Ct. remanded – the case was weak but they should be allowed more discovery
    - Trial Court found for Eisner again – b/c the directors' conduct was less than ideal, but not in bad faith or grossly negligent.
- ISSUE/HOLDING
    - The contract was drafted badly b/c it incentivized him leaving early... BUT doesn't rise to the level of breach of good faith
    - Were the actions of the Disney directors in approving the employment agreement, hiring Ovitz, and then terminating his employment "not for cause" made without any violations of the fiduciary duties of due care and good faith?
        - <u>Due Care</u>
            - What did plaintiff need to prove to show breach of the duty of care?
                - Gross negligence in failing to inform themselves of all the material reasonably available to it
                - Gross negligence = failure to do stuff well, being really sloppy
                - BJR applies because a decision was made
            - What did the court suggest would be "best practice"?
                - Best case scenario: All committee members would have received, before or at the committee's first meeting a spreadsheet prepared by a compensation expert. Making different, alternative assumptions, the spreadsheet would disclose the amounts that Ovitz could receive under the OEA in each circumstance that might foreseeably arise (including NFT). The contents of the spreadsheet would be explained to the committee members, either by the expert who prepared it or by a fellow committee member similarly knowledgeable about the subject. This spreadsheet, which ultimately would become an exhibit to the minutes of the compensation committee meeting, would form the basis of the committee's deliberations and decision."
            - What actually happened?
                - The compensation committee met and saw the term sheet and the basic idea that in the event of a no-fault termination, they'd pay out at least $40 mil... but may not have known how much he would receive from his accelerated options
            - Were the directors liable for breach of the duty of care? NO
            - How is this case different from *Van Gorkom*?
                - Van Gorkom was selling the entire company for cash. The magnitude of that is immense. And it wasn't so grossly sloppy that there hadn't been evidence showing that they hadn't done anything. Also there might have been a spreadsheet

- Good Faith
  - What's at stake with how the court defines good faith?
    - It will determine if 102(b)(7) applies…statutory provisions. If they're found to have breached the duty of good faith, they may be held liable (even if they didn't breach their duty of care)
- Corporate Waste?
  - They didn't breach duty of care even though it wasn't best practices. No breach of duty of good faith b/c it's not even gross negligence and that's not even on the spectrum on "bad faith."
  - The only thing left for the (P) would be to show waste
    - Exchange was so one-sided that no person of sound business judgment would enter into that transaction / the corporation hasn't received adequate consideration
  - Doesn't apply here. They didn't irrationally squander/ give away corporate assets. This must be rare and unconscionable
  - Here, this isn't corporate waste b/c they contractually obligated to do so.
  - Was there any rational business purpose? Yes! – trying to induce Ovitz to leave CAA to come to Disney. He was already getting paid a lot. Needs to be an attractive

- REASONING
  - Identified two possible bases for finding that directors acted in bad faith:
    - 1. **Intentional conduct motivated by bad faith**
      - Conduct motivated by subjective bad faith (i.e., an actual intent to do harm)
    - 2. **Conscious disregard of one's responsibilities**
      - You're not aware that you're supposed to be doing something = bad faith
      - "Intentional dereliction of duty, a conscious disregard for one's responsibilities"
    - **Gross negligence ≠ bad faith!
  - Gave examples of conduct in bad faith
    - [**EX**] Intentionally acting with a purpose other than advancing the best interests of the corporation = bad faith
    - [**EX**] Intent to violate the law = bad faith
    - [**EX**] Intentionally failing to act in the face of a known duty to act, demonstrating a conscious disregard for duties = face
  - The Court declined to decide whether there is a distinct fiduciary duty to act in good faith independent of the duties of loyalty and care.
- TAKEAWAY
  - Some practical lessons of *Disney*: What should the board or compensation committee have done in approving the compensation for Ovitz? What process would you advise based on the Delaware Supreme Court's decision?
  - Court didn't answer whether duty of good faith was its own fiduciary duty

DUTY OF OVERSIGHT

In General

- As a general rule of oversight:
  - A director should acquire **at least a rudimentary understanding of the corporation's business**. If he has insufficient experience, he should either acquire the knowledge or refuse to act.
  - Directors are under a continuing obligation to keep informed about the activities of the corporation.
    - This does not require a detailed inspection of day-to-day activities, but a general monitoring, attending board meeting regularly (not every day but as a matter of practice – depending on the type of business), maintain familiarity w/ corporation's financial status
- Failure to do so = breach of duty of care for failure of oversight
  - Duty of care might not be enough to compel the action of the board. It's not hard to meet... As long as you do something (as opposed to nothing at all) they get the benefit of BJR.

- It has long been established that the DOC requires directors to pay ongoing attention to the business of the corporation. (Recall *Francis*)

- Board may rely in good faith on officer and expert reports (DGCL § 141(e))
- Board must become informed of all material information reasonably available (DOC focuses on the process of decision-making)
- After which, courts will not question decisions even if they're substantively bad (this is because of the BJR)

- But what about the quality of information getting to the directors and officers? Do boards have an affirmative duty to assure that a corporate info and reporting system is in place to provide info about legal compliance?

In re Caremark Int'l Inc. Derivative Litigation

- In **dicta**, the court stated that as part of its duty of oversight, the Board must make "good faith efforts" to ensure that there's a system to ensure compliance.
    - Ensure that a corporation has adequate reporting and information systems
    - *Failure to do so may render a director liable for losses caused by non-compliance w/ legal standards
    - Liability will attach ONLY for "a sustained or systematic failure to exercise oversight" or "[a]n utter failure to attempt to ensure a reporting and information system." → difficult to win

- "**Caremark claim**" = A cause of action against boards for failing to take minimal steps to achieve legal compliance and provide information to monitor business.

- Examples of **"Adequate" Law Compliance Program**
    - Policy manual
    - Training of employees
    - Compliance audits
    - Sanctions for violation
    - Provisions for self-reporting of violations to regulators
    - Other controls to verify compliance with laws and to give the board the ability to monitor the business

Stone v. Ritter

*Good faith in context of oversight
* Addressed *Caremark*'s validity and clarified good faith and how it fits into the fiduciary duty framework.

- FACTS
    - Corporation = AmSouth Bank
    - AmSouth shareholders, William and Sandra Stone = (P)s
    - AmSouth directors = (D)s
    - 2 employees were found guilty of a money-laundering scheme. Then, AmSouth had to pay $50 million in fines and penalties for failure of its employees to file a "Suspicious Activity Report" required by the Bank Secrecy Act.
    - (P)'s filed a derivative complaint against the board for breach of oversight duty without making a pre-suit demand on the board
        - *A pre-suit demand is required by Court of Chancery Rule 23.1 – must make a demand and then plead that the directors failed to obtain the action/did not make an effort)
- ISSUE
    - Can the shareholders hold the board of directors liable for breach of oversight when the company's employer's failure to comply with the BSA?
- RULE
    - Confirms **Caremark Claim** is a breach of duty of good faith and it's a subset of Duty of Loyalty (If you breach the duty of good faith, you are thereby breaching the duty of loyalty)

    - **CAREMARK CLAIM**:
        - Liable for failure of director of oversight if:
        - [1] One of the following AND
            - (a) Directors **utterly failed to implement** any reporting or information system or controls; OR
            - (b) Having implemented such a system or controls, **consciously failed to monitor** or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

- [2] Imposition of liability requires a **showing** that the **directors knew** that **they were not discharging their fiduciary obligations**.

- HOLDING
  - Here, no failure of director of oversight
    - There were reasonable systems in place... it was supposed to be reported up to the board and designed to allow directors periodic review... and the audit committee had overseen the compliance program on a constant basis... there was employee training etc.
  - Concededly, there may have been some bad things but that's a one or two bad apple. There will be some bad apple employees in the company. This doesn't mean that the board failed to implement an information/reporting system... The implementation will not deter all employees from not acting legally.
- REASONING
  - Caremark
    - "[A] **sustained or systematic failure** of the board to exercise oversight—such as an **utter failure** to attempt to assure a reasonable information and reporting system exists… will establish the lack of good faith that is a necessary condition to liability."
  - Stone (raises the bar – harder to make a claim)
    - Re-characterizes duty of good faith as a duty of LOYALTY issue.
    - A failure to act in good faith requires an **act that is more culpable than gross negligence**
    - **Requires that the directors KNEW that they were discharging their fiduciary obligations** and a conscious disregard for their responsibilities
    - "A showing of bad faith is essential to establish a director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty"
- Breach of duty of loyalty →
  - Directors are not exculpated 102b7
  - Directors are not indemnified under 103.5
- Breach of duty of care →
  - Exculpated automatically if 102b7
  - Indemnified under 103.5
- Incentive to plead as a duty of LOYALTY claim b/c BJR doesn't apply to lack of good faith
  - Only duty of care and loyalty (good faith is part of loyalty)

Questions

- If *Caremark* claims are now characterized as good faith and therefore duty of loyalty claims, what other claims should be characterized as violations of the DOL? (Hint: What examples of bad faith did the Court mention in *Disney*?)
  - Any case in which the directors know that they are discharging their obligations
  - Or if the directors act w/ intent to violate the law

- After *Disney* and *Stone*, how would you analyze the decision of a board authorizing corporate employees to break a traffic regulation? Assume the board informed itself and considered the issue and determined it was cost-effective to violate the law and pay the fines.
  - What are the damages for violating the law?
  - Here, the directors and officers... they're not doing it for their personal benefit. They're doing it for the benefit of the company.
  - It's not clear yet – not many cases since Stone and Disney.
    - Disney: intent to violate the law
    - Stone: bad faith
    - BUT remember: corporations can only engage in lawful conduct.

- Suppose that the AmSouth board had considered the issue and affirmatively decided not to adopt any law compliance program. Would it be liable if that decision resulted in corporate losses?
  - BJR would apply b/c they made an affirmative decision.
  - But ... is it a conscious disregard of a known duty to act if it was a conscious decision NOT to do it? Unclear
    - Caremark: utter failure to put in place a reporting or information system. It would seem like there is some sort of affirmative obligation to adopt some sort of policy. Although it

was not explicit, the decision suggests that you can be found liable for utterly failing to put something in place. Still unclear.

- Does DGCL § 102(b)(7) allow for exculpation of directors for breaches of DOL or bad faith?

FIDUCIARY DUTIES OF OFFICERS

- Officers have the same duties as directors.
  - E.g. Usurping corporate opp... apply to officers the same as officers
- * BUT whether the standards are the same = unclear
  - Do the officers get the same BJR presumption?
    - **CA** Corporate Code codifies the BJR which refers ONLY to directors. Majority of CA courts have said CA BJR doesn't apply to corporate officers.
    - **DE** is unclear on this point.
      - But note that DGCL 102(b)(7) and 141(e) applies ONLY to directors by their language.
    - **If not BJR, is the standard gross negligence?
- **When you're doing a fact pattern, look @ whether the person is acting in the capacity as a director or an officer**.

[**CORPORATIONS**] – DUTIES AND ISSUES INVOLVING CONTROLLING SHAREHOLDERS

FIDUCIARY DUTIES OF CONTROLLING SHAREHOLDERS

In General

- As a general matter, **shareholders have no obligations/duties** to each other.
  - They are allowed to act in their own interest in deciding how to vote their shares.

- Some situations where shareholders may owe fiduciary duties:
  1. Where a shareholder is elected to the **board**, the **shareholder becomes a director** → in that capacity, that shareholder-director owes fiduciary duties to other shareholders
  2. Shareholder w/ CONTROL
     - Recognizing that a board in this context may not act independently of the controlling shareholder, courts began to extend aspects of the board's fiduciary duties to the controlling shareholder.

- Controlling Shareholder:
  - There is no bright-line rule for determining whether a controlling SH relationship exists; the determination is on a case-by-case basis:
    - ***Does a majority of the board lack independence from the allegedly controlling SH?***
  - 2 ways to become controlling SH
    - **De jure**: If a shareholder owns more than 50% of the voting stock, then the shareholder has de jure control.
    - **De facto**: A shareholder owning less than 50% of the voting stock has de facto control if a majority of the board lacks independence from the shareholder. (Plaintiff bears burden to prove.)

- **Standard of Review** when Controlling SH allegedly breaches fiduciary duty:
  **No provision analogous to DGCL § 144*
  - Generally, the standard of review = **fairness**

- The defendant-controlling SH bears the burden of proving the transaction was fair to the corporation.
  - Effect of "cleansing" the transaction: If there was approval by the informed, disinterested shareholders (a.k.a., majority of minority), the burden may shift onto the plaintiff to show that the transaction was unfair to the corporation.
    - *Notice: This doesn't go to BJRs

- **Freeze-outs or cash-out mergers** in which the minority SHs are eliminated. → They don't get BJR immediately. They get more scrutiny

- Depending on the process, there may be an entire fairness standard or burden shifting and the standard may be lowered….dissenting SHs may also have an appraisal remedy…
- *Appraisal rights give dissenting shareholders the right to get the fair amount of their shares appraised

- **Exceptions to the General Rule**
    - ***General rule**: A controlling SH is free to dispose of her stock as she sees fit and on such terms as a willing buyer offers (including a control premium).
    - A sale of control under circumstances indicating that the buyer intends to loot or mismanage the corporation;
    - The sale involves fraud or misuse of confidential information, the sale is a wrongful appropriation of corporate assets, or the sale is for corporate office (e.g., selling less than majority of the voting stock and receiving portion of $ to put in place a sequential resignation plan for directors).

Parent-Subsidiary Transactions:

*Corporate group situation

- Parent + Wholly-owned subsidiary (100%)
- Parent + Majority-owned subsidiary (51%)
- Minority shareholders will question whether parent actions = benefit the majority shareholders at the expense of the minority SHs. Argue that they owe a fiduciary duty to the minority SHs

Sinclar Oil v. Levin

**Duties w/in Corporate Groups (Parent-Subsidiary Transactions)*

- TAKEAWAY
    - If a **shareholder dominates or controls** corporation, and
    - The controlling shareholder **receives a benefit to the exclusion and at the expense of the minority shareholder**s, then
    - **Burden is on the controlling shareholder to prove intrinsic fairness** of transaction.
    - Otherwise BJR.
- FACTS
    - Defendant = Sinclair Oil Corp (Parent company) = Sinclair
    - Plaintiff = Sinclair Venez. Oil Co. (Subsidiary) = SinVen
    - Sinclair Int'l Oil Co. (Wholly-owned subsidiary)
    - Sinclair (1) Caused SinVen to pay excessive dividends that exceeded its profits and (2) was responsible for the damaged caused by a breach of K between SinOil and SinVen of which Sinclair was 3rd party beneficiary
- ISSUE
    - Did Sinclair breach its fiduciary duty to SinVen for those 2 actions?
- RULE/HOLDING
    - No to (1) and yes to (2)
    - RULE
        - Parent co. owes a duty to the subsidiary when there are parent-sub dealings.
        - When there is a **self-dealing** (parent has received a benefit to the exclusion and at the expense of the subsidiary) → the "**Intrinsic Fairness**" standard applies → Controlling SH has the burden of proof that it was fair
            - **Intrinsic Fairness** = Whether the *substance* of the dealings were fair, when compared to the price and terms expected in an arm's length, third party transaction
            - **Extrinsic Fairness** = Whether the *substance* and the *process* by which the transaction was initiated, timed, negotiated, decided and disclosed were fair
        - If it's NOT a self-dealing → BJR applies → Minority SHs have the burden of proof that it was improper motive or waste (otherwise, NO BREACH)
    - Action #1 – Excessive Dividends → Not a self-dealing! → BJR applies
        - Not self-dealing b/c the money was also received by the minority shareholders of SinVen… therefore, Sinclair didn't receive a benefit at the exclusion of SinVen.
            - BJR → Payments were made in compliance w/ Del C. Sec 170. Plaintiffs must show that the payments resulted from improper motives or amounted to waste
    - Action #2 – Usurping business opportunity. Opportunities in Paraguay that Int'l took but not SinVen.

        - Did Sinclair usurp a business opportunity of SinVen b/c it was unable to expand due to the excessive cash drain?
            - These opportunities are in Canada, Alaska and Paraguay – no proof that Sinven deserved these opportunities more than any other subsidiary
        - No. No proof of self-dealing therefore test is BJR again. Absent proof of waste/improper motive, this is not an interference of SinVen's business opp
    - Action #3 – Breach of K b/t SinOil and SinVen → Self-dealing → Intrinsic fairness standard
        - SinOil (1) didn't comply with the min. quantity req on contract and (2) its payments lagged as much as 30 days when the contract required payment upon receipt of the goods
        - This WAS a self-dealing b/c SinVen benefited from the contract (received SinVen's products through SinOil) and the minority shareholders of SinVen didn't share in those benefits (and actually lost $ to its detriment)
        - Intrinsically fair?
            - No – it would've needed to show that SinVen couldn't possibly have produced / obtained the contract minimums

OPPRESSION IN THE CLOSELY HELD CORPORATION
*Context in which controlling shareholders may be held to have fiduciary duties to protect the interests of minority shareholders

Closely-Held Corporation
- "**Closely held corporation**" = Corporations ...
    - Whose stock is owned by only a **small number of shareholders**;
    - The **shareholders participate actively** and substantially in managing the enterprise; AND
    - The company's **stock is not publically traded**
- Characteristics:
    - Many are **small organizations**, but they are not necessarily so
    - Closely held corporation investors are
        - Often **connected by family** or other personal relationships, and
        - Often **expect employment** by the corporation and a meaningful role in management, as well as financial return on their investment.
    - The minority shareholder in a closely held corporation is generally **locked into her investment** (i.e., you can't "buy low, sell high" b/c stock isn't on sale on a public market) absent a contractual arrangement (e.g., provision that allows you to sell stock back to the corporation for $)
        - Unlike an investor in a general partnership, she cannot readily liquidate her investment by exercising a statutory right to dissolve the business.
- Public corporations (in contrast):
    - Investors in public corporations typically are not employees and play no management role. They can readily liquidate their investments by selling shares in a public securities market.

Planning In the Closely Held Corporation
- Because shareholders in closely held corporations generally cannot exit by selling their shares, they commonly seek to use contracts or internal governance mechanisms to plan for these issues or provide for a voice in the corporation.
    - E.g., shareholder voting trusts, shareholder voting agreements, shareholder management agreements, restrictions on share transfers, buy-sell agreement
    - Also: employment contracts, supermajority provisions, etc.

Squeeze-outs, Freeze-outs, and other forms of Oppression in Closely Held Corps
- Without a market into which to sell their shares, minority SHs are vulnerable to board decisions about management, employment, compensation, dividends, etc.
- Controlling SHs have, at times, used various techniques to squeeze out, freeze out, or otherwise "oppress" the minority
    - E.g., buy or sell at unfair price to minority SHs
    - improperly withhold dividends, improperly terminate employment, management positions, and related benefits >> cut off minority SHs from financial return
    - siphon off disproportionate shares of corporate profits by paying themselves excessive salaries, bonuses, benefits, and perquisites

- self-dealing (i.e., commit the corporation to generous contracts with themselves or aligned parties made at less than arm's length such as with a license to use real or intellectual property, a contract to obtain services from a closely affiliated person or entity, or a loan at nonmarket rates)

Fiduciary Duties in Closely Held Corporations

- *Some* courts have responded to SH oppression by imposing special or heightened fiduciary duties in closely held corporations, but they differ about when and to whom the duties are owed.
- Many courts have held that **majority SHs have fiduciary duties to deal fairly with and not oppress the rights of minority SHs**…
  - This includes California. E.g., Neubauer v. Goldfarb, 133 Cal. Rptr. 2d 218 (Cal. Ct. App. 2003); Stephenson v. Drever, 947 P.2d 1301 (Cal. 1997); Jones v. H.F. Ahmanson & Co., 460 P.2d 464 (Cal. 1969) (controlling SHs cannot use their control to benefit themselves to the detriment of the minority without a compelling business purpose).

Wilkes v. Springside Nursing Home, Inc.

**Majority shareholders → freeze out minority shareholder*

- FACTS
  - Wilkes, Riche, Quinn and Pipkin purchased a building and created a nursing home business
  - They intention was that they each would receive money from the corporation in equal amounts, corporate resources permitting. All 4 received a weekly stipend.
  - Later, Pipkin sold his shares to Connor who didn't hold an officer position
  - Wilkes gave notice to sell his shares; the next month, the majority shareholders voted to raise Quinn's salary and continue paying Riche and Connor but NOT Wilkes. At the annual meeting, Wilkes was not reelected as a director or an officer and was terminated.
- ISSUE
  - Did the majority SHs breach the fiduciary duties owed to Wilkes, the minority SH?
- RULE/HOLDING
  - SHs in a close corporation owe one another substantially the same fiduciary duties in the operation of the enterprise that partners owe to one another – *Donahue*
  - "Freeze outs" may cause the minority stockholders to be deprived of corporate offices and of employment w/ the corporation but it may have a legitimate business purpose.
  - Test for whether majority SHs breached their fiduciary duties to minority SHs:
    - 1. Burden on the DEFENDANTS to demonstrate a legit business purpose for the action @ issue (understanding that they have a large measure discretion)?
    - 2. If YES → Burden shifts to PLAINTIFF to show that the same legitimate purpose could've been achieved through an alternative course of action less harmful to the minority's interest
    - 3. Then the ct. balances the two actions
  - HERE, Ds didn't show a legitimate business purpose
    - No evidence of misconduct by Wilkes as a director, officer or employee
    - Duty of good faith and loyalty demanded that the majority shouldn't act in disregard of the SHs' policy that employment would go hand in hand w/ stock ownership
    - Corporation never declared a dividend and Wilkes' salary was cut off – On top of that, he was not reelected as director/officer
    - Wilkes should receive lost wages

Nixon v. Blackwell

**Controlling SHs voted on a self-interested action that benefited employee-shareholders but not non-employee shareholders*

- FACTS
  - Founder's descendants of E.C. Barton (founder of closely-held company) sued the company's board for creating a employee-stock ownership plan (ESOP) that benefited employee stockholders but not non-employee stockholders.
  - Plaintiffs = Shareholders of non-voting Class B stock
  - Defendants = Director-Shareholders of Class B stock
  - ESOP allowed employee stockholders to cash out their shares when they left the company → that was not available to the Plaintiffs who were non-employees
- ISSUE

    - Did the Director-Shareholders breach their fiduciary duties to the non-voting shareholders by adopting ESOP?
- RULE/HOLDING
    - When the majority shareholders are on "both sides of the transaction," the "entire fairness test" applies (and they don't get the presumption of BJR)
        - *Stockholders need not always be treated EQUALLY, just FAIRLY
    - The Ds met their burden of establishing the "entire fairness" of their dealings
        - ESOP was established, at least in part, to benefit the Corporation
        - The minority SHs were not employees; they weren't entitled to share in an ESOP; and they weren't protected by specific provisions of the cert of incorp or by-laws
        - They were simply passive investors – entitled to be treated fairly but not necessarily to be treated equally

Reconciling the Approaches

- Both approaches seek to enforce what the court assumes to be the parties' expectations (casebook p. 979)
    - Both courts are trying to do what the parties' expectation seems to be.
    - Difference is in the ct's willingness to look beyond the formal corporate documents – should courts interpret fiduciary duties to fill perceived gaps? Or should the court look at what, if anything, the parties have done (e.g. corporate documents and contracts), without creating fiduciary duties?
        - DE looks to the corporate documents – they need to contract for stuff if the want special stuff
        - CA/MI looks beyond that and interprets...

Various Options and Remedies

- Some states have allowed for equitable remedies including court-ordered buyout of the minority SH at a fair price, dissolution where necessary to protect the interests of the complaining SHs, etc.
- Some states also have involuntary dissolution statutes.
    - [**EX**] California's involuntary dissolution statute authorizes a court to dissolve a corporation where those in control have been guilty of "persistent and pervasive fraud, mismanagement, or abuse of authority or persistent unfairness toward any shareholders." Cal. Corp. Code § 1800. Majority SHs can avoid involuntary dissolution through a buyout at fair value. *Id.* § 2000.

[**CORPORATIONS**] – Shareholder Voting Rights

Role, Duties, Rights of SHs

- Shareholder duties:
    – Generally none, unless controlling shareholder
- Shareholder roles and rights:
    – Sell
    – Vote (& make proposals)
    – Sue
- (plus inspection/information rights)

SH Voting: Trends in the law

- State corporation law
    – Shareholder voting for directors, on major transactions, amendment of certificate and bylaws
    – Fiduciary duty of disclosure
- 1930's federal securities laws
    – Regulates disclosure of information in connection with shareholder voting
    – Provides for shareholder proposals
- Recent few years—trend to increase shareholder power
    – Shareholder proposals on majority voting (vs. plurality default)
    – Shareholder proposals on proxy access (after D.C. Cir. struck down the SEC's new mandatory rule for this)
    – Dodd-Frank's non-binding "say on pay" voting regarding executive compensation
    – Rising importance of institutional investors and influence of proxy advisors (e.g., ISS, Glass Lewis)

A. Basics of SH Voting

A1. Shareholder Meetings

- SHs act [1] at **regularly scheduled annual meetings** and [2] at **special meetings** (convened for particular purposes)
- Annual Meetings
  - Location/Time
    - **Can be held anywhere**, as designated in the certificate or bylaws
    - Unless directors are elected by written consent, an annual meeting shall be held for the election of directors **on a date and at a time designated** by or in the manner provided by the bylaws
  - Subject Matter
    - Required matter: **Electing directors**
    - The board often seek SH approval on other matters (e.g., appointment of auditors, adoption of management compensation plans, ratification of decisions made by board in the past yr)
  - * Court can call a shareholder meeting if no meeting was called for 13 months
- Special Meetings
  - Can be called by the board / person authorized in articles or bylaws / by any 10% shareholder, under some statutes (not in DE)
  - Advance notice of meetings required (DGCL § 222)
- Written Consent
  - SHs can also act by written consent if...
    - They have **enough votes** such that they could take action @ a regular **annual meeting** (DGCL §228(a)) OR
    - To **elect directors** (w/ unanimous written consent) (DGCL §211(b)) OR
    - **Fill director vacancies** (with non-unanimous consent) (DGCL §211(b))
  - Action by written consent can be eliminated / restricted in the articles

A2. Shareholder Voting Procedures (Who/When/How)

- Notice must be**...**
  - **Written**
  - Sent to SHs entitled to vote @ **least 10 days** (but no more than 60 days) **before** the meeting
  - Describe:
    - **Time**
    - **Location**
    - ***Purpose** of meeting (if it's a special meeting)
- Entitlement to vote (Who votes)
  - 1. "Shareholders of record"
    - Only those SHs whose **ownership if reflected** in the corporation's books during the **fixed "record date"** are entitled to notice + vote – *DGCL §213*
      - Date is set by the board before notice is sent out
      - I.e., SHs who *sell* in b/t the record date and the meeting date are entitled to vote
      - SHs who *buy* in b/t the record date and the meeting date are NOT entitled to vote (b/c their shares are not reflected in the corporation's book as of the record date)
- Quorum required in SH meetings to vote (shares that must be present in person/repped by proxy for valid SH meeting)
  - Default quorum = **majority** shares
    - Certificate or bylaws can opt out of default, but never less than 1/3 – *DGCL § 216*
  - Purpose: To prevent minority taking acting w/o presence of the majority
- Voting by Proxy
  - SHs can vote in person or by a proxy (unlike directors) – *DGCL §212(b)*
  - Vocabulary:
    - **"Proxy holder," "proxy agent," or "proxy"** = Agent appointed by signed writing to appear and vote on behalf of the SH
    - "**Proxy card**" / "Proxy" = Document for appointing the agent and voting

        - “**Proxy statement**”: Information disclosure
            - E.g., SHs get in the mail a proxy statement before each annual meeting that has information about proposals, auditor details etc.
    - Appointment is effected by means of a proxy card.
        - Can specify how share is to be voted / give agent discretion
        - Depending on what is being voting on, the proxy card or voting instruction form gives a choice of voting “for,” “against,” or “abstain,” or “for” or “withhold.”
    - Characteristic of a proxy:
        - Most statutes limit proxies to **11 months**, unless a longer term is specified
        - Default: Can be revoked at any time
            - But can be made irrevocable by:
                - Submitting a notice of revocation
                - Signing a later-dated proxy; OR
                - Appearing in person at the meeting
    - Verification of Proxy
        - When questions arise as to the validities of the proxies—board hires a designated **election inspector** to …
            - Verify signatures
            - Ensure proper voting by fiduciaries
            - Confirm the dating of proxies
            - Count ballots
            - Certify the result
        - DE’s statute **requires** public corporations appoint 1/more inspectors in advance of any SH meeting

A3. Shareholder Voting Rights

- **General Rule = One-share/one-vote**
  **Articles may specify otherwise*
    - Permissible changes to general rule:
        - **Supermajority Voting**: Voting caps on any SH who owns more than a specified percentage of shares
            - Mostly used in closely-held corporations
        - **“Dual Class Stock”**
            - Corporation could have classes of stock w/ different voting rights, but that must be provided in the certificate.
            - **Non-voting Shares**: Classes of shares that have greater or lesser votes
            - [**EX**] Google’s Class B shares have 10 votes each. Class A shares each have 1 vote.
- Examples of certain transactions that require SH vote:
    - Directors
    - Bylaw Amendments, shareholder proposals, non-binding “say on pay” (SHs of public corporations get a nonbinding vote to thumbs up/down to CEOs’ pay)
    - Certificate amendment
    - Major transactions (e.g., mergers)

- Votes required vary depending on the type of transaction

Type of Transaction	Votes Required
Directors (**See below for more info*)**	▪ Default = **Plurality Voting** ▪ Can be changed to: (1) **Cumulative** voting or (2) **Majority** Voting, if provided in certificate/bylaws ▪ *Can amend to provide for “staggered terms”
Bylaw Amendments, SH proposals, Non-binding “say on pay”	▪ **Majority** of shares present / represented by proxy and entitled to vote

Certificate amendment	▪ The board must decide the do it and bring it to the SHs to vote on that ○ **Majority of OUTSTANDING stock** entitled to vote + vote in favor of the amendment (and by classes, if applicable)
Major Transactions (e.g., mergers)	▪ Look @ applicable statutory provisions, generally **majority of OUTSTANDING shares** entitled to vote

- Voting
  - **Plurality Voting**
    - Plurality = whoever gets the most votes for the seat
    - [**EX**] More nominees than available seats
      - One board seat open for election and 3 nominees: Al, Beth, and Carol
      - At SH meeting, Al receives 35% of votes, Beth 40% and Carol 25%
      - Who wins? Beth.
    - [**EX**] Single nominee per seat
      - One board seat open for election and 1 nominees
      - At the SH meeting 955M votes against him, 512 votes in favor
        - Does the nominee win the seat? Yes.
  - **Majority Voting**
    **More favored by SHs, usually seen in public corporations*
    - Each nominee must receive a majority of votes cast
    - A nominee who doesn't receive a majority must resign and his seat is filled by the board or at another election.
  - **Cumulative Voting**
    - In cumulative voting, each shareholder's # of votes is multiplied by the number of director positions up for election and the shareholder can split their votes any way they like between the nominees or vote all for one single nominee.
    - The nominees with the highest number of votes are elected.
    - Delaware: Default rule is plurality voting but may be changed to cumulative if it's in the certificate. – *DGCL § 214*
    - California: Cumulative voting is the default rule. You can't opt out of cumulative voting, unless you are a publicly-traded company
    - [**EX**]

Cumulative Voting Example

(from Bainbridge treatise on course reserve p. 237-238)

- ABC Corp. has 3 shareholders:
  - A who owns 250 shares
  - B who owns 300 shares
  - C who owns 650 shares
- Bylaws specify 4-member board
- Delaware default voting rule is plurality, which would mean C would elect the entire board of directors
- But if ABC Corp. provided for cumulative voting in its certificate,
  - A: 250 x 4 = 1,000 votes to use anyway chooses
  - B: 300 x 4 = 1,200 votes to use anyway chooses
  - C: 650 x 4 = 2,600 votes to use anyway chooses
- A & B nominate themselves and cast all of their votes on themselves, respectively
- C nominates herself and 3 other friends
- But C can't cast her votes in a way so as to elect all 4 of her nominees
- C might, for example, cast 1,201 for herself and 1,001 for friend #1, but that would not leave C enough to elect friend #2 and 3.
- Notice that even if B and C cumulated votes together, they could not prevent A from electing at least one director

▪ In a plurality

voting system, C would have control over all the seats. But in cumulative voting. Cumulative voting is good b/c it can give more voice to minority shareholders. They might be able to cumulate and put 1 or 2 ppl on the board.

B. Shareholder Rights in Fundamental Transactions

B1. Shareholder Voting and Appraisal Rights

- SH's voting rights can be considered "veto power"
  - The can block fundamental changes, but not initiate them
  - Some transactions, but not all, require approval
- Fundamental transactions requiring SH approval:
  *In general = Transactions that change the corporation's form, scope or continuity
  - Amendments to articles of incorporation
  - Significant mergers
  - Sale of all / substantially all of a corporation's assets
  - Corporate Dissolution
- Transactions that don't require SH approval (even though it fundamentally changes the business
  - Acquisition of a new division for cash
  - Major change in product focus
- Legislative response to minority's abuse of veto power
  - 1. Amended statute to allow fundamental changes crafted by the board to be approve by a majority/super-majority of its SHs
  - 2. Granting dissenting SHs a right to "opt out" of fundamental changes
    - Dissenting = Demanding that corporation pay in cash the "fair value" of his share, determined by court in an **appraisal** proceeding.
    - Appraisal = exit instead of veto
      - Every corporate statute authorizes SHs to demand appraisal and require corporation to repurchase their stock in cash for fair value
      - Statute varies on *when* SHs have voting and appraisal rights
      - Sometimes, SHs have voting rights but not appraisal rights in a transaction

C. Shareholder Power to Initiate Action

C1. Overview

- Shareholder veto rights are passive (it's a reaction to a board decision)
  - Amending the **certificate** – this needs to be initiated by the directors
  - Nominating directors (the power to nominate directors is vested in the board & they just generally re-elect themselves until someone resigns)
- There are 3 active SH powers:
  - To make recommendations
  - Remove for/without cause and/or replace directors (with notice + opp to defend) (*Auer* and *Loews*)
  - Amend **bylaws**
- Corporate statute gives SHs right to "direct or advise the board" – but does not specify *when*

C2. Power to Elect/Remove/Replace Directors

- Election of directors
  - In general, **all directors are up for election** at the annual meeting
    - Articles may provide for "**staggered terms**" (classified): In which directors are elected for multiple-year terms (usually 2-3 years).
      - [**EX**] If directors are elected on a 3-yr term, only 1/3 of the directors are up for election every year. This makes takeover / voting insurgency more difficult.
- **DGCL § 223** – Board Seat Vacancy
  - **Default Rule**: Vacancies get filled by the remaining board members.
  - In general, only directors can elect directors
    - But when a board seat is *vacant*, SHs or remaining directors may fill the vacancy (unless articles provide otherwise)
  - Cause of vacancies: Director resigns, dies, or is removed

            - There's no statute that requires all vacancies to be filled. You can operate w/ vacancies.
- **DGCL § 141(k)** – Removing the directors
    - SH power to remove directors is mandatory and cannot be restricted
    - SHs can generally remove directors with or without cause (unless otherwise provided by the articles)
        - 1. Call meeting
        - 2. Send notice
        - 3. Solicit proxies
        - 4. *If removing *for cause*
            - Proffer sufficient charges; and
            - Allow defense
    - **DGCL §141(k)(1)** – If you have a classified board, you can only remove for cause
        - Less incentive to have a classified board b/c if you don't have cause, you'd have to wait potentially 1-2 years to remove.
    - **DGCL §141(k)(2)** – If there's cumulative voting, and the minority finally got someone one the board, that person cannot suddenly be removed.

<u>C2. Shareholder Recommendations</u>

- SEC's Proposed Rule: SHs may, in public corporations, propose a resolution by adoption by other SHs through the corporate-financed proxy mechanism, provided the "proposal is proper under state law"
    - What matters are "proper"?
- <u>*Auer v. Dressel*</u>
    - The SHs have the power to remove share
    - FACTS:
        - SHs (owner of majority of Class A stock) brought an action to compel the president of R. Hoe & Co., Inc. to call a special SH meeting w/ the following purpose:
            - (A) Reinstate Joseph Auer (former president)
            - (B) Amend the articles + bylaws to allow SHs to fill director vacancies caused by removal (currently the board's right)
            - (C) Consider charges against 4 Class A directors + remove if charges were proven
        - SH right to call a special SH meeting was pursuant to the bylaws
        - Articles provided for an 11-member board (9 elected by Class A SHs, 2 elected by Common SHs)
        - President refused to call the meetings b/c the purposes were not "proper" to call a Class A SH meeting
    - HOLDING/REASONING
        - Compels the president to call the special meeting b/c there is no reason why they shouldn't be allowed to vote on those proposals
        - (A) → It's not invalid to express themselves of their intent to reinstate Auer, and putting on notice who will stand for election at the next annual meeting
        - (B) & (C)→
            - Class A SHs have the right to elect 9 directors and remove for cause thus, it's not inappropriate to elect the successors to fill the vacancies of directors SHs themselves removed for cause.
            - This right doesn't affect common stock holders.
            - The directors' right to remove other directors on charges pursuant to the cert. of incorporation doesn't mean the SHs relinquish their inherent power to remove directors

<u>C3. Proxy Contests + Who Pays for SH Voting</u>

- Proxy solicitation = extremely expensive ... need to put out ads and stuff
- *Rosenfeld v. Fairchild Engine & Airplane*
- Uncontested vote
    - Who pays? The corporation pays
- Contested vote
    - Who pays for incumbents?

        - RULE: The incumbents get reimbursed by the corporation for reasonable expenses incurred in good faith. If it was contested, it also has to be a contest about policy and not purely personal.
        - "Personal"
            - Personal attack. I know that guy – he's a horrible person so he shouldn't be running the corporation
        - About policy:
            - We think that the business should be focused on the Asia-Pacific division
            - We think we need to cut operational costs
    - Who pays for insurgents (challengers)?
        - RULE:
            - If the insurgents WIN, and if it's a contest over policy → reimbursement as to reasonable expenditures IF the shareholders ratify it (b/c insurgents are now interested – they're on both sides of the deal once they win)
                - Why? To avoid self-dealing
            - If the insurgents LOSE, they have to pay themselves

Shareholder Information Rights
INSERT CLASS NOTES

Shareholder Inspection Rights

- **DGCL §219** – SH List
    - Avail to SHs for purposes germane to meeting
    - Company doesn't have to provide it unless 10 days before the meeting

- **DGCL §220** – Books and Records
    - Upon written demand stating the purpose thereof, any SH may "inspect for any proper purpose" the "corporation's stock ledger, a list of its stockholders and its other books and records...A proper purpose shall mean a purpose reasonably related to such person's interest as a stockholder."
        - If SH is seeking **access to SH list, burden** is on the **corporation** to show that SH is doing so for improper reason
        - If SH is seeking **access to other corporate records**, the **burden** is on the **SHs** to prove requisite proper purpose

Why would a SH want to inspect?

- For shareholder litigation
    - A stockholder filing a derivative suit must allege either that the board rejected his presuit demand that the board assert the corporation's claim or allege with particularity why the stockholder was justified in not having made the effort to obtain board action. … If the stockholder cannot plead such assertions consistent with Chancery Rule 11, after using the "tools at hand" to obtain the necessary information before filing a derivative action, then the stockholder must make a presuit demand on the board. (*Grimes v. Donald*)
    - For a proxy contest
    - An insurgent has the tools of state inspection statutes, state voting list statutes, and Rule 14a-7 to help get voting lists or mailing done

What are "books and records"?

- Bare minimum:
    - Articles of incorporation
    - Bylaws
    - Minutes of board and sh meetings
    - Board or sh actions by written consent
- What about contracts, correspondence, and the like?
    - The Delaware Supreme Court has held that a request to access such records must be very narrowly tailored: "A Section 220 proceeding should result in an order circumscribed with rifled precision."

Shareholder Inspection Rights: Illustrative Cases

- ***State ex re. Pillsbury v. Honeywell***

    - Wanted the stock ledger ...(record that identifies shareholders, indicates how many shares they own and when they took ownership, etc) to elect someone to the board w/ his viewpoint to stop bombs that Honeywell was making
    - Court's test:
        - SH has to show a proper purpose (DGCL 220).
        - Reasonably related to such persons who is a stockholder
        - The burden is on the COMPANY to show that it's an improper purpose b/c They were seeking a ledger
    - SH in Honeywell case did not have a proper purpose in seeking the SH ledger b/c it was not germane to the SH or corporation's economic interest. It was designed just to further the SH's political and social beliefs. Denied litigation to force the company to get him the shareholder ledger.
- *Saito v. McKesson HBOC*
    - What was the sh's purpose and what books or records was he seeking?
    - Test? Who has burden?
    - Court's holding?
    - What are the underlying policy rationales?

SH Lists in Public Corporations (*NOT TESTED ON*)
- Types of shareholder lists
    - "CEDE" list: Stops at the "street names"
    - "NOBO" list: Specifies non-objecting beneficial owners
- Note: states vary on which type of list they require; Delaware law grants access to pre-existing lists of both types but doesn't require the corporation to compile a NOBO list.

[**CORPORATIONS**] – SH Litigation (Right to Sue)

Distinction Between Direct and Derivative Actions

Direct Actions
- Brought by the shareholder in his or her own name
- Cause of action belongs to the shareholder in his or her individual capacity
- Arises from an injury directly to the shareholder
- [**EX**] Claims based on disclosure reqs of securities laws
- [**EX**] Protecting voting rights for SHs
- [**EX**] Seeking more $ for sale of the corporation

Derivative Actions
- Brought by a shareholder on corporation's behalf
- Cause of action belongs to the corporation as an entity
- Arises out of an injury done to the corporation as an entity
- [**EX**] Breach of duty of care
- [**EX**] Breach of duty of loyalty

Tooley Case
- FACTS: SHs sued corporation for damages caused by merger delay. They were going to get money for their stock (they were getting cashed out)
- HOLDING:
    - It's not a derivative claim b/c no injury to company
    - It looks like a direct claim but it fails b/c the merger didn't happen yet so no damages yet (not ripe)
- To determine whether it's direct / derivative action:
    - Look @...
    - 1. Who suffered the alleged harm, the corporation or the suing shareholders individually?
    - 2. Who would receive the benefit of any recovery or other remedy, the corporation or the shareholders individually?

- [**<u>HYPO</u>**] ABC Corp entered into a contract with Jane Jones. Jones breached the contract, but ABC Corp has not sued her for that breach. May a shareholder of ABC Corp sue Jones directly?
    - It has to be brought as a **derivative** action.
    - Jones didn't owe a duty directly to shareholder.

- [**<u>HYPO</u>**] ABC Corp's treasurer embezzles all its money and absconds. Shareholders' stock is now worthless. May a shareholder of ABC Corp sue the treasurer directly?
    - **Derivative** action → corporation was the injured party overheard.
    - SH is being hurt derivatively. Cause of action = injury to CORPORATION

- [**<u>HYPO</u>**] The board of XYZ Inc. agrees to sell 80 percent of its assets to an unaffiliated purchaser. Although a vote is required by state law for the sale of "substantially all" of a corporation's assets, no shareholder vote is scheduled, because the board disputes the plaintiff's claim that the sale amounts to a disposition of substantially all of XYZ's assets. Board of directors is not giving SHs a vote that seems to be required under state law. May a shareholder sue the board directly?
    - Yes. Direct action → SH can sue the board directly on the theory that this is involving the SH's personal rights.

///

Derivative Suits

<u>Introduction</u>
- Derivative suit belongs to the corporation; But why didn't the corporation sue in the first place?
    - There might be a good business reason not to sue
    - Maybe the board was the party that did the wrong in the first place (possible conflicts of interest)
- Who is really in control of the lawsuit?
    - The plaintiff's lawyer look for a SH to use to bring the suit
- What are the incentives of the relevant parties: In bringing a suit? In settling one?
    - Corporation pays the costs if the suit succeeds/settles
    - Lawyer – great field for lawyer ... but SHs are not interested
    - Strike suite? Not meritorious... They don't have colorable claims – brought by Plaintiff's claims that are just interested in getting money out of settling
    - Lawyers and Defendants have an incentive to settle (minimizes risk for lawyers)
- Note the problem: Who is protecting shareholder interests in (a) bringing a suit, or (b) deciding to settle the suit or go to trial?
- Two potentially unfaithful "agents," on both sides:
    - the lawyer, who effectively controls the lawsuit
    - the defendant directors, who control the corporation
- Need mechanisms to protect shareholders from "agents" on both sides

<u>Screening Mechanisms</u>
*In place to make sure that the claims are meritorious and not frivolous (strike claims)

<u>1. Bonding Requirement</u>
- In some states (though not Delaware), a **derivative claimant** with "low stakes" must post security for the corporation's legal expenses. If deemed frivolous, bond is kept by corporation
- Rationale: To deter frivolous law suits

<u>*2. Demand Requirement</u>
- Most states require shareholders to **first make demand** that the board pursue legal action…unless demand is "excused" as "futile"
- "The demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of the corporation." *Aronson v. Lewis*

<u>**FRCP 23.1** (Ct. of Chancery Rule 23.1)</u>
- FRCP 23.1 – Procedural Rule for Derivative Actions by SHs
    - Requires that the shareholder:
        1. Retain ownership of the shares throughout the litigation;
        2. Make pre-suit demand on the board or allege with particularity the reasons why demand should be excused;

3. Obtain court approval of any settlement.

- Note that there are adequacy and standing rules for plaintiffs

Competing Policy Concerns

- Ideally promoting ongoing monitoring of management + deter them from acting badly b/c directors know they could get sued
- Logistical difficulties of coordinating SHs
- Derivative suits are a mechanism of managerial accountability
  - Potential for bias:
    - Directors cannot be expected to sue themselves

<v.s.>

- **Cause of action** belongs to the **corporation**
  - Like all assets, litigation is under control of the board
- Shareholder may have interests diverse from those of the corporation
  - Shareholders lawyers are often the real party in interest
- Therefore the board should have some say

What is the "**Demand**"?

- Typically a letter from shareholder to the board of directors.
  - Must request that the board bring suit on the alleged cause of action
  - Must be sufficiently specific as to apprise the board of the nature of the alleged cause of action and to evaluate its merits
- "At a minimum, a demand must ...
  - Identify the alleged wrongdoers,
  - Describe the factual basis of the wrongful acts and
  - The harm caused to the corporation, and request remedial relief."
    - *Allison v. Gen. Motors Corp.*
- **The shareholder-plaintiff must either make demand or plead that it is "excused"**

If demand is MADE:

- If demand is made, the plaintiff-shareholder is deemed to have **waived** or conceded **the right to contest board independence** and can no longer argue demand is excused
- The board may **accept** or **reject** the demand—either way, the shareholder-plaintiff loses control of the dispute
- *BJR applies to the board's decision about the demand/litigation
- All that is left for the shareholder-plaintiff is a potential argument that demand was wrongfully refused (and they would have to rebut the BJR)
  - i.e. board was **grossly negligent** in looking into the case and deciding that they are not going to pursue litigation

If plead that demand is "EXCUSED" or "FUTILE":

- If the shareholder-plaintiff pleads that demand is excused the question is … what is the standard? Demand is excused when "futile"…
  - Futile → Board has been SO tainted that it wouldn't make sense for them to decide whether or not to proceed w/ the case
- States have different standards… Delaware's is stated in *Aronson* and *Rales* (and California has a similar demand futility standard)
- If the standard is not met, failure to make demand is a procedural barrier and the suit will be dismissed or stayed

Aronson v. Lewis

- FACTS: Employment contract entitled 47% owner to get generous 5 year employment contract, subsequent term as a consultant with a large salary and annual bonus of 5% of company's pre tax profits. The K said it continued regardless of his continued ability to perform the job. → SHs said that this was a waste of corporate actions
- Paragraph 13 of the complaint:
  - Demand has not been made upon the directors of Meyers to bring this action because such attempt would be futile for the following reasons:

        - (a) All of the directors in office are named as defendants herein and they have participated in, expressly approved and/or acquiesced in, and are personally liable for, the wrongs complained of herein.
        - (b) Defendant Fink, having selected each director, controls and dominates every member of the Board and every officer of Meyers.
        - (c) Institution of this action by present directors would require the defendant directors to sue themselves, thereby placing the conduct of this action in hostile hands and preventing its effective prosecution.
- Court's ruling?
    - Plaintiffs failed to make a showing that a demand would have been futile.
    - To show demand futility, P must prove that there is a **reasonable DOUBT** that (1) the majority **directors are disinterested and independent** and (2) the challenged transaction was **otherwise the product of a valid exercise business judgment.**
    - Here, suggesting that Fink (who owned 47% of the corporation) personally selected each director and officer is sufficient to support a claim that Ds were NOT independent actors
        - It's not enough to say that the board of directors approved/participated on the transaction
        - Need more to show that they were interested/not independent
        - Not enough that they are named as defendants
    - Also, the fact that the board's approval of the employment agreement violates the business judgment is insufficient to show that the agreement is a waste of corporate assets.
    - These are too conclusory. Need to show specific facts

<u>2 Demand Futility Standards of DE</u>

- (#1) "**<u>Aronson Test</u>**" for Demand Futility
    - Demand is excused as **futile** if, with particularized allegations, the plaintiff creates <u>reasonable doubt</u> that:
        - (A) A majority of the directors are disinterested and independent; <u>OR</u>
            - You can either show EITHER that the directors are (a) not disinterested (all participate in the particular transaction) OR (b) not independent (have a familial stake)
            - Need to show particular facts to show why there weren't disinterested or independent
        - (B) The underlying transaction is the product of valid exercise of business judgment
            - It's really hard to show b/c you only have Section 220... or whatever the board has given you. You don't get full-blown discovery at this stage.
            - But you don't have to prove your whole case and win on the merits...
    - Applies in cases where the board that would consider the demand made the business decision challenged in the derivative action.
        - [**<u>HYPO</u>**] If the underlying business decision = enter into an employment contract ... it's those types of cases.
        - [**<u>HYPO</u>**] Suing the board in Ridley . Schlensky (don't want to install lights in baseball field)

- There is an alternative demand futility standard in Delaware from a case called *Rales v. Blasband.*
    - (#2) "***<u>Rales</u>* <u>standard</u>**":
        - Applies in certain cases:
            - In cases **not involving a business decision** (e.g., failure to exercise oversight claim, nonfeasance), or
            - Where a majority of the board has been replaced since the challenged transaction with disinterested and independent members, or
            - Where the challenged decision was made by the board of a different corporation or a third party.
    - "**Rales Test**" for Demand Futility in ^ Cases
        - Whether the derivative stockholder complaint **creates a reasonable doubt** that, as of the time the complaint is filed, the current board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.
            - You're trying to challenge whether there is a disinterested and independent board of directors NOW

- ***If the standard is NOT met, failure to make demand is a procedural barrier and the suit will be dismissed or stayed*

Alternative Approach of ALI and RMBCA: "Universal Demand"

- Adopted in some states – "Everyone has to make a demand"
  - Shifts the focus (from whether the litigation is frivolous) to whether once you made demand, whether the directors' decision to terminate the suit would be entitled to deference
- No demand futility test; Demand must be made in all cases.
    - No shareholder may commence a derivative suit until 90 days after the demand, unless (i) the shareholder has earlier been notified that the corporation has rejected the demand; or (ii) irreparable injury would result to the corporation by waiting.
- Somewhat strict judicial review of wrongful rejection
- Functionally ends up being more or less the same as the demand futility approach—ideally filter bad cases out and good ones in

Auerbach v. Bennett

- Facts:
  - SHs brought derivative suit against the corporation, board of directors and auditors b/c board of directors were involved in a bribe. Board responded by making a "special litigation committee" comprised of 3 independent directors who joined after the bribery occurred. Demand was not made; it would have been futile. Special litigation committee decided not to sue the earlier directors.
- Issue: Can the SLC do this?
- Holding:
  - Court → Their decision to make an SLC gets BJR if they (1) informed themselves and (2) acted in good faith.
  - Burdon is on the plaintiff to show that the directors on the SLC didn't inform themselves (grossly negligent in informing themselves) or didn't act in good faith in making that decision. If the P couldn't show that, the ct would defer to the SLC's recommendation.
  - Committee engaged special outside counsel, looked over everything and came to a decision. Court grants the motion to dismiss.

Zapata Corp v. Maldonado

- Facts:
  - Maldonado sued 10 officers and directors alleging excessive compensation (directors pushed back exercise date of stock options). Demand was not made → excused as futile... Zapata directors appointed 2 new directors to vacancies during the time litigation was filed and waiting to go to trial. Created a SLC who recommended dismissal (continued maintenance of the litigation is not good for the corporation's interest).
- Issue:
  - When should we allow a demand to be excused when an authorized board committee
- Holding
  - There needs to be some kind of permissible procedure under the board's authority to run the corporation to rid itself of detrimental litigation.
  - 141(c) allows board of directors to delegate powers to a committee
  - If it's really detrimental litigation, we should let the board get rid of this.
  - DE court doesn't like BJR ... it's too lax. Demand has already been excused.

DE Standard for Reviewing SLC Recommendations

- "***Zapata*** **Two-Step**" in demand-excused cases:
  - Step 1: **Procedural inquiry**
    - Inquiry into the **independence** and **good faith** of the committee and the bases supporting its conclusions
      - Limited discovery may be ordered to facilitate such inquiries
      - **Corporation has burden** of proving independence, good faith, and reasonable investigation
  - Step 2: **Substantive inquiry**

- If the court is satisfied with the above, the court may go on to apply its own business judgment as to whether the motion to dismiss should be granted
- Look @ what the SLC was looking at to decide to dismiss that suit
  - What do SLCs consider when recommending for the best interest of the corporation?
    - Merits of the claim
    - Cost
    - Reputation/PR
    - Ethical, commercial, employee relations, fiscal relations etc.

Review: 2 Approaches to SLCs

- ***Auerbach* (NY)***:* Procedural not substantive scrutiny of SLC
  - SLC decision covered by BJR
  - But judicial inquiry permitted with respect to:
    - Disinterested independence of SLC members
    - Adequacy of SLC's investigation
  - Burden of proof on plaintiff
- ***Zapata* (DE)*:*** In demand-excused cases, 2-step judicial inquiry into (1) independence, good faith, and a reasonable investigation, with corporation bearing burden, as well as (2) substance, with the court using its "own independent business judgment"
- States differ in which they follow
- California has adopted an approach to SLCs similar to NY

Independence

- Longtime Delaware standard:
  - *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984):
  - One of the defendant directors and alleged wrongdoers owned 47% of the corporation's stock and allegedly had personally selected each board member.
  - The DE Supreme Court held that this did not render the board per se incapable of exercising independent judgment.
    - Instead, **plaintiff must "demonstrate that through personal or other relationships the directors are beholden to the controlling person."**
- Does *Oracle* (Del. Ch. 2003) change the standard?

In re Oracle Corp. Derivative Litigation

- FACTS
  - Derivative action (P) stockholders brought... claiming that 4 members of the Oracle board allegedly were engaged in improper insider trading in oracle stock and actions of the other members of the Oracle board (different b/t what the company was doing and what the board was saying what they were doing – subjective bad faith)
  - Company appointed a special litigation committee from Stanford University. Who hired outside counsel ... and after investigation, they recommended dismissal of the derivative action.
- HOLDING
  - SLC members were not independent, and did not carry their burden of showing they were independent → refused to dismiss the action
  - Applied the rule of the Zapata 2-step test. SLC had the burden of proving that they were independent and put in good faith in coming to the conclusion
    - Facts in favor of independence
      - They were tenured professors at Stanford, not officers at Oracle. They were outside directors and tenured! Guarantee of a job.
      - Agreed to return the compensation if the court found that it was excessive (no financial strings)
      - There was an absence of any material ties b/t Oracle, the trading defendants and the SLC committee members
    - Facts against independence:
      - They were personal friends of the accused directors
      - Lots of donations from directors to Stanford University

        - One of the trading defendants = Stanford Professor, taught one of the SLC members
    - Too many collegial and monetary (donation) ties – bias that affects SLC's decision (bias could go in favor or against the directors... the SLC committee may have been even tougher on the directors because of these personal/donation ties)

Indemnification

- Indemnification is making, or agreeing to make, a person whole in light of possible or anticipated losses and expenses.
    - Depending on the circumstances, a corporation may indemnify directors and officers against judgments, amounts paid in settlement, and attorney's fees…
- Indemnification statutes generally contain provisions for **mandatory** and **permissive** indemnification. And they specify payments that corporations must not indemnify (prohibited).
    - Under the **mandatory statutory provisions**, corporations must indemnify those individuals who satisfy certain statutory prerequisites.
        - See, e.g., DGCL 145(c) (where a D or O "has been successful on the merits or otherwise in defense of any action…such person shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred…")
        - **"Successful on the Merits" = victory on trial, dismissal without paying damages
    - The **permissive statutory provisions**, on the other hand, grant corporate boards some discretion in determining whom to indemnify, and typically require that a specified standard of conduct be met. See, e.g., DGCL § 145(a) and (b)
- **DGCL § 145(a)** – Direct Suits
    - Indemnification in what types of actions?
        - Direct claims
    - Who is covered?
        - Director, officer employee or agent of the corporation
    - What is indemnified?
        - Expenses, including attorney fees, judgments, fines settlements...
    - Standard
        - So long as... if the person acted in **good faith** and **reasonably believes to be not opposed to the company's interests**
- **DGCL § 145(b)** – Derivative Suits
    - Type of action:
        - Derivative
    - Who is covered?
        - Director, officer employee or agent of the corporation
    - What is indemnified?
        - JUST attorney fees that were incurred actually and reasonably
        - *Concern about circularity... if funds received by the corporation in the form of a settlement or judgment were returned to the person who is paying them.
    - Standard
        - good faith + reasonably believes to be not opposed to the corporation's interests
    - "No indemnification shall be made in respect of any claim... unless the Court of Chancery or the court in which such action or suit was brought shall determine upon application that ... such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper."

- **DGCL § 145(d)** – How to make the permissive indemnification
    - It's w/in the company's discretion and the board can decide to do this
    - There are 4 diff. ways you can get permissive indemnification
        - 1. Approval from majority of disinterested directors
        - 2. Approval from independent / special legal counsel
        - 3. Approval from majority of SHs
        - 4. Court approval

- **DGCL § 145(e)**

        - Authorizes corporations to advance, i.e., pay officers and directors their litigation expenses, including attorneys fees.

- **DGCL § 145(f)**
    - Statute is not exclusive and does not bar other rights to indemnification through bylaws, agreement, vote of stockholders or disinterested directors or otherwise (courts have use public policy considerations to set outer bounds though)
    - Allows the corporation to enter into a separate indemnification agreement or put it in your bylaws
- **DGCL § 145(g)**
    - A corporation may **buy insurance** with coverage broader than permissible indemnification
    - What doesn't get covered w/ derivative suits? Settlements! (It's covered under direct suits but not under derivative so corporation can buy insurance to cover settlements in derivative suits)

D&O Insurance

- D = Directors, O = Officers
- In General:
    - **Indemnification** and **D&O** Insurance are **mutually supportive** (as opposed to mutually exclusive)
    - All, or **nearly all, public corporations** carry D & O insurance
    - A **large % of private companies** do.
    - But it is often **expensive** and sometimes difficult or impossible to obtain.
        - Some corporations (esp ones that can't get D&O insurance) **put money away** to establish trust funds to pay damages or expenses.
    - Policies may have **high deductibles**, **maximum coverages**, and/or **exclusions** (e.g., for reckless conduct, intentional torts, violation of certain types of laws, etc.). = Detailed insurance policies
- Commonly has **different parts** to cover different things:
    - "Side A": An executive liability part.
        - Pays directors and officers directly for loss (including defense costs) when corporate indemnification is unavailable;
    - "Side B": A corporate reimbursement part
        - Pays the corporation for any money it has paid as indemnification to the insured directors and officers.
    - "Side C": Corporate entity coverage for securities claims
- To the extent that insurance covers a director's payment to the corporation (e.g., settlement), funds make a round trip: from the corporation (in the aggregate over time) to the insurance company, and from the insurance company back to the corporation.
    - Goes full circle...
    - What's the net value of this type of SH litigation? Deterrence effect

Attorneys' Fees in Derivative Actions

- 2 Different Rationales (need to show in order to convince courts to get paid by corporation funds)
    - (1) "**Common fund theory**"
        - Where the action produces **monetary recovery**
        - Monetary recovery benefited all of the SHs so they should all pay a piece for the attorney who obtained that recovery on behalf of the corporation
    - (2) "**Substantial benefit"/"Common benefit**"
        - A case outcome that **confers a substantial benefit** on the corporation
            - e.g., injunction resulting in improved disclosure, amendment to bylaws, adoption of a code of conduct or of a policy statement governing management, etc.
        - Courts liberally construe
        - Show that you (atty) conferred a substantial benefit in bringing the suit
        - More common b/c the outcome = usually a settlement
- Computation of fee:
    - Based on either lodestar (taking the reasonable # of hours, adjusted by the risk) or contingency (percentage of recovery methods)

- *Recall our discussion of incentives to settle

- Mutually agreeable settlement territory b/t Plaintiff's attorneys and the Defendants
    - "I'll be good from now on"
    - Governance changes (cosmetic?)
    - Perhaps a payment (from whom?)
- Recitation that suit conferred "substantial benefit"
- Recitation that directors acted in good faith
    - Plaintiffs' lawyer gets paid, directors covered by indemnification and insurance

- Judicial Approval of Settlements
    - Even if you can show that there has been a "substantial benefit," court STILL needs to approve the settlement.
        - * Judges usually approve the settlement, unless there's something that raises the brow

    - Courts purportedly consider a wide range of factors in deciding whether to approve a settlement, including
        - (1) the maximum and likely recovery;
        - (2) the complexity, expense, and duration of continued litigation;
        - (3) the probability of success;
        - (4) the stage of the proceedings;
        - (5) the ability of the defendants to pay a larger judgment;
        - (6) the adequacy of the settlement terms;
        - (7) whether the settlement vindicates important public policies;
        - (8) whether the settlement was approved by disinterested directors; and
        - (9) whether other shareholders have objected.

MERGERS & ACQUISITIONS
*Basic overview for the Bar Exam

- Point #1: SH Approval of M&As
    - You may or may NOT need SH approval for the merger, depending on how you structure
    - Typically, when there's a fundamental change, such as a sale of the company (e.g., Van Gorkum) or a sale of the substantial assets (> 75%), then you have to follow some type of procedure:
        - 1. Board adopts action
        - 2. Written notice goes to SH
        - 3. ***SH needs to approve***
        - 4. Some type of change to articles of incorporation or bylaws
        - 5. Change gets filed
    - BUT Mergers and acquisitions can be structured in a whole bunch of different ways... that changes the procedures that have to be followed.
        - Different types of structures:
            - [EX] One company merges into another and ceases to exist
            - [EX] One company acquires another and creates a subsidiary corporation and the other company is flipped in the subsidiary
            - [EX] Share exchange – Company A buys Company B, tells B shareholders exchange their B shares into A shares
- Point #2: SH Appraisal Rights
    - When there's an M&A Deal and a SH vote is required, there is a mechanism to protect dissenting SHs who oppose the deal = Appraisal Right
    - SH is required to dissent before the vote is taken and demand the fair value of your shares. If the SH doesn't like that, they can sue.
    - Illust: "I don't like this deal. I don't think it's the fair value of my shares. I want the fair value"
- Point #3: Fiduciary duties in the context of M&A
    - Issue of breach of fiduciary duties in the context of M&A:
        - Is there a fiduciary duty by directors by not agreeing to a merger, putting in place anti-takeover devices, not trying to get the best price for the shareholders etc.
- Point #4: Tender Offers
    - Tender Offers = If a company bids on another company by a tender offer, there is a federal law called the **Williams Act** that regulates tender offers

- **Williams Act**:
    - If an entity or a person is doing a tender (made an offer to buy shares of company for a certain price by a certain time) – once they hit the 5% mark, they have disclose their identity and financials and state what their plan is concerning a target company ...
    - They have to do the tender offer must be open for at least 20 days, offer same price to everyone, etc.
- *Thus, coercive tender offers will be a violation of the Williams Act

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[CORPORATIONS] – Securities Fraud

Securities Fraud

Background:

- 10b5 Securities Fraud à Insider Trading (Subset of 10b5)
- **Trading of Stock Takes Place on 2 Markets**
    - Primary Markets
        - Issuer of securities (i.e., corporation) sells them to investors
        - ~Buying Audi at the dealership
    - Secondary Markets
        - Investors are trading amongst themselves
        - ~Buying Audi second-hand, by a previous owner
- **History**:
    - Wanted to protect securities investors from speculative schemes (worried about fraudsters selling stock)
- **Securities Law Framework**
    - *Security = Broad; Includes stocks, notes and bonds (form of debt), investment contracts, etc.
        - Securities law regulates more than just corporate stock
        - Know corporate stock as a security for the purposes of this class
    - Securities Act of 1933
        - Goals = Integration of stock and market stability (regulating the sale of new securities in primary markets)
    - Securities Act of 1934
        - Exchange act regulates secondary trading activity
        - SEC's 3 primary functions
            - Provide interpretive guidance to provide info to private parties on how securities law applies
            - Advises the commissions as to the new rules or existing rules
            - Investigates and prosecutes violations of securities laws (i.e., insider trading)
    - *10(b)(5) – Anti Fraud Provision
- **Who can bring the action**?
    - The DOJ, the SEC or private parties could bring actions under 10b and 10b5.
    - **DOJ** à Criminal action, if willful violation
    - **SEC** à Civil action or call the DOJ for criminal action
    - **Private Parties** à (P)'s lawyers bringing securities fraud suits
        - Supreme Court has ruled that there is an implied right of action for private parties

Rule 10b-5 – Anti-Fraud Securities Legislation

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

1. Defraud,
2. Make untrue statement/omission of material fact
3. Engage in any act/business which would operate as fraud/deceit on any person in connection with the purchase or sale of any security

Claims Made Under Rule 10b-5

- Bring it in **federal district courts** (except actions under state corporate law)

- The lead plaintiff of a 10b-5 class action must be the "most adequate plaintiff" = the only with the largest $ stake and imposes heightened pleading reqs and other burdens

- **<u>Prerequisites:</u>**
  - **<u>Jurisdiction:</u>**
    - Almost always met
  - **<u>"Standing" Requirements</u>**
    - [1] Fraud involved the use of
      - Any means or instrumentality of **interstate commerce**, <u>OR</u>
      - Mail or facility of a **national securities exchange**"

    - [2] Activity involves a "security"
      - Stock, notes, bonds, debentures, options and voting trust certificates

    - [3] Activity is in connection w/ the purchase/sale of securities
      - "**Transactional Nexus**" = In connection w/ the purchase of sale of any security
        - "In connection" =
          - Touch and concern the purchase of sale.
          - No req of privity (even if D is not a party to the transaction, so long as the behavior affects transaction)
          - Someone bought stock BEFORE a claim of misrep or LONG AFTER the claimed misrep, the fraud/deception was probably not in connection with the sale of their security
          - You can sue company even if company was not buying/selling own stock

- **<u>5 Elements of the Claim</u>**
  - **<u>[1] Materially False/Misleading Statements</u>**
    - Material:
      - Probability/Magnitude Test
        - Probability of the event occurring
        - Magnitude: Significance/importance of the event
    - Omissions and a Duty to Disclose:
      - Duty to Disclose:
        - No duty of continuous disclosure under federal securities law
        - When does a duty to speak arise:
          - Defendant has a relationship of trust and confidence with the Plaintiff
          - Company is trading in its own securities (e.g., repurchase)
        - When does a duty to update arise?
          - Information that the company put out and is still in circulation is now false
          - Correct things that other analysts make and the company comments on
      - *"**No comment**" statement is functionally equivalent of silence à Not misleading (No duty to disclose all information at all times)

    - <u>*Basic v. Levinson*</u>
      - Company was in merger negotiations w/ another company and it flatly denied about the fact that there were M&A discussions in progress
        - Materiality? Stock price could go up = deal rumors are important in a stock market
        - Kept denying the rumors until it was acquired
        - Investors who sold their stock between the denial and actual sale
        - Relied on the denials and sold the stock, didn't get benefit from the upside of the sale
      - "Material Representation"

- Substantial likelihood that a reasonable SH would consider the fact important
- Highly fact-dependent probability/magnitude balancing approach
- Probability that the underlying information is happening
- Importance of the event
  - [**EX**] Death of the corporation = magnitude is great
- Material if high magnitude and low probability, or low magnitude and high probability

- **[2] Scienter (Intent to Deceive)**
  - Requires "intent" to deceive; negligence is not enough (although some courts allow deliberate recklessness)
  - *Tellabs v. Makor Issues & Rights*
    - FACTS: Allegation that CEO made misrepresentations which had to do w/ channel stuffing (done to inflate what the financials look like at currently). CEO makes statements about one of the most important products
    - ISSUE: Pleading standards for scienter in a securities fraud case
      - "State w/ particularity facts giving rise to a strong inference that the (D) acted w/ the required state of mind" in making a false/misleading statement
      - What counts as a strong inference?
    - Steps to Determining "Strong Inference" of Scienter:
      - (1) Court, when faced w/ Rule 12(b)(6) motion in a securities fraud, **accept all factual allegations as true**
      - (2) **Consider the complaint in its entirety**, as well as other sources of which the court can take judicial notice of
        - Whether all of the facts alleged collectively give a strong inference of scienter (not whether a particular allegation meets that standard)
      - (3) Strong inference that there was scienter – **taking into account plausible opposing inferences**
        - Only if a reasonable person will deem scienter "cogent"
          - Meaning, at least as compelling as any other opposing inference
        - "More likely than not" that (D) acted w/ scienter
    - **Court said that CEO was talking about one of the most important products – it's a probable conclusion that he had some intent to defraud
  - [**HYPO**] On behalf of Mining Co., a public corporation, the CEO issued a statement that the corporation was experiencing average or below average productivity levels. The CEO knew that the situation was in fact significantly better because of a recent major mineral discovery on the edge of its land. The CEO had a legitimate desire, however, to acquire additional nearby leases for Mining Co. before it revealed its mineral discovery.
    - Assuming the plaintiffs can show the above, is there sufficient scienter to support a Rule 10b-5 claim?
    - Yes, b/c he KNEW that the statement had a propensity to mislead. Proof of a legitimate a motive doesn't mitigate against a finding of a culpable state of mind
      - He was doing it w/ the hopes to buy some more time to get the additional nearby leases and afraid that if he announced to the world that he was sitting on a goldmine, those ppl would raise their land
      - Person is doing it for the good of the company but he's still intending to deceive by making a material misrepresentation (knew that there was something that was something that was materially misleading – awareness that they were making a material representation)

- **[3] Plaintiff's Reliance**
  - In General,
    - Reliance must be reasonable on the material misrepresentation/omission
  - In omission cases,
    - Reliance is **presumed** if the undisclosed facts were **material**

- In misrepresentation cases:
  - Reliance will be difficult to show in a class action
  - **"Fraud on the Market" Theory**: Rebuttable presumption that investor relied on integrity of public trading market price when making investment decision – so investor need not have seen misrepresentation
    - Can only be used on "publicly traded stock" on an open and efficient market
    - Invoked When
      - Material + public misrepresentation
      - The stock traded in an efficient market
      - (P) traded the stock b/t when the misrepresentations were made and when the truth was revealed
    - Rebutting the Presumption (3 Ways)
      - 1. Show that the challenged misrepresentation didn't affect the stock price b/c the true information was already available
      - 2. Specific (P)s would've bought/sold anyway
      - 3. Stock wasn't trading on an efficient market
    - Policy/Rationale: In an open and developed securities market, the stock price is determined by available material information regarding the company and its business
      - The semi-efficiency theory: Historical and currently public info get incorporated into the trading price that's going on in a market very quickly b/c it's an efficient market

- **[4] Causation**
  - (1) **Transaction** (But-For) Causation
    - *Presumed if omission / fraud on the market cases
      - Closely related to reliance
    - But for the fraud, P would not have entered the transaction / would have entered under diff. terms
  - (2) **Loss** Causation
    - *Must be shown by Ps (typically by expert witnesses)
      - Akin to proximate cause
    - The fraud was caused the (P)'s loss
      - Battle of the experts when it goes to trial
        - Try to measure the impact of the fraudulent statement by doing a vac study – cumulative abnormal returns to see if market reacted to something at a particular time
      - [**EX**] Show a change in stock prices when the misrepresentations were made and then an opposite change when corrective disclosures were made
      - If the stock price did not change w/ the corrective disclosure / SH sold before the corrective disclosure, the P might be out of luck for showing loss causation

- **[5] Economic Harm / Damages**
  - Possible Damages:
    - Recession
      - Face-to-face transactions w/ identifiable parties
    - Disgorgement
      - Get (D)'s profits back
    - Out-of-pocket Damages (Most common)
      - Diff b/t purchase price and what the true price should have been when you bought
      - PSLRA Caps Damages – At diff b/t the transacted price and the average of the daily prices

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[CORPORATIONS] – Insider Trading

Overview:

- Focus on federal law (state law action exists but not as well developed)
- This is a subset of a 10b-5 action
- Historic Timeline
  - 1934: Exchange Act 10(b) and 16(b)
  - 1940s: SEC promulgates Rule 10b-5
  - 1960s:
    - In Re Cody, Roberts – SEC administrative ruling that insider trading violates Rule 10b-5
    - Texas Gulf Sulpher
    - Case Law: Insiders have a duty to disclose or abstain
  - 1980s:
    - Chiarella (Classical)
    - Dirks (Tipping)
    - Legislative clarifications and increased penalties for insider trading
  - 1990s: O'Hagan (Misappropriation)
  - 200s: Rule 10b5-1 and 2; Reg FD
- *Insider trading is not trading on the basis of non-public information. It has to fall under one of three theories being studied today

(1) Classic Insider Trading

- Classic Insider Trading Scenario:
  - A company's insider who owes a fiduciary duty to the corporation / SH is in possession of material, non- trades on that company's stock and trades on that company's stock
- **<u>RULE</u>**: An insider [1] who owes a **duty to disclose** is liable for violating 10b-5 if he traded in his own company's stock [2] based on **material, non-public information** prior to the trade and [3] **failed to disclose.**
  - Applies both to:
    - "Insider": Directors, officers, and agent of the company
    - "Constructive Insider": Someone (1) who obtains material, nonpublic info (2) with an expectation on the part of the corporation that the person will keep the info confidential (3) relationship implies such a duty
      - "Implies such a duty" – by the nature of the relationship there is a duty to keep the info confidential
      - e.g., Lawyers, accountants, bankers, consultants.

- ***<u>Chiarella v. U.S</u>***.
  - <u>RULE</u>: Insider trading violates Rule 10b-5 when one fails to disclose material, non-public information prior to the consummation of a transaction **if he had a duty to disclose**.
    - "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"
  - <u>FACTS</u>: Chiarella worked as a printing company as a printer. Was printing tender offers of a secret take-over bid; figured out who the parties to the transaction were and bought the shares of the target company (one that's being acquired). Makes $ from buying low and selling high
  - <u>HOLDING</u>:
    - Chiarella's conduct was not a violation of Rule 10b-5 because he was not an "insider" with a duty to disclose. He was not an agent of the target company or the acquiring company – he was an employee of the printing company that was not party to the transaction
    - No relationship of "trust and confidence" w/ the SH of the target firm w/ whom he traded
      - There was no violation of trust between the corporation's shareholders and Chiarella b/c he had no duty to disclose or abstain
    - This is NOT classical insider trading. You have to be trading w/ your own company stock with whom you have a fiduciary relationship with
  - *He would have been held liable under a "misappropriation theory" but (P) didn't address it fully enough so the Supreme Court didn't need to consider it.

(2) Tipper/Tippee Liability

- <u>**RULES**</u>:
    - <u>Tipper</u> is liable if he
        - (1) **Owes a fiduciary duty** to the company and
        - (2) Disclosed information in breach of that duty by **receiving a direct/indirect personal benefit**
            - Quid-pro-quo (reciprocal information)
            - Pecuniary gain
            - Gift to a relative/friend (might not be enough if not meaningfully close)
            - Reputational gain that will translate to future earnings
            - The mere fact of a tip is not a sufficient breach – need to owe a duty and disclose for an improper personal benefit

    - <u>Tippee</u> is liable only if tipper is liable;
        - Tippee's liability is derivative of the Tipper's liability

    - <u>Tippee's tippee</u> is liable if he knows / has reason to know that there has been a breach

- <u>***Dirks v. SEC***</u>
    - FACTS: Secrist (insider, tipper) told Dirks (broker/analyst, tippee) who told him that there was fraud going on at the company. Dirks told his clients, SEC and the Wall Street Journal. Clients began selling their shares
        - *Classic insider trading wouldn't work as a theory to go after Dirks b/c he didn't owe a fiduciary duty
    - HOLDING:
        - Dirks is not liable because Secrist (tipper) is not liable and the tippee's liability is derivative of the tipper's liability.
    - Tipper/Tippee Liability Analysis:
        - Tipper's Liability:
            - <u>(1) Does Secrist owe a **duty** to Equity Funding?</u>
                - Yes
            - <u>(2) Did Secrist disclose the info for an improper **personal benefit**?</u>
                - No. → No Tipper liability and no tippee derivative liability
                - [<u>**HYPO**</u>] If Secrist had been exchanging stock tips with Dirks
                    - Improper benefit b/c expect a future quid pro quo even though this particular tip was to whistle blow...
                - [<u>**HYPO**</u>] If Secrist disclosed the fraud in part b/c he had been fired?
                    - Is "getting revenge" a personal benefit? Prof. says unclear
                - [<u>**HYPO**</u>] Dirks merely overhead Secrist describing the fraud in a public elevator
                    - Not enough to show personal benefit
                - [<u>**HYPO**</u>] Secrist had disclosed inside info to Dirks b/c of a bribe from Dirks. Dirks then advised his clients to sell their Equity Funding Stock.
                    - Secrist = tipper liability
                    - Dirks = liable as tippee b/c Secrist is liable
                    - Clients= Liable if knew or had reason to know that Dirks had breached his fiduciary duty

        - *If Tipper was liable... Did Tippee know/have reason to know that there has been a breach? If yes → inherits the tipper's duty
        - If yes, " chain of sub-tippees"
- <u>***SEC v. Switzer***</u>
    - Switzer claimed that when he was sitting in the bleachers at his daughter's track meet, he overheard a CEO telling his wife that he would be out of town b/c his company might be liquidated. Switzer and his pals traded on the information
        - NO LIABILITY; he is just an eavesdropper.
        - No duty owed to company

- *Note: **<u>Regulation FD</u>** (adopted by SEC in 2000)
    - Restricts selective disclose of material non-public information by someone acting on behalf of a public corporation
    - If a corp. discloses MNPI to securities market pros or SHs who may trade on that info, the corp. must disclose the information to the public, to widely disseminate the news
    - Intentional disclosures must be ...
- *<u>Understanding Dirks Today / Recent Developments</u>:
    - US v.s. Newman

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Nikki's Notes
Rule 14e-3

- Prohibits insider trading during a tender offer and thus supplements Rule 10b-5.
    - Once substantial steps towards a tender offer have been taken, Rule 14e-3(a) prohibits anyone, except the bidder, who possesses material, nonpublic information about the offer from trading in the target's securities.
    - Rule 14e-3(d) prohibits anyone connected with the tender offer from tipping material, nonpublic information about it.
- Rule 14e-3 is not premised on breach of a fiduciary duty.
    - *O'Hagan* upholds it anyway.
        - Rule of Law
        - (1) A person is guilty of securities fraud when he misappropriates confidential information for securities trading purposes, in breach of a duty to the source of that information.
        - (2) SEC Rule 14e-3 is a proper use of the SEC's rulemaking authority and should be given deference.
        - Why no classical insider trading theory, in this case?
            - O'Hagan wasn't an insider of Pillsbury (his firm worked for Grand Met so only owed them a fiduciary duty).
        - Who no tipper/tippee liability?
            - No one tipped O'Hagan (so no breach of fiduciary duty for personal benefit)
        - Misappropriation
            - Defendant misappropriates confidential info in breach of a duty owed to the source of the info. → When D took the info from his law firm's client he breached a duty to his firm and the client.

Misappropriation Theory 10b-5

- Defendant misappropriates confidential info in breach of a duty owed to the source of the info.
- How do we determine whether the defendant had a fiduciary duty?
    - Does the corporation expect the outsider to keep the information confidential?
        - O'Hagan: Lawyer's ethical codes, Lawyer's position/role → yes.
        - Also, other guidance about who owes a duty: Rule 10b5-2
            - List (see below)
- How could O'Hagan have avoided liability?
    - Abstain from trading
    - Disclosure to the source of the info (client and the law firm*); public disclosure not required
    - Practical impact:
        - Disclosure vs. consent; federal vs. state law
        - Rule 14e-3? If the firm gave D consent, then the firm would have violated 14e-3

Rule10b5-2

- Rule 10b5-2 provides a <u>non-exclusive</u> list of three situations in which a person has a <u>duty of trust or confidence</u> for the purpose of the misappropriation theory:
- (1) Whenever a person agrees to maintain info in confidence;
- (2) Whenever the person communicating info and the person to whom it is communicated have a history, pattern or practice of sharing confidences, such that the recipient of the info knows or reasonably should know that the person communicating the info expects the recipient to maintain confidentiality; or

- (3) Whenever the info is obtained from a *spouse, parent, child or sibling,* unless recipient shows that history, pattern or practice indicates no expectation of confidentiality.

Summary: Outsider Trading in Violation of Rule 10b-5

- Tipper-Tippee Liability
    - Rule: Tipper in fiduciary relationship of trust and confidence disclosed info for personal benefit [= breach of duty] and
        - (1) Tippee knows or has reason to know that there has been a breach [inherits duty]
        - (2) Tippee trades or causes others to trade
    - ***Duty is to disclose to public or refrain from trading***
- Misappropriation
    - Rule: Defendant misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the info
    - ***Duty is to disclose to source or refrain from trading***

What is **Rule 10b5-1**

- Rule 10b5-1 specifies that a purchase or sale constitutes trading "on the basis of" MNPI where the person making the purchase or sale was aware of MNPI at the time the purchase or sale was made.

What is a **Rule 10b5-1 plan**?

- = A written plan for trading securities that is designed in accordance with Rule 10b5-1(c).
- Any person executing pre-planned transactions pursuant to a Rule 10b5-1 plan that was established in good faith at a time when that person was unaware of MNPI has an affirmative defense against accusations of insider trading, even if actual trades made pursuant to the plan are executed at a time when the individual may be aware of MNPI that would otherwise subject that person to liability under Exchange Act § 10(b) or Rule 10b-5.
- 10b5-1 plans are especially useful for people presumed to have inside information, such as officers and directors.
- Exchange Act § 16(b) still applies to trades made pursuant to a Rule 10b5-1 plan.

Insider Trading Penalties

- Civil:
    - Injunction
    - Disgorgement of profits
    - SEC can seek treble money sanctions, up to 3x profits realized or losses avoided
        - Because the SEC can seek disgorgement and treble damages, an inside trader thus faces potential civil liability up to 4 times profit gained.
    - Administrative proceedings for regulated market professionals (censure, suspension or revocation of broker/dealer licenses, etc.)
- Criminal:
    - Prison up to 20 years
    - Fines up to $5 million fine for individuals; $25 million for corporate defendants

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SEC Section 16(b) Short Swing Liability

- Short swing profits / Exchange Act Section 16:
    - *Section 16 applies only to **public corporations**

- **SEC Act 16(a)** – Reporting obligations
    - 3 types of people:
        - Someone who holds more than 105 of any class of stock
        - Director
        - Officer
    - Have to file w/ the SEC commission a statement disclosing their trades w/in a certain period of time following a transaction

        - "I sold/bought stocks in my company"
    - *SOX accelerated the deadlines for reporting insider transactions

- **SEC Act 16(b)** – Bright-line short-swing trading rule (over-and-under inclusive for insider trading)
    - "Any profit realized by someone [1] who holds more than 10% of any class of stock, [2] director or [2] officer from any purchase and sale, or any sale and purchase of any equity security of such issuer w/in any period of less than 6 months ... shall inure to and be recoverable by the issuer.
    - i.e., Any profit realized by 10% or more SH, director or officer w/in 6 months of buying/selling public company's stock has to pay it back to the company

- SEC Act 16(b) Rule Highlights
    - Rule is **strict liability**.
        - Requires disgorgement to public corporation of profits made
        - W/in a 6-month period
        - By certain insiders and beneficial owners
        - Therefore, intent is irrelevant
    - Applies only to officers, directors or SHs w/ more than 10% of stock
        - Officer: SEC definition includes prez, CFO, chief accounting officers, VPs of principal business units and any person with significant "policymaking function"
        - Beneficial owner: 10% of any class of any equity of security
            - Stock classes are considered separately
            - If have 2 diff. classes of stock, Class A and B. If SH holds more than 10% of Class A stock
        - Deputization:
            - If Corp X authorizes one of its employees to serve on the board of Corporation Y, and Corporation X profits on Y stock w/in a 6 month period, Corp X may be liable under section 16(b).
                - Imputed liability
        - **Matching Rules** (Made sale price and purchase price to maximize profits)
            - Directors and officers
                - You **cannot** match a transaction made **prior** to appointment to one made **after** appointment
                    - Law assumes that before they're holding the office, they don't have access to insider information.
                    - *Any trades they made before appointment to office are not subject to this rule.
                - You **can** match transactions that occur after he/she ceases to be an officer/ director with those made while still in office
                    - For a period of time after they leave, they might still have that information.
                    - *Can match transactions AFTER he leaving office, as long as they're w/in the 6 months period
            - Beneficial owner:
                - 16(b) liability only if she owned more than 10% both at the time of the purchase AND of the sale (i.e., Beneficial owner at both purchase AND sale)
                    - ***Foremost-McKesson v. Provident Securities***
                        - Oct. 20: Provient acquired debentures convertible into > than 10% of Foremost stock
                        - Oct 24: Provident distributed some debentures to SHs, reducing the convertible debt holdings to less than 10%
                        - Oct 28: Provident sells remaining debentures, then distributed cash proceeds to shareholders and dissolved
                        - Can we match the Oct 20 acquisition and Oct. 24 disposition? NO. Beneficial owner has to have owned stock both at the time of purchase and sale. They weren't a beneficial owner on Oct. 20.

            - If you have a purchase and a sale, the transaction in which the SH crosses the 10% threshold, counts as a process of them becoming a 10% owner... but doesn't count as them being an actual 10% holder.
    - Rules only apply to **public companies**
        - 1. Companies w/ shares traded on a national exchange
        - 2. Companies that are forced to go public under 12(g)
            - Companies w/ $10million in assets and ore than 2,000 SHs
        - 3. Registered under the 1934 Act
        - *Note that 10b-5 applies to ALL issuers;
    - Applies to **equity securities**
        - Stocks, convertible debt and options to buy/sell (a "call" or "put")
        - Rule 10b-5 applies to ALL securities
    - Applies to both types of transactions:
        - 1. Sale → Purchase and
        - 2. Purchase → Sale
    - Courts will interpret the statute to **maximize the gain** that the company recovers
        - Therefore, shares are fungible for the purposes of 16(b).
        - If a trader sells 10 shares of stock and w/in 6 months, they buy 10 different shares at a cheaper price, they're still liable
    - Recovery goes back to the company
        - 16(b) profits can be discovered through
            - SEC filings
            - SHs can sue derivatively (SH's lawyer can get a contingent fee out of any recovery/settlement)
        - Statute of limitations: 2 years
- Approaching the 16(b) issue
    - Is the company public?
    - Is the defendant a director, officer or beneficial owner of the company?
        - D&O:
            - Match if transactions **while** in position
            - Match transactions that occur **after** leaving position, so long as w/in 6 month period
        - Beneficial Owner:
            - If she owned more than 10% both at the time they entered into the transaction and after the sale
    - Can you match any purchase and sale w/in a 6 month period that yield profits?
        - Buy low and sell high
        - Sell high and buy low
    - "<u>Matchable</u>": Situation in which you have a D O or Beneficial Owner
        - w/in 6 months
        - Bought low and sold high / sold high and bought low

1. Director
    a. 16(b) Short Swing Trade Liability –
        i. A director/officer of a public company is liable to the corporation for any profit realized by buying/selling stock within 6 months.
        ii. Liable for $20,000 (bought 1,000 for $25 and sold 1,000 at $5)
    b. 10b-5
        i. Unclear who made the announcement on behalf of the corporation on January 2 and June 18.
        ii. If it was the director, there might be a material misrepresentation.
            1. Jurisdiction
            2. In connection w/ the purchase/seller of a security
                a. Must have bought/sold the stock
            3. Material Misrepresentation
                a. Substantial likelihood that the reasonable SH would consider the fact important

            b. "Expected" earning – did this term reasonably suggest uncertainty?
        4. Reliance/Causation/Economic Loss
            a. Fraud on the Market Theory – Rebuttable presumption
    c. Duty to disclose to correct information that the company put out and is still in circulation
    d. **10b5** – Classic Insider Trading
        i. An insider [1] who owes a **duty to disclose** is liable for violating 10b-5 if he traded in his own company's stock [2] based on **material, non-public information** prior to the trade and [3] **failed to disclose.**
        ii. "On the basis of" material non-public = aware of
            1. When he sold the shares on Mar 1:
                a. Facts indicate sold his shares more than 3 months BEFORE the corporation learned that b/c of unforeseen expenses, its revenues would decrease
            2. When he bought the shares on July 1:
                a. The information was made public;
                b. Depends on whether he was aware of material non-public information

2. Officer
    a. Tipper Liability
        i. A tipper is liable if he (1) owes a fiduciary duty to the company and (2) disclosed information in breach of hat duty by receiving a direct/indirect personal benefit
            1. Officer owed a fiduciary duty
            2. Officer disclosed for what purpose? It looks like it's just an instrumental disclosure to get his taxes done. Doesn't look like he was giving that info for personal benefit
                a. Was disclosing in confidence to get his taxes done
                b. Need to expect something FOR THAT INFO

3. Lawyer
    a. Misappropriation
    b.

- **<u>RULES</u>**:
    - <u>Tipper</u> is liable if he
        - (1) **Owes a fiduciary duty** to the company and
        - (2) Disclosed information in breach of that duty by **receiving a direct/indirect personal benefit**
            - Quid-pro-quo (reciprocal information)
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LIMITED LIABILITY COMPANIES (LLCs)

IN GENERAL

- Characteristics:
    - LLCs are their own **unique form of biz organization** (not partnerships / corporations)
        - The "C" in LLC refers to company NOT corporation
    - **Not subject to the restrictions applicable to S corps** (e.g., 100 sharholds, US citizens/residents)
    - They typically have **characteristics** of **both partnerships and corporations**

        - **Tax advantages** (can choose to be taxed like a partnership or a corporation; partnership = pass-through tax)
        - **Limited liability** (like corporations)
    - Hallmark Characteristics of LLC = **FLEXIBILITY**
        - Premised on notion of "private ordering"
            - A LLC is as much a creature of *contract* as of statute
        - Except as expressly limited by statute, the "operating agreement" sets the rules for the LLC
- *Notes on CA LLCs:
    - Licensed professionals cannot operate through LLCs in California
    - In choosing b/t forms of business, consider tax and fee issues

LLC BASICS

- State LLC laws vary:
    - Each state has its own LLC statute
    - There is a uniform statute, RULLCA adopted by over a dozen states (CA included)
    - LLC case law is developing, but is generally much less extensive than partnership and corporate case law b/c LLCs are relatively new
- Look @ the "**operating agreement**" → it's the key doc for an LLC; courts have drawn on contract principles as well as partnership and corporate law principles in resolving disputes

FORMATION

- Choose state of organization and reserve the LLC name
- Draft articles/cert of organization consistent w/ statutory reqs and file w/ Secretary of State, paying filing gees an the franchise tax
        - Check the reqs
            - LLC's name
            - Purpose
            - Agent for services of process
            - Desc of type of biz that constitutes the principal biz activity of the LLC
            - In CA: If the LLC is to be managed by 1 / more managers and not by all its members, the articles shall contain a statement to that effect
- Tax arrangements (sate and federal)
- Designate office and agent for service of process
- Draft and enter into an **operating agreement**
        - The basic contract governing the affairs of a LLC and stating the various rights and duties of the members
            - Member's units/interests
            - Rights and duties
            - Allocate profits losses, divisions, distributions
            - Amendment of the agmt
            - Remedies in the event that the members disagree
            - Exit provisions (e.g., withdrawal, dissociation, admission) and dissolution
        - *In CA, all LLCs are req'd to have an operating agreement (diff from partnership law b/c partnerships are not req'd to have a partnership agreement in CA)
- *In CA, file a "Statement of Info" w/ Secretary of State w/in 90 days

LIMITED LIABILITY / VEIL PIERCING EXCEPTION

- **General Rule**:
    - No member/manager of a limited liability company is obligated personally for any debt, obligation, or liability of the LLC solely by reason of being a member or acting as a manager of the limted liability company
- Exceptions:
    - Courts have imported veil piercing concepts into LLC law
    - Courts have pierced the LLC veil of limited liability to reach the personal assets of members under circumstances similar to those under which courts would pierce the veil of a corporation
        - In large ways, the test is similar to that of PCV

        - You wouldn't use in the factors whether or not corporate formalities were followed b/c the whole idea of LLCs is flexibility

MANAGEMENT RIGHTS

- Variable management structure: can choose member-managed or manager-managed and can customize governance

- The **default** is member-managed (e.g., RULLCA § 407)
    - Most matters (ordinary course of business) are decided by majority vote
    - States vary regarding whether the default allocation is one-person/one-vote or by ownership interests in the company (percentage or units)
        - Significant matters require unanimous consent
        - E.g., merger, admission of new member, amending the operating agreement, etc…

- **Manager-managed** LLC option available
    - Can be structured as a committee, "board of managers," a CEO, etc.
    - Some statutes require that the choice be specified in the articles/certificate of organization (California requires both the articles and operating agreement to explicitly state manager-managed if want to establish that structure)

FINANCE

- Contributions
    - No min amount of capital to be contributed
    - Not all members need to make capital contributions
    - Members are free to decide among themselves how much cash, property or services each member will contribute
- Allocation of Profits and Losses
    - Typically provided in the operating agreement
        - Profits and losses may be allocated differently
    - DE Default: Allocate profits and losses on a pro rata basis per the ownership interest in the company (percentage or units)
    - RULLCA does not provide a default (it does for contributions + distributions) '
- Distributions
    - Refers to the transfer of LLC property (e.g., cash) to members
    - Members have no statutory right to compel a distribution – go by rules in the operating agreement
    - When there is a distribution declared, statues usually have 1 of 2 default rules:
        - Distributions on pro rata basis per the ownership int in the co (percentage or units) (CA)
        - Equal share rules per capita like partnership (eg RULLCA)
- Transferability
    - Unless otherwise provided in the LLC's operating agreement, a member may assign her financial interest in the LLC
        - Such a transfer typically transfers only the member's right to receive distributions and does not confer governance rights or rights to participate in management.
        - An assignee of a financial interest in an LLC may acquire other rights only by being admitted as a member of the company if all the remaining members consent or the operating agreement so provides.
        - Analogous to partnership rules.

FIDUCIARY DUTIES

- Depends if it's manager-managed or member-managed

- If Manager-Managed LLC:
    - The mangers of a manager-managed LLC have a default duty of care and loyalty
        - Standard of care varies by state (some state an ordinary care standard, some state gross negligence)
    - Usually members have no duties to the LLC or its members by reason of being members

- If Member-Managed:
    - All members of a member-managed LLC have a default duty of care and loyalty

- Standard of care varies by state (some state an ordinary care standard, some state gross negligence)

- <u>*Derivative Actions</u>
  - Member may bring an action on behalf of the LLC to recover a judgment in its favor of the members w/ authority to bring the action refuse to do so

- <u>*Freedom of K</u>
  - RULLCA permits modification but not elimination of fiduciary duties ("manifestly unreasonable" standard)
  - Some states (like DE) have allowed for elimination of fiduciary duties if clearly and expressly provided in the operating agreement
  - The implied contractual covenant of good faith and fair dealing is non-waivable (RULLCA allows the operating agreement to prescribe standards, if not manifestly unreasonably, by which the performance of the obligation is to be measured)

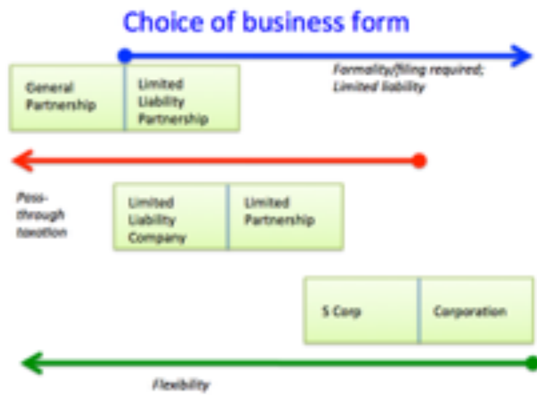
DISSOCIATION AND DISSOLUTION (RULLCA)

- RULLCA provides for dissociation and dissolution default rules generally similar to RUPA with some big differences:
  - the unilateral withdrawal of a member by express will does not result in a dissolution;
  - there is no default provision for a buyout upon dissociation (instead the dissociated member holds interest as a transferee)
  - provides different events by which a member can dissociate and also means of expelling a member (incl. where a member transfers all her interest)
- RULLCA thus creates more stability (like a corp) by making it far harder for a member to force a dissolution and winding up than in a partnership.
- Remember: importance of customized rules in an operating agreement.

DISSOCIATION AND DISSOLUTION (DE)

- Provides default rules for dissolution upon any of the following:
  - At the time, or upon the happening of events, specified in the operating agreement;
  - Unless otherwise provided in the operating agreement, upon the vote or consent of members who own more than 2/3 of the then-current percentage interests in the LLC;
  - Within 90 days of an event that terminated the membership of the last remaining member (with limited exceptions); or
  - Upon the entry of a decree of judicial dissolution.
- Unless otherwise provided in the operating agreement, a member cannot unilaterally resign or withdraw until the LLC has been dissolved and wound up.

Partnership	Corporation
Informal • Advisable to have partnership agreement though.	**State filing & corporate formalities required**
Decentralized: owner-managed • Can alter by contract (e.g., law firms)	**Centralized: manager-managed** • Separation of ownership & control • Can alter by contract/statute (closely held corporations)
Unlimited liability • Partnership agreement can have indemnity provisions • Get insurance!	**Limited liability** • Creditors seek guarantees (closely held) • May not be an option for certain professions
Full partnership interest not freely transferable • Can alter by contract	**Free transferability of interest** • Not realistic option in closely held • Can restrict transfers
No continuity (at will) • Can alter by creating a term	**Continuity/perpetual** • Can limit to a definite term



Review Benefit Corporation Powerpoint! Know different between Benefit corporation and B Corp.