ALAN JAMES KLUEGEL

A PRACTICAL CASEBOOK FOR BUSINESS ASSOCIATIONS

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Dedicated to

Contents

1. *Introduction*

What Is A Corporation?

A CORPORATION is a pile of money with a line drawn around it. (This goes for the other business entities[1] we will cover in this book, too.) Almost everything in corporate law relates to (1) who controls what is done with that pile of money, and (2) who gets to grab money out of the pile and take it home with them.

[1] Right off the hop: I use the terms "corporate entity" and "business entity" interchangeably to refer to an organization formed by law to conduct for-profit business. The terms **corporation**, **partnership**, and **limited liability company** refer to specific types of these organizations, and are not interchangeable.

You might hear people describe a corporation (or a partnership, or a limited liability company) in other ways, all of which are various degrees of doofy:

"A Team" A team is comprised of people working together for a common purpose.[2] A team might work for a corporation, and contracts that the corporation enters into might facilitate that team, but the corporation itself is an entity, not a team. You don't see kids with "GO SHAREHOLDERS!" posters on their bedroom walls.

[2] Unless the team in question is the Chicago Cubs, which exists as a sort of tax write-off for an unrelated real estate concern.

"A Family" If you work at a company, and your boss calls it a "family", you are in for the worst working conditions of your life. A corporation is not a family, no matter how many of the boss's children are inexplicably on the company's health care plan.

"A Person" This is a common but extremely limited metaphor. Corporations can enter into contracts, sue and be sued, own property, borrow and lend money, pay taxes, and be held criminally liable – just like people. However, unlike people, corporations have potentially unlimited life spans, cannot experience pain, feel no emotions[3], have no values of their own, cannot speak for themselves, and are brought into and out of being by filing various pieces of paper.

[3] Read this part in your best "Linda Hamilton in *Terminator 2: Judgment Day*" voice.

In reality, the most accurate anthropomorphic metaphor for a corporation is the *golem* from Jewish folklore.[4] According to various Eastern European legends, a golem is a person-like creature

[4] Not to be confused with the Gollum that is tricksed by hobbitses.

> made out of dirt, brought to life by inserting into its mouth a piece of paper with holy words written on it, and controlled by the human who created it for whatever purpose they see fit. At the end of its life, the golem crumbles into dust, which is functionally similar but way more dramatically satisfying than a corporate liquidation.
>
> In 2010 – and we will discuss this more fully in Chapter 17 – five justices of the Supreme Court briefly confused metaphor with reality and granted corporations a largely incoherent set of First Amendment rights, the contours of which are still being litigated. That particular bit of weirdness aside, a corporation is not a person and should not be treated like one or reasonably be expected to act like one.

What each of these flawed metaphors has in common is that they are trying in their own way to make a single, important point: a corporation is a ***unique legal entity***, distinguishable from the people who run it and the parties who invest in it.[1] The same is true for partnerships and limited liability companies, a fact which is often spelled out explicitly in the statutes under which these entities are created:

Partnership	KRS §362.1-201(1)	"A partnership is an entity distinct from its partners"
LLC	KRS §275-010(2)	"A limited liability company is a legal entity distinct from its members"

[1] "[A] corporation is usually recognized as an entity which is distinct from its shareholders, officers, and directors," *White v. Winchester Land Development Corp.*, 584 SW 2d 56, 61, (Ky. Ct of Appeals 1979); KRS §271B.6-220(2) (specifying that the corporation and shareholders have distinct liabilities).

THE REASON to hammer home this point right at the start is that there are two popular misconceptions about corporate entities.

The first misconception is that a business entity is nothing more than an amalgation of its investors, like a Voltron of shareholders.[2] This is often paired with a claim that, because shareholders "own" the corporation (they don't), it should be run exclusively to maximize their returns (this is called "shareholder primacy", among other things, and we discuss it in Chapter 9). Leaving aside the moral bankruptcy and legal hollowness of the shareholder primacy claim, as a matter of law the claim that a corporation is coterminous with its investors is completely untrue. A corporate entity is legally separate and distinct from the investors that have contributed money to it.

[2] Or Megazord from *Power Rangers*, or the Combiners from *Transformers*. They might have had this sort of thing in *Mobile Suit Gundam*, too? I'm so behind schedule in putting this chapter together that I'm not about to go look that up.

The second misconception is that a business entity is merely an extension of its leadership. What is Tesla but Elon Musk? What is

Amazon but Jeff Bezos? What is Apple but That Guy Who Isn't Steve Jobs?[1] In reality, as powerful as they are and as synonomous with the company as they become, the managers of a company are employees of the company, not the company itself. A corporate entity is legally separate and distinct from those who manage it.

[1] "I used to say, 'Tim, you got to start doing it over here.' And you really have. I mean, you've really put a big investment in our country. We appreciate it very much, Tim Apple." – Donald Trump to Apple CEO Tim Cook, March 6, 2019.

In addition to avoiding those common points of confusion, understanding a business association as a standalone entity is critical to understanding two legal concepts that we will return to over and over in this book: **limited liability** and **fiduciary duties**.[2]

[2] It will also be relevant to establishing standing in shareholder suits and in our discussions on how these entities are taxed.

Limited Liability

All forms of business entities – with the exception of a General Partnership (Chapter 3) – offer what is called "limited liability" to their investors. Having limited liability means that the investor (a shareholder in a corporation, for example) cannot be held personally liable for the debts and obligations (in contract or tort) of the entity that they've invested in. The investor can lose whatever money they've invested in the company (hence the name: *liability* is *limited* to their investment), but they do not risk any of their other assets.[3]

[3] Note that an investor can still *choose* to take on this liability via contract, for example by co-signing a loan to a corporation they are a shareholder in.

If the corporate entity and its investors were one and the same, limited liability would make no sense – a claimant could reasonably sue either the company or the investor to be made whole. Limited liability thus requires a strict separation of the aforementioned piles of money: these are the corporation's assets, which can be used to satisfy an obligation; those are the investors' assets, which are off-limits.[4]

[4] The failure by an investor to respect this separation can allow courts to disregard the corporate entity entirely and impose liability on the investor directly, a legal doctrine called "piercing the corporate veil" (Chapter 11). The corporation is a separate entity, and you damn well better treat it that way because if you don't, then you blow the whole thing.

Fiduciary Duties

A business entity – being a pile of money with a line drawn around it, remember? – cannot act for itself. It relies on managers to act on its behalf, and these managers are natural persons who are appointed to run the entity. These people are *agents* of the entity, empowered under the laws governing agency (Chapter 2) to make decisions, enter into agreements, and control the resources of the entity.

As agents of the corporate entity, they are also *fiduciaries* of the entity and owe the entity certain fiduciary duties. These fiduciary duties can be broadly understood as requiring managers to look after the entity's interests and put those interests above their own.[5] Again, the idea of a business being a distinct entity with distinct interests is critical to conceiving of these fiduciary duties, because if they were one and the same – if Elon Musk really *was* Tesla – a manager acting in

[5] These can vary by type of entity, and will be covered in excruciating detail in Chapters 3, 7, 8, and 12.

their own interest would by definition be acting in the interest of the business, and these duties could never be breached.

This fundamental question – when does someone have to put the interests of a business above their own? – is at the heart of *Meinhard v. Salmon*.[1] A quick note before we begin: we start with this classic case not because it is particularly relevant to modern practice (general partnerships are rarely used for any reason today, and surely would not be used for a deal like this), but because it deals with themes and legal concepts that we will see throughout the material: governance rules, contractual obligations and baseline duties, the expectations of the parties, and choices about risk- and profit-sharing.[2]

[1] Here, and throughout the book, judicial opinions have been edited for brevity and clarity. You're welcome.

[2] In other words (and as I said in the first paragraph of this chapter): power and money.

Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928)

CARDOZO, C.J.

On April 10, 1902, Louisa M. Gerry leased to the defendant Walter J. Salmon[3] the premises known as the Hotel Bristol at the northwest corner of Forty-second street and Fifth avenue in the city of New York. The lease was for a term of twenty years, commencing May 1, 1902, and ending April 30, 1922. The lessee undertook to change the hotel building for use as shops and offices at a cost of $200,000. Alterations and additions were to be accretions to the land.

[3] Not pronounced like the fish, just FYI. Think "Saul" like *Better Call Saul*.

Salmon, while in course of treaty with the lessor as to the execution of the lease, was in course of treaty with Meinhard[4], the plaintiff, for the necessary funds. The result was a joint venture with terms embodied in a writing. Meinhard was to pay to Salmon half of the moneys requisite to reconstruct, alter, manage and operate the property. Salmon was to pay to Meinhard 40% of the net profits for the first five years of the lease and 50% for the years thereafter. If there were losses, each party was to bear them equally. Salmon, however, was to have sole power to "manage, lease, underlet and operate" the building. There were to be certain pre-emptive rights for each in the contingency of death.[5]

[4] Morton H. "Money" Meinhard to you.

[5] File this away for when we talk about *Stahl v. Apple Bancorp*.

The two were coadventurers,[6] subject to fiduciary duties akin to those of partners. As to this we are all agreed. The heavier weight of duty rested, however, upon Salmon. He was a coadventurer with Meinhard, but he was manager as well. During the early years of the enterprise, the building, reconstructed, was operated at a loss. If the relation had then ended, Meinhard as well as Salmon would have carried a heavy burden. Later the profits became large with the result that for each of the investors there came a rich return. For each, the venture had its phases of fair weather and of foul. The two were in it jointly, for better or for worse.

[6] This and "joint adventurers" makes it sound like some *Lean On Me* shit, but here Cardozo just means that they were the participants in the joint venture to the run the hotel.

When the lease was near its end, Elbridge T. Gerry[7] had become the

[7] Pronounced like the guy on *Parks and Recreation*. Has a much more famous grandfather with the same name.

owner of the reversion. He owned much other property in the neighborhood, one lot adjoining the Bristol Building on Fifth avenue and four lots on Forty-second street. He had a plan to lease the entire tract for a long term to some one who would destroy the buildings then existing, and put up another in their place. In the latter part of 1921, he submitted such a project to several capitalists and dealers. He was unable to carry it through with any of them. Then, in January, 1922, with less than four months of the lease to run, he approached the defendant Salmon. The result was a new lease to the Midpoint Realty Company, which is owned and controlled by Salmon,[1] a lease covering the whole tract, and involving a huge outlay. The term is to be twenty years, but successive covenants for renewal will extend it to a maximum of eighty years at the will of either party. The existing buildings may remain unchanged for seven years. They are then to be torn down, and a new building to cost $3,000,000 is to be placed upon the site. The rental, which under the Bristol lease was only $55,000, is to be from $350,000 to $475,000 for the properties so combined. Salmon personally guaranteed the performance by the lessee of the covenants of the new lease until such time as the new building had been completed and fully paid for.

[1] Note here that when Salmon is trying to go into business for himself, he creates a corporation. Too little, too late, buddy!

The lease between Gerry and the Midpoint Realty Company was signed and delivered on January 25, 1922. Salmon had not told Meinhard anything about it.[2] Whatever his motive may have been, he had kept the negotiations to himself. Meinhard was not informed even of the bare existence of a project. The first that he knew of it was in February when the lease was an accomplished fact. He then made demand on the defendants that the lease be held in trust as an asset of the venture, making offer upon the trial to share the personal obligations incidental to the guaranty. The demand was followed by refusal, and later by this suit.

[2] In fact, they had fallen out well before 1922. At the time Salmon signed the new lease, the two hadn't spoken in five years.

Salmon Tower (built in 1927)

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

The owner of the reversion, Mr. Gerry, had vainly striven to find a tenant who would favor his ambitious scheme of demolition and construction.

Baffled in the search, he turned to the defendant Salmon in possession of the Bristol, the keystone of the project. He figured to himself beyond a doubt that the man in possession would prove a likely customer. To the eye of an observer, Salmon held the lease as owner in his own right, for himself and no one else. In fact he held it as a fiduciary, for himself and another, sharers in a common venture. If this fact had been proclaimed, if the lease by its terms had run in favor of a partnership, Mr. Gerry, we may fairly assume, would have laid before the partners, and not merely before one of them, his plan of reconstruction. The pre-emptive privilege, or, better, the pre-emptive opportunity, that was thus an incident of the enterprise, Salmon appropriated to himself in secrecy and silence. He might have warned Meinhard that the plan had been submitted, and that either would be free to compete for the award. If he had done this, we do not need to say whether he would have been under a duty, if successful in the competition, to hold the lease so acquired for the benefit of a venture then about to end, and thus prolong by indirection its responsibilities and duties. The trouble about his conduct is that he excluded his coadventurer from any chance to compete, from any chance to enjoy the opportunity for benefit that had come to him alone by virtue of his agency. This chance, if nothing more, he was under a duty to concede. The price of its denial is an extension of the trust at the option and for the benefit of the one whom he excluded.[1]

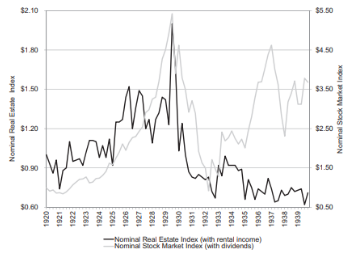
No answer is it to say that the chance would have been of little value even if seasonably offered. Such a calculus of probabilities is beyond the science of the chancery. Salmon, the real estate operator, might have been preferred to Meinhard, the woolen merchant. On the other hand, Meinhard might have offered better terms, or reinforced his offer by alliance with the wealth of others. Perhaps he might even have persuaded the lessor to renew the Bristol lease alone, postponing for a time, in return for higher rentals, the improvement of adjoining lots. We know that even under the lease as made the time for the enlargement of the building was delayed for seven years. All these opportunities were cut away from him through another's intervention. He knew that Salmon was the manager. As the time drew near for the expiration of the lease, he would naturally assume from silence, if from nothing else, that the lessor was willing to extend it for a term of years, or at least to let it stand as a lease from year to year. Not impossibly the lessor would have done so, whatever his protestations of unwillingness, if Salmon had not given assent to a project more attractive. The very fact that Salmon was in control with exclusive powers of direction charged him the more obviously with the duty of disclosure, since only through disclosure could opportunity be equalized. If he might cut off renewal by a purchase for his own benefit when four months were to pass before the lease would have an end, he might do so with equal right while there remained as

[1] Fun fact: not even a year after this case was decided, the entirety of the world economy crashed and commercial real estate lost more than half of its value practically overnight. Because partners in a general partnership share the profits ***and losses*** equally, Meinhard's insistence on getting cut in on this deal ended up reducing Salmon's losses by half. The legend goes that Salmon sent a bouquet of flowers to Justice Cardozo on every anniversary of the decision to thank him for this unexpected benefit.

many years. He might steal a march on his comrade under cover of the darkness, and then hold the captured ground. Loyalty and comradeship are not so easily abjured.

Little profit will come from a dissection of the precedents.[1] None precisely similar is cited in the briefs of counsel. What is similar in many, or so it seems to us, is the animating principle. Authority is, of course, abundant that one partner may not appropriate to his own use a renewal of a lease, though its term is to begin at the expiration of the partnership. The lease at hand with its many changes is not strictly a renewal. Even so, the standard of loyalty for those in trust relations is without the fixed divisions of a graduated scale. Equity refuses to confine within the bounds of classified transactions its precept of a loyalty that is undivided and unselfish. A constructive trust is then the remedial device through which preference of self is made subordinate to loyalty to others.

[1] Little profit came anyway.



(*via* Tom Nicholas and Anna Scherbina, "Real Estate Prices During the Roaring Twenties and the Great Depression," *Real Estate Economics* 41, no. 2 (Summer 2013): 278–309.)

We have no thought to hold that Salmon was guilty of a conscious purpose to defraud. Very likely he assumed in all good faith that with the approaching end of the venture he might ignore his coadventurer and take the extension for himself. He had given to the enterprise time and labor as well as money. He had made it a success. Meinhard, who had given money, but neither time nor labor, had already been richly paid. There might seem to be something grasping in his insistence upon more. Such recriminations are not unusual when coadventurers fall out. They are not without their force if conduct is to be judged by the common standards of competitors. That is not to say that they have pertinency here. Salmon had put himself in a position in which thought of self was to be renounced, however hard the abnegation. He was much more than a coadventurer. He was a managing coadventurer. For him and for those like him, the rule of undivided loyalty is relentless and supreme. A different question would be here if there were lacking any nexus of relation between the business conducted by the manager and the opportunity brought to him as an incident of management. For this problem, as for most, there are distinctions of degree. If Salmon had received from Gerry a proposition to lease a building at a location far removed, he might have held for himself the privilege thus acquired, or so we shall assume. Here the subject-matter of the new lease was an extension and enlargement of the subject-matter of the old one. A managing coadventurer appropriating the benefit of such a lease without warning to his partner might fairly expect to be reproached with conduct that was underhand, or lacking, to say the least, in reasonable candor, if the partner were to surprise him in the act of signing the new instrument. Conduct subject to that reproach does not receive from equity a healing benediction.

A question remains as to the form and extent of the equitable interest to be allotted to the plaintiff. The trust as declared has been held to attach to the lease which was in the name of the defendant corporation. We think it ought to attach at the option of the defendant Salmon to the shares of stock which were owned by him or were under his control. The difference may be important if the lessee shall wish to execute an assignment of the lease, as it ought to be free to do with the consent of the lessor. On the other hand, an equal division of the shares might lead to other hardships. It might take away from Salmon the power of control and management which under the plan of the joint venture he was to have from first to last. The number of shares to be allotted to the plaintiff should, therefore, be reduced to such an extent as may be necessary to preserve to the defendant Salmon the expected measure of dominion. To that end an extra share should be added to his half.

ANDREWS, J., dissenting

I am of the opinion that the issue here is simple. Was the transaction in view of all the circumstances surrounding it unfair and inequitable? I reach this conclusion for two reasons. There was no general partnership, merely a joint venture for a limited object, to end at a fixed time. The new lease, covering additional property, containing many new and unusual terms and conditions, with a possible duration of eighty years, was more nearly the purchase of the reversion than the ordinary renewal with which the authorities are concerned.

The referee[1] finds that this arrangement did not create a partnership between Salmon and Meinhard. In this he is clearly right. He is equally right in holding that while no general partnership existed the two men had entered into a joint adventure and that while the legal title to the lease was in Salmon, Meinhard had some sort of an equitable interest therein. Salmon was to manage the property for their joint benefit. He was bound to use good faith. He could not willfully destroy the lease, the object of the adventure, to the detriment of Meinhard.

[1] Old timey reference to the trial judge in this case.

Were this a general partnership between Salmon and Meinhard I should have little doubt as to the correctness of this result assuming the new lease to be an offshoot of the old. Such a situation involves questions of trust and confidence to a high degree; it involves questions of good will; many other considerations. As has been said, rarely if ever may one partner without the knowledge of the other acquire for himself the renewal of a lease held by the firm, even if the new lease is to begin after the firm is dissolved.

We have here a different situation governed by less drastic principles. It seems to me that the venture so inaugurated had in view a limited object and was to end at a limited time. There was no intent to expand it into a far greater undertaking lasting for many years. The design was to exploit a particular lease. Doubtless in it Meinhard had an equitable interest, but in it alone. This interest terminated when the joint adventure terminated. There was no intent that for the benefit of both any advantage should be taken of the chance of renewal — that the adventure should be continued beyond that date. Salmon has done all he promised to do in return for Meinhard's undertaking when he distributed profits up to May 1, 1922.

Suppose this lease, non-assignable without the consent of the lessor, had contained a renewal option. Could Meinhard have exercised it? Could he have insisted that Salmon do so? Had Salmon done so could he insist that the agreement to share losses still existed or could Meinhard have claimed that the joint adventure was still to continue for twenty or eighty years? I do not think so. The adventure by its express terms ended on May 1, 1922. The contract by its language and by its whole import excluded the idea that the tenant's expectancy was to subsist for the benefit of the plaintiff. On that date whatever there was left of value in the lease reverted to Salmon, as it would had the lease been for thirty years instead of twenty. Any equity which Meinhard possessed was in the particular lease itself, not in any possibility of renewal. There was nothing unfair in Salmon's conduct.

SOME DISCUSSION QUESTIONS:

1. What exactly were the expectations of Meinhard and Salmon heading into this joint venture? How were those expectations manifested in their agreement? What was left out?

2. Why didn't Meinhard simply hire Salmon as an employee to run the venture? Why didn't Salmon simply borrow money from Meinhard with a promise to pay him interest on the loan?[1]

3. A "joint venture" by itself is not a business entity (it is a kind of contractual arrangement, which can include creating a new entity but does not have to). A partnership, however, is. What were the features of the Salmeinhard[2] arrangement that leads Justice Cardozo to find that this was a partnership? Why does the dissent disagree?

Why Fiduciary Duties?

Cardozo makes clear (and the dissent agrees) that partners in a partnership owe a "duty of the finest loyalty", something above the mere "morals of the market place". This raises the question: what's wrong with the morals of the market place? This is a capitalist society,[3] Salmon saw an opportunity to make money after this joint venture was over, and so he went out and took it. In America, when someone offers you money, you grab it with both hands.[4] So what did Salmon

[1] "Why does Ross, the largest friend, not simply eat the other five?"

[2] As the tabloids probably called them.

[3] This isn't Russia. Is this Russia? This isn't Russia, is it?

[4] "Everybody needs money. That's why they call it *money*."

do wrong?

One way to answer this question is to think about what the business world would be like if the people running a business entity were able to abandon the entity and take for themselves whatever opportunities came along.[1] If everyone was out for themselves – and everyone knew everyone else was out for themselves – why would anyone start a business with anyone else? Would Meinhard have invested in this business if he thought Salmon would take the new lease without him? Would anyone invest in anything?

[1] "... something, something ... act only according to that maxim whereby you can at the same time will that it should become a universal law ... idk whatever ..." — some German dude

Some would argue that Meinhard could have protected himself by contracting for the right to be cut in on future deals,[2] even though it would be difficult to foresee exactly what kind of situations the parties might find themselves in twenty years down the line. In many ways, however, this is the point of fiduciary duties: they bind managers of business entities in situations both foreseen and unforeseen, encouraging investment in those entities by offering some degree of certainty to investors that the people managing the business won't either shirk their responsibilities or use their position to personally profit at the expense of the business.

[2] Also fair to ask: would Salmon have entered into the deal if he knew he'd be locked in for longer than the twenty years stipulated in the contract?

Principal and Agent

Seen from this perspective, *Meinhard v. Salmon* provides a nice introduction to Agency Law (Chapter 2), by illuminating the conflicting incentives between principals and agents. An agent, when acting on behalf of the principal, will often acquire information that could be useful to the principal OR to the agent.[3] As such, the principal wants to make sure that the agent uses that information to benefit the principal, and while there are multiple ways to do that (contract, monitoring, incentives, etc.), one way that agents are kept in line is through default fiduciary duties that run between the agent and the partner. In *Meinhard v. Salmon*, the new opportunity arose because of the work that he was doing on behalf of the partnership — at least this is how Cardozo sees it — and so the fiduciary duty of loyalty demands that the partnership gets the benefit of that opportunity.

[3] Cardozo's opinion is a little confusing on this point, so it's worth clarifying: Salmon is an agent of the **partnership**, not an agent of Meinhard individually.

Cardozo gets wildly poetic — and, let's be honest, pretty weepy — about how standards of honor and respect should guide the relationship between partners. When it comes time to fashion a remedy, however, his focus shifts. Instead of dwelling on how Salmon's conduct damaged Meinhard (the subject of the more passionate parts of the opinion), Cardozo sets about to repair the *partnership* itself, the true victim of Salmon's breach.

Remedies

Meinhard and Salmon had a contract, and the primary remedy for breach of contract is damages.[1] Unbeknownst to Salmon, however, the two men had a general partnership (at least according to Justice Cardozo), and under such an arrangement the two are to share in the profits and losses of the business. In finding that Salmon's conduct constituted a breach of his fiduciary duties to that partnership, Cardozo opens the door to a wider range of potential remedies than merely damages (which at this point would be largely speculative). As such, Cardozo sets up a constructive trust, and essentially continues the partnership between Meinhard and Salmon on basically the same terms with regard to the new lease.

[1] Specific performance is generally discouraged unless contemplated in the contract. Elon Musk recently learned this in connection with his failed attempt to get out of acquiring Twitter.

This kind of solution might seem strange — the corporate law equivalent of shackling together two prisoners that hate each other — but courts have a wide range of equitable remedies to draw on in corporate law cases (particularly those that involve a breach of fiduciary duty). They can unwind agreements, mandate or halt payments, nullify managerial decisions, and even order the dissolution of a corporate entity. To the extent that corporate law is about finding a balance between the interests of investors and managers — and, consequently, keeping the engines of capitalism running — these powers are necessary to maintain that balance.

MORE QUESTIONS:

1. Cardozo awards one additional share to Salmon, basically giving him 50.1% of the interest in the business, leaving Meinhard 49.9% of the interest.[2] Why?

[2] "Hey, kid. Here's a little something for the effort."

2. If Salmon had been aware that he was in a partnership with Meinhard, could he have contracted with Meinhard to allow him to take a business opportunity for himself?[3]

[3] We'll discuss this exact question further in Chapter 3 (and in Chapter 8 for corporations, and Chapter 12 for LLCs).

And Now, A Word From Karl Marx

Referencing Marx in a corporate law casebook is mostly a joke,[4] but in fact Marx did briefly discuss the role of the corporation in the capitalist system, and as per usual he knocked it out of the goddamn park. In Volume III of *Das Kapital*, published in 1894 (a decade after Marx's death), Marx considers the emergence of privately-held (as opposed to state-chartered and state-controlled) corporations. For Marx, there were three consequences arising from the formation of these joint stock companies (the early term for corporations) and placing them in private hands:

[4] "Marxists and MBAs know the same things, they just disagree on whether they're good or bad." – James Fallows Tierney

1. An enormous expansion of the scale of production and of enterprises, that was impossible for individual capitalists. At the same time, enterprises that were formerly government enterprises, become public.
2. The capital, which in itself rests on a social mode of production and presupposes a social concentration of means of production and labour-power, is here directly endowed with the form of social capital (capital of directly associated individuals) as distinct from private capital, and its undertakings assume the form of social undertakings as distinct from private undertakings. It is the abolition of capital as private property within the framework of capitalist production itself.
3. **Transformation of the actually functioning capitalist into a mere manager, administrator of other people's capital, and of the owner of capital into a mere owner, a mere money-capitalist.** Even if the dividends which they receive include the interest and the profit of enterprise, i.e., the total profit (for the salary of the manager is, or should be, simply the wage of a specific type of skilled labour, whose price is regulated in the labour-market like that of any other labour), this total profit is henceforth received only in the form of interest, i.e., as mere compensation for owning capital that now is entirely divorced from the function in the actual process of reproduction, just as this function in the person of the manager is divorced from ownership of capital. Profit thus appears (no longer only that portion of it, the interest, which derives its justification from the profit of the borrower) as a mere appropriation of the surplus-labour of others, arising from the conversion of means of production into capital, i.e., from their alienation vis-à-vis the actual producer, from their antithesis as another's property to every individual actually at work in production, from manager down to the last day-labourer. In stock companies the function is divorced from capital ownership, hence also labour is entirely divorced from ownership of means of production and surplus-labour. **This result of the ultimate development of capitalist production is a necessary transitional phase towards the reconversion of capital into the property of producers, although no longer as the private property of the individual producers, but rather as the property of associated producers, as outright social property.** On the other hand, the stock company is a transition toward the conversion of all functions in the reproduction process which still remain linked with capitalist property, into mere functions of associated producers, into social functions.[1]

[1] Karl Marx, *Das Kapital, Volume III*, Chap. 27, Part III.

I include this excerpt not to radicalize you into bureaucratic collectivism or whatever,[2] but to underline that the modern corporation was a radical invention. In place of the individual capitalist (who owned all the property, had full control of the business, received all of the profits, and bore all of the risks) we now have:

[2] Marx also thought that the introduction of the corporation "reproduces a new financial aristocracy, a new variety of parasites in the shape of promoters, speculators and simply nominal directors; a whole system of swindling and cheating by means of corporation promotion, stock issuance, and stock speculation", which, yeah, you know, *fair point.*

1. The investor, who receives distributions of money from the corporate entity (what Marx called "interest"), but who does not own either the entity or the assets of the business.

2. The manager, who has control over and who acts on behalf of the corporate entity (the "administrator"), but who likewise does not own the entity or the assets of the business, and does not receive a return on capital invested (unless the manager is also an investor).

3. The corporate entity, brought into being by virtue of being recognized by the state, who owns all of the business' property and collects the profits, bears the risk of losses,[1] but is not owned by anyone (the "social property").

[1] The risk of losses is also externalized via limited liability, borne by people outside of the corporation, because shareholders cannot be liable to third parties in excess of the capital they contributed to the corporation.

The corporation thus takes the capitalist out of capitalism, and creates a new system with two distinct groups of natural persons (investors and managers) and a legal fiction separate and apart from both of them. Under this new regime, the interests of these parties will sometimes align and sometimes conflict. This book, and the field of corporate law more generally, is about identifying, avoiding, and resolving those conflicts.

To that end, we begin in the next chapter with the law of agency, which was designed to handle conflicts between principals and agents, and assign responsibility to one or the other when it comes to obligations to third parties.

2. *Agency*

Qui facit per alium, facit per se ipsum – whoever acts through another acts as if they were doing it themselves.[1] The law of agency is old as hell, and aspects of it can be found in many areas of the law (contract, tort, employment, etc.). In this book we will primarily be examining agency in terms of individuals acting on behalf of business entities, but it is important to understand the broad contours of agency law before we focus on its role in business law.

[1] Extremely rough translation here. If you speak Latin and you want to pedantically correct me, send your complaints to jonathan.shaub@uky.edu, thanks.

To that end, in this chapter we will discuss:

- How an agency relationship is formed
- The duties that agents and principals owe each other
- How liabilities to third parties get assigned to one or both of the agent and principal

The Principal-Agent Problem

Before we get into the legal doctrines that make up this area of law, it is worth critically examining how the conflicting goals and incentives of the principal and agent create the central concern of agency law: the so-called "principal-agent problem". Here, I turn it over to the sociologist Susan Shapiro to explicate the asymmetries and conflicts inherent in agency relationships:

Agency Theory

Let me introduce myself. I am an agent. The editors of the Annual Review of Sociology delegated to me the task of writing an essay on agency theory. They are the principals and together we are bound in a principal-agent relationship. They have a principal-agent relationship with you (the readers) as well.[2] They are your agents, and so am I, although not every agency theorist would agree with my loose conceptualization of your role in this, and few would be interested in you at all (although I am).

[2] Think about your position in this class and mine. Who is the principal of whom and who is an agent of whom? Why is it set up like that?

I am not sure how or why my principals selected me for this task. Perhaps they Googled me. I do use the words "agent," "principal," and "agency relationship" a lot. But I doubt that they used a more sophisticated search engine. If they had, they would have realized that I have never used the words "agency" and "theory" side by side (although I guess it's possible that they did and wanted someone who is not so identified with this peculiar way of understanding social reality or is not solidly in one camp or another in a rather contentious literature). In any event, in selecting me and all the other authors in this volume, they faced a classic agency problem of asymmetric information. We know far more about ourselves — our abilities, expertise, honesty, etc. — than they do, and we sometimes make matters worse by exaggerating our talents. I know how much of the agency literature I have bothered to read and how much of it I understand.

I know whether I skip the paragraphs in the economics articles that begin, "let gamma be..." and then go on to use mathematical fonts I can't even find on my computer. I know better how good a sociologist I am and how analytical and original I am or am capable of being. I know better how many other projects I have on my plate right now and how responsible, conscientious, and diligent I am. Actually I know who would have been a better choice to write this essay. But my editors/principals don't. They never do, and therefore every assignment in this volume is tainted by adverse selection (in the insurance vernacular) or what Arrow[1] calls "hidden information": they "will attract a disproportionate number of low-quality applicants". The principals probably could have found someone better but just didn't know enough to identify them or didn't provide incentives compelling enough to attract them. So they got us.

[1] Economist Kenneth Arrow, famous for, among other things, Arrow's Impossibility Theorem in voting.

Of course, that is not their only agency problem. Information asymmetries not only mean that principals don't know the true "type" (to borrow from the agency theory jargon) of the varied candidates in the pool of potential agents, but they also don't know what we are doing once they select us. They don't know what I am reading, if anything, or whether I am scouring literature reviews or plodding through the actual primary sources. They don't know whether I have been thorough or fair. They don't know if I got someone else to write this for me or if I plagiarized it. Agency theorists are mostly worried that I might be shirking—not working hard enough, if at all. Many theorists also assume that I am "opportunistic" and will take advantage of the "perquisites" of this appointment for my own benefit. But sadly, my agency-savvy principals didn't give me any perquisites. (I have tried to use my inside information to trade on Annual Review futures, but I can't find this product on any of the commodities exchanges.) My principals, then, are also threatened by the version of informational asymmetry known in insurance as moral hazard, or what

Arrow labels "hidden action."

The one thing they can be sure of is that our goals are incompatible. My principals want the "highest-quality scientific literature reviews in the world" that "defin[e] the current state of scientific knowledge," and they want them on time and in the correct format. I want the glory with none of the work and desperately need the deadline to be extended.[1] And I will exploit all the information asymmetries I can contrive to insure that I maximize my own interests at their expense.

[1] Attacked in my own home.

So what do the poor principals do? Agency theory dictates that my principals will try to bridge the informational asymmetries by installing information systems and monitoring me. My manuscript will be peer reviewed, for example. And because my reputation is tied up in the quality of my work, they can count on some self-regulation on my part. They also offer me incentives in an effort to align my interests with theirs. They tell me that the earlier my manuscript arrives, the closer it will be placed toward the front of the volume.

As part of this incentive alignment, my principals compensate me, not for my agreement to do this work for them or for the amount of time I spent on the project— consistent with a "behavior-oriented contract"—but for what I actually deliver, an "outcome-oriented contract." They tell me that if the manuscript arrives late, they will not guarantee that they will publish it at all, ever (and you know how difficult it will be to recycle this sort of review essay into another journal). That, of course, shifts the risk to me, because events outside of my control (like the fact that a lightening strike or virus fried my hard drive) or other environmental uncertainties may affect my ability to deliver on our agreement. Agency theory reminds us that, although principals are risk neutral (they have diversified and have plenty of other manuscripts to use), agents are risk averse, because they have placed all their eggs in this one basket. That is another reason our interests conflict, by the way; shrouded behind my information asymmetries, I will do perverse things contrary to my principal's welfare to protect myself from risk. All these efforts undertaken by my principals, coupled with the fact that I still didn't give them exactly what they wanted, constitute agency costs. The trick, in structuring a principal-agent relationship, is to minimize them.

...

Long before there was a theory of agency, there was a law of agency. Indeed, it was not until the twenty-first century that the Restatement of the Law of Agency replaced "master/servant" with "employer/employee."

> The law of agency encompasses the legal consequences of consensual relationships in which one person (the 'principal') manifests assent that another person (the 'agent') shall, subject to the principal's right of

> control, have power to affect the principal's legal relations through the agent's acts and on the principal's behalf.

In other words, the central focus of the law of agency is on "the legal consequences of choosing to act through another person in lieu of oneself". Agency doctrine defines the legal obligations that principals have with third parties for actions that agents took on their behalf. The principal, for example, may be "bound to contracts and transactions made by the agent and may be vicariously liable for some instances of the agent's misconduct". Because principals will be held responsible for the actions of their agents, the law also attends to the sources of agent authority, clearly demarcating what constitutes an agency relationship, the rights of principals to control their agents, and the fiduciary duty and other obligations that agents owe their principals.

However hard principals try to minimize them, all agency relationships experience agency costs; about this all the paradigms agree. Agency costs arise from many sources: the costs of recruitment, adverse selection, specifying and discerning preferences, providing incentives, moral hazard, shirking, stealing, self-dealing, corruption, monitoring and policing, self-regulation, bonding and insurance, agents who oversee agents who oversee agents, as well as failures in these costly corrective devices.

Costs also increase because organizations are structured to minimize opportunism – checks and balances are created, reporting requirements implemented, redundancies introduced, employees rotated, responsibilities fragmented, layers of supervision added, revolving doors locked, and so on. Costs increase because principals, fearful of abuse, impose procedures, decision rules, protocols, or formularies to limit agent discretion, or their agents do. Ironically, principals who seek out agents because they lack the expertise to make decisions tell their agents how to make decisions on their behalf, or else they tie their hands. Although organizational sociology has demonstrated that agents sometimes bend the rules to better serve their principals, others ritualistically follow the letter rather than the spirit of the law, thereby deepening agency costs. Because we fear that agents might act on their self-interests, we require that they be disinterested; we take agents out of embedded networks where their loyalties and interests are entangled with others, but at the price of losing the social capital, reputation, goodwill, and inside information that they might have used profitably in service of their principals.

In short, because we are fearful that agents will get our preferences wrong, we construct a protective social edifice that insures that they will get them less right. As I wrote in a different context some time ago, these trade-offs between one kind of agency cost over another are akin to the choice between Type I and Type II errors in statistics.[1] Are the

[1] Type I errors are saying something is when it ain't. Type II errors are saying something ain't when it is.

constraints set so narrowly that desirable agent behavior is deterred or so flexibly that inappropriate behavior is tolerated? Either way, you get an error. Perfect agency is rare indeed.[1]

[1] Susan P. Shapiro. Agency Theory. Annual Review of Sociology, 31(1): 263–284, 2005

Formation of Principal-Agent Relationship

THE MOST COMMON WAY to establish a principal-agent relationship is to enter into a contract in which the Agent agrees to act on behalf of the Principal for some particular purpose, subject to the control of the Principal.[2] In modern times, this usually — but not always — takes the form of an employment contract.

[2] In Restatement-ese: "Agency is the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act." RESTATEMENT (THIRD) OF AGENCY §1.01.

Once established, the Agent can act on behalf of the Principal, doing their business and entering into contracts for the benefit of the Principal. This is super convenient for the Principal! (And not just convenient but necessary if the principal is a business entity instead of a natural person.) The Principal can go do other business while their Agent is working on their behalf, allowing them to business ***twice as hard***.[3] Or they can just go to a beach and sip mai tais or whatever, I'm not about to judge.

[3] "I'm not a businessman, I'm a *business*, man. Let [my agent] handle my business, damn."

The flip side for the Principal, however, is that they are liable for contracts their Agent enters into and for torts that their Agents commit while in the Principal's employ. After all, the Agent is an *extension of the Principal* when they are under the Principal's control. As such, many business relationships are structured to avoid principal-agent liability by referring to outcomes/payments/etc. rather than specifying methods or working conditions.[4] It is only when one is acting on another's behalf and under another's control that an agent-principal relationship arises.

[4] E.g., when you go and get a hair cut, you aren't temporarily deputizing the stylist as your agent, as they maintain control over their work and working conditions. Just giving them instructions ("give me a haircut like the kids on Tiktok have") does not make them your agent.

There are three ways to establish agency: by **contract** (an express or implied agreement that the agent will act for the principal; does not need to be written), by **ratification** (a confirmation by the principal of the agency relationship *after* the agent has already acted on the principal's behalf; applies retroactively) or by **operation of law** (when a court appoints someone to act of someone else; often family members and usually reserved for emergencies).

There are three kinds of principals:

1. *Disclosed*: Principals that the agent has identified to the third party so that the third party is on notice that they are dealing with the principal.
2. *Undisclosed*: Principals that the agent is working for but who are not disclosed to the third party; the third party has no notice that they are dealing with the principal. This makes the agent liable along with the principal. Not good!
3. *Unidentified*: When an agent informs a third party that they are acting on behalf of a principal, but does not identify that principal. The agent can avoid liability with an unidentified principal **only** if they are absolutely clear that the agent is not party to the contract.

There is really only one kind of agent, but there are two minor variants:

- *Gratuitous Agent*: An agent acting on behalf of a principal without compensation. The gratuitous agent can still bind the principal to an agreement with a third party, but they are not actually under any obligation to do the principal's bidding, and cannot be held liable for breach of duty. (You get what you pay for.)
- *Subagent*: An agent can hire their own agent, who is called a subagent — so long as the agreement between the principal and agent allows the agent to do so. The duties and liabilities associated with a principal-agent relationship apply equally to an agent-subagent relationship. Futhermore, subagents can themselves have subagents, so you could theoretically have infinite subagents.

"We heard you like agents, so ..."

When does a ordinary transactional relationship between two parties cross the line and become a principal-agent relationship? Good question! The following case gives us some clues.

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

Peterson, J.

Plaintiffs, 86 individual, partnership or corporate farmers, brought this action against defendant Cargill, Inc. (Cargill) and defendant Warren Grain & Seed Co. (Warren) to recover losses sustained when Warren defaulted on the contracts made with plaintiffs for the sale of grain. After a trial by jury, judgment was entered in favor of plaintiffs, and Cargill brought this appeal. We affirm.

This case arose out of the financial collapse of defendant Warren Seed & Grain Co., and its failure to satisfy its indebtedness to plaintiffs. Warren, which was located in Warren, Minnesota, was operated by Lloyd Hill and his son, Gary Hill. Warren operated a grain elevator and as a result was involved in the purchase of cash or market grain from local farmers. The cash grain would be resold through the Minneapolis Grain Exchange or to the terminal grain companies directly. Warren also stored grain for farmers and sold chemicals, fertilizer and steel storage bins. In addition, it operated a seed business which involved buying seed grain from farmers, processing it and reselling it for seed to farmers and local elevators.

Lloyd Hill decided in 1964 to apply for financing from Cargill. Cargill's officials from the Moorhead regional office investigated Warren's operations and recommended that Cargill finance Warren.

Warren and Cargill thereafter entered into a security agreement which provided that Cargill would loan money for working capital to Warren on "open account" financing up to a stated limit, which was originally set as $175,000.[1] Under this contract, Warren would receive funds and pay its expenses by issuing drafts drawn on Cargill through Minneapolis banks. The drafts were imprinted with both Warren's and Cargill's names. Proceeds from Warren's sales would be deposited with Cargill and credited to its account. In return for this financing, Warren appointed Cargill as its grain agent for transaction with the Commodity Credit Corporation. Cargill was also given a right of first refusal to purchase market grain sold by Warren to the terminal market.

[1] Warren used this to pay off another unrelated debt, just to give you a sense of how good with money the Hills were.

A new contract was negotiated in 1967, extending Warren's credit line to $300,000 and incorporating the provisions of the original contract. It was also stated in the contract that Warren would provide Cargill with annual financial statements and that either Cargill would keep the books for Warren or an audit would be conducted by an independent firm. Cargill was given the right of access to Warren's books for inspection.

In addition, the agreement provided that Warren was not to make capital improvements or repairs in excess of $5,000 without Cargill's prior consent. Further, it was not to become liable as guarantor on another's indebtedness, or encumber its assets except with Cargill's permission. Consent by Cargill was required before Warren would be allowed to declare a dividend or sell and purchase stock.

Officials from Cargill's regional office made a brief visit to Warren shortly after the agreement was executed. They examined the annual statement and the accounts receivable, expenses, inventory, seed, machinery and other financial matters. Warren was informed that it would be reminded periodically to make the improvements recommended by Cargill. At approximately this time, a memo was given to the Cargill official in charge of the Warren account, Erhart Becker, which stated in part: "This organization [Warren] needs very strong paternal guidance."[1]

[1] They are talking about grown-ass men here. Yeesh.

In 1970, Cargill contracted with Warren and other elevators to act as its agent to seek growers for a new type of wheat called Bounty 208. Warren, as Cargill's agent for this project, entered into contracts for the growing of the wheat seed, with Cargill named as the contracting party. Farmers were paid directly by Cargill for the seed and all contracts were performed in full. In 1971, pursuant to an agency contract, Warren contracted on Cargill's behalf with various farmers for the growing of sunflower seeds for Cargill. The arrangements were similar to those made in the Bounty 208 contracts, and all those contracts were also completed. Both these agreements were unrelated to the open account financing contract. In addition, Warren, as Cargill's agent in the sunflower seed business,[2] cleaned and packaged the seed in Cargill bags.

[2] Note that both parties agree that Warren was Cargill's agent for sale of seed. The question before the court is whether Warren is Cargill's agent with regard to the sale of grain.

During this period, Cargill continued to review Warren's operations and expenses and recommend that certain actions should be taken. Warren purchased from Cargill various business forms printed by Cargill and received sample forms from Cargill which Warren used to develop its own business forms.

Cargill wrote to its regional office in 1970 expressing its concern that the pattern of increased use of funds allowed to develop at Warren was similar to that involved in two other cases in which Cargill experienced severe losses. Cargill did not refuse to honor drafts or call the loan, however. A new security agreement which increased the credit line to $750,000 was executed in 1972, and a subsequent agreement which raised the limit to $1,250,000 was entered into in 1976.[3]

[3] Question for the reader: what is the "sunk cost fallacy"?

Warren was at that time shipping Cargill 90% of its cash grain. When Cargill's facilities were full, Warren shipped its grain to other companies. Approximately 25% of Warren's total sales was seed grain which was sold directly by Warren to its customers.

As Warren's indebtedness continued to be in excess of its credit line, Cargill began to contact Warren daily regarding its financial affairs. Cargill headquarters informed its regional office in 1973 that, since Cargill money was being used, Warren should realize that Cargill had the right to make some critical decisions regarding the use of the funds. Cargill headquarters also told Warren that a regional manager would be working with Warren on a day-to-day basis as well as in monthly planning meetings. In 1975, Cargill's regional office began to keep a daily debit position on Warren. A bank account was opened in Warren's name on which Warren could draw checks in 1976. The account was to be funded by drafts drawn on Cargill by the local bank.

In early 1977, it became evident that Warren had serious financial problems. Several farmers, who had heard that Warren's checks were not being paid, inquired or had their agents inquire at Cargill regarding Warren's status and were initially told that there would be no problem with payment. In April 1977, an audit of Warren revealed that Warren was $4 million in debt. After Cargill was informed that Warren's financial statements had been deliberately falsified,[1] Warren's request for additional financing was refused. In the final days of Warren's operation, Cargill sent an official to supervise the elevator, including disbursement of funds and income generated by the elevator.

[1] But everything had been going so well up until now!

After Warren ceased operations, it was found to be indebted to Cargill in the amount of $3.6 million. Warren was also determined to be indebted to plaintiffs in the amount of $2 million, and plaintiffs brought this action in 1977 to seek recovery of that sum. Plaintiffs alleged that Cargill was jointly liable for Warren's indebtedness as it had acted as principal for the grain elevator.

The court determined that Cargill was the disclosed principal of Warren. It was concluded that Cargill was jointly liable with Warren for plaintiffs' losses, and judgment was entered for plaintiffs.

The major issue in this case is whether Cargill, by its course of dealing with Warren, became liable as a principal on contracts made by Warren with plaintiffs. Cargill contends that no agency relationship was established with Warren, notwithstanding its financing of Warren's operation and its purchase of the majority of Warren's grain. However, we conclude that Cargill, by its control and influence over Warren, became a principal with liability for the transactions entered into by its agent Warren.

Agency is the fiduciary relationship that results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act. In order to create an agency there must be an agreement, but not necessarily a contract between the parties. An agreement may result in the creation of an agency relationship although the parties did not call it an agency and did not intend the legal consequences of the relation to follow. The existence of the agency may be proved by circumstantial evidence which shows a course of dealing between the two parties. When an agency relationship is to be proven by circumstantial evidence, the principal must be shown to have consented to the agency since one cannot be the agent of another except by consent of the latter.

Cargill contends that the prerequisites of an agency relationship did not exist because Cargill never consented to the agency, Warren did not act on behalf of Cargill, and Cargill did not exercise control over Warren. We hold that all three elements of agency could be found in the particular circumstances of this case. By directing Warren to implement its recommendations, Cargill manifested its consent that Warren would be its agent. Warren acted on Cargill's behalf in procuring grain for Cargill as the part of its normal operations which were totally financed by Cargill. Further, an agency relationship was established by Cargill's interference with the internal affairs of Warren, which constituted *de facto* control of the elevator.

A number of factors indicate Cargill's control over Warren, including the following:

1. Cargill's constant recommendations to Warren by telephone;
2. Cargill's right of first refusal on grain;
3. Warren's inability to enter into mortgages, to purchase stock or to pay dividends without Cargill's approval;
4. Cargill's right of entry onto Warren's premises to carry on periodic checks and audits;
5. Cargill's correspondence and criticism regarding Warren's finances, officers salaries and inventory;
6. Cargill's determination that Warren needed "strong paternal guidance";[1]
7. Provision of drafts and forms to Warren upon which Cargill's name was imprinted;
8. Financing of all Warren's purchases of grain and operating expenses; and
9. Cargill's power to discontinue the financing of Warren's operations.

[1] Once again: you say this about me, you better be ready to throw hands.

We recognize that some of these elements, as Cargill contends, are found in an ordinary debtor-creditor relationship. However, these factors cannot be considered in isolation, but, rather, they must be viewed in light of all the circumstances surrounding Cargill's aggressive financing of Warren.

On the whole, there was a unique fabric in the relationship between Cargill and Warren which varies from that found in normal debtor-creditor situations. We conclude that, on the facts of this case, there was sufficient evidence from which the jury could find that Cargill was the principal of Warren within the definitions of agency set forth in Restatement (Second) of Agency §§ 1 and 140.

From the facts in the record, it is unclear whether plaintiffs were on notice that Warren was acting on Cargill's behalf. However, it is not necessary to decide whether Cargill was a disclosed or undisclosed principal.

We believe that Cargill cannot avoid its liability to plaintiffs by payment to its agent even if it had operated as an undisclosed principal.

An undisclosed principal is not discharged from liability to the other party to a transaction conducted by an agent by payment to, or settlement of accounts with, the agent, unless he does so in reasonable reliance upon conduct of the other party which is not induced by the agent's misrepresentations and which indicates that the agent has settled the account.[1]

[1] A disclosed principal is automatically liable for any contract the agent enters into. An undisclosed principal is also liable for any contract the agent enters into, *unless the agent takes care of it themselves.*

Since plaintiffs did not indicate to Cargill that Warren had settled their accounts, Cargill, as principal, is not discharged from liability to plaintiffs by payment to Warren.

SOME DISCUSSION QUESTIONS:

1. At any point did Cargill believe that Warren was acting as their agent? At any point did the farmers believe Warren was acting as Cargill's agent? Did any of that matter?
2. What was Cargill thinking?
3. Why do you think the court was willing to find an agency relationship here?

Duties of Agents and Principals

A PRINCIPAL'S DUTIES TO THE AGENT include:

- *Duty to Compensate*: If the agent is to be paid (i.e., not a gratuitous agent), the principal has to pay them. Usually set out in the contract.
- *Duty to Reimburse and Indemnify*: If the agent either makes expenditures on behalf of the principal in the course of their job, and/or incurs legal liability on a contract made on behalf of the principal, the principal is obligated to reimburse and/or indemnify the agent, respectively.
- *Duty to Cooperate*: A principal shouldn't interfere with its own agent or prevent them from doing their job, and must communicate information necessary for the agent to complete their tasks.

An Agent's Duties to the Principal are *fiduciary* duties,[1] and include:

[1] As we discussed in Chapter 1, a fiduciary is someone who stands in a special relationship of trust with another, and who must put the other's interests above their own.

- *Duty of Loyalty*: Within the scope of the agent's responsibilities, an agent has to act solely for the benefit of the principal and cannot put their own interests (or those of a third party) ahead of the principal.
- *Duty of Performance*: An agent is required to perform their duties with the level of skill and care that a reasonably similar person doing the same activities would apply. Another way of phrasing this is as a "duty of care".
- *Duty to Obey*: An agent must follow all lawful and reasonable instructions from the principal. If the instructions are unclear, the agent should seek clarification.
- *Duty to Notify*: An agent must promptly notify the principal of matters that come to the agent's attention in connection with the subject matter of the agent's duties.
- *Duty to Account*: The agent has to keep records of all money and property paid and received on behalf of the principal and make this information available to the principal.
- *Duty of Confidentiality*: An agent cannot disclose confidential information received in connection with the agent-principal relationship or in the course of the agent's duties. Unlike an agent's other duties, this sucker survives the termination of the agency relationship.[2]

[2] Just like an attorney's duty of confidentiality survives the attorney-client relationship. Wonder where they got that one from?

A violation of these duties can lead to the agent being liable to the principal for damages. What would that look like? Let's find out!

General Automotive Mfg. Co. v. Singer, 19 Wis. 2d 528 (1963)

Brown, C.J.

We have carefully reviewed the evidence and have ourselves reached conclusions as stated by the trial court and set forth in its findings of fact, as follows:

> 3. That heretofore and on or about the 28th day of March, 1953, the plaintiff hired and employed the defendant as general manager of its business and affairs and the defendant accepted such employment under and pursuant to a written contract.
>
> 4. That said contract of employment was for a term of one (1) year from March 30, 1953, to March 29, 1954, and was renewed for a period of two

> (2) years to March 28, 1956, and thereafter was extended for an indefinite period of time and continued in existence with no change either in the duties the defendant performed or the compensation the defendant received (one reduction in rate mutually agreed to) including the commission of 3% of the plaintiff's gross sales. That the said contract was finally terminated and the defendant left the employ of the plaintiff on or about May 7, 1959.
>
> 8. That in and by said contract, in consideration of compensation to be paid by the plaintiff to the defendant, the defendant promised and agreed:
>
> (a) To devote his entire time, skill, labor, and attention to said employment, during the term of this employment, and not to engage in any other business or vocation of a permanent nature during the term of this employment, and to observe working hours for five and one-half days.
>
> (b) Not to, either during the term of his employment, or at any time thereafter, disclose to any person, firm, or corporation any information concerning the business or affairs of the employer which he may have acquired in the course of or as incident to his employment hereunder, for his own benefit, or to the detriment or intended or probable detriment of the employer.
>
> 9. That the defendant under the agreement as manager was a fiduciary agent with respect to solicitation of business for the plaintiff and as such was bound to the exercise of the utmost faith and loyalty to his principal and employer.

Although stated as a finding of fact, Finding 10 is mainly a conclusion of law. It produces the principal issue in the case and deserves further discussion. It reads:

> 10. That the defendant breached his contract of employment with the plaintiff and violated the duty of loyalty which he owed to the plaintiff and his fiduciary duty of general manager thereof during the existence of such employment by engaging in business activities directly competitive with the plaintiff, to wit, by obtaining orders from a customer for his own account.

The record leaves no room for doubt of the correctness of Finding 11, as follows:

> 11. That thereafter, instead of turning such orders over to the plaintiff the defendant turned such orders over to other concerns to be filled, collected the proceeds thereof from the customers for his own account, and kept the profits accruing therefrom.

Study of the record discloses that Singer was engaged as general manager of Automotive's operations. Among his duties was solicitation and procurement of machine-shop work for Automotive. Because of Singer's high reputation in the trade he was highly successful in attracting orders.

Automotive is a small concern and has a low credit rating. Singer was invaluable in bolstering Automotive's credit. For instance, when collections were slow for work done by Automotive, Singer paid the customer's bill to Automotive and waited for his own reimbursement until the customer remitted. Also, when work was slack, Singer set Automotive's shop to make parts for which there were no present orders and himself financed the cost of materials for such parts, waiting for recoupment until such stockpiled parts could be sold. Some parts were never sold and Singer personally absorbed the loss upon them.[1]

[1] For Sale. Auto Parts. Never Used.

As time went on, a large volume of business attracted by Singer was offered to Automotive but which Singer decided could not be done by Automotive at all, for lack of suitable equipment, or which Automotive could not do at a competitive price. When Singer determined that such orders were unsuitable for Automotive he neither informed Automotive of these facts nor sent the orders back to the customer. Instead, he made the customer a price, then dealt with another machine shop to do the work at a less price, and retained the difference between the price quoted to the customer and the price for which the work was done.[2] Singer was actually behaving as a broker for his own profit in a field where by contract he had engaged to work only for Automotive. We concur in the decision of the trial court that this was inconsistent with the obligations of a faithful agent or employee.

[2] A practice that is also known as "capitalism".

Singer finally set up a business of his own, calling himself a manufacturer's agent and consultant, in which he brokered orders for products of the sort manufactured by Automotive – this while he was still Automotive's employee and without informing Automotive of it.[3] Singer had broad powers of management and conducted the business activities of Automotive. In this capacity he was Automotive's agent and owed a fiduciary duty to it. Under his fiduciary duty to Automotive Singer was bound to the exercise of the utmost good faith and loyalty so that he did not act adversely to the interests of Automotive by serving or acquiring any private interest of his own.[4] He was also bound to act for the furtherance and advancement of the interest of Automotive.

[3] Forget the haters, this is peak Hustle Mentality. Get a job, *then* go into business for yourself while still at that job, *then* make your job twice as hard by competing with yourself. Alpha Grindset in action.

[4] A move that is apparently called overemployment.

If Singer violated his duty to Automotive by engaging in certain business activities in which he received a secret profit he must account to Automotive for the amounts he illegally received.

The trial court found that Singer's sideline business, the profits of which were $64,088.08, was in direct competition with Automotive. However, Singer argues that in this business he was a manufacturer's agent or consultant, whereas Automotive was a small manufacturer of automotive parts. The title of an activity does not determine the question whether it was competitive but an examination of the nature of the business must be made. In the present case the conflict of interest between Singer's business and his position with Automotive arises from the fact that Singer received orders, principally from a third party called Husco, for the manufacture of parts. As a manufacturer's consultant he had to see that these orders were filled as inexpensively as possible, but as Automotive's general manager he could not act adversely to the corporation and serve his own interests. On this issue Singer argues that when Automotive had the shop capacity to fill an order he would award Automotive the job, but he contends that it was in the exercise of his duty as general manager of Automotive to refuse orders which in his opinion Automotive could not or should not fill and in that case he was free to treat the order as his own property. However, this argument ignores, as the trial court said, "defendant's agency with plaintiff and the fiduciary duties of good faith and loyalty arising therefrom."

Rather than to resolve the conflict of interest between his sideline business and Automotive's business in favor of serving and advancing his own personal interests, Singer had the duty to exercise good faith by disclosing to Automotive all the facts regarding this matter. Upon disclosure to Automotive it was in the latter's discretion to refuse to accept the orders from Husco or to fill them if possible or to subjob[1] them to other concerns with the consent of Husco if necessary, and the profit, if any, would belong to Automotive. Automotive would then be able also to decide whether to expand its operations, install suitable equipment, or to make further arrangements with Singer or Husco. By failing to disclose all the facts relating to the orders from Husco and by receiving secret profits from these orders, Singer violated his fiduciary duty to act solely for the benefit of Automotive. Therefore he is liable for the amount of the profits he earned in his sideline business.

[1] I think the court means "subcontract" here, but also:

We conclude that Singer's independent activities were in competition with Automotive and were in violation of his obligation of fidelity to that corporation, as stated in Finding of Fact 10, and Singer must account for his profits so obtained.[2]

[2] In awarding damages to Automotive, the court actually accounts for the commission that Singer would have gotten if he had just forwarded the business to Automotive and reduces the damages accordingly. Kind of nice if you ask me.

SOME DISCUSSION QUESTIONS:

1. What if Singer had told Automotive what he was doing? Would that have changed the outcome of this case?

2. Singer claimed that Automotive didn't have the capacity to do these jobs. What was wrong with him collecting a fee to route those jobs to other shops?

3. How does the court decide damages? What other possible remedies could there have been?

Liability under Contract for Principals

PRINCIPAL LIABILITY UNDER CONTRACT is determined by whether the Agent is authorized to act on the Principal's behalf. There are two main types of authority that a Principal can use to empower to an Agent: "Actual Authority" and "Apparent Authority". There is also a third – much less used – type of authority called "Inherent Authority", which we will briefly discuss.

Types of Authority

ACTUAL AUTHORITY is determined by the manifestations of the Principal to the Agent – either through words or through their conduct – about their objectives and the methods by which the Agent should achieve those objectives.[1]

[1] In Restatement-ese: "An agent has actual authority when, at the time of taking action, the agent reasonably believes, in accordance with the principal's manifestations to the agent, that the principal wishes the agent so to act." RESTATEMENT (THIRD) OF AGENCY §2.01.

Actual authority can be *express* (acts included in the explicit instructions given by the Principal to the Agent) or *implied* (acts that a reasonable person would understand to be necessary in order to accomplish the Principal's stated objective). So when Henry II asked his court "will no one rid me of this meddlesome priest?", and a bunch of knights ran off and killed Thomas Becket (the meddlesome priest), that's implied authority.[2] Although distinguishing between the two can sometimes be difficult – a lot of even pretty clear instructions rely on the reader making reasonable inferences – it is important to remember that they are both types of actual authority, so either gets you to a proper principal-agent relationship.

[2] If Henry II had said, "Hey, somebody go stab that Becket dude", that would be express authority.

Mill St. Church v. Hogan, 785 S.W.2d 263 (Ky. Ct. App. 1990)

Howard, J.

Mill Street Church of Christ and State Automobile Mutual Insurance Company petition for review of a decision of the New Workers' Compensation Board [hereinafter "New Board"] which had reversed an earlier decision by the Old Workers' Compensation Board [hereinafter "Old Board"]. The Old Board had ruled that Samuel J. Hogan was not an employee of the Mill Street Church of Christ and was not entitled to any workers' compensation benefits. The New Board reversed and ruled that Samuel Hogan was an employee of the church.

Samuel Hogan filed a claim for workers' compensation benefits for an injury he received while painting the interior of the Mill Street Church of Christ on December 15, 1986. In 1986, the Elders of the Mill Street

Church of Christ decided to hire church member, Bill Hogan, to paint the church building.[1] The Elders decided that another church member, Gary Petty, would be hired to assist if any assistance was needed. In the past, the church had hired Bill Hogan for similar jobs, and he had been allowed to hire his brother, Sam Hogan, the respondent, as a helper.

[1] I went on a journey here and now you have to, too. There are *two* Mill Street Churches of Christ in Kentucky, one in Letchfield and one in London. Based on my examination of each church's delightfully amateur-hour hosted-by-Angelfire-lookin' websites, the one in Letchfield appears to have closed down in 2020. The one in London is still going, answering the important questions for their parishioners, like "Can a Mason be a Christian?" (The answer: no.)

Dr. David Waggoner, an Elder of the church, soon contacted Bill Hogan, and he accepted the job and began work. Apparently Waggoner made no mention to Bill Hogan of hiring a helper at that time. Bill Hogan painted the church by himself until he reached the baptistry portion of the church. This was a very high, difficult portion of the church to paint, and he decided that he needed help. After Bill Hogan had reached this point in his work, he discussed the matter of a helper with Dr. Waggoner at his office. According to both Dr. Waggoner and Hogan, they discussed the possibility of hiring Gary Petty to help Hogan. None of the evidence indicates that Hogan was told that he had to hire Petty. In fact, Dr. Waggoner apparently told Hogan that Petty was difficult to reach. That was basically all the discussion that these two individuals had concerning hiring a helper. None of the other Elders discussed the matter with Bill Hogan.

On December 14, 1986, Bill Hogan approached his brother, Sam, about helping him complete the job. Bill Hogan told Sam the details of the job, including the pay, and Sam accepted the job. On December 15, 1986, Sam began working. A half hour after he began, he climbed the ladder to paint a ceiling corner, and a leg of the ladder broke. Sam fell to the floor and broke his left arm. Sam was taken to the Grayson County Hospital Emergency Room[2] where he was treated. He later was under the care of Dr. James Klinert, a surgeon in Louisville. The church Elders did not know that Bill Hogan had approached Sam Hogan to work as a helper until after the accident occurred.

[2] Bingo! It's gotta be the one in Letchfield.

You know, I really thought the ceiling was gonna be higher.

As part of their argument, petitioners argue the New Board also erred in finding that Bill Hogan possessed implied authority as an agent to hire Sam Hogan. Petitioners contend there was neither implied nor apparent authority in the case at bar.

It is important to distinguish implied and apparent authority before proceeding further. Implied authority is actual authority circumstantially proven which the principal actually intended the agent to possess and includes such powers as are practically necessary to carry out the duties actually delegated. Apparent authority on the other hand is not actual authority but is the authority the agent is held out by the principal as possessing. It is a matter of appearances on which third parties come to rely.

Petitioners attack the New Board's findings concerning implied authority. In examining whether implied authority exists, it is important to focus upon the agent's understanding of his authority. It must be determined whether the agent reasonably believes because of present or past conduct of the principal that the principal wishes him to act in a certain way or to have certain authority. The nature of the task or job may be another factor to consider. Implied authority may be necessary in order to implement the express authority. The existence of prior similar practices is one of the most important factors. Specific conduct by the principal in the past permitting the agent to exercise similar powers is crucial.

The person alleging agency and resulting authority has the burden of proving that it exists. Agency cannot be proven by a mere statement, but it can be established by circumstantial evidence including the acts and conduct of the parties such as the continuous course of conduct of the parties covering a number of successive transactions. Specifically one must look at what had gone on before to determine if the agent had certain authority. If considering past similar acts done in a similar manner, it is found that the present action was taken with the apparent scope of the agent's authority, the act is binding upon the principal.

In considering the above factors in the case at bar, Bill Hogan had implied authority to hire Sam Hogan as his helper. First, in the past the church had allowed Bill Hogan to hire his brother or other persons whenever he needed assistance on a project. Even though the Board of Elders discussed a different arrangement this time, no mention of this discussion was ever made to Bill or Sam Hogan. In fact, the discussion between Bill Hogan and Church Elder Dr. Waggoner, indicated that Gary Petty would be difficult to reach and Bill Hogan could hire whomever he pleased. Further, Bill Hogan needed to hire an assistant to complete the job for which he had been hired. The interior of the church simply could not be painted by one person. Maintaining a safe and attractive place of worship clearly is part of the church's function, and one for which it would designate an agent to ensure that the building is properly painted and maintained.

Finally, in this case, Sam Hogan believed that Bill Hogan had the authority to hire him as had been the practice in the past. To now claim that Bill Hogan could not hire Sam Hogan as an assistant, especially when Bill Hogan had never been told this fact, would be very unfair to Sam Hogan. Sam Hogan relied on Bill Hogan's representation. The church treasurer in this case even paid Bill Hogan for the half hour of work that Sam Hogan had completed prior to the accident. Considering the above facts, we find that Sam Hogan was within the employment of the Mill Street Church of Christ at the time he was injured.

SOME DISCUSSION QUESTIONS:

1. Is there ever a situation where a principal's goal is so clearly and unambiguously articulated such that an agent would never need to rely on implied authority, and would only use express authority?

2. Ludwig Wittgenstein argued that words and sentences have meaning only as a result of the rules of the "language-game" in which they are used, which is necessarily contextual. Would Wittgenstein have felt differently if he had fallen off a ladder?

3. Does the fact that the law of agency explicitly contemplates not just the text of a command but also the implication of the command make this centuries-old doctrine infinitely more coherent than the current state of constitutional law?

APPARENT AUTHORITY, in contrast to actual authority (express or implied), is determined not by the dealings between the Principal and the Agent, but by the dealings between the Principal and a Third Party.[1] When a Principal takes actions to identify someone as their representative, and it is reasonable for the Third Party to interpret the Principal's actions as indicating a Principal-Agent relationship, then courts will find that the Agent had "apparent authority" to bind the Principal – even if there was no actual authority there.[2]

[1] Note that an Agent can't create apparent authority on their own – it has to involve the Principal.

[2] In Restatement-ese: "Apparent authority holds a principal accountable for the results of third-party beliefs about an actor's authority to act as an agent when the belief is reasonable and is traceable to a manifestation of the principal." RESTATEMENT (THIRD) OF AGENCY §2.03.

This doctrine, as you might imagine, is grounded in equity rather than contract. Specifically, courts justify apparent authority as necessary to protect innocent third parties from being left without recourse in arrangements where they reasonably believed they were dealing with an authorized agent. As such, apparent authority can survive the termination of actual authority (so long as the Agent is still being held out as such by the Principal) or attach without actual agency ever being established.

Ophthalmic Surgeons, v. Paychex, 632 F.3d 31 (1st Cir. 2011)

Torruella, J.

OSL, a Rhode Island corporation, is a medical practice specialized in ophthalmology. Dr. William J. Andreoni has worked at OSL as a physician and surgeon for twenty-six years. He has been part owner of OSL since 1986 and became the sole owner of the practice in 1993. During the mid-1980s, OSL began to grow. Therefore, the company sought to find a better way to administer its payroll. To this end, in 1989, OSL entered into an oral contract with Paychex for payroll processing services (the "1989 Agreement").

In 1984, Carleen Connor began working for OSL as a technician who earned $7.00 per hour. She later became a licensed optician and the office manager, at which point she earned $16.00 per hour. It is undisputed that, from the mid-1990s until her termination in 2006, Connor handled payroll for OSL and was its office manager and designated payroll contact.

Paychex contacted Connor regularly to inquire about OSL's payroll. As Dr. Andreoni was aware, Connor would often call in more than one week's worth of payroll at a time. OSL alleges that during the years that Connor requested unearned paychecks, 2001 to 2006, its employees were paid on a weekly basis, In 2001, Connor began requesting that Paychex direct deposit into her bank account more money than required to pay her annual salary. During the pay periods when Connor requested more than her base pay, she requested that Paychex split her pay into two direct deposit payments. At some point, a Paychex representative told Connor that issuing her more than one payment for a given pay period was more expensive for OSL. Connor stated that she wanted to split her checks because a single larger check would result in a larger tax withholding. Paychex did not contact anyone at OSL to verify Connor's request.

It is undisputed that between 2001 and 2006, Connor directed Paychex to pay her, and Paychex did in fact pay her, a total of $233,159 more than her authorized annual salary.[1] It is also undisputed that Paychex sent to OSL reports confirming all payments made. These reports were sent to Connor's attention and Dr. Andreoni alleges that he saw none of these reports because they were not sent directly to his attention. OSL discovered the unauthorized payments when another employee took over Connor's duties.

[1] Her salary was around $33,000 a year. SCAM GODDESS.

On October 30, 2007, OSL and Dr. Andreoni, as co-plaintiffs, filed a breach of contract action in Rhode Island Superior Court against Paychex and Chase Bank, USA, NA. On September 9, 2009, the district court issued summary judgment in favor of Paychex.

We find that the relevant contract language clearly and unambiguously establishes that it is the Client who has to specify the amounts that Paychex is authorized to withdraw from the Client's bank account. After examining the contract as a whole, we conclude that the writing evidences the intent to agree that it was OSL's responsibility to specify the amounts that Paychex was authorized to withdraw from the accounts.

Although we have found that the contract creates no obligation for Paychex to verify the information that the payroll contact provides, we must now examine whether agency law creates such an obligation. OSL argues that the district court erred by ignoring a disputed issue of material fact regarding Connor's lack of apparent authority to "specify" the withdrawal of payments adding up to more than her authorized weekly salary. We find that OSL's argument is without merit.

Although the existence of apparent authority is normally a question of fact that courts do not resolve on a motion for summary judgment, here we find that even viewing the facts in the light most favorable to OSL, it is clear that OSL acted in a manner that created apparent authority in Connor.

A corporation must, by necessity, act through its agents. It is undisputed that Connor was in fact authorized to handle payroll and was the designated payroll contact assigned to communicate with Paychex. Connor's actual authority, however, did not extend to embezzling funds by authorizing the issuance of paychecks in amounts in excess of her salary as this is not what OSL, the principal, instructed her to do. The question remains, however, as to whether Connor was cloaked with apparent authority such that Paychex could have reasonably relied upon her authority to issue additional paychecks in her name. OSL argues that Connor had no apparent authority where OSL, as principal, did not act in a way that gave the appearance that Connor had the authority to order the paychecks at issue here and that Paychex is therefore liable for making the unauthorized payments.

We find that Paychex's reliance was reasonable and that Connor had apparent authority because OSL put Connor in a position where it appeared that she had the power to authorize additional pay-checks. In her position as the designated payroll contact, Connor often called in more than one week's worth of payroll at a time without objection from OSL. Further, Dr. Andreoni admits that, after 1989, he had no further contact with Paychex. Even if we assume that, in 1989, the purported conversation between Dr. Andreoni, as agent of OSL, and a representative of Paychex occurred and that during that conversation, Dr. Andreoni informed Paychex that he wanted OSL employees to be paid weekly for fifty-two weeks each year, OSL's argument fails. This conversation does not expressly convey a limitation on Connor's authority, especially where the conversation did not occur in connection with the formation of the 1994 Agreement. Further, it was reasonable for Paychex to assume its clients' needs might change and that the payroll contact would be authorized to convey such a change.

Paychex's reliance was also reasonable because of OSL's failure to object to the transactions that Connor authorized. "A principal's inaction creates apparent authority when it provides a basis for a third party reasonably to believe the principal intentionally acquiesces in the agent's representations or actions. . . . If the third party has observed prior interactions between the agent and the principal, the third party may reasonably believe that a subsequent act or representation by the agent is authorized because it conforms to the prior pattern observed by the third party. The belief is thus traceable to the principal's participation in the pattern and failure to inform the third party that no inferences about the agent's authority should be based upon it." Restatement (Third) of Agency § 3.03 cmt. b (internal citation omitted).

We find that by placing Connor in a position where it appeared that she had authority to order additional checks and by acquiescing to Connor's acts through its failure to examine the payroll reports, OSL created apparent authority in Connor such that Paychex reasonably relied on her authority to issue the additional paychecks.

Some discussion questions:

1. Did Connor have actual authority? If so, to do what?

2. Who did what to create apparent authority for Connor to bind OSL?

3. If Connor had disclosed her embezzlement to OSL, would that change the outcome of the case?

Inherent Authority is a largely disfavored concept, and was in fact written out of the most recent Restatement of Agency. It is included in this book because (a) it hangs around corporate law as a kind of off-brand version of apparent authority and (b) some states still inexplicably use it.[1]

[1] What kind of backwards-ass state still uses a theory of agency that was rejected by nearly everybody?

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

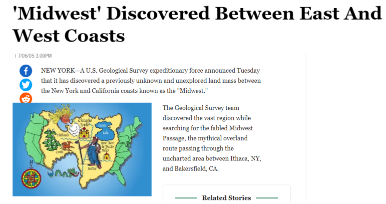
Sullivan, J.[2]

[2] Ah, Indiana. Yeah, that scans.

Dage-MTI, Inc. ("Dage"), is a closely held Indiana corporation which manufactures specialized electronics equipment. At all times relevant to this appeal, Dage was governed by a six-member board of directors ("Board"), consisting of Ronald and Lynn Kerrigan, Louis Piccolo (a financial consultant retained by Ronald Kerrigan), Arthur and Marie Sterling, and William Conners. In addition to being a Board member, Arthur Sterling ("Sterling") had served as president of Dage for at least 20 years at the time of the trial on this matter.

For many years, Sterling operated Dage without significant input from or oversight by the Board. Over the course of the summer and early fall of 1993, however, Kerrigan took steps to subject Dage management to Board control. In late October of 1993, Sterling first informed other directors that Menard, Inc., had expressed interest in purchasing a 30-acre parcel of land owned by Dage and located in the Michigan City area. Menard is a Wisconsin corporation that owns and operates home improvement stores in the Midwestern region of the United States.

Sterling presented a two-part proposed resolution ("consent resolution") to the Board: the first part authorized Sterling to "offer and purchase" another parcel located immediately to the north of the 30-acre parcel and referred to as the "Simon property"; the second part authorized Sterling to "offer and sell" the 30-acre parcel. Sterling, Kerrigan, Piccolo, and Gorinsky discussed the offer and Sterling was told to change the "offer and sell" provision to "to offer for sale." He was also instructed that he could purchase the Simon property on behalf of Dage, but could only "offer" the 30-acre parcel to Menard at a particular price. Additionally, Sterling was told that in soliciting offers for the 30-acre parcel, he was not to negotiate the terms of a sale. Gorinsky reminded Sterling that any offer from Menard would require Board review and acceptance, and he instructed Sterling to forward any offer to the Board for approval or rejection. Based upon the discussion, Sterling drafted a new resolution, which stated that he was authorized "to take such actions as are necessary to *offer for sale* our 30 acre parcel for a price not less than $1,200,000."


'Midwest' Discovered Between East And West Coasts

7/06/05 3:00PM

NEW YORK—A U.S. Geological Survey expeditionary force announced Tuesday that it has discovered a previously unknown and unexplored land mass between the New York and California coasts known as the "Midwest."

The Geological Survey team discovered the vast region while searching for the fabled Midwest Passage, the mythical overland route passing through the uncharted area between Ithaca, NY, and Bakersfield, CA.

Related Stories

aka the Pritzker caliphate

During a week-long series of discussions beginning December 14, 1993, and unknown to any other member of the Dage Board, Sterling negotiated several minor changes in the Menard agreement and then signed the revised offer on behalf of Dage. Menard also signed, accepting the offer. Under Paragraph 5(c)(I) of the agreement, Sterling, as president of Dage, represented as follows: "The persons signing this Agreement on behalf of the Seller are duly authorized to do so and their signatures bind the Seller in accordance with the terms of this Agreement." No one at Dage had informed Menard that Sterling's authority with respect to the sale of the 30-acre parcel was limited to only the solicitation of offers.

Menard ultimately filed suit to require Dage to specifically perform the agreement and to secure the payment of damages. Following a bench trial, the trial court ruled in favor of Dage. The Court of Appeals affirmed, finding that Sterling did not have the express or apparent authority to bind the corporation in this land transaction.

Two main classifications of authority are generally recognized: "actual authority" and "apparent authority." Actual authority is created "by written or spoken words or other conduct of the principal which, reasonably interpreted, causes the agent to believe that the principal desires him so to act on the principal's account." Apparent authority refers to a third party's reasonable belief that the principal has authorized the acts of its agent; it arises from the principal's indirect or direct manifestations to a third party and not from the representations or acts of the agent.

On occasion, Indiana has taken an expansive view of apparent authority, including within the discussion the concept of "inherent agency power." Inherent agency power is a term used to indicate the power of an agent which is derived not from authority, apparent authority or estoppel, but solely from the agency relation and exists for the protection of persons harmed by or dealing with a servant or other agent. This "status based" form of vicarious liability rests upon certain important social and commercial policies, primarily that the business enterprise should bear the burden of the losses created by the mistakes or overzealousness of its agents because such liability stimulates the watchfulness of the employer in selecting and supervising the agents. And while representations of the principal to the third party are central for defining apparent authority, the concept of inherent authority differs and originates from the "customary authority of a person in the particular type of agency relationship so that no representations beyond the fact of the existence of the agency need be shown."

We find the concept of inherent authority – rather than actual or apparent authority – controls our analysis in this case. Menard did not negotiate and ultimately contract with a lower-tiered employee or a prototypical "general" or "special" agent, with respect to whom actual or apparent authority might be at issue. Menard dealt with the president of the corporation, whom the law recognizes as one of the officers who are the means, the hands and the head, by which corporations normally act.[1]

[I]f one of two innocent parties must suffer due to a betrayal of trust-either the principal or the third party-the loss should fall on the party who is most at fault. Because the principal puts the agent in a position of trust, the principal should bear the loss.

Shepard, C.J., dissenting

I think today's decision will leave most corporate lawyers wondering what the law actually is.

A board of directors authorizes the president to sell some real estate but requires that the sale be submitted to the board for approval or disapproval. The president understands that he must submit any sale to the board. He tells the potential buyer that he must submit it. The buyer knows that its offer must be submitted to the board after the president signs the sales agreement. The agreement is in fact submitted to the board and disapproved. Our Court holds that the agreement is binding anyway.

The majority calls this "an expansive view of apparent authority." Facially, this seems like an understatement. While I agree with the general legal principles laid out by the majority, those principles seem undercut by the resolution of this case.

[1] The court laid out the following test for inherent authority: "(1) the [acts] usually accompany or are incidental to transactions which the agent is authorized to conduct if, although they are forbidden by the principal, (2) the other party reasonably believes that the agent is authorized to do them, and (3) has no notice that he is not so authorized." The Court found for Menard on all three points.

SOME DISCUSSION QUESTIONS:

1. What did Sterling do to make Menard think he had the authority to sell them the parcel of land?

2. What should Dage have done to protect itself?

3. Menard, Inc. is the company that operates the chain of home improvement stores called "Menard's". An easy way to remember this is that Menard is the doctor and Menard's is the monster.

IN THE NEXT SECTIONS, we turn to questions of determining agent and principal liability to third parties, in both contract and in tort.

Liability under Contract

PRINCIPAL LIABILITY UNDER CONTRACT is solely determined by whether the Agent had authority – actual, apparent, or *shudder* inherent – to enter into the contract on the Principal's behalf. If the Agent was authorized, the Principal is liable, the Agent's off the hook, and everything is Kool and the Gang.

AGENT LIABILITY UNDER CONTRACT is determined by a relatively straightforward question: when the Third Party entered into an agreement with the Agent, were they misled about who they were contracting with? If who they *thought* they contracted with differs from who they *actually* contracted with, then the Agent will be liable on that contract.[1] This can happen in one of the following ways:

- The Agent is misleading the Third Party into thinking the Agent has authority to act on behalf of a Principal but they either do not have authority OR there is no Principal. In either case, the Agent is liable.

- The Agent is misleading the Third Party into thinking that they are dealing with just the Agent, but there is actually an undisclosed Principal. In this case, both the Principal and the Agent are liable.

- The Agent is misleading the Third Party regarding the identity of the Principal. The Third Party thinks they are dealing with Principal #1, but in a switcheroo they are actually dealing with Principal #2. In this case, both Principal #2 and the Agent are liable.

[1] Note that this contractual liability is not mutually exclusive. If the Principal authorized the Agent to enter into the contract and the Agent misled the third party as to the identity of the Principal, they will be jointly liable on that contract.

Atlantic Salmon A/S v. Curran, 32 Mass. App. Ct. 488 (1992)

Warner, C.J.

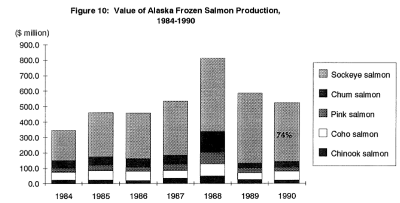
These are the plaintiffs' appeals from a Superior Court judgment for the defendant. The issue presented is as to the personal liability of an agent who at the relevant times was acting on behalf of a partially disclosed or unidentified principal.

The defendant began doing business with the plaintiffs, Salmonor A/S (Salmonor) and Atlantic Salmon A/S (Atlantic), Norwegian corporations and exporters of salmon, in 1985 and 1987, respectively. At all times, the defendant dealt with the plaintiffs as a representative of "Boston International Seafood Exchange, Inc.," or "Boston Seafood Exchange, Inc." The salmon purchased by the defendant was sold to other wholesalers. Payment checks from the defendant to the plaintiffs were imprinted with the name "Boston International Seafood Exchange, Inc.," and signed by the defendant, using the designation "Treas.," intending thereby to convey the impression that he was treasurer. Wire transfers of payments were also made in the name of Boston International Seafood Exchange, Inc. The defendant gave the plaintiffs' representatives business cards which listed him as "marketing director" of "Boston International Seafood Exchange, Inc." Advertising placed by the defendant appeared in trade journals under both the names "Boston Seafood Exchange, Inc.," and "Boston International Seafood Exchange, Inc." (indicating in one instance as to the latter that it was "Est: 1982"). At the relevant times, no such Massachusetts or foreign corporation had been formed by the defendant or had existed.

On May 31, 1977, a Massachusetts corporation named "Marketing Designs, Inc.," was organized. It was created for the purpose of selling motor vehicles. As of 1983, the defendant was the president, treasurer, clerk, a director, and the sole stockholder of that corporation.[1] The extent of activity or solvency of the corporation is not shown on the record. On October 19, 1983, however, Marketing Designs, Inc., was dissolved, apparently for failure to make requisite corporate filings. On December 4, 1987, a certificate was filed with the city clerk of Boston declaring that Marketing Designs, Inc. (then dissolved), was conducting business under the name of Boston Seafood Exchange (not with the designation "Inc." and not also under the name Boston International Seafood Exchange, Inc.).

[1] This is like one of those student films where the director is also the writer and is also the editor and is also the actor, etc.

Salmonor is owed $101,759.65 and Atlantic $153,788.50 for salmon sold to a business known as Boston International Seafood Exchange or Boston Seafood Exchange during 1988. Marketing Designs, Inc., was dissolved at the time the debt was incurred. In that year, advertising in a trade journal appeared in the name of "Boston Seafood Exchange, Inc.," and listed the plaintiffs as suppliers, and the defendant delivered to representatives of the plaintiffs his business card on which he was described as "marketing director" of "Boston International Seafood Exchange, Inc." On July 8, August 19 and 30, and September 9, 1988, the defendant made checks, imprinted with the name "Boston International Seafood Exchange, Inc.," to one or the other of the plaintiffs as payments for shipments of salmon.



Frozen salmon was hot for a minute in the late '80s.

The defendant never informed the plaintiffs of the existence of Marketing Designs, Inc., and the plaintiffs did not know of it until after the commencement of the present litigation on November 25, 1988. Marketing Designs, Inc., was revived for all purposes on December 12, 1988. In the fall of 1988, the defendant had communications with representatives of both plaintiffs, suggesting a "reorganization" or "restructuring" of Boston International Seafood Exchange, Inc., and a preferred stock position for the plaintiffs in exchange for debt.

In the course of his direct testimony, the defendant said: "We do business in seafood, and we're only in seafood. Boston Seafood Exchange is the name we use because it identifies us very closely with the industry and the products that we deal in. 'Marketing Designs, Inc.,' in the seafood business, would have absolutely no bearing or no recall or any factor at all. I picked the name Boston Seafood Exchange, Inc., because it defines where we are, who we deal with, the type of product we're into, and where our specialties are. The reason we have 'Inc.' on there is because also it seemed to me at the time — obviously it seemed to me at the time that it's incumbent upon me to tell people that I'm dealing with and to let them know that they're dealing with a corporation.[1] So, we used 'Inc.' just to notify them; and I signed all my checks 'Treasurer' and so forth."

At trial and on appeal the defendant argues that he was acting as an agent of Marketing Designs, Inc., in 1988 when he incurred the debt which the plaintiffs seek to recover from him individually. It makes no difference that the plaintiffs thought they were dealing with corporate entities which did not exist, the defendant contends, because they were "aware" that they were transacting business with a corporate entity and not with the defendant individually. The judge essentially adopted the defendant's position. The plaintiffs argue that the defendant had no principal, as he was conducting business in the name of nonexistent corporations, and he was, therefore, himself the principal, or, in the alternative, that he was acting for a partially disclosed principal (Marketing Designs, Inc.), not known to the plaintiffs, and, consequently, a party to the contracts with the plaintiffs. The judge seems to have treated the case as if it were one involving the defendant as an agent for a partially disclosed principal. Then the analysis went astray.

"If the other party [to a transaction] has notice that the agent is or

[1] Note that Curran says "a corporation". Not *this* corporation, no no no. The indefinite article is the last refuge of a scoundrel.

may be acting for a principal but has no notice of the principal's identity, the principal for whom the agent is acting is a partially disclosed principal." Restatement (Second) of Agency §4(2) (1958). Here, the plaintiffs had notice that the defendant was purporting to act for a corporate principal or principals but had no notice of the identity of the principal as claimed by the defendant in this litigation. "Unless otherwise agreed, a person purporting to make a contract with another for a partially disclosed principal is a party to the contract."

The judge reasoned that since the defendant had filed a certificate with the city of Boston in December, 1987, that Marketing Designs, Inc., was doing business as Boston Seafood Exchange, the plaintiffs could have discerned "precisely with whom they were dealing by reference to public records before the 1988 credits were extended." But the defendant had dealt with Salmonor, and probably Atlantic, before that date, continued to deal with both under the name Boston International Seafood Exchange, Inc., thereafter, and even proposed to the plaintiffs a corporate restructuring of that nonentity. In any event, it was not the plaintiffs' duty to seek out the identity of the defendant's principal; it was the defendant's obligation fully to reveal it.

It is not sufficient that the plaintiffs may have had the means, through a search of the records of the Boston city clerk, to determine the identity of the defendant's principal. Actual knowledge is the test. "The duty rests upon the agent, if he would avoid personal liability, to disclose his agency, and not upon others to discover it. It is not, therefore, enough that the other party has the means of ascertaining the name of the principal; the agent must either bring to him actual knowledge or, what is the same thing, that which to a reasonable man is equivalent to knowledge or the agent will be bound. There is no hardship to the agent in this rule, as he always has it in his power to relieve himself from personal liability by fully disclosing his principal and contracting only in the latter's name. If he does not do this, it may well be presumed that he intended to make himself personally responsible." Mechem on Agency §1413 (2d ed. 1914).

Finally, the defendant's use of trade names or fictitious names by which he claimed Marketing Designs, Inc., conducted its business is not in the circumstances a sufficient identification of the alleged principal so as to protect the defendant from personal liability. Indeed, the defendant's own testimony expresses the impossibility of any rational connection.

The judgment is reversed, and new judgments are to be entered against the defendant for Atlantic in the amount of $153,788.50 and for Salmonor in the amount of $101,759.65, both with appropriate interest and costs.

SOME DISCUSSION QUESTIONS:

1. Who was Curran an agent for, if anyone?
2. If Boston Seafood Exchange, Inc. had been the company that actually existed, would its revival in December of 1988 (after the wheelings and dealings that are the subject of this lawsuit had occurred) have made a difference in the outcome of this case?
3. Should counterparties to a deal like this be required to look up public records in order to ascertain who they are dealing with? Why or why not?

Liability under Tort

LIABILITY UNDER TORT for both Agent and Principal is governed by a legal doctrine called *respondeat superior*. Under this doctrine, if (1) there was a Principal-Agent (or Employer-Employee) relationship, and (2) the Agent/Employee was acting "within the scope of their employment", then the Principal is liable for the acts of the Agent. If either part of the test is failed, however – if there was no Principal-Agent relationship **or** if the Agent was acting outside their employment, then the Agent is liable for their conduct.

The next two cases address the first part of the test, by examining whether apparent authority exists for franchisees of major brands.

Hoover v. Sun Oil Company, 212 A.2d 214 (Del. Super. Ct. 1965)

Christie, J.

This case is concerned with injuries received as the result of a fire on August 16, 1962 at the service station operated by James F. Barone. The fire started at the rear of plaintiff's car where it was being filled with gasoline and was allegedly caused by the negligence of John Smilyk an employee of Barone. Plaintiffs brought suit against Smilyk, Barone and Sun Oil Company (Sun) which owned the service station.

Sun has moved for summary judgment as to it on the basis that Barone was an independent contractor and therefore the alleged negligence of his employee could not result in liability as to Sun. The plaintiffs contend instead that Barone was acting as Sun's agent and that Sun may therefore be responsible for plaintiff's injuries.

Barone began operating this business in October of 1960 pursuant to a lease dated October 17, 1960. The station and all of its equipment, with the exception of a tire-stand and rack, certain advertising displays and miscellaneous hand tools, were owned by Sun. The lease was subject to termination by either party upon thirty days' written notice after the first six months and at the anniversary date thereafter. The rental was partially determined by the volume of gasoline purchased but there was also a minimum and a maximum monthly rental.

At the same time, Sun and Barone also entered into a dealer's agreement under which Barone was to purchase petroleum products from Sun and Sun was to loan necessary equipment and advertising materials. Barone was required to maintain this equipment and to use it solely for Sun products. Barone was permitted under the agreement to sell competitive products but chose to do so only in a few minor areas. As to Sun products, Barone was prohibited from selling them except under the Sunoco label and from blending them with products not supplied by Sun.

Barone's station had the usual large signs indicating that Sunoco products were sold there. His advertising in the classified section of the telephone book was under a Sunoco heading and his employees wore uniforms with the Sun emblem, the uniforms being owned by Barone or rented from an independent company.

Other facts typifying the company-service station relationship were the weekly visits of Sun's sales representative, Peterson, who would take orders for Sun products, inspect the restrooms, communicate customer complaints, make various suggestions to improve sales and discuss any problems that Barone might be having. Besides the weekly visits, Peterson was in contact with Barone on other occasions in order to implement Sun's "competitive allowance system" which enabled Barone to meet local price competition by giving him a rebate on the gasoline in his inventory roughly equivalent to the price decline and a similarly reduced price on his next order of gasoline.

While Peterson did offer advice to Barone on all phases of his operation, it was usually done on request and Barone was under no obligation to follow the advice.[1] Barone's contacts and dealings with Sun were many and their relationship intricate, but he made no written reports to Sun and he alone assumed the overall risk of profit or loss in his business operation. Barone independently determined his own hours of operation and the identity, pay scale and working conditions of his employees, and it was his name that was posted as proprietor.

[1] In a section of the decision that I've omitted, the court describes Barone going to some sort of "school" run by Sun that taught service station operators the highly technical ins and outs of selling AriZona Iced Tea to construction workers or whatever. Just in case you thought law school was boring.

Plaintiffs contend in effect that the aforegoing facts indicate that Sun controlled the day-to-day operation of the station and consequently Sun is responsible for the negligent acts of Barone's employee. Specifically, plaintiffs contend that there is an issue of fact for the jury to determine as to whether or not there was an agency relationship.

The legal relationships arising from the distribution systems of major oil-producing companies are in certain respects unique.[1] In some situations traditional definitions of principal and agent and of employer and independent contractor may be difficult to apply to service station operations, but the undisputed facts of the case at bar make it clear that Barone was an independent contractor.

[1] "This distribution system has grown up primarily as the result of economic factors and with little relationship to traditional legal concepts in the field of master and servant, so that it is perhaps not surprising that attempts by the court to discuss the relationship in the standard terms have led to some difficulties and confusion." 83 A.L.R. 2d 1282, 1284 (1962).

Barone's service station, unlike retail outlets for many products, is basically a one-company outlet and represents to the public, through Sunoco's national and local advertising, that it sells not only Sun's quality products but Sun's quality service. Many people undoubtedly come to the service station because of that latter representation.

However, the lease contract and dealer's agreement fail to establish any relationship other than landlord-tenant, and independent contractor.[2] Nor is there anything in the conduct of the individuals which is inconsistent with that relationship so as to indicate that the contracts were mere subterfuge or sham. The areas of close contact between Sun and Barone stem from the fact that both have a mutual interest in the sale of Sun products and in the success of Barone's business.

[2] Always remember: check the gas station's lease and dealer's agreement before putting gas in your car, kids.

The cases cited by both plaintiffs and defendant indicate that the result varies according to the contracts involved and the conduct and evidence of control under those contracts. Both lines of cases indicate that the test to be applied is that of whether the oil company has retained the right to control the details of the day-to-day operation of the service station; control or influence over results alone being viewed as insufficient.

The facts of this case differ markedly from those in which the oil company was held liable for the tortious conduct of its service station operator or his employees. Sun had no control over the details of Barone's day-to-day operation. Therefore, no liability can be imputed to Sun from the allegedly negligent acts of Smilyk.

Some discussion questions:

1. Sun Oil clearly wants Barone to run the service station in a particular manner – requiring Barone to lease a certain location, maintain a certain appearance, offer certain products for sale, use certain equipment, etc. What is the point of having a franchisee run the service station instead of just doing it themeselves?

2. The *Hoover* court is essentially saying that because everyone has gotten used to treating these contractual relationships as something other than what they obviously are, it is difficult to get these companies to comply with existing law. Does this have any modern parallels? *cough cough* UBER *cough*

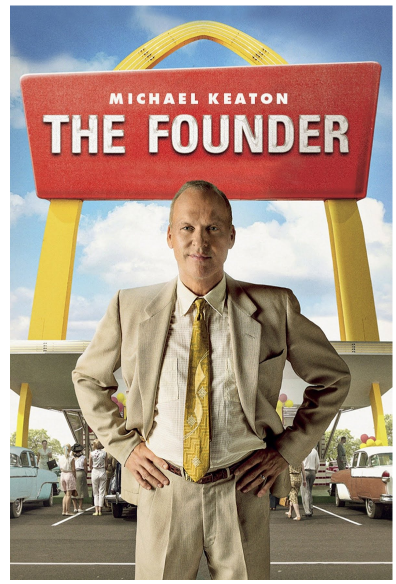
Miller v. McDonald's Corp., 945 P.2d 1107 (Or. App. 1997)

Warren, J.

Plaintiff seeks damages from defendant McDonald's Corporation for injuries that she suffered when she bit into a heart-shaped sapphire stone while eating a Big Mac sandwich[1] that she had purchased at a McDonald's restaurant in Tigard. The trial court granted summary judgment to defendant on the ground that it did not own or operate the restaurant; rather, the owner and operator was a non-party, 3K Restaurants (3K), that held a franchise from defendant. Plaintiff appeals, and we reverse.

[1] "Two all beef patties, special sauce, lettuce, cheese, precious jewels, pickles, onions on a sesame seed bun."

3K owned and operated the restaurant under a License Agreement (the Agreement) with defendant that required it to operate in a manner consistent with the "McDonald's System." The Agreement described that system as including proprietary rights in trade names, service marks and trade marks, as well as "designs and color schemes for restaurant buildings, signs, equipment layouts, formulas and specifications for certain food products, methods of inventory and operation control, bookkeeping and accounting, and manuals covering business practices and policies."



This movie whips.

The manuals contain "detailed information relating to operation of the Restaurant," including food formulas and specifications, methods of inventory control, bookkeeping procedures, business practices, and other management, advertising, and personnel policies. 3K, as the licensee, agreed to adopt and exclusively use the formulas, methods, and policies contained in the manuals, including any subsequent modifications, and to use only advertising and promotional materials that defendant either provided or-approved in advance in writing.

The Agreement described the way in which 3K was to operate the restaurant in considerable detail. It expressly required 3K to operate in compliance with defendant's prescribed standards, policies, practices, and procedures, including serving only food and beverage products that defendant designated. 3K had to follow defendant's specifications and blueprints for the equipment and layout of the restaurant, including adopting subsequent reasonable changes that defendant made, and to maintain the restaurant building in compliance with defendant's standards. 3K could not make any changes in the basic design of the building without defendant's approval.[2]

[2] Ray Kroc – the dude who ran McDonald's after kinda sorta screwing over original founders Richard and Maurice "Mac" McDonald – was obsessed with making sure every restaurant served the same food prepared the same way with the same branding. Kroc thought that people would value food that was fast, cheap, and predictable more than they would value quality — and boy was he extremely correct. Now, if you'll excuse me, I'm going to Postmates myself a Filet-O-Fish.

The Agreement required 3K to keep the restaurant open during the hours that defendant prescribed, including maintaining adequate supplies and employing adequate personnel to operate at maximum capacity and efficiency during those hours. 3K also had to keep the restaurant similar in appearance to all other McDonald's restaurants. 3K's employees had to wear McDonald's uniforms, to have a neat and clean appearance, and to provide competent and courteous service. 3K could use only containers and other packaging that bore McDonald's trademarks. The ingredients for the foods and beverages had to meet defendant's standards, and 3K had to use "only those methods of food handling and preparation that [defendant] may designate from time to time." In order to obtain the franchise, 3K had to represent that the franchisee had worked at a McDonald's restaurant; the Agreement did not distinguish in this respect between a company-run or a franchised restaurant. The manuals gave further details that expanded on many of these requirements.

In order to ensure conformity with the standards described in the Agreement, defendant periodically sent field consultants to the restaurant to inspect its operations. 3K trained its employees in accordance with defendant's materials and recommendations and sent some of them to training programs that defendant administered. Failure to comply with the agreed standards could result in loss of the franchise.

Despite these detailed instructions, the Agreement provided that 3K was not an agent of defendant for any purpose.[1] Rather, it was an independent contractor and was responsible for all obligations and liabilities, including claims based on injury, illness, or death, directly or indirectly resulting from the operation of the restaurant.

[1] "The parties agree that even though it looks like a duck, walks like a duck, and quacks like a duck, it is not, in fact, a duck." Good luck with that, my man.

Plaintiff went to the restaurant under the assumption that defendant owned, controlled, and managed it. So far as she could tell, the restaurant's appearance was similar to that of other McDonald's restaurants that she had patronized. Nothing disclosed to her that any entity other than defendant was involved in its operation. The only signs that were visible and obvious to the public had the name "McDonald's," the employees wore uniforms with McDonald's insignia, and the menu was the same that plaintiff had seen in other McDonald's restaurants. The general appearance of the restaurant and the food products that it sold were similar to the restaurants and products that plaintiff had seen in national print and television advertising that defendant had run. To the best of plaintiff's knowledge, only McDonald's sells Big Mac hamburgers.

In short, plaintiff testified, she went to the Tigard McDonald's because she relied on defendant's reputation and because she wanted to obtain the same quality of service, standard of care in food preparation, and general attention to detail that she had previously enjoyed at other McDonald's restaurants.

Under these facts, 3K would be directly liable for any injuries that plaintiff suffered as a result of the restaurant's negligence. The issue on summary judgment is whether there is evidence that would permit a jury to find defendant vicariously liable for those injuries because of its relationship with 3K. Plaintiff asserts two theories of vicarious liability, actual agency and apparent agency. We hold that there is sufficient evidence to raise a jury issue under both theories. We first discuss actual agency.

[W]e believe that a jury could find that defendant retained sufficient control over 3K's daily operations that an actual agency relationship existed. The Agreement did not simply set standards that 3K had to meet. Rather, it required 3K to use the precise methods that defendant established, both in the Agreement and in the detailed manuals that the Agreement incorporated. Those methods included the ways in which 3K was to handle and prepare food. Defendant enforced the use of those methods by regularly sending inspectors and by its retained power to cancel the Agreement. That evidence would support a finding that defendant had the right to control the way in which 3K performed at least food handling and preparation. In her complaint, plaintiff alleges that 3K's deficiencies in those functions resulted in the sapphire being in the Big Mac and thereby caused her injuries. Thus, there is evidence that defendant had the right to control 3K in the precise part of its business that allegedly resulted in plaintiff's injuries. That is sufficient to raise an issue of actual agency.

Plaintiff next asserts that defendant is vicariously liable for 3K's alleged negligence because 3K was defendant's apparent agent.[4] The relevant standard is:

> "One who represents that another is his servant or other agent and thereby causes a third person justifiably to rely upon the care or skill of such apparent agent is subject to liability to the third person for harm caused by the lack of care or skill of the one appearing to be a servant or other agent as if he were such."

In this case, there is an issue of fact about whether defendant held 3K out as its agent. Everything about the appearance and operation of the Tigard McDonald's identified it with defendant and with the common image for all McDonald's restaurants that defendant has worked to create through national advertising, common signs and uniforms, common menus, common appearance, and common standards. The possible existence of a sign identifying 3K as the operator does not alter the conclusion that there is an issue of apparent agency for the jury. There are issues of fact of whether that sign was sufficiently visible to the public, in light of plaintiff's apparent failure to see it, and of whether one sign by itself is sufficient to remove the impression that defendant created through all of the other indicia of its control that it, and 3K under the requirements that defendant imposed, presented to the public.

Plaintiff testified in her affidavit that her reliance on defendant for the quality of service and food at the Tigard McDonald's came in part from her experience at other McDonald's restaurants. Defendant's argument that she must show that it, rather than a franchisee, operated those restaurants is, at best, disingenuous. A jury could find that it was

> defendant's very insistence on uniformity of appearance and standards, designed to cause the public to think of every McDonald's, franchised or unfranchised, as part of the same system, that makes it difficult or impossible for plaintiff to tell whether her previous experiences were at restaurants that defendant owned or franchised.
>
> [I]]n this case plaintiff testified that she relied on the general reputation of McDonald's in patronizing the Tigard restaurant and in her expectation of the quality of the food and service that she would receive. Especially in light of defendant's efforts to create a public perception of a common McDonald's system at all McDonald's restaurants, whoever operated them, a jury could find that plaintiff's reliance was objectively reasonable. The trial court erred in granting summary judgment on the apparent agency theory.

SOME DISCUSSION QUESTIONS:

1. Why is there a different outcome in *Miller* than in *Hoover*?
2. How much does it matter that McDonald's actually does own and operate some of its own restaurants?
3. Who was in a better position to monitor the employees and make sure they didn't randomly put gemstones in the food – the franchisee or McDonald's? Why?
4. What if this was a Popeye's?

Both cases dance around the distinction between employees on one hand (who have an agency relationship with their employer) and independent contractors on the other (who do not, and therefore have no vicarious liability to the employer). Courts generally look towards whether a party has the right to exercise control over the other party – things like specifying the time, place, and manner of work, for example – with the idea being that if an employer gets the benefits of controlling their employee, then they should then bear the corresponding costs incurred by that employee. Another rationale is that if an employer is in control of their employee, the employer is better able to take steps to avoid the injury caused by their employee and therefore the burden of tort liability should fall on them. That logic is also relevant to the next step of determining tort liability in principal-agent relationships, which we discuss next.

IF AN PRINCIPAL-AGENT RELATIONSHIP EXISTS, a party claiming *respondeat superior* must then prove that the Agent/Employee acted "within the scope of their employment". The easiest kind of case to resolve is when the Principal instructs the Agent to carry out the tort (or ratifies the Agent's action afterwards).[1] There, the Principal is commanding the agent to commit the tort and therefore is directly liable, no fuss, no muss.

More common, however, is when the Agent inadvertently injures a Third Party and the Third Party seeks recovery under *respondeat superior* from the Principal. There, courts must determine whether the particular actions of the Agent count as occurring within the scope of the Agent's employment. Courts have developed and use two basic tests for this analysis: *foreseeability* and *purpose*.

[1] For example, in the movie *Road House*, the bad guy – yes, I know, it's weird that they cast independent film legend Ben Gazzara as the villain – instructs one of his goons to drive a monster truck – hmmm, yeah, no, I don't think it's street legal, he just owns one for some reason – through a car dealership because he's mad at Patrick Swayze, the head bouncer of a local bar and the second-most-famous bouncer in America. This makes exactly as much sense in the movie as it does in on paper. Anyway, by ordering the goon to commit the tort, the bad guy is liable under *respondeat superior*.

Ira S. Bushey & Sons, Inc. v. U.S., 398 F.2d 167 (2d Cir. 1968)

Friendly, C.J.

While the United States Coast Guard vessel Tamaroa was being overhauled in a floating drydock located in Brooklyn's Gowanus Canal, a seaman returning from shore leave late at night, in the condition for which seamen are famed, turned some wheels on the drydock wall. He thus opened valves that controlled the flooding of the tanks on one side of the drydock. Soon the ship listed, slid off the blocks and fell against the wall. Parts of the drydock sank, and the ship partially did — fortunately without loss of life or personal injury. The drydock owner sought and was granted compensation by the District Court for the Eastern District of New York in an amount to be determined; the United States appeals.

I cannot stress this enough: lmao

The Tamaroa had gone into drydock on February 28, 1963; her keel rested on blocks permitting her drive shaft to be removed and repairs to be made to her hull. The contract between the Government and Bushey provided in part:

> The work shall, whenever practical, be performed in such manner as not to interfere with the berthing and messing of personnel attached to the vessel undergoing repair, and provision shall be made so that personnel assigned shall have access to the vessel at all times, it being understood that such personnel will not interfere with the work or the contractor's workmen.

Access from shore to ship was provided by a route past the security guard at the gate, through the yard, up a ladder to the top of one drydock wall and along the wall to a gangway leading to the fantail deck, where men returning from leave reported at a quartermaster's shack.

Seaman Lane, whose prior record was unblemished, returned from shore leave a little after midnight on March 14. He had been drinking heavily; the quarter-master made mental note that he was "loose." For reasons not apparent to us or very likely to Lane, he took it into his head, while progressing along the gangway wall, to turn each of three large wheels some twenty times; unhappily, as previously stated, these wheels controlled the water intake valves. After boarding ship at 12:11 A.M., Lane mumbled to an off-duty seaman that he had "turned some valves" and also muttered something about "valves" to another who was standing the engineering watch. Neither did anything; apparently Lane's condition was not such as to encourage proximity. At 12:20 A.M. a crew member discovered water coming into the drydock. By 12:30 A.M. the ship began to list, the alarm was sounded and the crew were ordered ashore. Ten minutes later the vessel and dock were listing over 20 degrees; in another ten minutes the ship slid off the blocks and fell against the drydock wall.[1]

[1] For a delightful retelling of what happened afterwards by a sailor who joined the crew after the incident, click here.

The Government attacks imposition of liability on the ground that Lane's acts were not within the scope of his employment. It relies heavily on § 228(1) of the Restatement of Agency 2d which says that "conduct of a servant is within the scope of employment if, but only if it is actuated, at least in part by a purpose to serve the master." Courts have gone to considerable lengths to find such a purpose, as witness a well-known opinion in which Judge Learned Hand concluded that a drunken boatswain who routed the plaintiff out of his bunk with a blow, saying "Get up, you big son of a bitch, and turn to," and then continued to fight, might have thought he was acting in the interest of the ship. It would be going too far to find such a purpose here; while Lane's return to the Tamaroa was to serve his employer, no one has suggested how he could have thought turning the wheels to be, even if — which is by no means clear — he was unaware of the consequences.

In light of the highly artificial way in which the motive test has been applied, the district judge believed himself obliged to test the doctrine's continuing vitality by referring to the larger purposes respondeat superior is supposed to serve. He concluded that the old formulation failed this test. We do not find his analysis so compelling, however, as to constitute a sufficient basis in itself for discarding the old doctrine. It is not at all clear, as the court below suggested, that expansion of liability in the manner here suggested will lead to a more efficient allocation of resources. As the most astute exponent of this theory has emphasized, a more efficient allocation can only be expected if there is some reason to believe that imposing a particular cost on the enterprise will lead it to consider whether steps should be taken to prevent a recurrence of the accident. *Calabresi, The Decision for Accidents: An Approach to Nonfault Allocation of Costs, 78 Harv. L. Rev. 713, 725-34 (1965)*.[2] And the suggestion that imposition of liability here will lead to more intensive screening of employees rests on highly questionable premises. The unsatisfactory quality of the allocation of resource rationale is especially striking on the facts of this case. It could well be that application of the

[2] Guido Calabresi became famous for his "cheapest cost avoider" approach assigning liability under tort law. To Calabresi, the correct system places the burden of avoiding accidents (and, therefore, the cost of paying for the damages of accidents) on the party best able to minimize third-party harms.

traditional rule might induce drydock owners, prodded by their insurance companies, to install locks on their valves to avoid similar incidents in the future, while placing the burden on shipowners is much less likely to lead to accident prevention. It is true, of course, that in many cases the plaintiff will not be in a position to insure, and so expansion of liability will, at the very least, serve respondeat superior's loss spreading function. But the fact that the defendant is better able to afford damages is not alone sufficient to justify legal responsibility, and this overarching principle must be taken into account in deciding whether to expand the reach of respondeat superior.

A policy analysis thus is not sufficient to justify this proposed expansion of vicarious liability. This is not surprising since respondeat superior, even within its traditional limits, rests not so much on policy grounds consistent with the governing principles of tort law as in a deeply rooted sentiment that a business enterprise cannot justly disclaim responsibility for accidents which may fairly be said to be characteristic of its activities. It is in this light that the inadequacy of the motive test becomes apparent. We concur in the statement of Mr. Justice Rutledge in a case involving violence injuring a fellow-worker, in this instance in the context of workmen's compensation:

> "Men do not discard their personal qualities when they go to work. Into the job they carry their intelligence, skill, habits of care and rectitude. Just as inevitably they take along also their tendencies to carelessness and camaraderie, as well as emotional make-up. In bringing men together, work brings these qualities together, causes frictions between them, creates occasions for lapses into carelessness, and for fun-making and emotional flare-up. These expressions of human nature are incidents inseparable from working together. They involve risks of injury and these risks are inherent in the working environment."

Put another way, Lane's conduct was not so "unforeseeable" as to make it unfair to charge the Government with responsibility. We agree with a leading treatise that "what is reasonably foreseeable in this context [of respondeat superior] is quite a different thing from the foreseeably unreasonable risk of harm that spells negligence. The foresight that should impel the prudent man to take precautions is not the same measure as that by which he should perceive the harm likely to flow from his long-run activity in spite of all reasonable precautions on his own part. The proper test here bears far more resemblance to that which limits liability for workmen's compensation than to the test for negligence. The employer should be held to expect risks, to the public also, which arise 'out of and in the course of' his employment of labor." *See also Calabresi, Some Thoughts on Risk Distribution and the Law of Torts, 70 Yale L.J. 499, 544 (1961).* Here it was foreseeable that crew members crossing the drydock might do damage, negligently or even intentionally, such as pushing a Bushey employee or kicking property into the water. Moreover, the proclivity of seamen to find solace for solitude by copious resort to the bottle while ashore has been noted in opinions too numerous to warrant citation. Once all this is granted, it is immaterial that Lane's precise action was not to be foreseen.

One can readily think of cases that fall on the other side of the line. If Lane had set fire to the bar where he had been imbibing or had caused an accident on the street while returning to the drydock, the Government would not be liable; the activities of the "enterprise" do not reach into areas where the servant does not create risks different from those attendant on the activities of the community in general. Here Lane had come within the closed-off area where his ship lay to occupy a berth to which the Government insisted he have access, and while his act is not readily explicable, at least it was not shown to be due entirely to facets of his personal life. The risk that seamen going and coming from the Tamaroa might cause damage to the drydock is enough to make it fair that the enterprise bear the loss.

Some discussion questions:

1. Did the court reach this decision by appealing to justice and fairness or to public policy?

2. The court says that "a business enterprise cannot justly disclaim responsibility for accidents which may fairly be said to be characteristic of its activities." Was this characteristic of the Coast Guard's activities?

The alternative to the "foreseeability" test for determining whether an Agent is acting within the scope of their employment is the "purpose" test. This test asks whether the Agent was engaged in activity with the purpose of serving the Principal at the time of the accident.[1] Of course, a lot of time spent in the employment of someone else is doing things that don't directly benefit the employer – getting and eating lunch, shit-talking your boss, watching stuff on your phone, staring vacantly into space, etc. As such, courts that employ a purpose test distinguish between a mere "detour" (deviating only temporarily from one's ostensible job) and the more consequential "frolic" (which represents something like the total abandonment of one's work responsibilities).

When you read the next case, ask whether the employee in question was engaged in a *frolic*, like some sort of Victorian schoolboy in a field of flowers, or merely taking a *detour*, like a casebook author making a weird analogy before returning to the analysis of the law?

[1] In Restatement-ese: "An employee acts within the scope of employment when performing work assigned by the employer or engaging in a course of conduct subject to the employer's control. An employee's act is not within the scope of employment when it occurs within an independent course of conduct not intended by the employee to serve any purpose of the employer." RESTATEMENT (THIRD) OF AGENCY §7.07.

Clover v. Snowbird Ski Resort, 808 P.2d 1037 (Utah 1991)

Hall, C.J.

Plaintiff Margaret Clover sought to recover damages for injuries sustained as the result of a ski accident in which Chris Zulliger, an employee of defendant Snowbird Corporation ("Snowbird"), collided with her. From the entry of summary judgment in favor of defendants, Clover appeals.

At the time of the accident, Chris Zulliger was employed by Snowbird as a chef at the Plaza Restaurant. Zulliger was supervised by his father, Hans Zulliger, who was the head chef at both the Plaza, which was located at the base of the resort, and the Mid-Gad Restaurant, which was located halfway to the top of the mountain. Zulliger was instructed by his father to make periodic trips to the Mid-Gad to monitor its operations. Prior to the accident, the Zulligers had made several inspection trips to the restaurant. On at least one occasion, Zulliger was paid for such a trip. He also had several conversations with Peter Mandler, the manager of the Plaza and Mid-Gad Restaurants, during which Mandler directed him to make periodic stops at the Mid-Gad to monitor operations.

Pictured: Zulliger and Norman

On December 5, 1985, the date of the accident, Zulliger was scheduled to begin work at the Plaza Restaurant at 3 p.m. Prior to beginning work, he had planned to go skiing with Barney Norman, who was also employed as a chef at the Plaza. Snowbird preferred that their employees know how to ski because it made it easier for them to get to and from work. As part of the compensation for their employment, both Zulliger and Norman received season ski passes. On the morning of the accident, Mandler asked Zulliger to inspect the operation of the Mid-Gad prior to beginning work at the Plaza.

Zulliger and Norman stopped at the Mid-Gad in the middle of their first run. At the restaurant, they had a snack, inspected the kitchen, and talked to the personnel for approximately fifteen to twenty minutes. Zulliger and Norman then skied four runs[1] before heading down the mountain to begin work. On their final run, Zulliger and Norman took a route that was often taken by Snowbird employees to travel from the top of the mountain to the Plaza. About mid-way down the mountain, at a point above the Mid-Gad, Zulliger decided to take a jump off a crest on the side of an intermediate run. He had taken this jump many times before. A skier moving relatively quickly is able to become airborne at that point because of the steep drop off on the downhill side of the crest. Due to this drop off, it is impossible for skiers above the crest to see skiers below the crest. The jump was well known to Snowbird. In fact, the Snowbird ski patrol often instructed people not to jump off the crest. There was also a sign instructing skiers to ski slowly at this point in the run. Zulliger, however, ignored the sign and skied over the crest at a significant

[1] !!!

speed. Clover, who had just entered the same ski run from a point below the crest, either had stopped or was traveling slowly below the crest. When Zulliger went over the jump, he collided with Clover, who was hit in the head and severely injured.[1]

[1] Yeah, but I bet he got *sick air, bro.*

Under the doctrine of respondeat superior, employers are held vicariously liable for the torts their employees commit when the employees are acting within the scope of their employment. Clover's respondeat superior claim was dismissed on the ground that as a matter of law, Zulliger's actions at the time of the accident were not within the scope of his employment. In a recent case,[2] this court addressed the issue of what types of acts fall within the scope of employment. In *Birkner*, we stated that acts within the scope of employment are "those acts which are so closely connected with what the servant is employed to do, and so fairly and reasonably incidental to it, that they may be regarded as methods, even though quite improper ones, of carrying out the objectives of the employment."

[2] *Birkner v. Salt Lake County*, 771 P.2d 1053 (Utah 1989).

In *Birkner*, we observed that the Utah cases that have addressed the issue of whether an employee's actions, as a matter of law, are within or without the scope of employment have focused on three criteria. "First, an employee's conduct must be of the general kind the employee is employed to perform.... In other words, the employee must be about the employer's business and the duties assigned by the employer, as opposed to being wholly involved in a personal endeavor." Second, the employee's conduct must occur substantially within the hours and ordinary spatial boundaries of the employment. "Third, the employee's conduct must be motivated at least in part, by the purpose of serving the employer's interest." Under specific factual situations, such as when the employee's conduct serves a dual purpose or when the employee takes a personal detour in the course of carrying out his employer's directions, this court has occasionally used variations of this approach. These variations, however, are not departures from the criteria advanced in *Birkner*. Rather, they are methods of applying the criteria in specific factual situations.

In applying the *Birkner* criteria to the facts in the instant case, it is important to note that if Zulliger had returned to the Plaza Restaurant immediately after he inspected the operations at the Mid-Gad Restaurant, there would be ample evidence to support the conclusion that on his return trip Zulliger's actions were within the scope of his employment. There is evidence that it was part of Zulliger's job to monitor the operations at the Mid-Gad and that he was directed to monitor the operations on the day of the accident. There is also evidence that Snowbird intended Zulliger to use the ski lifts and the ski runs on his trips to the Mid-Gad. It is clear, therefore, that Zulliger's actions could be considered to "be of the general kind that the employee is employed to perform." It is also clear that there would be evidence that Zulliger's actions occurred within the hours and normal spatial boundaries of his employment. Zulliger was expected to monitor the operations at the Mid-Gad during the time the lifts were operating and when he was not working as a chef at the Plaza. Furthermore, throughout the trip he would have been on his employer's premises. Finally, it is clear that Zulliger's actions in monitoring the operations at the Mid-Gad, per his employer's instructions, could be considered "motivated, at least in part, by the purpose of serving the employer's interest."

The difficulty, of course, arises from the fact that Zulliger did not return to the Plaza after he finished inspecting the facilities at the Mid-Gad. Rather, he skied four more runs and rode the lift to the top of the mountain before he began his return to the base. Snowbird claims that this fact shows that Zulliger's primary purpose for skiing on the day of the accident was for his own pleasure and that therefore, as a matter of law, he was not acting within the scope of his employment.[1]

[1] Look at Snowbird, throwing its own employee under the bus!

There is ample evidence that there was a predominant business purpose for Zulliger's trip to the Mid-Gad. Therefore, this case is better analyzed under our decisions dealing with situations where an employee has taken a personal detour in the process of carrying out his duties. This court has decided several cases in which employees deviated from their duties for wholly personal reasons and then, after resuming their duties, were involved in accidents. In situations where the detour was such a substantial diversion from the employee's duties that it constituted an abandonment of employment, we held that the employee, as a matter of law, was acting outside the scope of employment. However, in situations where reasonable minds could differ on whether the detour constituted a slight deviation from the employee's duties or an abandonment of employment, we have left the question for the jury.

Under the circumstances of the instant case, it is entirely possible for a jury to reasonably believe that at the time of the accident, Zulliger had resumed his employment and that Zulliger's deviation was not substantial enough to constitute a total abandonment of employment. First, a jury could reasonably believe that by beginning his return to the base of the mountain to begin his duties as a chef and to report to Mandler concerning his observations at the Mid-Gad, Zulliger had resumed his employment. In past cases, in holding that the actions of an employee were within the scope of employment, we have relied on the fact that the employee had resumed the duties of employment prior to the time of the accident.

This is an important factor because if the employee has resumed the duties of employment, the employee is then "about the employer's business" and the employee's actions will be "motivated, at least in part, by the purpose of serving the employer's interest." The fact that due to Zulliger's deviation, the accident occurred at a spot above the Mid-Gad does not disturb this analysis. In situations where accidents have occurred substantially within the normal spatial boundaries of employment, we have held that employees may be within the scope of employment if, after a personal detour, they return to their duties and an accident occurs.

Second, a jury could reasonably believe that Zulliger's actions in taking four ski runs and returning to the top of the mountain do not constitute a complete abandonment of employment. It is important to note that by taking these ski runs, Zulliger was not disregarding his employer's directions. [F]ar from directing its employees not to ski at the resort, Snowbird issued its employees season ski passes as part of their compensation.

These two factors – along with other circumstances such as: throughout the day Zulliger was on Snowbird's property, there was no specific time set for inspecting the restaurant, and the act of skiing was the method used by Snowbird employees to travel among the different locations of the resort – constitute sufficient evidence for a jury to conclude that Zulliger, at the time of the accident, was acting within the scope of his employment.

SOME DISCUSSION QUESTIONS:

1. What distinguishes Zulliger's behavior from a full-on frolic?[1]
2. How would this case have been resolved under the "foreseeability" test? Would it have been different?
3. Whose idea was skiing, anyway? Why do people think this is fun?

[1] "I'm an alcoholic and that's all I can say / I call in to work, 'cause all I do is frolic and play."

Termination

EACH PARTY IN THE RELATIONSHIP has the right to terminate the principal-agent relationship. They can incur contractual penalties for this, depending on the terms of the contract and the method by which they terminate the relationship, but the parties can either "revoke" (if by the Principal) or "renounce" (if by the Agent) at their discretion. Other ways to terminate:

- Death of the agent or principal.
- Impossibility of performance.
- Mutual agreement.
- Bankruptcy of the agent or principal.

- Accomplishment of the specific task (if there was one) or the expiration of a specified term (if one was agreed to by the parties).[1]

As mentioned before, two things survive the termination of an agency relationship: (1) the duty of confidentiality and (2) apparent authority. As such, (1) the Agent must continue to keep confidential information of the Principal secret, and (2) the Principal may need to notify relevant Third Parties that the Agent is no longer representing them.

[1] An open-ended agency relationship can be found to have expired after a "reasonable" amount of time, the determination of which is made by a court reviewing the totality of the circumstances surrounding the relationship.

3. Partnership

THE PARTNERSHIP AS A TYPE of business association has a long and interesting history, none of which we will deal with here.[1] In the modern context, the partnership is a creation of state law, and there are two model statutes that states have adopted: the Uniform Partnership Act (1914) ("UPA") and the Revised Uniform Partnership Act (cited as the "Uniform Partnership Act (1997)" and known as "RUPA"). Kentucky, along with 34 other states and 2 territories, uses RUPA or something substantially similar; other states (most notably New York) continue to use UPA, the older version of the law.

[1] Psych! The precursor to the modern general partnership was probably born in Italy, probably in the 13th century, probably to pool capital for entrepreneurial families investing in international commerce – and almost certainly developed out of a combination of economic necessity, the Roman law conception of a *societas* (an entity distinct from its members), the Catholic Church's influence on Italian state-building, and pre-existing familial ties.

Max Weber. The History of Commercial Partnerships in the Middle Ages (1889). Translated by Lutz Kaelber. 2003; and John F. Padgett and Paul D. McLean. Organizational Invention and Elite Transformation: The Birth of Partnership Systems in Renaissance Florence. American Journal of Sociology, 111 (5):1463–1568, 2006

As we review the legal rules governing partnerships in this chapter, we will be using RUPA (though I will attempt to identify where and how those rules differ from the rules under UPA), with example text drawn from the Kentucky partnership statute. Note that several cases in this chapter apply partnership law under UPA or its state equivalent – either because they were decided before the revised version was adopted in that state or the case takes place in a UPA state. However, the key rules and duties interpreted in these cases are *identical* to the key rules and duties that exist under RUPA, as as such they will still be useful in understanding partnership law under either regime.

The General Partnership and the Limited Partnership

A partnership is defined in basically every jurisdiction as:

> an association of two (2) or more persons to carry on as co-owners a business for profit[2]

[2] KRS §362.1-101(10)

A GENERAL PARTNERSHIP is the most basic kind of business entity: two or more parties come together to do business as a new entity, pooling resources and effort to (hopefully) bring in profits that they will split between them, and who all bear liability in the event that the partnership cannot satisfy its obligations.

A LIMITED PARTNERSHIP (which we discuss later in this chapter) is slightly different: two or more parties come together to do business as a new entity, but in a limited partnership one (or more) of the partners has management rights in the business and is liable for the partnership's obligations (the "general partner"), while one (or more) of the partners has limited management rights and is not liable for the partnership's obligations (the "limited partner").

Both kinds of partnerships arise under state statutes, with general partnerships governed by the Revised Uniform Partnership Act,[1] and limited partnerships governed by the Revised Uniform Limited Partnership Act.[2] These statutes provide default rules for the creation, the liability, the governance, and the liquidation of these types of partnerships.[3]

[1] KRS §362.1 et seq.

[2] KRS §362.2 et seq.

[3] A limited liability partnership ("LLP") is a type of general partnership, and is governed by the same rules as a general partnership. A limited liability limited partnership ("LLLP"), where available, is a type of limited partnership, and is governed by the same rules as a limited partnership. These will be discussed later in this chapter.

We will start with the general partnership – its formation, its characteristics, its default rules under RUPA, and what partnership agreements can address – and work our way through all the kinds and types of partnerships as we move through the material.

Formation

> the association of two (2) or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership[4]

[4] KRS §362.1-202(1)

THE BEST WAY TO FORM A PARTNERSHIP is to enter into a binding contract with all of the partners, a document that is called a "Partnership Agreement". A good partnership agreement will lay out agreed-upon rules for management powers, voting procedures, the distribution of profits and losses, property rights in the partnership, partner withdrawal, dissolution, duration – basically anything that the partnership does not want settled by the default rules we discuss in this chapter.

This is, unfortunately, not the only way to form a general partnership. In *Meinhard v. Salmon* from Chapter 1, the court essentially found that Meinhard and Salmon were in a partnership despite the fact that they had never entered into a partnership agreement, and had arguably never even contemplated being in a formal partnership with one another. Reading the text of the statute above, notice the last line: *whether or not the persons intend to form a partnership.* General partnerships can be formed without the intent of the parties, which is honestly pretty wild if you think about it – especially since, as we discussed above, each of the partners in a general partnership are liable for the debts and obligations of the partnership.

What sort of things would two or more parties have to do to have courts find that they've formed a partnership without intending or expressing that they should become partners? The next case gets into that exact issue.

Martin v. Peyton, 158 N.E. 77 (N.Y. 1927)

Andrews, J.

Much ancient learning as to partnership is obsolete.[1] Today only those who are partners between themselves may be charged for partnership debts by others. There is one exception. Now and then a recovery is allowed where in truth such relationship is absent. This is because the debtor may not deny the claim.[2]

[1] No ancient Italian partnership law for you!

[2] So, the backstory here is that K.N.K. owes money to the plaintiff (Martin) but K.N.K. ain't got no money because they invested in let's see here ... German commercial prospects during the period immediately preceding World War I? Wow. Thanks, *Woodrow Wilson*. As such, the plaintiffs are going after Peyton and his associates, who are still solvent.

Partnership results from contract, express or implied. If denied it may be proved by the production of some written instrument; by testimony as to some conversation; by circumstantial evidence. If nothing else appears the receipt by the defendant of a share of the profits of the business is enough.

Assuming some written contract between the parties the question may arise whether it creates a partnership. If it be complete; if it expresses in good faith the full understanding and obligation of the parties, then it is for the court to say whether a partnership exists. It may, however, be a mere sham intended to hide the real relationship. Then other results follow. In passing upon it effect is to be given to each provision. Mere words will not blind us to realities.[3] Statements that no partnership is intended are not conclusive. If as a whole a contract contemplates an association of two or more persons to carry on as co-owners a business for profit a partnership there is. On the other hand, if it be less than this no partnership exists.[4] Passing on the contract as a whole, an arrangement for sharing profits is to be considered. It is to be given its due weight. But it is to be weighed in connection with all the rest. It is not decisive. It may be merely the method adopted to pay a debt or wages, as interest on a loan or for other reasons.

[3] Luminous beings are we, not this crude matter.

[4] Did a pirate write this?

An existing contract may be modified later by subsequent agreement, oral or written. A partnership may be so created where there was none before. And again, that the original agreement has been so modified may be proved by circumstantial evidence — by showing the conduct of the parties.

In the case before us the claim that the defendants became partners in the firm of Knauth, Nachod & Kuhne ("K.N.K"), doing business as bankers and brokers, depends upon the interpretation of certain instruments.

In the spring of 1921 the firm of K.N.K. found itself in financial difficulties. John R. Hall was one of the partners. He was a friend of Mr. Peyton.[1] From him he obtained the loan of almost $500,000 of Liberty bonds, which K.N.K. might use as collateral to secure bank advances. This, however, was not sufficient. The firm and its members had engaged in unwise speculations, and it was deeply involved. Mr. Hall was also intimately acquainted with George W. Perkins, Jr.,[2] and with Edward W. Freeman[3]. He also knew Mrs. Peyton and Mrs. Perkins and Mrs. Freeman. All were anxious to help him.[4] He, therefore, representing K.N.K., entered into negotiations with them. While they were pending a proposition was made that Mr. Peyton, Mr. Perkins and Mr. Freeman or some of them should become partners. It met a decided refusal. Finally an agreement was reached. It is expressed in three documents, executed on the same day, all a part of the one transaction. They were drawn with care and are unambiguous.

[1] William C. Peyton invented smokeless gunpowder and married into the duPont family, so, yeah, he's pretty stacked.

[2] Perkins was the heir to a wealthy J.P. Morgan partner, also stacked.

[3] Freeman was ... some dude. Probably had a nice smile or something?

[4] We get it, we get it, he's popular. I don't even have six friends that would help me move, let alone lend me $2.5 million.

We have no doubt as to their general purpose. The respondents were to loan K.N.K. $2,500,000 worth of liquid securities, which were to be returned to them on or before April 15, 1923. The firm might hypothecate[5] them to secure loans totalling $2,000,000, using the proceeds as its business necessities required. To insure respondents against loss K.N.K. were to turn over to them a large number of their own securities which may have been valuable, but which were of so speculative a nature that they could not be used as collateral for bank loans. In compensation for the loan the respondents [K.N.K.] were to receive 40 per cent of the profits of the firm until the return was made, not exceeding, however, $500,000 and not less than $100,000. The respondents also were given an option to join the firm if they or any of them expressed a desire to do so before June 4, 1923.

[5] Put them up as collateral.

Many other detailed agreements are contained in the papers. Are they such as may be properly inserted to protect the lenders? Or do they go further? Whatever their purpose, did they in truth associate the respondents with the firm so that they and it together thereafter carried on as co-owners a business for profit? The answer depends upon an analysis of these various provisions.

As representing the lenders, Mr. Peyton and Mr. Freeman are called "trustees." The loaned securities when used as collateral are not to be mingled with other securities of K.N. K., and the trustees at all times are to be kept informed of all transactions affecting them. To them shall be paid all dividends and income accruing therefrom. They may also substitute for any of the securities loaned securities of equal value. With their consent the firm may sell any of its securities held by the respondents, the proceeds to go, however, to the trustees.

So far there is no hint that the transaction is not a loan of securities with a provision for compensation. Later a somewhat closer connection with the firm appears. Until the securities are returned the directing management of the firm is to be in the hands of John R. Hall, and his life is to be insured for $1,000,000, and the policies are to be assigned as further collateral security to the trustees. These requirements are not unnatural. Hall was the one known and trusted by the defendants. Their acquaintance with the other members of the firm was of the slightest. These others had brought an old and established business to the verge of bankruptcy. As the respondents knew, they also had engaged in unsafe speculation. The respondents were about to loan $2,500,000 of good securities. As collateral they were to receive others of problematical value. What they required seems but ordinary caution. Nor does it imply an association in the business.

The trustees are to be kept advised as to the conduct of the business and consulted as to important matters. They may inspect the firm books and are entitled to any information they think important. Finally they may veto any business they think highly speculative or injurious. Again we hold this but a proper precaution to safeguard the loan. The trustees may not initiate any transaction as a partner may do. They may not bind the firm by any action of their own. Under the circumstances the safety of the loan depended upon the business success of K.N. K. This success was likely to be compromised by the inclination of its members to engage in speculation. No longer, if the respondents were to be protected, should it be allowed. The trustees, therefore, might prohibit it, and that their prohibition might be effective, information was to be furnished them. Not dissimilar agreements have been held proper to guard the interests of the lender.

As further security each member of K.N.K. is to assign to the trustees their interest in the firm. No loan by the firm to any member is permitted and the amount each may draw is fixed. No other distribution of profits is to be made. So that realized profits may be calculated the existing capital is stated to be $700,000, and profits are to be realized as promptly as good business practice will permit. In case the trustees think this is not done, the question is left to them and to Mr. Hall, and if they differ then to an arbitrator. There is no obligation that the firm shall continue the business. It may dissolve at any time. Again we conclude there is nothing here not properly adapted to secure the interest of the respondents as lenders. If their compensation is dependent on a percentage of the profits still provision must be made to define what these profits shall be.

Finally we have the "option." It permits the respondents or any of them or their assignees or nominees to enter the firm at a later date if they desire to do so by buying 50 per cent or less of the interests therein of all or any of the members at a stated price. Or a corporation may, if the respondents and the members agree, be formed in place of the firm. Meanwhile, apparently with the design of protecting the firm business against improper or ill-judged action which might render the option valueless, each member of the firm is to place his resignation in the hands of Mr. Hall. If at any time he and the trustees agree that such resignation should be accepted, that member shall then retire, receiving the value of his interest calculated as of the date of such retirement.

This last provision is somewhat unusual, yet it is not enough in itself to show that on June 4, 1921, a present partnership was created nor taking these various papers as a whole do we reach such a result. It is quite true that even if one or two or three like provisions contained in such a contract do not require this conclusion, yet it is also true that when taken together a point may come where stipulations immaterial separately cover so wide a field that we should hold a partnership exists. As in other branches of the law a question of degree is often the determining factor. Here that point has not been reached.

Some discussion questions:

1. The passive voice, this opinion is written in. Like it, do you?
2. What did the Peyton group do to get themselves intertwined with the business of K.N.K.? Why did they do that?
3. Where did the court draw the line between debtors looking out for themselves and partners in a business venture?

A number of factors are taken into account when deciding whether a partnership has been formed.[1] The most important (as determined both by RUPA and by courts) are:

[1] Rubbing off on me, the passive voice is.

- Sharing of profits (this creates a rebuttable presumption that there is a partnership under RUPA)
- Sharing of risk
- Pooling investment
- Sharing management rights

Other things – such as joint ownership of property and/or sharing of gross returns – are relevant but do not by themselves establish a partnership. As to "joint ownership of property", imagine a brother and sister who own an office building together. He's a doctor and a she's a lawyer, and they both operate separate practices. They pay the mortgage together, but are they partners? Hell no! They're each doing their own thing, and each succeeds or fails on their own, not as part of a partnership. As to "sharing of gross returns", imagine a band that plays at a venue and as part of their contract they get a cut of the ticket sales for their show. Are they in a partnership with the venue? Hell no! The band is playing a gig and getting a percentage of the gross returns as part of their compensation – simply getting a cut of the gate does not create a partnership. A partnership has to be more, and some version of "share and share alike" has to be present for a business arrangement to be a partnership.

Partnership Characteristics

Taxes

PARTNERSHIPS ARE PASS-THROUGH ENTITIES for the purpose of taxation. This means that partnerships do not pay taxes on the income they collect; instead, the partners pay taxes on the income they receive from the partnership.[1]

[1] Note that in some states partnerships may elect to be taxed as entity; this is often done to lower the individual tax burden of the partners.

The default rule for corporations, by contrast, is entity-level taxation: corporations pay corporate income taxes on the income they receive, and then shareholders pay capital gains taxes on any distributions they receive from the corporation. (Closely-held corporations with few shareholders can choose pass-through taxation if they are eligible; these small corporations are called "S-Corporations" for tax purposes.) Corporations can lower the amount they are taxed by offsetting their income with deductible expenditures, but for businesses that don't have major expenditures, it often makes more sense to set up as a partnership (or a pass-through LLC[2]) and let the investors should the tax burden. For this reason, investment funds and professional service firms often choose to organize as partnerships.

[2] To be discussed in Chapter 12.

Liability

JOINT AND SEVERAL LIABILITY is the rule for general partnerships, making every partner individually liable for the debts and obligations of the partnership. In practical terms, this means that if the partnership lacks the assets to fully satisfy its obligations to a third party, each and every partner is on the hook for the remaining balance owed. (As between the partners, however, each partner is only liable for their share of the liability and can go after the other partners for contribution if they pay more than their share.) Note that the partnership is first in line to handle debts and obligations, so if a partnership owes you money, you can't go knocking on the door of a partner demanding cash unless the partnership assets are exhausted. Still, the threat of potentially unlimited liability for partners makes a general partnership quite unappealing as a organizational form, and led to the development of a different type of general partnership: the limited liability partnership (LLP), which is discussed later in this chapter.

Profits, Losses, and Partnership Interest

PROFITS ARE SPLIT ON A EQUAL BASIS (and losses are allocated according to however profits are split) under the default rule for general partnerships. This holds true regardless of how much capital a partner contributes to the partnership relative to the other partners. In fact, while partners are credited with capital contributions when assessing their financial share of the partnership,[1] any money given to the partnership is partnership property and does not affect the sharing of profits and losses.

[1] For example, if the partnership is dissolved and any remaining assets are divvied up among the former partners

Because most investors would choose a different allocation method than equally splitting the money like cash on a mattress after a bank heist,[2] the law allows for the sharing of profits and losses to be determined by provisions in the partnership agreement.[3] Also determined by the partnership agreement is the timing of distributions from the partnership to the partners (this is sometimes called a "partnership draw"). Absent any provision in the partnership agreement, distributions will be made according to a majority vote of the partners.

[2] Meinhard and Salmon were pretty cool about going halfsies, though. That is, until they weren't.

[3] Reason #54,902 to have a partnership agreement.

Partners have an interest in the partnership, but do not own the partnership or the property of the partnership. This interest gives them management rights in the partnership and economic rights to distributions made by the partnership. Only the economic rights are freely transferable (they are called the "transferable interest")[4], and they entitle the transferee to receive distributions from the partnership that would have otherwise gone to the transferor. The management rights are not transferable, because doing so would essentially make the transferee a partner in the partnership and under the default rules one cannot become a partner in a partnership without the unanimous consent of the partners or joining via a provision in the partnership agreement.

[4] So they could, for example, be transferred to a creditor if a partner goes bankrupt (if this is permitted under the partnership agreement).

Dissociation and Dissolution

IF A PARTNERSHIP DECIDES TO CALL IT QUITS that is called "dissolution". The partnership has to wind up its businesses, pay its creditors, cash out its partners, and then terminate. This can happen voluntarily through a vote of the partners, or it can happen because an event triggers the dissolution.

IF A PARTNER WITHDRAWS FROM A PARTNERSHIP that is called a "dissociation".[1] In ye olden times (or in states that still use the original UPA), if a partner withdrew that was GAME OVER, MAN for the partnership and the whole-assed partnership had to dissolve. Can you imagine if a musical group had to dissolve and reform every time they changed members? We'd be on the sixth Metallica, the third Destiny's Child, and the 155th Guns 'N Roses.

[1] Not to be confused with dissociation.

Under the more modern RUPA, by contrast, if a partner withdraws according to the terms of the partnership agreement or is expelled according to the terms of the partnership agreement, the dissociation of the partner does not dissolve the partnership and the partnership is allowed to continue doing it's thang.[2] However, if a partner dissociates by voluntarily withdrawing from a partnership that has no withdrawal provision in the partnership agreement, that *will* dissolve the partnership.[3]

[2] This is why partnership agreements have buyout and continuation provisions.

[3] Reason #54,903 to have a partnership agreement.

There are other ways to dissociate from a partnership, including:

- The partner's expulsion by the unanimous vote of the other partners.[4]
- The partner's expulsion by judicial determination.[5]
- The partner's becoming a debtor in bankruptcy or assigning their transferable interest to creditors.
- The partner's death, the appointment of a guardian or general conservator for the partner, or a judicial determination that the partner has otherwise become incapable of performing the partner's duties under the partnership agreement.
- In the case of a partner that is a trust or an estate, the distribution of the trust or estate's entire transferable interest in the partnership.

[4] Under specific circumstances, like it would be unlawful to continue with the partner or the partner has transferred their interest.

[5] Because the partner engaged in wrongful conduct that adversely and materially affected the partnership business, or the partner willfully or persistently committed a material breach of the partnership agreement, or the partner engaged in conduct relating to the partnership business which makes it not reasonably practicable to carry on the business.

In any event, a partner always has the right to dissociate from the partnership, even though doing so may breach the partnership agreement. If a dissociation breaches the partnership agreement, it is called a "wrongful dissociation" and the partner leaving the partnership may owe damages for their breach.

Duties

PARTNERS OWE FIDUCIARY DUTIES to the partnership. Specifically, they owe:

- THE DUTY OF LOYALTY: You've seen this before, in *Meinhard v. Salmon* and also in the context of agency law (and we aren't done with it, either, not by a long shot). The duty of loyalty includes, but is not limited to, (1) the duty to account to the partnership and hold in trust any partnership property, (2) to refrain from dealing with the partnership on behalf of an adverse party, and (3) to refrain from competing with the partnership in the conduct of partnership business.[1] Violations of the duty of loyalty can be cured by disclosing all the material facts and having the partnership authorize or ratify the transaction.

[1] KRS §362.1-404(2).

- THE DUTY OF CARE: Kinda sorta similar to an agent's duty of performance. In Kentucky, the duty of care includes, but is not limited to, acting with the care that a reasonable person in a like position would exercise under similar circumstances and in a manner that the partner believes to be in the best interests of the partnership.[2]

[2] KRS §362.1-404(3).

Partners are also obligated to keep and maintain information about the partnership, and present that to a partner of the partnership upon demand.

The next case is very long and quite detailed (even in its abridged version), but it is particularly useful for two reasons. First, the court identifies the boundaries of the duty of loyalty that partners owe to the partnership, and works to distinguish self-interested conduct that is not necessarily in the partnership's interest but is still permissible, on the one hand, and self-interested conduct that actively harms the partnership and is not permissible, on the other.[3] Second, the case involves a situation that many lawyers find themselves in: being stuck in a law firm with a bunch of worthless bums and deciding to get the hell out.

[3] This need to sort out which particular actions constituted violations of the duty of loyalty is one of the reasons why the opinion is so fact-intensive.

Meehan v. Shaughnessy, 404 Mass. 419 (1989)

Hennessey, C.J.[4]

[4] Holy shit, these are some Boston-ass names.

The plaintiffs, James F. Meehan (Meehan) and Leo V. Boyle (Boyle), were partners of the law firm, Parker, Coulter, Daley & White (Parker Coulter). After Meehan and Boyle terminated their relationship with Parker Coulter to start their own firm, they commenced this action both to recover amounts they claim the defendants, their former partners, owed them under the partnership agreement, and to obtain a declaration as to amounts they owed the defendants for work done at Parker Coulter on cases they removed to their new firm. The defendants (hereinafter collectively Parker Coulter) counterclaimed that Meehan and Boyle violated their fiduciary duties, breached the partnership agreement, and tortiously interfered with their advantageous business and contractual relationships. As grounds for these claims, Parker Coulter asserted that Meehan and Boyle engaged in improper conduct in withdrawing cases and clients from the firm, and in inducing employees to join the new firm of Meehan, Boyle & Cohen, P.C. (MBC). Parker Coulter also filed a third-party action with similar claims against MBC and against Cynthia J. Cohen (Cohen), a former junior partner, and Steven H. Schafer (Schafer), a former associate, who, among others, left the firm to join MBC.

After a jury-waived trial, a Superior Court judge rejected all of Parker Coulter's claims for relief, and found that Meehan and Boyle were entitled to recover amounts owed to them under the partnership agreement. The judge also found, based on the partnership agreement and a quantum meruit theory, that Parker Coulter was entitled to recover from Meehan and Boyle for time billed and expenses incurred on the cases Meehan and Boyle removed to their own firm.

Although we are in agreement with most of the judge's reasoning and conclusions which he reached after lengthy and painstaking proceedings, we nevertheless reverse the judgment entered below and remand for further findings and a hearing, consistent in all respects with this opinion. This result follows from our conclusion, infra, that the judge erred in deciding that Meehan and Boyle acted properly in acquiring consent to remove cases to MBC.

We summarize the facts as found by the judge. Aside from certain conclusions which the judge reached, and which we address in more detail below, the parties agree that these findings were warranted by the evidence. Parker, Coulter, Daley & White is a large partnership which specializes in litigation on behalf of both defendants and plaintiffs. Meehan joined the firm in 1959, and became a partner in 1963; his practice focuses primarily on complex tort litigation, such as product liability and aviation defense work. Boyle joined Parker Coulter in 1971, and became a partner in 1980; he has concentrated on plaintiffs' work. Both have developed outstanding reputations as trial lawyers in the Commonwealth. Meehan and Boyle each were active in the management of Parker Coulter. They each served, for example, on the partnership's executive committee and, as members of this committee, were responsible for considering and making policy recommendations to the general partnership. Boyle was also in charge of the "plaintiffs department" within the firm, which managed approximately 350 cases. At the time of their leaving, Meehan's interest in the partnership was 6% and Boyle's interest was 4.8%.

Meehan and Boyle had become dissatisfied at Parker Coulter. On June 27, 1984, after unsuccessfully opposing the adoption of a firm-wide pension plan, the two first discussed the possibility of leaving Parker

Coulter. Another partner met with them to discuss leaving but told them their proposed firm would not be suitable for his type of practice. On July 1, Meehan and Boyle decided to leave Parker Coulter and form their own partnership.

Having decided to establish a new firm, Meehan and Boyle then focused on whom they would invite to join them. The two spoke with Cohen, a junior partner and the de facto head of Parker Coulter's appellate department, about joining the new firm as a partner. They arranged to meet with her on July 5, and told her to keep their conversations confidential. The day before the July 5 meeting, Boyle prepared two lists of what he considered to be his cases. The lists contained approximately eighty to 100 cases, and for each case indicated the status, fee arrangement, estimated settlement value, and potential fee to MBC. Boyle gave these lists to Cohen for her to examine in preparation for the July 5 meeting.

At the July 5 meeting, Meehan and Boyle outlined to Cohen their plans for the new firm, including their intent to offer positions to Schafer, Peter Black (Black), and Warren Fitzgerald (Fitzgerald), who were associates at Parker Coulter. Boyle stated that he hoped the clients he had been representing would go with him to the new firm; Meehan said he would take the aviation work he had at Parker Coulter with him. Both stated that they felt others at Parker Coulter were getting paid as much as or more than they were, but were not working as hard.[1] Cohen decided to consider the offer from Meehan and Boyle, and agreed to keep the plans confidential until formal notice of the separation was given to the partnership. Although the partnership agreement required a notice period of three months, the three decided to give only thirty days' notice. They chose to give shorter notice to avoid what they believed would be an uncomfortable situation at the firm, and possible retaliatory measures by the partnership. Meehan and Boyle had agreed that they would leave Parker Coulter on December 31, 1984, the end of Parker Coulter's fiscal year.

[1] My rough estimate is that in the average law firm about 20% of the lawyers do all of the work, and the rest are freeloading chumps. My goal in life was to become one of those freeloading chumps, but I left practice to become a different kind of freeloading chump (grad student).

During the first week of August, Cohen accepted the offer to join the new firm as a partner. Her primary reason for leaving Parker Coulter to join MBC was that she enjoyed working with Meehan and Boyle.

In July, 1984, Boyle offered a position at MBC to Schafer, who worked closely with Boyle in the plaintiffs department. Boyle told Schafer to organize his cases, and "to keep an eye towards cases to be resolved in 1985 and to handle these cases for resolution in 1985 rather than 1984."[2] He also told Schafer to make a list of cases he could take with him to MBC, and to keep all their conversations confidential.

[2] Pictured: the clients who could have used that money in 1984.

Late in the summer of 1984, Meehan asked Black and Fitzgerald to become associates at MBC. Fitzgerald had worked with Meehan in the past on general defense work, and Black worked with Meehan, particularly in the aviation area. Meehan was instrumental in attracting Black, who had previously been employed by U.S. Aviation Underwriters (USAU), to Parker Coulter. Although Black had already considered leaving Parker Coulter, he was concerned about whether USAU would follow him to a small firm like MBC, and wanted to discuss his leaving Parker Coulter with the vice president of USAU. In October, 1984, Black and Meehan met with the USAU vice president in New York. They later received assurances from him that he would be interested in sending USAU business to the proposed new firm. Black then accepted the offer to join MBC. Fitzgerald also accepted. Schafer, Black, and Fitzgerald were the only associates Meehan, Boyle, and Cohen approached concerning the new firm.

During July and the following months, Meehan, Boyle, and Cohen made arrangements for their new practice apart from seeking associates. They began to look for office space and retained an architect. In early fall, a lease was executed on behalf of MBC in the name of MBC Realty Trust. They also retained an attorney to advise them on the formation of the new firm.[1]

[1] Bang up job by this dude.

While they were planning their departure, from July to approximately December, Meehan, Boyle, Cohen, Schafer, Black, and Fitzgerald all continued to work full schedules. They settled cases appropriately, made reasonable efforts to avoid continuances, tried cases, and worked on discovery. Each generally maintained his or her usual standard of performance.

"This very night, before the rooster crows, you will disown the law firm three times."

Meehan and Boyle had originally intended to give notice to Parker Coulter on December 1, 1984. Rumors of their leaving, however, began to circulate before then. During the period from July to early fall, different Parker Coulter partners approached Meehan individually on three separate occasions and asked him if the rumors about his leaving were true. On each occasion, Meehan denied that he was leaving. On November 30, 1984, a partner, Maurice F. Shaughnessy (Shaughnessy), approached Boyle and asked him whether Meehan and Boyle intended to leave the firm. Shaughnessy interpreted Boyle's evasive response as an affirmation of the rumors. Meehan and Boyle then decided to distribute their notice that afternoon, which stated, as their proposed date for leaving, December 31, 1984. A notice was left on the desk of each partner. When Meehan, Boyle, and Cohen gave their notice, the atmosphere at Parker Coulter became "tense, emotional and unpleasant, if not adversarial."

On December 3, the Parker Coulter partners appointed a separation committee and decided to communicate with "important sources of business" to tell them of the separation and of Parker Coulter's desire to continue representing them. Meehan and Boyle asked their partners for financial information about the firm, discussed cases and clients with them, and stated that they intended to communicate with clients and referring attorneys on the cases in which they were involved. Sometime during the week of December 3, the partners sent Boyle a list of cases and requested that he identify the cases he intended to take with him.

Boyle had begun to make telephone calls to referring attorneys on Saturday morning, December 1. He had spoken with three referring attorneys by that date and told them of his departure from Parker Coulter and his wish to continue handling their cases. On December 3, he mailed his previously typed letters and authorization forms, and by the end of the first two weeks of December he had spoken with a majority of referring attorneys, and had obtained authorizations from a majority of clients whose cases he planned to remove to MBC.

Although the partners previously were aware of Boyle's intention to communicate with clients, they did not become aware of the extent of his communications until December 12 or 13. Boyle did not provide his partners with the list they requested of cases he intended to remove until December 17. Throughout December, Meehan, Boyle, and Schafer continued to communicate with referring attorneys on cases they were currently handling to discuss authorizing their transfer to MBC. On December 19, 1984, one of the partners accepted on behalf of Parker Coulter the December 31 departure date and waived the three-month notice period provided for by the partnership agreement. Meehan, Boyle, and Cohen formalized their arrangement as a professional corporation on January 1, 1985.

MBC removed a number of cases from Parker Coulter. Of the roughly 350 contingent fee cases pending at Parker Coulter in 1984, Boyle, Schafer, and Meehan removed approximately 142 to MBC. Meehan advised Parker Coulter that the 4,000 asbestos cases he had attracted to the firm would remain, and he did not seek to take certain other major clients. Black removed thirty-five cases; Fitzgerald removed ten; and Cohen removed three. A provision in the partnership agreement in effect at the separation provided that a voluntarily retiring partner, upon the payment of a "fair charge," could remove "any matter in which the partnership had been representing a client who came to the firm through the personal effort or connection of the retiring partner," subject to the right of the client to stay with the firm. Approximately thirty-nine of the 142 contingent fee cases removed to MBC came to Parker Coulter at least in part through the personal efforts or connections of Parker Coulter attorneys other than Meehan, Boyle, Cohen, Schafer, Black, or Fitzgerald. In all the cases removed to MBC, however, MBC attorneys had direct, existing relationships with the clients. In all the removed cases, MBC attorneys communicated with the referring attorney or with the client directly by telephone or letter. In each case, the client signed an authorization.

Schafer subsequently separated his practice from MBC's. He took with him a number of the cases which had been removed from Parker Coulter to MBC.

Based on these findings, the judge determined that the MBC attorneys did not manipulate cases, or handle them differently as a result of their decision to leave Parker Coulter. He also determined that Parker Coulter failed to prove that the clients whose cases were removed did not freely choose to have MBC represent them. Consequently, he concluded that Meehan and Boyle neither violated the partnership agreement nor breached the fiduciary duty they owed to their partners. In addition, the judge also found that Meehan and Boyle did not tortiously interfere with Parker Coulter's relations with clients or employees. He similarly rejected Parker Coulter's claims against Cohen and Schafer.

Parker Coulter argues that these attorneys breached their duties (1) by improperly handling cases for their own, and not the partnership's benefit, (2) by secretly competing with the partnership, and (3) by unfairly acquiring from clients and referring attorneys consent to withdraw cases to MBC. We do not agree with Parker Coulter's first two arguments but agree with the third. We first address the claims against Meehan and Boyle, and then turn to those against Cohen and Schafer.

It is well settled that partners owe each other a fiduciary duty of "the utmost good faith and loyalty." As a fiduciary, a partner must consider his or her partners' welfare, and refrain from acting for purely private gain. Partners thus "may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty."[1] Meehan and Boyle owed their copartners at Parker Coulter a duty of the utmost good faith and loyalty, and were obliged to consider their copartners' welfare, and not merely their own.

[1] Practice tip: if the court starts off its opinion with some highfalutin' language about duties and good faith, you know the backstabbers are gonna lose. If they start the opinion talking about the harsh realities of the business world, however, you know the backstabbers are gonna win.

Parker Coulter first argues that Meehan and Boyle violated their fiduciary duty by handling cases for their own benefit, and challenges the judge's finding that no manipulation occurred. Parker Coulter [] claims that we should disregard the judge's finding of no manipulation because the finding is clearly contradicted by other subsidiary findings, namely that Boyle planned to, and told Schafer to, handle cases for resolution at MBC rather than at Parker Coulter; that Boyle reassigned a number of a departing attorney's cases to himself and Schafer; and that a number of cases which were ready to resolve at Parker Coulter were, in fact, not resolved there. We do not agree that there is a conflict. The judge's finding that Boyle spoke of engaging in improper conduct does not require the conclusion that this conduct actually took place. Similarly, his finding that the reassignment of cases did not establish manipulation is consistent with a determination that the reassignment was based on merit and workload. Furthermore, the judge's finding that the MBC attorneys worked full schedules provides a reason for the delayed resolution of certain cases other than the improper motivation which Parker Coulter urges. Finally, Parker Coulter points to no specific case which the MBC attorneys manipulated for their own benefit. We have reviewed the record, and conclude that the judge was warranted in determining that Meehan and Boyle handled cases no differently as a result of their decision to leave Parker Coulter, and that they thus fulfilled their fiduciary duty in this respect.

Parker Coulter next argues that the judge's findings compel the conclusion that Meehan and Boyle breached their fiduciary duty not to compete with their partners by secretly setting up a new firm during their tenure at Parker Coulter. We disagree. We have stated that fiduciaries may plan to compete with the entity to which they owe allegiance, "provided that in the course of such arrangements they [do] not otherwise act in violation of their fiduciary duties." Here, the judge found that Meehan and Boyle made certain logistical arrangements for the establishment of MBC. These arrangements included executing a lease for MBC's office, preparing lists of clients expected to leave Parker Coulter for MBC, and obtaining financing on the basis of these lists. We believe these logistical arrangements to establish a physical plant for the new firm were permissible, especially in light of the attorneys' obligation to represent adequately any clients who might continue to retain them on their departure from Parker Coulter. There was no error in the judge's determination that this conduct did not violate the partners' fiduciary duty.

Lastly, Parker Coulter argues that the judge's findings compel the conclusion that Meehan and Boyle breached their fiduciary duties by unfairly acquiring consent from clients to remove cases from Parker Coulter. We agree that Meehan and Boyle, through their preparation for obtaining clients' consent, their secrecy concerning which clients they intended to take, and the substance and method of their communications with clients, obtained an unfair advantage over their former partners in breach of their fiduciary duties.

A partner has an obligation to "render on demand true and full information of all things affecting the partnership to any partner." On three separate occasions Meehan affirmatively denied to his partners, on their demand, that he had any plans for leaving the partnership. During this period of secrecy, Meehan and Boyle made preparations for obtaining removal authorizations from clients. Meehan traveled to New York to meet with a representative of USAU and interest him in the new firm. Boyle prepared form letters on Parker Coulter's letterhead for authorizations from prospective MBC clients. Thus, they were "ready to move" the instant they gave notice to their partners.

On giving their notice, Meehan and Boyle continued to use their position of trust and confidence to the disadvantage of Parker Coulter. The two immediately began communicating with clients and referring attorneys. Boyle delayed providing his partners with a list of clients he intended to solicit until mid-December, by which time he had obtained authorization from a majority of the clients.

Finally, the content of the letter sent to the clients was unfairly prejudicial to Parker Coulter. Here, the judge found that the notice did not "clearly present to the clients the choice they had between remaining at Parker Coulter or moving to the new firm." By sending a one-side announcement, on Parker Coulter letterhead, so soon after notice of their departure, Meehan and Boyle excluded their partners from effectively presenting their services as an alternative to those of Meehan and Boyle.

Meehan and Boyle could have foreseen that the news of their departure would cause a certain amount of confusion and disruption among their partners. The speed and preemptive character of their campaign to acquire clients' consent took advantage of their partners' confusion. By engaging in these preemptive tactics, Meehan and Boyle violated the duty of utmost good faith and loyalty which they owed their partners. Therefore, we conclude that the judge erred in deciding that Meehan and Boyle acted properly in acquiring consent to remove cases to MBC.

We conclude, therefore, that Meehan and Boyle hold in a constructive trust for the benefit of the former partnership the profits they have derived or may derive from any cases which they unfairly removed.

We now address the consequences to Cohen and Schafer of their breach of fiduciary duty. The judge found that Cohen participated in the removal of some insurance defense cases, and that Schafer participated in the removal of a number of contingent fee cases. Therefore, we conclude that Schafer must hold in a constructive trust for the benefit of the former partnership any profits, as we have defined this term, which he has received or may receive in his separate practice from cases which the judge determines were unfairly removed. Cohen also must hold any profits she has received or may receive from unfairly removed cases in a similar constructive trust. Although Cohen and Schafer were not parties to the partnership agreement, and thus were not contractually bound to remove cases fairly, we believe their fiduciary duties require this result.

SOME DISCUSSION QUESTIONS:

1. Partners DO have to consider the interests of the partnership they are in, but DO NOT have to be completely altruistic and give up

their own interests in favor of the collective (this is why it is called a "partnership" and not a "martyrdom"). What crossed the line between reasonable and allowable behavior and a breach of fiduciary duty?

2. What do you think the future attorneys at MBC could have done to keep this all nice and legal?

3. The court has a heat check moment and rules that Cohen[1] and Schafer[2] also breached fiduciary duties to Parker Coulter. Why do you think the court ruled against these two as well as against Meehan and Boyle?

4. Follow up question: does a partner have to sign the partnership agreement to be bound by the duty of loyalty?

5. Could Parker Coulter have put something in the partnership agreement to address this situation? If so, what?

[1] A partner in the partnership, but who unlike Meehan and Boyle had not signed the partnership agreement.

[2] An associate at Parker Coulter, who wasn't a partner in any sense of the word.

Control

The Three Muskateers Problem

"All for one, and one for all" is the motto of the Three Muskateers. It's a nice little quip – everyone loves a good syllogism,[3] teamwork makes the dream work, and it's short and memorable – but there's a problem with it as the slogan of the Three Muskateers.[4] Namely: **which one is it?** Is it all for one *or* one for all? "All for one" suggests that any action by the group is unanimous, but "one for all" suggests that every individual Muskateer represents the group. Partnership law, believe it or not, has the exact same problem.

[3] See, e.g., basically every JFK speech.

[4] There's a bigger problem with the Three Muskateers, and it's that there were fucking four of them. Athos, Porthos, Aramis, and oh look who's here: d'Artagnan. Un, deux, trois, quatre. FOUR. Get your shit together, Alexandre Dumas.

Under RUPA (and UPA), the default rule is that every partner has equal rights in the management of the partnership, and disagreements about the ordinary course of business are resolved by majority vote[5] ("all for one").

Also under RUPA (and UPA), the default rule is that every partner is by themselves an agent of the partnership, capable of binding the partnership in the ordinary course of business[6] ("one for all").

Thus, management decisions in a partnership must be made by majority vote, but also every partner is an agent of the partnership and can bind the partnership on their own (unless that power is removed by majority vote). How a court interprets the powers of partners in

[5] Each partner has equal rights in the management and conduct of the partnership business. KRS §362.1-401(6). A difference arising as to a matter in the ordinary course of business ... may be decided by a majority of the partners. KRS §362.1-401(10).

[6] Each partner is an agent of the partnership for the purpose of its business. An act of a partner ... binds the partnership, unless the partner had no authority to act for the partnership in the particular matter and the person with whom the partner was dealing had notice that the partner lacked authority. KRS §362.1-301(1).

large part depends on which rule the court considers more important: the majority-rule provision or the partner-agent provision. If the former, the court can read the rules to to *constrain* each individual partner in absence of a majority vote; if the latter, the court can read the rules to *empower* each individual partner in absence of a majority vote.[1] Both are contemplated, both are reasonable. Which is it?

[1] Which raises the age-old question: is it better to ask permission or beg forgiveness?

As confusing as the Three Muskateers Problem can be under ordinary circumstances, it becomes even more so when courts have to confront another question: in a partnership with an even number of partners, what constitutes majority approval? The following two cases take two different approaches.

Summers v. Dooley, 481 P.2d 318 (Idaho 1971)

Donaldson, J.

The pertinent facts leading to this lawsuit are as follows. Summers entered a partnership agreement with Dooley (defendant-respondent) in 1958 for the purpose of operating a trash collection business. The business was operated by the two men and when either was unable to work, the non-working partner provided a replacement at his own expense. In 1962, Dooley became unable to work and, at his own expense, hired an employee to take his place. In July, 1966, Summers approached his partner Dooley regarding the hiring of an additional employee but Dooley refused. Nevertheless, on his own initiative, Summers hired the man and paid him out of his own pocket. Dooley, upon discovering that Summers had hired an additional man, objected, stating that he did not feel additional labor was necessary and refused to pay for the new employee out of the partnership funds. Summers continued to operate the business using the third man and in October of 1967 instituted suit in the district court for $6,000 against his partner, the gravamen of the complaint being that Summers has been required to pay out more than $11,000 in expenses, incurred in the hiring of the additional man, without any reimbursement from either the partnership funds or his partner. After trial before the court, sitting without a jury, Summers was granted only partial relief and he has appealed. He urges in essence that the trial court erred by failing to conclude that he should be reimbursed for expenses and costs connected in the employment of extra help in the partnership business.

The principal thrust of appellant's contention is that in spite of the fact that one of the two partners refused to consent to the hiring of additional help, nonetheless, the non-consenting partner retained profits earned by the labors of the third man and therefore the non-consenting partner should be estopped from denying the need and value of the employee, and has by his behavior ratified the act of the other partner who hired the additional man.

The issue presented for decision by this appeal is whether an equal partner in a two man partnership has the authority to hire a new employee in disregard of the objection of the other partner and then attempt to charge the dissenting partner with the costs incurred as a result of his unilateral decision.

An application of the relevant statutory provisions and pertinent case law to the factual situation presented by the instant case indicates that the trial court was correct in its disposal of the issue since a majority of the partners did not consent to the hiring of the third man. I.C. §53-318(8) provides:

> "Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners"

The concept of equality between partners with respect to management of business affairs is a central theme and recurs throughout the [UPA], which has been enacted in this jurisdiction. Thus the only reasonable interpretation of I.C. §53-318(8) is that business differences must be decided by a majority of the partners provided no other agreement between the partners speaks to the issues.[1]

[1] The court cites an expert that agrees: "[I]f the partners are equally divided, those who forbid a change must have their way." Walter B. Lindley, A Treatise on the Law of Partnership, Ch. II, §III.

In the case at bar one of the partners continually voiced objection to the hiring of the third man. He did not sit idly by and acquiesce in the actions of his partner. Under these circumstances it is manifestly unjust to permit recovery of an expense which was incurred individually and not for the benefit of the partnership but rather for the benefit of one partner.

National Biscuit Co. v. Stroud, 106 S.E.2d 692 (N.C. 1959)

Parker, J.

In March 1953, C. N. Stroud and Earl Freeman entered into a general partnership to sell groceries under the name of Stroud's Food Center. Thereafter plaintiff [National Biscuit Co.] sold bread regularly to the partnership. Several months prior to February 1956 the defendant Stroud advised an agent of plaintiff that he personally would not be responsible for any additional bread sold by plaintiff to Stroud's Food Center. From 6 February 1956 to 25 February 1956 plaintiff through this same agent, at the request of the defendant Freeman, sold and delivered bread in the amount of $171.04 to Stroud's Food Center. Stroud and Freeman by agreement dissolved the partnership at the close of business on 25 February 1956.

Stroud has paid all of the partnership obligations amounting to $12,014.45, except the amount of $171.04 claimed by plaintiff.[2]

[2] The pettiness! I love it.

There is nothing in the agreed statement of facts to indicate or suggest that Freeman's power and authority as a general partner were in any way restricted or limited by the articles of partnership in respect to the ordinary and legitimate business of the partnership. Certainly, the purchase and sale of bread were ordinary and legitimate business of Stroud's Food Center during its continuance as a going concern.

G.S. 59-39 is entitled PARTNER AGENT OF PARTNERSHIP AS TO PARTNERSHIP BUSINESS, and subsection (1) reads: "Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority."

G.S. 59-45 provides that "all partners are jointly and severally liable for the acts and obligations of the partnership."

G.S. 59-48 is captioned RULES DETERMINING RIGHTS AND DUTIES OF PARTNERS. Subsection (e) thereof reads: "All partners have equal rights in the management and conduct of the partnership business." Subsection (h) thereof is as follows: "Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners; but no act in contravention of any agreement between the partners may be done rightfully without the consent of all the partners."

Freeman as a general partner with Stroud, with no restrictions on his authority to act within the scope of the partnership business so far as the agreed statement of facts shows, had under the Uniform Partnership Act "equal rights in the management and conduct of the partnership business." Under G.S. 59-48(h) Stroud, his co-partner, could not restrict the power and authority of Freeman to buy bread for the partnership as a going concern, for such a purchase was an "ordinary matter connected with the partnership business," for the purpose of its business and within its scope, because in the very nature of things Stroud was not, and could not be, a majority of the partners.[1] Therefore, Freeman's purchases of bread from plaintiff for Stroud's Food Center as a going concern bound the partnership and his co-partner Stroud.

[1] The court cites an expert that agrees: "In cases of an even division of the partners as to whether or not an act within the scope of the business should be done, of which disagreement a third person has knowledge, it seems that logically no restriction can be placed upon the power to act. The partnership being a going concern, activities within the scope of the business should not be limited save by the expressed will of the majority deciding a disputed question; half of the members are not a majority." Crane on Partnership, 2nd Ed.

Some discussion questions:

1. In either case, was there a majority vote to strip the contracting partner (Summers or Freeman) of their authority to act on behalf of

the partnership? In either case, was there a majority vote to authorize the contracting partner to enter into the contract? What's the difference?

2. What facts distinguish the cases?

3. What could the partners have done to avoid this outcome? (Note: this is the solution to the Three Muskateers Problem in general.)

THE DEFAULT RULES REGARDING MANAGEMENT RIGHTS give equal voting power to every partner in a partnership – regardless of capital invested, labor contributed, or job title. As the previous cases show, this arrangement can get pretty silly, and as such voting rights and voting power are another one of the partnership features that can be modified in the partnership agreement.

The Partnership Agreement

PARTNERSHIP AGREEMENTS ARE A GOOD IDEA.[1] While you do not technically need one to form a general partnership, as you can see from that whole **waves hand around in the direction of the cases we've just read** thing, a partnership agreement is extremely useful in avoiding, negotiating, and resolving potential conflicts that arise in the course of a general partnership.

According to RUPA, the partnership agreement governs the entirety of the relationships between the partners and the partnership,[2] with two major exceptions. First, where the partnership agreement is silent, the default rules under RUPA apply to the partnership. Second, some rules are simply not waivable or modifiable under the partnership agreement. Quoting directly from the statute here:

> The partnership agreement shall not:
>
> (a) Vary the rights and duties except to eliminate the duty to provide copies of statements to all of the partners;
>
> (b) Unreasonably restrict the right of access to books and records or unreasonably restrict the right to information;
>
> (c) Eliminate the duty of loyalty, but:
>
> 1. The partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; or
> 2. All of the partners or a number or percentage specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;

[1] A partnership agreement is also a legal necessity for limited partnerships (both LPs and LLLPs), and in some jurisdictions they are necessary to form a limited liability partnership.

[2] Except as otherwise provided in subsection (2), relations among the partners and between the partners and the partnership are governed by the partnership agreement. KRS §362.1-103(1).

(d) Unreasonably reduce the duty of care;

(e) Eliminate the obligation of good faith and fair dealing, but the partnership agreement may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable;

(f) Vary the power to dissociate as a partner, except to require the notice to be in writing;

(g) Vary the right of a partner or the partnership to seek a partner's expulsion by judicial determination or vary the right of a court to expel a partner;

(h) Vary the requirement to wind up the partnership business;

(i) Vary the law applicable to a limited liability partnership; or

(j) Vary the liabilities and remedies to a greater extent than variations are in fact made under this section in the substantive rights in the partnership agreement giving rise to the partner claims at issue.[1]

[1] KRS §362.1-103(2).

The big ones in there are: (1) no eliminating the fiduciary duty of loyalty (though partners can agree to specify activities that don't violate it); (2) no eliminating the fiduciary duty of care; and (3) no eliminating the obligation of good faith and fair dealing.[2] That third one refers to the contractual obligation to interpret the partnership agreement in good faith (which we will see tested in *Bohatch*, later on in this chapter).

[2] The partnership agreement also cannot be used to modify the liabilities of the partners in a general partnership, but that is because partnership agreements do not govern liability to third parties – only relations among partners and the partnership.

Limited Liability Partnerships (LLPs)

If a group of investors wanted the nice parts of a general partnership (strong fiduciary duties, equal rights in management, pass-through taxation) but didn't want the unlimited liability associated with a general partnership, what could they do? One solution is to have each partner in the general partnership be a corporation[3] run by an individual investor, so that the individual investor's personal assets aren't on the line. This is a particularly cumbersome and complicated structure, however, and it might not actually shield investors from particular kinds of claims (as we will see in *In re USACafes LP*, later on in this chapter).

[3] Or an LLC, or a trust, or something with limited liability for its investors.

An alternative arose in the 1990s: the Limited Liability Partnership (LLP). The LLP was first introduced in a handful of states as a means of shielding lawyers in law firms from unlimited liability for malpractice claims against other partners in their firms[4] and was quickly adopted throughout the country. LLPs are exactly the same as general partnerships, with the only difference being that none of the partners are personally liable for the debts and obligations of the

[4] Sometimes its good to be the ones writing the laws, you know?

partnership beyond whatever capital they have already contributed.[1] After the LLP form became available, professionals that had organized their firms as general partnerships – accountants, consultants, doctors, architects, and lawyers especially – immediately reorganized as limited liability partnerships, and there are very few general partnerships still in operation today.

[1] Worth noting: limited liability does not protect partners from liabilities that they personally create in their actions as a partner (e.g., a doctor committing malpractice or a lawyer embezzling client money).

In order to organize as a limited liability partnership, a partnership must (a) meet any eligibility requirements a state might impose,[2] (b) vote as a partnership to become an LLP,[3] and (c) file a certificate with the state establishing that the partnership is an LLP.[4] The LLP must have "L.L.P." in its name, in order to put third parties on notice that they are dealing with an entity that has full limited liability. And as I have said above – and I'm sorry to keep harping on this, but it's important – the LLP is a type of general partnership and is thus governed by all of the statutory rules and duties that general partnerships are subject to.

[2] For example, California only allows licensed professionals to form LLPs.

[3] The threshold for this vote is whatever the partnership agreement establishes as the threshold for voting to amend the partnership agreement.

[4] In Kentucky this is called a "Statement of Qualification". KRS §362.1-931.

In addition to the GP/LLP, however, there is another kind of partnership – one that creates a hard division between the parties that manage the entity and the parties that merely invest in the entity, and as such has a structure more like a traditional corporation while retaining the features of a partnership: the limited partnership (LP).

Limited Partnerships

A LIMITED PARTNERSHIP ("LP") is a kind of business entity that gives investors limited liability (like a corporation) while having strong fiduciary duties and the flexibility to set rules through a negotiated agreement (like a partnership). There are two important figures in a limited partnership: the general partner and the limited partner – and a limited partnership must have at least one of each.

The **general partner** has strong management rights and act as agents for the partnership, but is liable for the debts and obligations of the partnership and owes fiduciary duties to the partnership. Typically, they invest relatively little of their own money and are compensated for their role in running the partnership.

The **limited partner** does not have strong management rights and cannot act as agents for the partnership, but has limited liability (they can only lose the money they've invested in the partnership and no more) and owes no fiduciary duties to the partnership. A limited partner will not lose its limited liability protection merely by becoming an employee or independent contractor of the partnership, and a limited partner may also consult with and advise the general partner regarding the business of the partnership. However, if a limited partner takes a management role in the partnership, they can lose limited liability protections, and be liable to third parties for the debts and obligations of the partnership. Typically, the limited partners contribute most of the partnership capital and their role in management is highly circumscribed (in this way, they resemble shareholders in a corporation).

Characteristics of a Limited Partnership

As with a general partnership, a limited partnership is taxed as a pass-through entity, with income being taxed only upon being distributed to the partners.[1]

[1] This is one reason why limited partnerships are popular among investment funds, which pool together money from outside investors (the limited partners), invest in securities (typically), and then return profits from their investments to the limited partners at times designated in the partnership agreement. The investors pay taxes on the profits, not the fund.

Unlike a general partnership, the default rule is for profits and losses to be allocated based on the capital contributions of the limited partners (aka "pro rata") rather than split equally between the partners. As with a general partnership, the rules for allocation of profits and losses can be changed in the partnership agreement.

As with a general partnership, an entity with limited liability (a corporation or an LLC) can serve as general partner of a limited partnership. The practical effect of having a corporate entity as general partner is to cabin liability in the limited partnership. It also allows a single entity to effectively run multiple limited partnerships by creating and controlling a unique general partner for each of the LPs.

Unlike a general partnership, a limited partner does not have the unilateral right to dissociate from the partnership. Instead, the terms of the partnership agreement dictate a limited partner's power to withdraw.[2]

[2] A common feature of limited partnerships is a "lock-up" period, where a limited partner cannot withdraw their capital for a certain amount of time.

Unlike a general partnership, the withdrawal of a limited partner does not threaten the dissolution of the partnership. The withdrawal of a general partner, however, will dissolve the limited partnership unless the limited partners elect a new general partner to keep the LP going, in accordance with the partnership agreement.

Formation of a Limited Partnership

Limited partnerships must have a partnership agreement, and they must file a certificate with the state. The reason to have a partnership agreement is to be able to identify the general partners of the limited partnership, delineate their management powers, and distinguish them from the limited partners. The reason to file a certificate with the state is to put third parties on notice that this particular entity is a limited partnership and therefore the third parties cannot seek recovery from the limited partners. A limited partnership must have "L.P." in its name.

Limited Liability Limited Partnership

A limited liability limited partnership (LLLP) is a type of limited partnership. Specifically, it is a limited partnership where the general partner retains management rights and fiduciary duties to the partnership, but *also* gets limited liability protections. In an LLLP, the general partner gets the same limited liability as the limited partners, and therefore cannot lose more than their initial investment in the partnership.

Even though an LLLP is legally and functionally equivalent to an LP with a corporation or LLC serving as general partner, this form of business entity has not been universally adopted. This can be an issue for businesses that cross state lines (or anticipate crossing state lines).

- 33 states and territories allow for the formation of LLLPs.[1]
- Some states recognize LLLPs created in other states, but do not allow LLLPs to be formed in their states (most notably California).
- Some states do not recognize LLLPs at all (most notably New York), and will treat them as LPs, disregarding the limited liability protections for the general partner. This is, legally speaking, not great for an LLLP.

[1] Kentucky does!

I've said it before and I'll say it again: always check your state's rules.

Partnership Disputes

The next three cases have unusual, ridiculous, and/or shocking fact patterns – but they all address common disputes within partnerships. Namely, who can be held responsible for violating fiduciary duties to the partnership? When are the decisions made on behalf of the partnership governed by the partnership agreement and when do those decisions implicate fiduciary duties? And what constitutes permissible or impermissible grounds for the expulsion of a partner?

In re USACafes, L.P. Litigation, 600 A.2d 43 (Del. Ch. 1991)

Allen, Ch.

These consolidated actions arise out of the October 1989 purchase by Metsa Acquisition Corp. of substantially all of the assets of USACafes, L.P., a Delaware limited partnership (the "Partnership") at a cash price of $72.6 million or $10.25 per unit. Plaintiffs are holders of limited partnership units. They bring these cases as class actions on behalf of all limited partnership unitholders except defendants. The relief sought includes, inter alia, the imposition of constructive trusts on certain funds received by defendants in connection with the Metsa sale and an award of damages to the class resulting from the sale.

The Partnership was formed in the 1986 reorganization of the business of USACafes, Inc., a Nevada corporation. Also formed as part of that reorganization was USACafes General Partner, Inc. (the "General Partner"), a Delaware corporation that acts as the general partner of the Partnership. Both the Partnership and the General Partner are named as defendants in this action. A second category of defendants is composed of Sam and Charles Wyly,[1] brothers who together own all of the stock of the General Partner, sit on its board, and who also personally, directly or indirectly, own 47% of the limited partnership units of the Partnership.[2] Sam Wyly chairs the Board of the General Partner.

[1] Aptronyms!

[2] "So I'm getting screwed over by a pair of Wyly brothers ... no, you see, both of the brothers are ... yeah, I just heard myself saying it now, not sure what I was thinking ..."

The third category of defendants are four other individuals who sit on the board of directors of the General Partner.[3] All of these persons are alleged to have received substantial cash payments, loan forgiveness, or other substantial personal benefits in connection with the 1989 Metsa purchase. The last of the defendants is Metsa, the buyer of the Partnership's assets. Metsa is not alleged to be related in any way to the Wylys or any other defendant except as a buyer in the transaction under review.

[3] In other words, these individuals along with the Wyly brothers, control the corporation that serves as General Partner of the limited partnership.

The amended complaint arrays four theories of liability[4] against these defendants. The first and most central theory involves an alleged breach of the duty of loyalty. In essence, it claims that the sale of the Partnership's assets was at a low price, favorable to Metsa, because the directors of the General Partner all received substantial side payments that induced them to authorize the sale of the Partnership assets for less than the price that a fair process would have yielded. Specifically, it is alleged that, in connection with the sale, (1) the Wylys received from Metsa more than $11 million in payments (or promises to pay in the future) which were disguised as consideration for personal covenants not to compete; (2) the General Partner (which the Wylys wholly own) received a $1.5 million payment right in consideration of the release of a claim that plaintiffs assert was non-existent; (3) defendant Rogers, a director of the General Partner and President of the Partnership was forgiven the payment of a $956,169 loan from the Partnership and was given an employment agreement with the Partnership that contemplated a one million dollar cash payment in the event, then imminent, of a "change in control"; (4) defendant Tuley, also a director of the General Partner, was forgiven repayment of a $229,701 loan; and (5) the other directors were given employment

[4] We're only dealing with the first two claims – the breach of the duty of loyalty and care – though plaintiff did allege an interesting claims against Metsa for its participation in these shenanigans.

agreements providing for a $60,000 payment in the event of a change in control. In sum, it is alleged that between $15 and $17 million was or will be paid to the directors and officers of the General Partner by or with the approval of Metsa; those payments are alleged to constitute financial inducements to the directors of the General Partner to refrain from searching for a higher offer to the Partnerships. Plaintiffs add that, even assuming that Metsa was the buyer willing to pay the best price, some part at least of these "side payments" should have gone to the Partnership.

The second theory of liability reflected in the amended complaint asserts that the General Partner was (or the directors of the General Partner were) not sufficiently informed to make a valid business judgment on the sale. This theory focuses upon the absence of shopping of the Partnership's assets, or of any post-agreement market check procedure, and on the alleged weakness of the investment banker's opinion. Thus, this claim is that the defendants were uninformed when they authorized the sale to Metsa.

...

[T]the Wyly defendants and the other director defendants move under Rule 12(b)(6) to dismiss the breach of fiduciary duty claims in the amended complaint asserting that, while the General Partner admittedly did owe fiduciary duties to the limited partners, they as directors of the General Partner owe no such duties to those persons. The whole remedy of the limited partners for breach of the duties of loyalty and care, it is said, is against the General Partner only and not its directors.

...

I turn first to the director defendants' motion to dismiss for failure to state a claim with respect to the sale of the Partnership's assets. The gist of this motion is the assertion that the directors of the General Partner owed the limited partners no duty of loyalty or care. In their view their only duty of loyalty was to the General Partner itself and to its shareholders (i.e., the Wyly brothers). Thus, in alleging that the director defendants breached duties of loyalty and care running to them, the directors say the limited partners have asserted a legal nullity. In my opinion the assertion by the directors that the independent existence of the corporate General Partner is inconsistent with their owing fiduciary duties directly to limited partners is incorrect. Moreover, even were it correct, their position on this motion would have to be rejected in any event because the amended complaint expressly alleges that they personally participated in the alleged breach by the General Partner itself, which admittedly did owe loyalty to the limited partners.

The first basis of this holding is the more significant. While I find no corporation law precedents directly addressing the question whether directors of a corporate general partner owe fiduciary duties to the partnership and its limited partners, the answer to it seems to be clearly indicated by general principles and by analogy to trust law. I understand the principle of fiduciary duty, stated most generally, to be that one who controls property of another may not, without implied or express agreement, intentionally use that property in a way that benefits the holder of the control to the detriment of the property or its beneficial owner.

The theory underlying fiduciary duties is consistent with recognition that a director of a corporate general partner bears such a duty towards the limited partnership. That duty, of course, extends only to dealings with the partnership's property or affecting its business, but, so limited, its existence seems apparent in any number of circumstances.[1] Consider, for example, a classic self-dealing transaction: assume that a majority of the board of the corporate general partner formed a new entity and then caused the general partner to sell partnership assets to the new entity at an unfairly small price, injuring the partnership and its limited partners. Can it be imagined that such persons have not breached a duty to the partnership itself? And does it not make perfect sense to say that the gist of the offense is a breach of the equitable duty of loyalty that is placed upon a fiduciary?

[1] Two courts have, in fact, held a sole shareholder/director of a corporate general partner personally liable for breach of fiduciary duty to limited partners, although without much discussion of the issue here considered. See Tobias v. First City National Bank and Trust Co., 709 F.Supp. 1266, 1277-78 (S.D.N.Y. 1989); Remenchik v. Whittington, Tex.Ct.App., 757 S.W.2d 836 (1988); see also In re Integrated Resources, Inc., Case No. 90-B-10411 (CB) (Bankr.S.D.N.Y. Oct. 22, 1990) (controlling shareholder held liable).

While these authorities extend the fiduciary duty of the general partner to a controlling shareholder, they support as well, the recognition of such duty in directors of the General Partner who, more directly than a controlling shareholder, are in control of the partnership's property. It is not necessary here to attempt to delineate the full scope of that duty. It may well not be so broad as the duty of the director of a corporate trustee. But it surely entails the duty not to use control over the partnership's property to advantage the corporate director at the expense of the partnership.

SOME DISCUSSION QUESTIONS:

1. Ordinarily, the directors of a corporation like USACafes General Partner, Inc. are responsible only for that corporation. Why does the court extend the duty of loyalty to the partnership to those directors?

2. Did the limited partners know what they were getting into when they got into the partnership with USACafes General Partner, Inc.?

3. What is the basis for the breach of the duty of care claim? Why do the limited partners make that claim?

Day v. Sidley Austin, 394 F. Supp. 986 (D.D.C. 1975)

Parker, J.

This case involves a dispute between a former senior partner of Sidley Austin (S&A), a Chicago law firm, and some of his fellow partners. The controversy centers around the merger between that firm and another Chicago firm, Liebman, Williams, Bennett, Baird and Minow (Liebman firm), and the events subsequent to the merger which ultimately led to plaintiff's resignation. Plaintiff seeks damages claiming a substantial loss of income, damage to his professional reputation and personal embarrassment which resulted from his forced resignation.

On July 1, 1974, plaintiff J. Edward Day filed a complaint in the Superior Court for the District of Columbia against Sidley Austin itself, and 12 named partners (members of the firm's executive committee) alleging breach of fiduciary duty, breach of contract, fraud and misrepresentation, conspiracy, wrongful dissolution or ouster of co-partner and breach of partnership agreement.

The basic and material facts in this controversy may be briefly detailed.

Mr. Day was first associated with Sidley Austin in 1938. His legal career was interrupted by World War II service in the Navy and by his tenure with both the Illinois state government and as Postmaster General of the United States. Upon leaving the federal government, he was instrumental in establishing a Washington office for the firm in 1963. As a senior underwriting partner, he was entitled to a certain percentage of the firm's profits, and was also privileged to vote on certain matters which were specified in the partnership agreement. He was never a member of the executive committee, however, which managed the firm's day-to-day business. He remained an underwriting partner with Sidley Austin from 1963 until his resignation in December 1972.

At some time between February 1972 and July 12, 1972, S&A's executive committee explored the idea of a possible merger between that firm and the Liebman firm. S&A partners who were not on the executive committee were unaware of the proposal until it was revealed at a special meeting of its underwriting partners on July 17, 1972. At that meeting, each partner present, including plaintiff, voiced approval of the merger idea and favored pursuing further that possibility in such manner as the executive committee of S&A might think proper or advisable, with the understanding that any proposed agreement would first be submitted to all partners for their consideration before any binding commitments were made. The merger was further discussed at meetings of the underwriting partners held on September 6, September 22, September 26 and September 28. The plaintiff received timely notice of the meetings but did not attend.

The final Memorandum of Understanding dated September 29, 1972 and the final amended Partnership Agreement, dated October 16, 1972 were executed by all S&A partners, including plaintiff. The Memorandum incorporated a minor change requested by plaintiff.

At a meeting of the executive committee of the combined firm on October 16, 1972, it was decided that the Washington offices and the Washington office committees of the two predecessor firms would be consolidated. The former chairmen of the Washington office committees of the two firms were appointed co-chairmen of the new Washington Office Committee.

Day was not a member of the executive committee of the merged firm. He had been the chairman of the S&A Washington Office and John Robson had been chairman of the equivalent Liebman office before the merger. Day contends that the decision to have co-chairmen had been made well before the October 16 executive committee meeting and indeed, the alleged concealment of this fact forms the basis for plaintiff's claim that the approval of the merger was fraudulently induced. There is no dispute, however, that the matter was finalized and made known to plaintiff as of October 16th.

In late October of 1972, the new Washington Office Committee recommended to the Management Committee that a combined Washington Office be set up at 1730 Pennsylvania Avenue, thus eliminating the old S&A Washington office in the Cafritz Building. A decision was then made to move to the new location despite plaintiff's objections.

Mr. Day resigned from Sidley Austin effective December 31, 1972 claiming that the changes which occurred after the merger in the Washington Office — the appointment of co-chairmen and the relocation of the office — made continued service with the firm intolerable for him.

Mr. Day contends that he had a contractual right to remain the sole chairman of the Washington Office, and that the maintenance of this status was a condition precedent for his rejoining the firm in 1963 and opening the Washington office. According to plaintiff, the decision to appoint co-chairmen was made prior to the merger and defendants' concealment of that decision was a material omission and without that prior information his vote of approval for the merger would not have been given.

He further alleges that certain active misrepresentations about the results of the proposal also had the effect of voiding the approval of the merger. These other alleged misrepresentations were:

1. that no Sidley partner would be worse off in any way as a result of the merger, including positions on committees;

2. that two senior partners of the Liebman firm would soon be leaving law practice;
3. that the merged firm would drop representation of a certain Liebman client whose interests might conflict with some Sidley clients;
4. that the merger with Liebman would be advantageous to the Sidley partners and would add to the standing and prestige of the firm;
5. that all aspects of the merger had been exhaustively investigated by defendants; and
6. that there were good, sound, objective reasons which made the merger highly desirable.[1]

[1] 7. That the new partners will be my friends;
8. That everyone will agree I look cool in a leather jacket;
9. That ...

Events after the merger, allegedly void because of the mentioned omissions and misrepresentations, inevitably led to plaintiff's resignation. The loss of his status as sole chairman of the Washington office was viewed by plaintiff as a humiliating experience, especially as it was accompanied by harrassment by the defendants. Day points to the method of handling the relocation of the consolidated firm as the most obvious manifestation of the defendants' intent to force his resignation. In an affidavit submitted by plaintiff, he asserts that the process of approving the office move entailed a series of meetings held and decisions made without consulting him, all in derogation of his former status as the final decision maker for the S&A Washington office.

Defendants do not concede that misrepresentations or omissions tainted the approval of the merger, nor do they admit engaging in harrassment techniques intended to force plaintiff to resign. The thrust of defendants' argument for summary judgment is that plaintiff's factual allegations are not material because they fail to state a cause of action. Defendants contend that any possible taint of plaintiff's vote in favor of the merger is of no consequence because only a majority, and not unanimous consent, was required for the merger under the provisions of the partnership agreements. Defendants also contend that any diminution of status as perceived by plaintiff cannot have any legal consequences because he had no vested contractual right to remain the sole chairman. They rely on the terms of the partnership agreements to support this defense. Under the agreements, the Executive Committee had the authority to govern the composition of all other firm committees and no special provisions had been made as to plaintiff's vested right in the Washington office.

The key misrepresentation which forms the basis of plaintiff's complaint is that no Sidley partner would be worse off as a result of the merger. Plaintiff interpreted this to mean that he would continue to serve as the sole chairman of the Washington Office and that he would wield the commanding authority regarding such matters as expanding office space. It was the change in plaintiff's status at the Washington Office which directly precipitated his resignation.

This misrepresentation regarding plaintiff's status cannot support a cause of action for fraud, however, because plaintiff was not deprived of any legal right as a result of his reliance on this statement. The 1970 S&A Partnership Agreement, to which plaintiff was a party, sets forth in some detail the relationships among the partners and the structure of the firm. No mention is made of the Washington Office or plaintiff's status therein, whereas special arrangements are specified for certain other partners. If chairmanship of the Washington Office was of the importance now claimed, the absence of such a provision from the partnership agreement requires a measured explanation which Mr. Day does not supply. Plaintiff's allegations of an unwritten understanding cannot now be heard to contravene the provisions of the Partnership Agreement which seemingly embodied the complete intentions of the parties as to the manner in which the firm was to be operated and managed.

Nor can plaintiff have reasonably believed that no changes would be made in the Washington Office since the S&A Agreement gave complete authority to the executive committee to decide questions of firm policy, which would clearly include establishment of committees and the appointment of members and chairpersons. Having read and signed the 1970 and 1972 S&A Partnership Agreements which implicitly authorized the Executive Committee to create, control or eliminate firm committees, plaintiff could not have reasonably believed that the status of the Washington Office Committee was inviolate and beyond the scope and operation of the Partnership Agreements. Thus, since plaintiff had no right to remain chairman of the Washington Office, a misrepresentation regarding his chairmanship does not form the basis for a cause of action in fraud.

Plaintiff also alleges that defendants breached their fiduciary duty by beginning negotiations on a merger with the Liebman firm without consulting the other partners who were not on the Executive Committee and by not revealing information regarding changes that would occur as a result of the merger, such as the co-chairmen arrangement for the Washington office. An examination of the case law on a partner's fiduciary duties, however, reveals that courts have been primarily concerned with partners who make secret profits at the expense of the partnership. Partners have a duty to make a full and fair disclosure to other partners of all information which may be of value to the partnership. The essence of a breach of fiduciary duty between partners is that one partner has advantaged himself at the expense of the firm.

What plaintiff is alleging in the instant case, however, concerns failure to reveal information regarding changes in the internal structure of the firm. No court has recognized a fiduciary duty to disclose this type of information, the concealment of which does not produce any profit for the offending partners nor any financial loss for the partnership as a whole. Not only was there no financial gain for defendants, but the remaining partners did not acquire any more power within the firm as the result of the alleged withholding of information from plaintiff. They were already members of the executive committee and as such had wide-ranging authority with regard to firm management. Thus plaintiff's claim of breach of fiduciary duty must fail.

What this Court perceives from Mr. Day's pleadings and affidavits is that he may be suffering from a bruised ego[1] but that the facts fail to establish a legal cause of action. As an able and experienced attorney, it should have been clear[2] that the differences and misunderstandings which developed with his former partners were business risks of the sort which cannot be resolved by judicial proceedings. Mr. Day, a knowledgeable, sophisticated and experienced businessman and a responsible member of a large law firm, bound himself to a well-defined contractual arrangement when he executed the 1970 Partnership Agreement. The contract clearly provided for management authority in the executive committee and for majority approval of the merger with the Liebman firm. Even if plaintiff had voted against the merger, he could not have stopped it. Furthermore, the Partnership Agreement, to which he freely consented, denies the existence of a contractual right to any particular status within the firm for plaintiff. If plaintiff's partners did indeed combine against him, it is clear that their alleged activities did not amount to illegality, and that any personal humiliation or injury was a risk that he assumed when he joined with others in the partnership.[3]

[1] Damn.

[2] Damn, damn.

[3] Damn, damn, DAMN.

Some discussion questions:

1. What is the interplay between the partnership agreement and the fiduciary duty of loyalty? Which one does the court view as better for establishing what partners are owed?

2. Sidley & Austin is and was a large, sprawling, multi-office law firm. How did they set up the management structure of the firm? Did this infringe on the "equal powers" of partners in management that UPA/RUPA establishes?

3. Let's pretend Day stuck around, but was really, really, *really* annoying about everything. Under what circumstances could the firm have expelled Day?

Bohatch v. Butler & Binion, 977 S.W.2d 543 (Tex. 1998)

Enoch, J.

Partnerships exist by the agreement of the partners; partners have no duty to remain partners. The issue in this case is whether we should create an exception to this rule by holding that a partnership has a duty not to expel a partner for reporting suspected overbilling by another partner. The trial court rendered judgment for Colette Bohatch on her breach of fiduciary duty claim against Butler & Binion and several of its partners (collectively, "the firm"). The court of appeals held that there was no evidence that the firm breached a fiduciary duty and reversed the trial court's tort judgment; however, the court of appeals found evidence of a breach of the partnership agreement and rendered judgment for Bohatch on this ground. We affirm the court of appeals' judgment.

Bohatch became an associate in the Washington, D.C., office of Butler & Binion in 1986 after working for several years as Deputy Assistant General Counsel at the Federal Energy Regulatory Commission. John McDonald, the managing partner of the office, and Richard Powers, a partner, were the only other attorneys in the Washington office. The office did work for Pennzoil almost exclusively.

Bohatch was made partner in February 1990. She then began receiving internal firm reports showing the number of hours each attorney worked, billed, and collected. From her review of these reports, Bohatch became concerned that McDonald was overbilling Pennzoil and discussed the matter with Powers. Together they reviewed and copied portions of McDonald's time diary. Bohatch's review of McDonald's time entries increased her concern.[1]

[1] According to the dissent, Bohatch claimed that McDonald was billing Pennzoil eight to twelve hours a day, which would be absolutely insane. That allegation was contested by the firm, as you might expect.

On July 15, 1990, Bohatch met with Louis Paine, the firm's managing partner, to report her concern that McDonald was overbilling Pennzoil. Paine said he would investigate. Later that day, Bohatch told Powers about her conversation with Paine. The following day, McDonald met with Bohatch and informed her that Pennzoil was not satisfied with her work and wanted her work to be supervised. Bohatch testified that this was the first time she had ever heard criticism of her work for Pennzoil.

The next day, Bohatch repeated her concerns to Paine and to R. Hayden Burns and Marion E. McDaniel, two other members of the firm's management committee, in a telephone conversation. Over the next month, Paine and Burns investigated Bohatch's complaint. They reviewed the Pennzoil bills and supporting computer print-outs for those bills. They then discussed the allegations with Pennzoil in-house counsel John Chapman, the firm's primary contact with Pennzoil. Chapman, who had a long-standing relationship with McDonald, responded that Pennzoil was satisfied that the bills were reasonable.

In August, Paine met with Bohatch and told her that the firm's investigation revealed no basis for her contentions. He added that she should begin looking for other employment, but that the firm would continue to provide her a monthly draw, insurance coverage, office space, and a secretary. After this meeting, Bohatch received no further work assignments from the firm.[1]

[1] The firm motto? "Snitches Get Stitches".

In January 1991, the firm denied Bohatch a year-end partnership distribution for 1990 and reduced her tentative distribution share for 1991 to zero. In June, the firm paid Bohatch her monthly draw and told her that this draw would be her last. Finally, in August, the firm gave Bohatch until November to vacate her office.

By September, Bohatch had found new employment. She filed this suit on October 18, 1991, and the firm voted formally to expel her from the partnership three days later, October 21, 1991.

The breach of fiduciary duty claim and a breach of contract claim were tried to a jury. The jury found that the firm breached the partnership agreement and its fiduciary duty. It awarded Bohatch $57,000 for past lost wages, $250,000 for past mental anguish, $4,000,000 total in punitive damages (this amount was apportioned against several defendants)[2], and attorney's fees.[3]

[2] Later reduced.

[3] Later thrown out, then reinstated.

All parties appealed. The court of appeals held that the firm's only duty to Bohatch was not to expel her in bad faith. The court of appeals stated that "[b]ad faith in this context means only that partners cannot expel another partner for self-gain." Finding no evidence that the firm expelled Bohatch for self-gain, the court concluded that Bohatch could not recover for breach of fiduciary duty. However, the court concluded that the firm breached the partnership agreement when it reduced Bohatch's tentative partnership distribution for 1991 to zero without notice, and when it terminated her draw three months before she left.

We have long recognized as a matter of common law that "[t]he relationship between partners is fiduciary in character, and imposes upon all the participants the obligation of loyalty to the joint concern and of the utmost good faith, fairness, and honesty in their dealings with each other with respect to matters pertaining to the enterprise." Yet,[4] partners have no obligation to remain partners; "at the heart of the partnership concept is the principle that partners may choose with whom they wish to be associated." The issue presented, one of first impression, is whether the fiduciary relationship between and among partners creates an exception to the at-will nature of partnerships; that is, in this case, whether it gives rise to a duty not to expel a partner who reports suspected overbilling by another partner.

[4] Howeva!

Courts in other states have held that a partnership may expel a partner for purely business reasons. Further, courts recognize that a law firm can expel a partner to protect relationships both within the firm and with clients. Finally, many courts have held that a partnership can expel a partner without breaching any duty in order to resolve a "fundamental schism."

The fiduciary duty that partners owe one another does not encompass a duty to remain partners or else answer in tort damages. Nonetheless, Bohatch and several distinguished legal scholars urge this Court to recognize that public policy requires a limited duty to remain partners – i.e., a partnership must retain a whistleblower partner. They argue that such an extension of a partner's fiduciary duty is necessary because permitting a law firm to retaliate against a partner who in good faith reports suspected overbilling would discourage compliance with rules of professional conduct and thereby hurt clients.

While this argument is not without some force, we must reject it. A partnership exists solely because the partners choose to place personal confidence and trust in one another. Just as a partner can be expelled, without a breach of any common law duty, over disagreements about firm policy or to resolve some other "fundamental schism," a partner can be expelled for accusing another partner of overbilling without subjecting the partnership to tort damages. Such charges, whether true or not, may have a profound effect on the personal confidence and trust essential to the partner relationship. Once such charges are made, partners may find it impossible to continue to work together to their mutual benefit and the benefit of their clients.

We are sensitive to the concern expressed by the dissenting Justices that "retaliation against a partner who tries in good faith to correct or report perceived misconduct virtually assures that others will not take these appropriate steps in the future." However, the dissenting Justices do not explain how the trust relationship necessary both for the firm's existence and for representing clients can survive such serious accusations by one partner against another. The threat of tort liability for expulsion would tend to force partners to remain in untenable circumstance – suspicious of and angry with each other – to their own detriment and that of their clients whose matters are neglected by lawyers distracted with intra-firm frictions.

We hold that the firm did not owe Bohatch a duty not to expel her for reporting suspected overbilling by another partner.

The court of appeals concluded that the firm breached the partnership agreement by reducing Bohatch's tentative distribution for 1991 to zero without the requisite notice. The firm contests this finding on the ground that the management committee had the right to set tentative and year-end bonuses. However, the partnership agreement guarantees a monthly draw of $7,500 per month regardless of the tentative distribution. Moreover, the firm's right to reduce the bonus was contingent upon providing proper notice to Bohatch. The firm does not dispute that it did not give Bohatch notice that the firm was reducing her tentative distribution. Accordingly, the court of appeals did not err in finding the firm liable for breach of the partnership agreement.

Spector, J., dissenting

> *[W]hat's the use you learning to do right when it's troublesome to do right and ain't no trouble to do wrong, and the wages is just the same?*
>
> – The Adventures of Huckleberry Finn

The issue in this appeal is whether law partners violate a fiduciary duty by retaliating against one partner for questioning the billing practices of another partner. I would hold that partners violate their fiduciary duty to one another by punishing compliance with the Disciplinary Rules of Professional Conduct. Accordingly, I dissent.

The majority views the partnership relationship among lawyers as strictly business. I disagree. The practice of law is a profession first, then a business. Moreover, it is a self-regulated profession subject to the Rules promulgated by this Court.

I believe that the fiduciary relationship among law partners should incorporate the rules of the profession promulgated by this Court. Although the evidence put on by Bohatch is by no means conclusive, applying the proper presumptions of a no-evidence review, this trial testimony amounts to some evidence that Bohatch made a good-faith report of suspected overbilling in an effort to comply with her professional duty. Further, it provides some evidence that the partners of Butler & Binion began a retaliatory course of action before any investigation of the allegation had begun.

The Court's writing in this case sends an inappropriate signal to lawyers and to the public that the rules of professional responsibility are subordinate to a law firm's other interests. Under the majority opinion's vision for the legal profession, the wages would not even be the same for "doing right"; they diminish considerably and leave an attorney who acts ethically and in good faith without recourse. Accordingly, I respectfully dissent.

SOME DISCUSSION QUESTIONS:

1. Is there any limit to what the grounds for expulsion from a partnership can be?

2. Why wasn't the expulsion in bad faith?

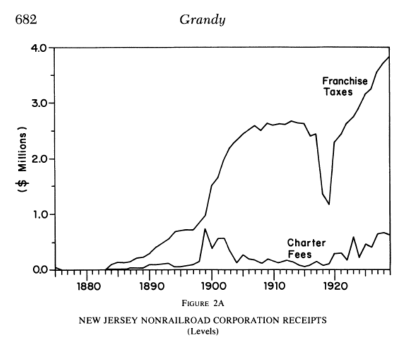
3. What does this tell you about the perils of reporting malfeasance at a law firm? Should you still do it?

4. Corporation Basics

THE MODERN CORPORATION BEGAN, as many awful things do, in New Jersey. In the late 19th century, the New Jersey legislature – searching for sources of revenue to replace dwindling railroad tax receipts – dramatically liberalized its statutes regarding corporate creation in an attempt to get corporations to change their state of incorporation to New Jersey and thus collect charter fees and franchise taxes from those corporations.[1]

[1] Christopher Grandy. New Jersey Corporate Chartermongering, 1875–1929. The Journal of Economic History, 49(3):677–692, September 1989

Prior to 1875, corporations in New Jersey – and every other state in the country – had to be incorporated via an act of the state legislature. New Jersey removed this requirement via state constitutional amendment, and subsequently passed a number of laws giving corporations the right to merge, to hold stock in other corporations, to operate outside of the state, and finally – in a revision to New Jersey's general corporation law in 1896 – the right for corporate managers to create and define the corporation's purpose and the corporation's powers. In other words, corporations were allowed to be formed, be combined, be owned, and be run in the ways that corporations are today.



line go up

The result for New Jersey was a windfall in corporate tax revenue, as corporate managers took advantage of these newly-granted freedoms and incorporated in New Jersey in record numbers. However, New Jersey did not remain the center of the corporate world for very long, as it was very quickly displaced by Delaware as the pre-eminent state for major corporations. In the decades that followed, all of the rest of the states passed some version of New Jersey's liberalized corporate statute, allowing corporations to form just by filing articles of incorporation with the state, and allowing corporations to define their own purpose for existing.[2]

[2] In 1899, Delaware literally copied New Jersey's statute verbatim, and then offered corporations lower franchises taxes as a sweetener. Let that be a lesson for anyone who tells you that you can't just cut and paste your way to success.

In this chapter, we will start by learning the fundamental characteristics of a corporation common to **all** corporations, regardless of which state's laws they were formed under. We will then briefly survey the intersecting rights, powers, and duties of investors and managers in corporations, and look at the kind of conflicts that arise between and among these groups. We will next turn to the sources of corporate law, with an idea to understanding which laws applies to what sorts of corporate action, the role of state law in setting corporate governance procedures, and how conflicts between laws are resolved. Finally, we will look at the formal process of incorporation under both Kentucky and Delaware law,[1] and the liabilities that can arise when the process of incorporation goes wrong.

[1] Delaware remains by far the most popular state in which to incorporate.

Corporate Fundamentals

While there can be real differences between the various state corporation statutes – particularly when it comes to corporate formation, corporate governance, and corporate mergers – the basics of a corporation are the same in all jurisdictions. A corporation has:

- SHAREHOLDERS. Investment in corporations comes through purchase of shares in the corporation. Corporations can have variable amount of total shares available for purchase, and the price of these shares can vary widely as well. Purchasing a share (either from the corporation itself or from a previous shareholder) entitles the shareholder to vote in corporate elections, to sue management in the case of corporate malfeasance, and to collect any money that the corporation distributes to its shareholders (either voluntarily or in liquidation).

- DIRECTORS AND OFFICERS. The Management of a corporation is centralized in a board of directors that is elected by the shareholders. The Board of Directors then appoints officers (the Chief Executive Officer, the Chief Financial Officer, etc.) to run the corporation. Both directors and officers may own shares in the corporation.

- STRICT SEPARATION of the assets, powers, and responsibilities of the corporation's investors (the shareholders), the corporation's managers (the directors and officers), and the corporation itself.

- LIMITED LIABILITY for the corporation's investors, meaning that while the corporation can lose all of its assets, enter into bankruptcy, and/or be liquidated, the assets of a shareholder are strict off-limits to creditors or other claimants. This is also known as the "asset partitioning" function of a corporation.

- PERPETUAL EXISTENCE, like vampires or Henry Kissinger. A corporation may be dissolved voluntarily or by judicial decree, but if it remains in good standing with state authorities it can continue forever.

- ENTITY-LEVEL TAXATION, meaning that the default rule for corporations is that they are taxed on their income prior to any distributions to shareholders (who then pay capital gains taxes on any money they receive from the corporation). There is an exception to this in the tax code, where a small corporation can elect to be taxed as an "S-Corporation"[1], and under that designation the corporation is disregarded and the shareholders' distributions are taxed as ordinary income – just like the way a partnership is taxed.[2]

- TRANSFERABLE PROPERTY INTERESTS as the default rule, meaning that absent a separate agreement to the contrary, a shareholder may freely sell their interest in the corporation to a third party. Contrast this with a partnership, where consent from the partnership is required to substitute one partner with another.

- STRONG MANAGEMENT RIGHTS for the directors and officers of the corporation. The flip side of giving investors more control over buying and selling their interest in the corporation is that the managers of a corporation exert almost complete control over the corporation itself. The only agents of the corporation are the board of directors,[3] the designated officers of the corporation, and anybody specifically empowered by either of those groups. Individual shareholders are not agents of the corporation. The primary limit on the legal powers of management are the fiduciary duties that attach to those positions.

- STRONG VOTING RIGHTS for shareholders of the corporation. Absent a separate agreement otherwise or language in the articles of incorporation that modifies these rights,[4] the default rule is that one share is worth one vote, and shareholders have the exclusive right to elect a corporation's board of directors. Both shareholders and managers have strictly delineated powers, and the parties can go to court to stop one group from intruding on the other's powers.

[1] A normal corporation is technically a "C-Corporation".

[2] The big requirements for an S-Corporation are that they must be a domestic corporation, with no more than 100 shareholders, and those shareholders must be natural persons or estates (no corporations or partnerships).

[3] As a whole, not each individual director.

[4] Some corporations give certain shares more votes than others, which seems extremely *Animal Farm*-ish but is surprisingly legal. We will discuss these "dual-class" corporate structures in Chapter 5.

A Quick Note On "Public" and "Private"

You might hear people refer to a "private corporation" compared to a "public corporation" and talk about the differences between the two. This is sometimes meant to distinguish for-profit corporations whose shares are held by individuals from corporations set up by the government,[1] and sometimes meant to distinguish small family-controlled corporations from large prominent corporations. These terms are vague, confusing, and often applied inconsistently, and as such we will not use them in this book.[2] Instead, we will use these more specific terms:

[1] Such as the Corporation for Public Broadcasting or Fannie Mae or the National Park Foundation.

[2] Yell at me if you see me using them in subsequent chapters.

- A PUBLICLY-TRADED CORPORATION is a corporation whose shares are traded on a national stock exchange. These are mostly the large corporations[3] that have come to dominate every facet of our economic, political, and social lives. What makes them distinct is that their shares are available for purchase and sale to members of the general public through a stock exchange, and because of this they are subject to federal securities laws and required to make periodic disclosures. We are eternally grateful to these corporate overlords for their benevolent guidance, and we pray for their stock prices to be forever buoyant.

[3] Some of which you have likely heard of (Apple, Facebook, Nike), some of which you have likely not (Accuride, Cambrex, Spherion).

- A PRIVATELY-HELD CORPORATION is a corporation whose shares are not traded on an exchange, but instead are owned by a small group of investors. While the majority of privately-held corporations are small enterprises, there are a number of large corporations that are privately-held.[4] Ownership of shares in large privately-held corporations tend to either be distributed among a wealthy and possibly insane family or among early-stage investment funds (the former usually intend to keep the corporation privately-held, the latter usually seek to eventually make the corporation publicly-traded).

[4] For example, Chick-fil-a is owned by the Cathy family, Trader Joe's is owned by a family of reclusive German billionaires, and Land O'Lakes is owned by a very large cow.

- A CLOSELY-HELD CORPORATION is a kind of privately-held corporation where a small number of investors own all the shares of a company and the corporation is tightly controlled by one or more of those investors. Courts tend to treat closely-held corporations (particularly those involving family members) differently than the typical large publicly-traded corporation where investors and managers do not have close ties to one another.

- A STATE-OWNED ENTERPRISE is a corporation chartered and owned by either the state or federal government. They might be funded by the government or they might collect revenue through other sources. While they have a separate legal existence from the government, they are generally designated by the government to have a very specific purpose, usually to serve the public in some capacity. While they are quite interesting, we do not deal with them in this book, for reasons.

You might also encounter something called a "Professional Corporation" (a "P.C."). This is a special designation available in some states to associations of professionals that are otherwise restricted by ethical rules from practicing through a standard for-profit corporation.[1] These function as ordinary corporations, except that issuance or transfer of shares in the P.C. is limited to other similarly licensed professionals, and the P.C. cannot do business outside of their designated profession.

[1] In Kentucky, a group of licensed professionals may form a Professional Services Corporation under KRS §274.015. Licensed professionals include "certified public accountants, public accountants, chiropractors, osteopaths, physicians and surgeons, doctors of medicine, doctors of dentistry, podiatrists, chiropodists, architects, veterinarians, optometrists, and attorneys-at-law". KRS §274.005. How the fuck did *chiropractors* make it on to that list?

There is also — and I am sighing deeply as I write this — a kind of corporation called a "Benefit Corporation" or a "Public Benefit Corporation" available in some states. Even though they have a pro-social title and slightly different paperwork requirements, these corporations (whether they are large or small, publicly-traded or privately-held) are exactly the same as every other kind of for-profit corporation. They are corporations for people with an "I Voted!" sticker on their laptops. They are corporations for people who bring their own bags to the grocery store. They are corporations for people that own *Hamilton* on Blu-ray. We will cover them in Chapter 17 and I will hate every second of it.

Foundational Documents

A corporation has two required foundational documents: the **Articles of Incorporation** and the **Bylaws**. The Articles of Incorporation[2] are filed with the state and establish the existence of the corporation. Whichever state the Articles are filed in is the state whose law governs the corporation. The Articles are surprisingly bare bones, setting out a few fundamental details – the corporation's name, the designated agent, the number of authorized shares, etc. – that are required by the state.[3] Once adopted, the Articles can only be amended through a shareholder vote.

[2] The exact title of the document can vary, so you can see a "Certificate of Incorporation" or a "Statement of Incorporation" – these are all fundamentally the exact same document. The old timey word for this document is a "corporate charter", and you can still hear that used from time to time.

[3] See, e.g., Amazon's Articles, reproduced later in this chapter.

The corporation's Bylaws, by contrast, is a much lengthier document that will go into greater detail regarding the powers of the directors and officers, the procedures for the election, removal, and appointment of directors, the formalities of shareholder voting, and other governance issues. The Bylaws are not filed with the state, and can be amended by the Board of Directors or by a vote of the shareholders.

In addition to the Articles and the Bylaws, there are a number of other documents that are relevant to understanding the governance of a corporation but are not considered foundational. For example, two shareholders might enter into a Shareholder Agreement where Shareholder 1 agrees that if they sell their shares, they will sell them to Shareholder 2 at market price.[1] While this sort of agreement is extremely relevant to understanding how real-world power is distributed in the corporation, it binds *only those shareholders* and not the corporation, so it is not a foundational document of the corporation.

[1] These sorts of agreements are often used to keep corporate control in the hands of a certain group of shareholders.

Corporate Actors

There are three important roles in a corporation: shareholder, director, and officer. These roles are not mutually exclusive – directors and officers can own shares, major shareholders can serve on the board of directors, etc. – but they do have clearly delineated positions in the organization.

Shareholders can be natural persons or other corporate entities. They invest in the corporation by purchasing shares of that corporation either directly from a corporation (in what is called an "offering") or on the secondary market from another investor. However those shares ends up in a shareholder's hands, a single share entitles the shareholder to cast a vote for the board of directors and on other important corporate matters, and also entitles the shareholder to a proportional cut of any distribution of money or property that comes out of the corporation.[2] Multiple shares give the shareholder multiple votes and increases the shareholder's *pro rata* cut of any distribution of money. The shareholder does not own or control any of the property of the corporation, however, and the shareholder is not an agent of the corporation, nor do they have any management rights over the corporation itself.

[2] When a corporation voluntarily distributes money to its shareholders, this is called a "dividend". Other distributions might come through a sale of the corporation to a third party, or through a corporate liquidation.

Directors must be natural persons. They are elected by the shareholders to serve as fiduciaries of the corporation on the Board of Directors. A corporation must have at least one director, though most reasonably large corporation opt for a board with multiple directors. Directors can be "inside directors", who are employees or officers of the corporation, or "outside directors", who are not formally affiliated with the corporation. The Board of Directors approves important decisions of the corporation by majority vote, provides guidance and strategy to the upper-level management of the corporation, and appoints the officers of the corporation. Directors owe fiduciary duties to the corporation, and can be sued for breaching those duties. The Board of Directors as a whole is an agent of the corporation, but each individual director is not (unless the Board designates that director to be an agent for some purpose).

OFFICERS must also be natural persons. They are appointed by the Board of Directors to run the corporation on a day-to-day basis. While they can control the use and disposition of the corporation's money and property, they (like shareholders and directors) do not own the corporation's assets. Officers owe fiduciary duties to the corporation, and can be sued for breaching those duties. Officers are agents of the corporation, though the scope of their agency is defined by their particular position. The specific positions and powers of a corporation's officers are laid out in a corporation's bylaws, but typical officers include:

- The CEO: The Chief Executive Officer has ultimate managerial authority in a corporation, and is always an agent of the corporation.
- The CFO or Treasurer: The Chief Financial Officer usually has authority over a corporation's borrowing and spending, and has responsibility for the financial information internal to the corporation and for a corporation's financial disclosures.
- The President: The President's powers ~~are determined by Neil Gorsuch~~ vary substantially from corporation to corporation. In the past, this was customarily a powerful position, responsible for the day-to-day operation of the company (hence the occasional recognition of the "inherent" authority of a corporation's President). Nowadays the position is a big honkin' ***it depends*** — sometimes it is a powerful second-in-command, sometimes it is a CEO-in-waiting type with specialized authority, and sometimes it is an impotent figurehead. Check the bylaws and/or board resolutions to be certain!
- The Secretary: The Corporate Secretary is in charge of corporate documentation, coordinating board actions, and is the person you will call when you need to get the resolutions that show that the corporation actually meant to do what you think they meant to do.
- General Counsel: The head of a corporation's legal department. Hires outside counsel and is often responsible for a corporation's regulatory compliance. Knows all the corporation's dirty secrets. The ultimate corporate knifefighter. Gerri from *Succession*. This could be you!

Of course, there are a whole hell of a lot of other parties that interact with or are affected by a corporation. These include *customers*, *employees*, *vendors*, *counterparties*, *creditors*, *MTV's Dan Cortese*, *communities*, *nations*, *the environment of the planet we all live on*, *God*, and *your professor*.[1] All of these parties have been unhelpfully lumped into a category called **stakeholders**, and there are two important things to understand about stakeholders. First, nobody in a

[1] Listed in order of importance.

corporation legally owes stakeholders anything outside of what they contracted for. While the managers of a corporation do have the right to consider stakeholders when making corporate decisions,[1] nobody owes fiduciary duties to any of them.[2]

[1] This is absolutely true as a matter of law, and tends to bug conservative types.

[2] This is absolutely true as a matter of law, and tends to bug liberal types.

The second important thing about stakeholders – and related to why nobody owes fiduciary duties to them – is that the term is so broad, and the groups involved are so varied, and the concept is so poorly specified that the idea of acting in their interest is completely nonsensical. Employees might have different interests than environmentalists, customers might have different interests than vendors – hell, even in Frank Capra movies we see creditors having different interests than communities.[3] Has this conceptual incoherence stopped people from claiming that corporations should or must act for the benefit of its stakeholders? I think you know the answer.

[3] Check out the lost ending of *It's A Wonderful Life.*

Rights and Duties of Investors and Managers

> Under German law everything which is not allowed is forbidden, while under French law everything which is not forbidden is allowed.
>
> – Old Comparative Law Joke[4]

[4] I'm gonna call this an "old joke" so I don't have to look up who said it.

When it comes to control over a corporation, the legal powers of investors and managers mirror the joke: for investors, everything which is not allowed is forbidden; for managers, everything which is not forbidden is allowed. The state of play within a corporation reflects this uneven distribution of power: shareholders (investors) are generally passive, while the directors and officers (management) are generally active.

This is not always the case, however, as certain rights empower shareholders to act in ways that can be deeply consequential to the corporation, and certain duties bind directors and officers in ways that produce different outcomes than if they were given a free hand to run the corporation. While we will cover the rights, duties, powers, actions, liabilities, and incentives of investors and managers in corporations extensively in the following chapters, for now let us take a quick look at the rights of shareholders and the duties of directors and officers.

Rights of Shareholders

As residual claimants of the corporation, shareholders cannot manage the corporation directly, or use its property, or access its funds. If a shareholder disagrees with corporate policy, they have three options: **sell**, **vote**, and/or **sue**.[5]

[5] aka Exit, Voice and (a certain kind of) Loyalty.

Albert O. Hirschman. Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States. Harvard University Press, 1970

Selling is straightforward enough (though there can be issues finding a willing buyer for shares in closely-held corporations), and we will address suing for breaches of fiduciary duty in the next section. For now, we will examine one of the most fundamental rights that comes with ownership of shares in a corporation: the right to vote.

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

Plaintiffs,[1] who are stockholders of the defendant, seek a preliminary injunction against the carrying out by such corporation of a change in the date of its annual meeting of stockholders which was ostensibly accomplished by an amendment to its by-laws adopted at a directors' meeting held on October 18, 1971. As a result of such change in by-law and the fixing of a new date by the directors, such annual meeting is now scheduled to be held on December 8, 1971 instead of on the date fixed in the by-law in question before its amendment, namely the second Tuesday in January, 1972.

[1] I have taken this facts section from the underlying Chancery Court opinion. There, the Vice Chancellor refused to grant a preliminary injunction to the plaintiffs despite obvious manipulation by the corporation's board, and the plaintiffs appealed to the Delaware Supreme Court.

Plaintiffs and other dissident stockholders, who constitute a stockholders committee on which the plaintiff Schnell serves, are dissatisfied with defendant's recent business performance, which has been poor, plaintiffs contending that defendant has sustained losses of over $6,500,000 over the past two years. Accordingly, they have embarked on a proxy contest[2] against present management with the purpose in mind of electing new directors and installing new management at Chris-Craft.[3]

[2] A proxy contest is an attempt to elect new management at the corporation's annual meeting.

[3] Chris-Craft makes boats and owns television stations, just FYI. You can feel the synergy.

Plaintiffs contend that by advancing the date of defendant's annual meeting by over a month and by the selection of an allegedly isolated town in up-state New York as the place for such meeting, defendant's board has deliberately sought to handicap the efforts of plaintiffs and other stockholders sympathetic to plaintiffs' views adequately to place their case before their fellow stockholders for decision because of the exigencies of time. Plaintiffs accordingly pray for the entry of a preliminary injunction enjoining the convening of the annual meeting of stockholders of Chris-Craft as now scheduled for December 8, 1971 on the ground that the change in defendant's by-laws made on October 18, 1971 was improperly accomplished and constitutes a manipulation of corporate machinery solely to insure that present management may be perpetuated in office to Chris-Craft's detriment. Plaintiffs further pray that the order which they seek to have entered reinstate the former annual meeting date of January 11, 1972, as provided for in the by-laws before the October 18, 1971 amendment, or that the Court fix such other date and place as the Court may deem to be fair and reasonable for such annual meeting.

[I]n 1967 the Delaware Legislature, in approving a substantial redrafting of a number of sections of the Corporation Law, amended § 211 so as to provide as follows:

> "(a) Meetings of stockholders may be held at such place, either within or without this State, as may be designated by or in the manner provided in the by-laws or, if not so designated, at the registered office of the corporation in this State." "(b) An annual meeting of stockholders shall be held for the election of directors on a date and at a time designated by or in the manner provided in the by-laws. Any other proper business may be transacted at the annual meeting."

On October 18, 1971, at a meeting of seven members of defendant's board of directors held in New York, notice of which, according to defendant's secretary, was given as required by the by-laws to every member of the board (minutes of which, however, were unjustifiably withheld from plaintiffs until the Court orally directed their production), Section 1 of Article 1 of Chris-Craft's by-laws was amended pursuant to the provisions of 8 Del. C. § 211(b) allegedly to give more flexibility in fixing the date of the annual meeting and to permit the directors to set a convenient date within a specified period rather than having a fixed date set by the by-laws. Such by-law amendment reads in part as follows:

> "1. Annual Meeting. The annual meeting of stockholders of Chris-Craft Industries, Inc. (hereinafter called the "Corporation") shall be held for the election of the directors * * * in the two month period commencing December 1 and ending on January 31 and at such time as shall be designated by the Board. * * *"

At the same October 18 meeting, at which two directors, Linowes and Rochlis, were absent, the directors present fixed December 8, 1971, at 9:30 a.m. as the date and time for the annual meeting of the stockholders of Chris-Craft. Such meeting also named the Holiday Inn at Cortland, New York,[1] where defendant operates a plant, as the place of such annual meeting of stockholders, and October 29, 1971, as the record date for stockholders eligible to vote at such meeting.

[1] Town motto: "At least we're not Ithaca."

As a result of such by-law amendment adopted pursuant to statutory authority and action taken thereunder, defendant's stockholders, to whom notice was mailed on November 8, will have received thirty days notice of the annual meeting as now scheduled under the terms of the applicable by-law, as amended on October 18, 1971, a change accomplished more than sixty days before the date of annual meeting fixed in the pertinent by-law before its amendment, namely January 11, 1972.

Plaintiffs contend, however, that notwithstanding defendant's compliance with the Delaware law having to do with the fixing and noticing of annual meetings,[2] the obvious design of defendant's management has been to impede the efforts of plaintiffs and others aligned with them to solicit votes in favor of a rival slate of directors and thus constitutes a use

[2] !!!

of corporate machinery to retain present management's control and not for a purpose beneficial to the defendant and its stockholders.

Defendant for its part does not concede that its management has taken advantage of a change in the Delaware Corporation Law in order to blunt the attack on it of a substantial group of dissident stockholders, arguing, in addition to its contentions about weather conditions in Cortland, New York in January, as opposed to early December, that the normal delays in delivery of notices to stockholders resulting from Christmas mails supply another reason for choosing a pre-Christmas date for the annual meeting. Finally, defendant argues that as a result of its current financial records having been put in final form in connection with the settlement of a lawsuit in New York, defendant's final financial statements through August 31, 1971 are now ready for the December meeting but would be stale by mid-January.

I am satisfied, however, in a situation in which present management has disingenuously resisted the production of a list of its stockholders to plaintiffs or their confederates and has otherwise turned a deaf ear to plaintiffs' demands about a change in management designed to lift defendant from its present business doldrums, management has seized on a relatively new section of the Delaware Corporation Law for the purpose of cutting down on the amount of time which would otherwise have been available to plaintiffs and others for the waging of a proxy battle. Management thus enlarged the scope of its scheduled October 18 directors' meeting to include the by-law amendment in controversy after the stockholders committee had filed with the S.E.C. its intention to wage a proxy fight on October 16.

Thus plaintiffs reasonably contend that because of the tactics employed by management (which involve the hiring of two established proxy solicitors as well as a refusal to produce a list of its stockholders, coupled with its use of an amendment to the Delaware Corporation Law to limit the time for contest), they are given little chance, because of the exigencies of time, including that required to clear material at the S.E.C., to wage a successful proxy fight between now and December 8.

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Hermann, J.

In our view, those conclusions amount to a finding that management has attempted to utilize the corporate machinery and the Delaware Law for the purpose of perpetuating itself in office; and, to that end, for the purpose of obstructing the legitimate efforts of dissident stockholders in the exercise of their rights to undertake a proxy contest against management. These are inequitable purposes, contrary to established principles of corporate democracy. The advancement by directors of the by-law date of a stockholders' meeting, for such purposes, may not be permitted to stand.

When the by-laws of a corporation designate the date of the annual meeting of stockholders, it is to be expected that those who intend to contest the reelection of incumbent management will gear their campaign to the by-law date. It is not to be expected that management will attempt to advance that date in order to obtain an inequitable advantage in the contest.

Management contends that it has complied strictly with the provisions of the new Delaware Corporation Law in changing the by-law date. The answer to that contention, of course, is that inequitable action does not become permissible simply because it is legally possible.[1]

[1] Imagine going before a court of law, explaining what you did, having them rule that what you did was legal, and somehow losing anyway.

We agree with the rule ... that, in the absence of fraud or inequitable conduct, the date for a stockholders' meeting and notice thereof, duly established under the by-laws, will not be enlarged by judicial interference at the request of dissident stockholders solely because of the circumstance of a proxy contest. That, of course, is not the case before us.

There is no indication of any prior warning of management's intent to take such action; indeed, it appears that an attempt was made by management to conceal its action as long as possible. Moreover, stockholders may not be charged with the duty of anticipating inequitable action by management, and of seeking anticipatory injunctive relief to foreclose such action, simply because the new Delaware Corporation Law makes such inequitable action legally possible.

Accordingly, the judgment below must be reversed and the cause remanded, with instructions to nullify the December 8 date as a meeting date for stockholders; to reinstate January 11, 1972 as the sole date of the next annual meeting of the stockholders of the corporation; and to take such other proceedings and action as may be consistent herewith regarding the stock record closing date and any other related matters.

Stahl v. Apple Bancorp, Inc., 579 A.2d 1115 (Del. Ch. 1990)

Allen, C.

On March 28, 1990 Stanley Stahl, who is the holder of 30% of the outstanding common stock of Apple Bancorp, Inc. ("Bancorp"), announced a public tender offer for all of the remaining shares of Bancorp's stock. Mr. Stahl had earlier informed Bancorp's board of an intention to conduct a proxy contest for the election of directors to the company's board. On

April 10 Bancorp's board of directors elected to defer the company's annual meeting, which it had intended to call for mid-May, and announced it would explore the advisability of pursuing an extraordinary transaction, including the possible sale of the company. Mr. Stahl filed this action on April 12.

The complaint seeks an order requiring the directors of Bancorp to convene the annual meeting of the stockholders on or before June 16, 1990. The suit is not brought under Section 211 of the Delaware General Corporation Law which creates a right in shareholders to compel the holding of an annual meeting under certain circumstances. Rather, the theory of the complaint is that the directors of Bancorp had intended to convene an annual meeting in May or June — and had gone so far as to fix April 17 as the record date for the meeting — but dropped that plan when it appeared that a proxy contest by plaintiff was likely to succeed. This change in plans is said, in the circumstances, to constitute inequitable conduct because it seeks to protect no legitimate interest of the corporation but is designed principally to entrench defendants in office.

Defendants are the members of the board of directors of Bancorp. They answer the complaint by saying that in not scheduling the 1990 annual meeting in the Spring of the year as has been the practice, they are behaving responsibly in the best interests of the corporation and its shareholders. They claim that their decision to delay the annual meeting was not a response to a proxy contest by plaintiff but was a response to the announcement of plaintiff's tender offer which they conclude is coercive and at an inadequate price.

While the relief sought at this time — the holding of an annual meeting — is the final relief sought in the complaint, the matter has not been presented on a motion for summary judgment, nor has testimony been offered at final hearing. The pending motion is rather one for a preliminary mandatory injunction.[1]

[1] Note how quickly the court is moving on this action. That's Delaware, baby!

Bancorp is a Delaware corporation headquartered in New York. Since September 29, 1989, Bancorp has been the holding company of Apple Bank for Savings ("Apple Bank"), a savings bank chartered in New York. Pursuant to a reorganization on that date, all outstanding shares of Apple Bank were converted into shares of common stock of Bancorp. As of December 31, 1989, Bancorp had $3.41 billion in total deposits, $3.84 billion in total assets and $253.8 million of stockholders' equity. Bancorp's shares are listed on the New York Stock Exchange.

Mr. Stahl, who is Bancorp's largest shareholder, began acquiring shares of Apple Bank in 1986. Gradually he increased his holdings through open market purchases and privately negotiated transactions. Upon effectuation of the reorganization in September 1989, Stahl became the owner of approximately 20% of the then outstanding shares of Bancorp. By November 7, 1989, he owned approximately 30.3% of the outstanding Bancorp shares. As Stahl's proportionate share of Bancorp stock rose above 20%, Bancorp's financial advisor, and a large stockholder, each expressed concern to [Bancorp CEO] Mr. McDougal that Stahl might obtain control of the company without paying a control premium.[1]

[1] We'll talk about this in Chapter XX, but the general idea is that if an outsider wants control of a company, they might have to pay a little extra.

On November 15, 1989, the company's board of directors met to consider what action, if any, should be taken with respect to Stahl's stock accumulation. Two proposals were suggested: negotiating a standstill agreement with Stahl and adopting a stock purchase rights plan (a "rights plan").[2] The board authorized the preparation of the rights plan. On November 17, the board adopted the rights plan.

[2] This is a defensive measure that essentially stops an activist investor from buying up more shares. We talk about it in Chapter XX.

Stahl responded on November 22, 1989, by delivering to the company a proposal to be submitted to a vote at the next annual meeting of stockholders, calling for an amendment to the company's bylaws increasing the number of directors of the company from 12 to 21. In the proposal Stahl nominated 13 individuals (including himself) to be named to the board if his bylaw proposal were approved.[3] He nominated four individuals to be elected if his bylaw proposal were defeated. Later, Stahl stated in a Schedule 13D filing that he would solicit proxies[4] in favor of his proposal and for the election of his nominees to the board. That filing also stated that, if elected, Stahl intended to recommend to the full board that the rights under the rights plan be redeemed and that the board evaluate the performance of management and make any changes it deemed necessary to improve overall management performance.

[3] Why not fill all twenty-one seats on the board? Well, the Bancorp board members serve three year terms and only a third of the board seats are up for election in any given year, so only four of the twelve board seats in play. Stahl's proposal would replace those four board members and then appoint nine more seats to the board to give Stahl a majority while keeping the number of board seats divisible by three. Math!

[4] This just means he would collect votes from other shareholders.

On March 19, 1990 the board fixed April 17, 1990 as the record date for determining the shareholders entitled to vote at the company's 1990 annual meeting.[5] While no date for the annual meeting was fixed, it was anticipated that the meeting would be held in May 1990. Section 213 of the Delaware General Corporation Law provides that the record date for an annual meeting shall not be less than 10 or more than 60 days before the date the meeting is held. Thus, the latest date at which an annual meeting could be held with an April 17 record date would be June 16.

[5] A record date is the cutoff for being eligible to vote at the annual meeting. Everyone who owns shares as of the record date gets to vote.

On April 9 and 10, the company's board of directors held a special meeting. The company's proxy solicitor[6] informed the board that it was likely if the board did not present the stockholders with an economic alternative to Stahl's offer[7] that Stahl would prevail in a proxy fight by a significant margin.

[6] A person hired by the board to collect votes for them.

[7] In addition to waging a campaign to replace the board, Stahl made an offer to buy all the outstanding shares of Bancorp from the other shareholders.

The board resolved to recommend to Bancorp's stockholders that they reject Stahl's offer. It further resolved to withdraw the April 17 record date in order to allow itself more time to pursue alternatives to the Stahl offer. The directors decided that "it is not in the best interest of the company and its stockholders to hold the annual meeting until the company has had a fair opportunity to explore and pursue alternatives to the Stahl offer which would enable the company to maximize stockholder value." These alternatives included the sale of the company or the merger of the company with another financial institution.

Stahl asserts and it is not denied that defendants intended to hold Bancorp's 1990 annual meeting in May 1990. He claims that by requiring shareholders to submit matters to be voted upon at the annual meeting by November 1989 (which the board interpreted Bancorp's bylaws to do) and by fixing an April 17 record date, the defendants have initiated the proxy contest process. It is argued that the withdrawal of the record date is essentially a postponement of Bancorp's 1990 annual meeting, and that the postponement was effected in order to avoid the defeat the incumbent directors anticipated that they would suffer if the election of directors were held in May. Stahl argues that the board's action constitutes an impermissible manipulation of the corporate machinery having the effect of disenfranchising the company's stockholders and entrenching the incumbent directors.

Defendants do not dispute that the board originally intended to hold the 1990 annual meeting in late May. They point out, however, that no meeting date had been set, and under neither 8 Del. C. §211 nor Bancorp's bylaws, was one required until September of 1990. Thus, it is said, the board's withdrawal of the April 17 record date was not an action that impeded a shareholder vote. Defendants assert that ... the withdrawal of the April 17 record date did not render a shareholder vote ineffective, but simply delayed it.

Plaintiff contends that the deferral of the annual meeting and the rescission of the record date together constitutes a direct and intended interference with the exercise of the shareholders' right of franchise. It is said that to be sustained this action requires the directors to establish a compelling justification, which, plaintiff asserts, defendants cannot do.

It is an elementary proposition of corporation law that, where they exist, fiduciary duties constitute a network of responsibilities that overlay the exercise of even undoubted legal power. Thus it is well established, for example, that where corporate directors exercise their legal powers for an inequitable purpose their action may be rescinded or nullified by a court at the instance of an aggrieved shareholder. The leading Delaware case of *Schnell v. Chris-Craft Industries, Inc.* announced this principle and applied it in a setting in which directors advanced the date of an annual meeting in order to impede an announced proxy contest.

Action designed principally to interfere with the effectiveness of a vote inevitably involves a conflict between the board and a shareholder majority. Judicial review of such action involves a determination of the legal and equitable obligations of an agent towards his principal. This is not, in my opinion, a question that a court may leave to the agent finally to decide so long as he does so honestly and competently; that is, it may not be left to the agent's business judgment.

Thus the fundamental question when the motion is evaluated under these cases may be expressed as whether the defendants have exercised corporate power inequitably. In answering that question, it is necessary to ask, in the context of this case, whether they have taken action for the purpose of impairing or impeding the effective exercise of the corporate franchise and, if they have, whether the special circumstances are present (compelling justification) warranting such an unusual step.

In my opinion one employing this method of analysis need not inquire into the question of justification in this instance, for I cannot conclude that defendants have taken action for the primary purpose of impairing or impeding the effective exercise of the corporate franchise. I reach this conclusion understanding that the Bancorp board had planned to call the annual meeting of stockholders for May and that it changed that plan in response to the risk that the combination of the proposed Stahl proxy contest and tender offer would result in a change in board control and the sale of the company.

I place my opinion on the narrow ground that the action of deferring this company's annual meeting where no meeting date has yet been set and no proxies even solicited does not impair or impede the effective exercise of the franchise to any extent. To speak of the effective exercise of the franchise is to imply certain assumptions concerning the structure and mechanism that define the vote and govern its exercise. Shares are voted at meetings; meetings are generally called as fixed in bylaws. While the refusal to call a shareholder meeting when the board is not obligated to do so might under some imaginable circumstance breach a fiduciary duty, such a decision does not itself constitute an impairment of the exercise of the franchise that sparked the close judicial scrutiny of *Schnell*.

In no sense can the decision not to call a meeting be likened to kinds of board action found to have constituted inequitable conduct relating to the vote. In each of these franchise cases the effect of the board action – to advance or defer a meeting; to adopt a bylaw; or to fill board vacancies – was practically to preclude effective stockholder action or to snatch victory from an insurgent slate on the eve of the noticed meeting. Here the election process will go forward at a time consistent with the company's bylaws and with Section 211 of our corporation law. Defendant's decision does not preclude plaintiff or any other Bancorp shareholder from effectively exercising his vote, nor have proxies been collected that only await imminent counting. Plaintiff has no legal right to compel the holding of the company's annual meeting under Section 211(c) of the Delaware General Corporation Law, nor does he, in my opinion, have a right in equity to require the board to call a meeting now.

As indicated above, inquiries concerning fiduciary duties are inherently particularized and contextual. It is probably not possible to work out rules that will be perfectly predictive of future cases involving claimed impediments to the shareholder vote. It is sufficient to express a reasoned judgment on the facts presented. This I have now tried to do. The application for a preliminary injunction will be denied.

SOME DISCUSSION QUESTIONS:

1. Did the board in *Schnell* do anything wrong legally? What was the court concerned with?

2. The court in *Schnell* told the board to quit fucking around and hold their meeting, while the court in *Stahl* denied the preliminary injunction asking the court to do the same. What were the differences between the two cases?

3. Note that the court refers to a shareholders' "right of franchise" (aka the right to vote). What fiduciary duty would it violate for a corporation's board to attempt to stymie the effective exercise of shareholder voting in this corporate democracy?

4. Can you imagine for one second if the actual Supreme Court cared as much about preserving the right to vote as the Delaware Supreme Court?[1]

[1] If the default rule was "the person who has the most money gets the most votes" instead of "one person, one vote" do you think the Supreme Court would be a little more aggressive?

Duties of Directors and Officers

Directors and officers – like general partners in partnerships – owe their corporations the duty of loyalty and the duty of care. Over time, courts have worked to specify what precisely those duties entail, and in doing so came up with doctrine called the Business Judgment Rule, which insulates ordinary business decisionmaking from judicial review. The following case articulates and explores the limits of that rule.

Bayer v. Beran, 49 N.Y.S. 2d 2 (Sup. Ct. 1944)

Shientag, J.

Three derivative stockholders' suits[2] present for review transactions upon which plaintiffs seek to charge the individual defendants, who are directors, with liability in favor of the corporate defendant, the Celanese Corporation of America. Before taking up the specific transactions complained of, I shall consider generally certain pertinent rules to be applied

[2] A derivative suit is when a shareholder files suit on behalf of the corporation rather than as an individual plaintiff. We discuss this in more detail in Chapter 8.

in determining the liability of directors of a business corporation such as is here involved.

Despite abuses that have developed in connection with the derivative stockholders' suit, abuses which should be dealt with promptly and effectively, it must be remembered that such an action is, at present, the only civil remedy that stockholders have for breach of fiduciary duty on the part of those entrusted with the management and direction of their corporations. We cannot therefore allow the prevailing mood of justifiable dissatisfaction[1] with some of the temporary incidents of such suits to cause us to lose sight of certain deep-rooted, traditional concepts of the obligations of directors to their corporation and its stockholders.

[1] This just shows that people have been hating on plaintiff's lawyers for *generations*.

Directors of a business corporation are not trustees and are not held to strict accountability as such. Nevertheless, their obligations are analogous to those of trustees. Directors are agents; they are fiduciaries. The fiduciary has two paramount obligations: responsibility[2] and loyalty. Those obligations apply with equal force to the humblest agent or broker and to the director of a great and powerful corporation. They lie at the very foundation of our whole system of free private enterprise and are as fresh and significant today as when they were formulated decades ago. The responsibility – that is, the care and the diligence – required of an agent or of a fiduciary, is proportioned to the occasion. It is a concept that has, and necessarily so, a wide penumbra of meaning[3] – a concept, however, which becomes sharpened in its practical application to the given facts of a situation.

[2] aka "care"

[3] You hear that, Clarence Thomas? "Please do not emanate into the penumbra", ha ha ha? FOH with that.

The concept of loyalty, of constant, unqualified fidelity, has a definite and precise meaning. The fiduciary must subordinate his individual and private interests to his duty to the corporation whenever the two conflict. In an address delivered in 1934, Mr. Justice, now Chief Justice,[4] Stone declared that the fiduciary principle of undivided loyalty was, in effect, "the precept as old as Holy Writ, that 'a man cannot serve two masters'. More than a century ago equity gave a hospitable reception to that principle and the common law was not slow to follow in giving it recognition. No thinking man can believe that an economy built upon a business foundation can long endure without loyalty to that principle".

[4] Later, Captain Justice.

A director is not an insurer. On the one hand, he is not called upon to use an extraordinary degree of care and prudence; and on the other hand it is established by the cases that it is not enough for a director to be honest, that fraud is not the orbit of his liability. The director may not act as a dummy or a figurehead. He is called upon to use care, to exercise judgment, the decree of care, the kind of judgment that one would give in similar situations to the conduct of his own affairs.[5]

[5] They really gendered the shit out of corporate management positions back in the day.

The director of a business corporation is given a wide latitude of action. The law does not seek to deprive him of initiative and daring and vision. Business has its adventures, its bold adventures; and those who in good faith, and in the interests of the corporation they serve, embark upon them, are not to be penalized if failure, rather than success, results from their efforts. The law will not permit a course of conduct by directors, which would be applauded if it succeeded, to be condemned with a riot of adjectives simply because it failed. Directors of a commercial corporation may take chances, the same kind of chances that a man would take in his own business. Because they are given this wide latitude, the law will not hold directors liable for honest errors, for mistakes of judgment. The law will not interfere with the internal affairs of a corporation so long as it is managed by its directors pursuant to a free, honest exercise of judgment uninfluenced by personal, or by any considerations other than the welfare of the corporation.

To encourage freedom of action on the part of directors, or to put it another way, to discourage interference with the exercise of their free and independent judgment, there has grown up what is known as the 'business judgment rule'. 'Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.' Indeed, although the concept of 'responsibility' is firmly fixed in the law, it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest.

The 'business judgment rule', however, yields to the rule of undivided loyalty. This great rule of law is designed to avoid the possibility of fraud and to avoid the temptation of self-interest. Such personal transactions of directors with their corporations, such transactions as may tend to produce a conflict between self-interest and fiduciary obligation, are, when challenged, examined with the most scrupulous care, and if there is any evidence of improvidence or oppression, any indication of unfairness or undue advantage, the transactions will be voided. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation are challenged the burden is on the director not only to prove the good faith of the transaction but also to show its inherent fairness[1] from the viewpoint of the corporation and those interested therein.

[1] Put a pin in this one, we'll come back to "inherent fairness" later on.

The "advertising" cause of action charges the directors with negligence, waste and improvidence in embarking the corporation upon a radio advertising program beginning in 1942 and costing about $1,000,000 a year.[1] It is further charged that they were negligent in selecting the type of program and in renewing the radio contract for 1943. More serious than these allegations is the charge that the directors were motivated by a noncorporate purpose in causing the radio program to be undertaken and in expending large sums of money therefor. It is claimed that this radio advertising was for the benefit of Miss Jean Tennyson, one of the singers on the program, who in private life is Mrs. Camille Dreyfus, the wife of the president of the company and one of its directors; that it was undertaken to 'further, foster and subsidize her career'; to 'furnish a vehicle' for her talents.[2]

[1] I'm not gonna bust out the slide rule to give you an actual figure, but this is a hell of a lot of money in today's dollars.

[2] Literally the plot of *Citizen Kane*.

Eliminating for the moment the part played by Miss Tennyson in the radio advertising campaign, it is clear that the character of the advertising, the amount to be expended therefor, and the manner in which it should be used, are all matters of business judgment and rest peculiarly within the discretion of the board of directors. Under the authorities previously cited, it is not, generally speaking, the function of a court of equity to review these matters or even to consider them. Had the wife of the president of the company not been involved, the advertising cause of action could have been disposed of summarily. Her connection with the program, however, makes it necessary to go into the facts in some detail.

The directors, in considering the matter informally, but not collectively as a board, decided towards the end of 1941 to resort to the radio and to have the company go on the air with a dignified program of fine music, the kind of program which they felt would be in keeping with what they believed to be the beauty and superior quality of their products. The radio program was not adopted on the spur of the moment or at the whim of the directors. They acted after studies reported to them, made by the advertising department, beginning in 1939. A radio consultant was employed to advise as to time and station. An advertising agency of national repute was engaged to take charge of the formulation and production of the program. It was decided to expend about $1,000,000 a year, but the commitments were to be subject to cancellation every thirteen weeks, so that the maximum obligation of the company would be not more than $250,000.

So far, there is nothing on which to base any claim of breach of fiduciary duty. Some care, diligence and prudence were exercised by these directors before they committed the company to the radio program. It was for the directors to determine whether they would resort to radio advertising; it was for them to conclude how much to spend; it was for them to decide the kind of program they would use. It would be an unwarranted act of interference for any court to attempt to substitute its judgment on these points for that of the directors, honestly arrived at.

The expenditure was not reckless or unconscionable. Indeed, it bore a fair relationship to the total amount of net sales and to the earnings of the company. The fact that the company had offers of more business than it could handle did not, in law, preclude advertising. Many corporations not now doing any business in their products because of emergency conditions advertise those products extensively in order to preserve the good will, the public interest, during the war period. The fact that the company's product may not now be identifiable did not bar advertising calculated to induce consumer demand for such identification. That a program of classical and semiclassical[1] music was selected, rather than a variety program, or a news commentator program, furnishes no ground for legal complaint. True, variety programs have a wider popular appeal than do musicals, but it would be a very sad thing if the former were the only kind of radio programs to be used. Some of the largest industrial concerns in the country have recognized this and have maintained fine musical programs on the radio for many years.

[1] Can someone tell me what this means? Like, Beethoven but played on a kazoo?

Dr. Dreyfus, as was natural, consulted his wife about the proposed radio program; he also asked the advertising agency, that had been retained, to confer with her about it. She suggested the names of the artists, all stars of the Metropolitan Opera Company, and the name of the conductor, prominent in his field. She also offered her own services as a paid artist. All of her suggestions as to personnel were adopted by the advertising agency. While the record shows Miss Tennyson to be a competent singer, there is nothing to indicate that she was indispensable or essential to the success of the program. She received $500 an evening. It would be far-fetched to suggest that the directors caused the company to incur large expenditures for radio advertising to enable the president's wife to make $24,000 in 1942 and $20,500 in 1943.

The musical quality of 'Celanese Hour' has not been challenged, nor does the record contain anything reflecting on Miss Tennyson's competence as an artist. There is nothing in the testimony to show that some other soprano would have enhanced the artistic quality of the program or its advertising appeal. There is no suggestion that the present program is inefficient or that its cost is disproportionate to what a program of that character reasonably entails. Miss Tennyson's contract with the advertising agency retained by the directors was on a standard form, negotiated through her professional agent. Her compensation, as well as that of the other artists, was in conformity with that paid for comparable work. She received less than any of the other artists on the program. Although she appeared with a greater regularity than any other singer, she received no undue prominence, no special build-up. Indeed, all of the artists were subordinated to the advertisement of the company and of its products. The company was featured. It appears also that the popularity of the program has increased since it was inaugurated.

It is clear, therefore, that the directors have not been guilty of any breach of fiduciary duty, in embarking upon the program of radio advertising and in renewing it. It is unfortunate that they have allowed themselves to be placed in a position where their motives concerning future decisions on radio advertising may be impugned. The free mind should be ever jealous of its freedom.[1] Power of control carries with it a trust or duty to exercise that power faithfully to promote the corporate interests, and the courts of this State will insist upon scrupulous performance of that duty. Thus far, that duty has been performed and with noteworthy success. The corporation has not, up to the present time, been wronged by the radio advertising attacked in the complaints.

[1] The free mind should be ever jealous of its freedom ... I mean ... what?

1. Does the court spend any time talking about whether the ad campaign was good or bad for the company? Whether it increased profits or not?
2. Who does the Business Judgment Rule protect? And, more importantly, *what* does it protect?
3. Where did the Business Judgment Rule come from? I know I omitted the internal citations from the excerpt, but nowhere in the decision does the court cite a statute, and there is no mention of a relevant provision in the articles of incorporation or bylaws of the corporation.

SOME DISCUSSION QUESTIONS:
It is worth noting here that shareholders who are not officers or directors of the corporation do not owe fiduciary duties to the corporation. A shareholder may thus enter into a transaction that benefits themselves to the detriment of a corporation in which they've invested. A shareholder is free to invest in competitors of a corporation that they hold shares of. A shareholder has no responsibility to look after a corporation they own stock in, or keep themselves informed as to its business dealings. A shareholder sure as hell owes no legal obligation, fiduciary or otherwise, to their fellow shareholders by virtue of owning shares in the same company.[2] There is one exception to this general rule, and it is governed by the following doctrine.

[2] This can get dicey in situations involving small, closely-held corporations where one group of shareholders might seek to harm another group through actions of the corporation, and some state laws choose to treat those kinds of situations differently than an ordinary corporation. We'll look at these in Chapter 13.

The Fuck Around And Find Out Doctrine

A SHAREHOLDER CAN BE FOUND TO HAVE FIDUCIARY DUTIES to the corporation if they have the ability to exercise control over the corporation the way a corporate officer or director might, and they use that ability to influence corporate decisions. This makes them a "controlling shareholder" and they assume the fiduciary duties that apply to directors and officers of the corporation. The logic behind this rule is that if a shareholder can direct corporate policy by virtue of their holdings, they have functionally taken the powers of corporate management and thus should be bound by the same fiduciary duties as corporate managers. This can arise either when an individual shareholder has amassed a large stake in a corporation, or when a corporation owns a substantial stake in another corporation,[1] and as a result can control things like board elections to the extent that the directors and officers are effectively controlled by the shareholder.

[1] This is called a parent-subsidiary relationship, and a parent can either own all of the stock of the subsidiary (making it a "wholly-owned" subsidiary) or part of the stock of the subsidiary (making it a "partially-owned" subsidiary).

The easiest situation in which to identify a controlling shareholder, and the one recognized explicitly by Delaware law, is one where a shareholder has more than 50% of the corporation's voting power, and no combination of other shareholders can stop them from electing a board under their control. It gets trickier, and requires a deeper examination of the capital structure and the facts on the ground, when a shareholder has less that 50% of the shares. For example, if a shareholder owns 48% of a corporation, does that constitute control? If the other 52% are diffusely owned by a number of passive investors, and it would require those investors to band together with at least 92.3% of their shares to vote against the single shareholder,[2] a court would likely conclude that yes, the 48% shareholder was controlling. Neither statute nor caselaw has established a magic number for control, preferring to examine the facts of each individual case. In a recent decision, Elon Musk – who at the time owned 22.1% of Tesla's stock – was found to be a controlling shareholder.[3] This was in large part because of the size of his holdings and the diffuse ownership of the rest of the corporation's shares, but also because of his personal connections with board members — which included his brother Kimbal — and his importance to the company.

[2] Getting passive investors to vote for routine matters is like pulling teeth; rousting them to vote in North-Korean-election-style numbers against existing management is basically impossible.

[3] In re Tesla Motors, Inc. Stockholder Litigation, Consolidated C.A. No. 12711-VCS (Del. Ch. Mar. 28, 2018).

... are we sure Kimbal Musk isn't just Elon wearing a cowboy hat?

So what's the rule? Where's the line? What combination of ownership and active management transforms a shareholder into a quasi-director for the purposes of fiduciary duties? *Fuck around and find out.*

Sources of Corporate Law

Corporations are creatures of state law,[4] and the state of incorporation determines the law that governs the formation and management of the corporation.

[4] Historically, corporations called "joint-stock companies" were created by the English sovereign, and acted under the official authority of the state. (If you want to go even further back, the Catholic Church was the first quasi-corporation brought into existence for the purpose of ensuring that church lands would be held by the church indefinitely.) The British colonies extended this practice, chartering state corporations for religious, educational, and eventually business organizations.

Not everything a corporation does, however, is governed by the law of the state of incorporation, however. Corporations are bound by the contract laws of the states in which they enter into contracts, subject to the property laws of the states in which they own property, held liable in tort under the laws of the states where their agents/employees commit torts, etc. Moreover, a whole suite of federal laws determine whether and how corporations can acquire their competitors, how companies handle their debts when they are unable to repay them, and how businesses sell shares to potential investors,[1] and there are many, many other federal laws that regulate corporate behavior besides those.

[1] These are regulated by federal antitrust law, federal bankruptcy law, and federal securities laws, respectively.

State law remains preeminent, though, in determining the rights of shareholders, the duties of directors and officers, and the powers of the corporation over the property owned by the corporation – the *internal affairs* of the corporation, one might say. The most important of these state laws is the Delaware General Corporation Law ("DGCL"), though there is a rival/complement in the Model Business Code Act ("MBCA").[2] In this section, we will discuss both major sources of corporate law and examine the "internal affairs" doctrine, which determines when a particular state's laws govern a corporation's behavior.

[2] Jeffrey M Gorris, Lawrence A Hamermesh, and Leo E Strine Jr. Delaware Corporate Law and the Model Business Corporation Act: A Study in Symbiosis. Law and Contemporary Problems, 74:107–120

Delaware Law

Imagine being magically whisked away to ... Delaware.

As mentioned at the start of this chapter, one of the reasons that the DGCL came to dominate corporate law is that Delaware was one of the first states to liberalize its incorporation laws to allow the creation of corporations without a specific act of the legislature. While being a first-mover in this area certainly helped, Delaware has other structural, political, and geographic advantages. Specifically:

- Any amendment to the Delaware's corporate statute is formulated and proposed by the governing body of the Corporation Law Section of the Delaware State Bar Association (the "Council"), a long-standing custom in the Delaware General Assembly. The council is comprised of practitioners and expert corporate lawyers from renowned law firms, with a focus ranging from corporate litigation to transactional counseling to shareholder actions.

- Delaware law requires that any corporate law enjoy support of at least two-thirds of the legislators elected to each house before it can be enacted, keeping the law relatively stable.

- Delaware law also requires a partisan balance in its judiciary (despite being, as of right now, a heavily Democratic state), which sends a signal to corporate managers that the politics of the moment won't have as big an influence on the judiciary as they might in other states.

- 28% of Delaware's state budget is derived from corporate franchise taxes and entity filing fees,[1] which keeps it laser-focused on maintaining its status as a popular jurisdiction in which to incorporate.
- Delaware is a 90-minute train ride from both New York and Washington, DC, a real advantage over the South Dakotas of the world when it comes time to bust out the lawyers.

[1] I can only assume that the other 72% of the budget is generated by that bullshit toll on I-95.

Probably the most important advantage that Delaware has, however, is the Delaware Court of Chancery. The Court of Chancery consists of one chancellor and six vice chancellors, who are experts in corporate law, are nominated by the Governor, and are confirmed by the Senate for 12-year terms. The Delaware Court of Chancery is a non-jury trial court that serves as Delaware's court of original and exclusive equity jurisdiction for corporate matters. The Court of Chancery moves extremely quickly, engages in fact-intensive inquiries, and has for decades developed a comprehensive and (relatively) clear[2] body of caselaw that parties can look to for guidance in both litigating corporate disputes and when drafting deal documents.

[2] Obviously I have my own opinions about where they've fucked up over the years.

While a number of the other features of Delaware law – the ease of incorporation, the supermajority requirement for change, the general "pick me" vibes that Delaware gives off – give Delaware its reputation as a pro-management jurisdiction in which to set up a corporation, it is the Court of Chancery (and the Delaware Supreme Court that reviews Court of Chancery decisions) that has given Delaware corporate law its preeminence in the field.[3]

[3] Delaware decisions are routinely cited in other states that have their own corporation statutes, whereas Delaware courts rarely cite to decisions from other states.

This is because the Delaware court system understands that its task is to create a working equilibrium between management interests and shareholder interests.[4] When other states shift their corporate law too far in favor of management, it attracts scammers and unsavory types to set up corporations in those states (*see, e.g.* Nevada), and investors become wary of putting up capital. On the other hand, if states shift their corporate law in the direction of shareholder interests, managers will move to re-incorporate in other, more management-friendly states. Delaware courts seek to develop a law that strikes a balance between these groups.

[4] Delaware's weird role here makes more sense if you see Delaware is as a sort of stand-in for the system of capitalism. Largely insulated from direct political control, bigger than any one particular person or company, constantly resolving tensions in the system ... this doesn't sound like Delaware, but it does sound like capitalism, no?

Seen in this light, Delaware's real advantage is in resolving cases fast, without obviously favoring one group over another, while developing a body of caselaw that practitioners can use to guide their clients.[5] As a result, almost all corporations are incorporated either in (a) the state in which they are headquartered, or (b) Delaware – practically no corporations choose to be incorporated out-of-state anywhere other than Delaware. Like all of us, though, the DGCL is not without its haters.

[5] Also (and because this is a sociological observation, I'm putting it over here in the margins): Delaware offers corporations a sense of *legitimacy.* If you want to incorporate your businesss in, like, Mississippi, you better have a hell of a good reason to tell investors. Delaware is a commonly used, universally respected, and legitimate forum – no CEO has ever had to explain to potential investors why they incorporated in Delaware.

Model Business Corporation Act

Drafted by the Business Law section of the American Bar Association in 1950 (which at the time was mostly Chicago lawyers using Illinois law as a guide), the MBCA was promoted as a one-stop, all-inclusive, expertly-drafted model statute for states to adopt in an effort to regularize corporate law across the country and provide certainty for businesses operating in multiple states.[1]

[1] e.g., a business with a subsidiary in Wisconsin would want that to be governed by the same rules as a subsidiary in Missouri.

Even though most states had adopted the New Jersey/Delaware model of corporate law at the turn of the century, over the years states changed their rules for corporations in response to local economic concerns (particularly during the wild years pre- and post-Great Depression) and as a result the country had a mish-mash of state corporate statutes. The MBCA was designed to not only provide states with a uniform set of corporate laws, but also to modernize these sometimes-janky state corporate statutes and bring them in line with best practices and providing periodic revisions to address new issues. 32 states[2] and the District of Columbia have based their corporate statutes on the MBCA.

[2] Including Kentucky.

Sadly, the best laid schemes of mice and men – and the nerds who drafted the MBCA – go often askew, and a paradise of uniform corporate law across the nation has largely failed to materialize, as states often kept various idiosyncrasies in their state corporate statutes or amended their corporation statutes subsequent to adopting the MBCA.[3] Also, the MBCA and the DGCL have over the years come to resemble one another, as developments in Delaware have informed revisions of the MBCA and vice-versa.

[3] As an example, some states have very strong anti-takeover provisions that are absent in the MBCA (and the DGCL).

Because the MBCA has so many local variations, and because Delaware law is so influential, when we reference specific state corporate laws in this book it will be either Kentucky or Delaware.

Internal Affairs Doctrine

Corporations are not limited to doing business in the states in which they are incorporated, and shareholders can invest in corporations outside of the state in which they reside.[4] So what if shareholders domiciled in Kentucky sue a Delaware corporation that does business in New York and New Jersey? Huh? What then, tough guy?[5]

[4] I think this is because of the Supreme Court? The Eleventy-Twelfth Amendment guarantees that states can't discriminate against other states' corporations in commerce or travel or something? You go look it up, all that shit is fake to me.

[5] The answer is Delaware law applies. The answer is always that Delaware law applies.

In response to predicaments just like that, courts have applied what is called the internal affairs doctrine to settle choice of law questions regarding corporate management. This doctrine has a surprisingly sexy name but stands for a completely unsexy proposition, namely that any dispute about the corporation's "internal affairs" – aka shareholder voting rights, managerial fiduciary duties, distributions of money or property, shareholder information rights, the power of the corporation to acquire or be acquired, etc. – will be governed by the laws of the state in which it was incorporated.

McDermott v. Lewis, 531 A.2d 206 (Del. 1987)

Moore, J.

We confront an important issue of first impression — whether a Delaware subsidiary of a Panamanian corporation may vote the shares it holds in its parent company under circumstances which are prohibited by Delaware law, but not the law of Panama. Necessarily, this involves questions of foreign law, and applicability of the internal affairs doctrine under Delaware law.

Plaintiffs, Harry Lewis and Nina Altman, filed these consolidated suits in the Court of Chancery in December, 1982 seeking to enjoin or rescind the 1982 Reorganization under which McDermott Incorporated, a Delaware corporation ("McDermott Delaware"), became a 92%-owned subsidiary of McDermott International, Inc., a Panamanian corporation ("International"). Lewis and Altman are stockholders of McDermott Delaware, which emerged from the Reorganization owning approximately 10% of International's common stock. Plaintiffs challenged this aspect of the Reorganization, and the Court of Chancery granted partial summary judgment in their favor, holding that McDermott Delaware could not vote its stock in International.

We conclude that the trial court erred in refusing to apply the law of Panama to the internal affairs of International. There was no nexus between International and the State of Delaware. Moreover, plaintiffs concede that the issues here do not involve the internal affairs of McDermott Delaware. Accordingly, we reverse. In so doing, we reaffirm the principle that the internal affairs doctrine is a major tenet of Delaware corporation law having important federal constitutional underpinnings.

International was incorporated in Panama on August 11, 1959, and is principally engaged in providing worldwide marine construction services to the oil and gas industry. Its executive offices are in New Orleans, Louisiana, and there are no operations in Delaware. International does not maintain offices in Delaware, hold meetings or conduct business here, have agents or employees in Delaware, or have any assets here.

McDermott Delaware and its subsidiaries operate throughout the United States in three principal industry segments: marine construction services, power generation systems and equipment, and engineered materials. McDermott Delaware's principal offices are in New Orleans.

Following the 1982 Reorganization, McDermott Delaware became a 92%-owned subsidiary of International. The public stockholders of International hold approximately 90% of the voting power of International, while McDermott Delaware holds about 10%.

The stated "principal purpose" of the reorganization, according to International's prospectus, was to enable the McDermott Group to retain, reinvest and redeploy earnings from operations outside the United States without subjecting such earnings to United States income tax. The prospectus also admitted that the 10% voting interest given to McDermott Delaware would be voted by International,[1] "and such voting power could be used to oppose an attempt by a third party to acquire control of International if the management of International believes such use of the voting power would be in the best interests of the stockholders of International." An exchange offer, and thus the Reorganization, was supported by 89.59% of McDermott Delaware stockholders.

[1] Here's the rub: under all the corporate laws of all of the various states in the United States, a corporation may not vote in its own corporate elections, even if it holds shares of itself (from, say, buying back shares from investors). This logic extends to issuing shares to a subsidiary corporation and having them vote those shares, too. Imagine how different the situations in, say, *Stahl* and *Schnell* would be if management could create a subsidiary, give it a bunch of shares, and have the subsidiary vote in favor of management.

The applicable Panamanian law is set forth in the record by affidavits and opinion letters of Ricardo A. Durling, Esquire, and the deans of two Panamanian law schools, to support the claim that McDermott Delaware's retention of a 10% interest in International, and its right to vote those shares, is permitted by the laws of Panama. Therefore, I must conclude that, in the absence of an express prohibition by the law, a Panamanian corporation may vote the shares owned by another corporation in which the first owns the majority of the shares.

We note at the outset that if International were incorporated either in Delaware or Louisiana, its stock could not be voted by a majority-owned subsidiary. No United States jurisdiction of which we are aware permits that practice.

[T]he Court of Chancery concluded that Panama in effect would refrain from applying its laws under the facts of this case. On that basis, the trial court then concluded that since both Delaware and Louisiana law prohibit a majority-owned subsidiary from voting its parent's stock, the device was improper. We consider this an erroneous application of both Delaware and Panamanian law.

Internal corporate affairs involve those matters which are peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders. It is essential to distinguish between acts which can be performed by both corporations and individuals, and those activities which are peculiar to the corporate entity.

Corporations and individuals alike enter into contracts, commit torts, and deal in personal and real property. Choice of law decisions relating to such corporate activities are usually determined after consideration of the facts of each transaction. In such cases, the choice of law determination often turns on whether the corporation had sufficient contacts with the forum state, in relation to the act or transaction in question, to satisfy the constitutional requirements of due process. The internal affairs doctrine has no applicability in these situations. Rather, this doctrine governs the choice of law determinations involving matters peculiar to corporations, that is, those activities concerning the relationships *inter se* of the corporation, its directors, officers and shareholders.

The internal affairs doctrine requires that the law of the state of incorporation should determine issues relating to internal corporate affairs. Under Delaware conflict of laws principles and the United States Constitution, there are appropriate circumstances which mandate application of this doctrine.

Delaware's well established conflict of laws principles require that the laws of the jurisdiction of incorporation – here the Republic of Panama – govern this dispute involving McDermott International's voting rights.

The policy underlying the internal affairs doctrine is an important one, and we decline to erode the principle:

> Under the prevailing conflicts practice, neither courts nor legislatures have maximized the imposition of local corporate policy on foreign corporations but have consistently applied the law of the state of incorporation to the entire gamut of internal corporate affairs. In many cases, this is a wise, practical, and equitable choice. It serves the vital need for a single, constant and equal law to avoid the fragmentation of continuing, interdependent internal relationships. The lex incorporationis, unlike the lex loci delicti, is not a rule based merely on the priori concept of territoriality and on the desirability of avoiding forum-shopping. It validates the autonomy of the parties in a subject where the underlying policy of the law is enabling. It facilitates planning and enhances predictability. In fields like torts, where the typical dispute involves two persons and a single or simple one-shot issue and where the common substantive policy is to spread the loss through compensation and insurance, the preference for forum law and the emphasis on the state interest in forum residents which are the common denominators of the new conflicts methodologies do not necessarily lead to unacceptable choices. By contrast, applying local internal affairs law to a foreign corporation just because it is amenable to process in the forum or because it has some local shareholders or some other local contact is apt to produce inequalities, intolerable confusion, and uncertainty, and intrude into the domain of other states that have a superior claim to regulate the same subject matter.

Given the significance of these considerations, application of the internal affairs doctrine is not merely a principle of conflicts law. It is also one of serious constitutional proportions — under due process, the commerce clause and the full faith and credit clause — so that the law of one state governs the relationships of a corporation to its stockholders, directors and officers in matters of internal corporate governance. The alternatives present almost intolerable consequences to the corporate enterprise and its managers. With the existence of multistate and multinational organizations, directors and officers have a significant right, under the fourteenth amendment's due process clause, to know what law will be applied to their actions. Stockholders also have a right to know by what standards of accountability they may hold those managing the corporation's business and affairs. Thus, we conclude that application of the internal affairs doctrine is mandated by constitutional principles, except in "the rarest situations."

Addressing the facts originally presented to the trial court and to us, we must conclude that due process and the commerce clause, in addition to principles of Delaware conflicts law, mandate reversal. Due process requires that directors, officers and shareholders be given adequate notice of the jurisdiction whose laws will ultimately govern the corporation's internal affairs. Under such circumstances, application of [Delaware law] to International would unfairly and, in our opinion, unconstitutionally, subject those intimately involved with the management of the corporation to the laws of Delaware.

Moreover, application of [Delaware law] to International would violate the commerce clause. Delaware and Panama law clearly differ in their treatment of a subsidiary's voting rights under the facts originally presented here. For Delaware now to interfere in the internal affairs of a foreign corporation having no relationship whatever to this State clearly implies that International can be subjected to the differing laws of all fifty states on various matters respecting its internal affairs. Such a prohibitive burden has obvious commerce clause implications, and could not pass constitutional muster.

In conclusion, the trial court erred as a matter of law in ignoring the uncontroverted Panamanian law, and in applying Delaware and/or Louisiana law to the internal affairs of International contrary to established Delaware law and important constitutional principles. Accordingly the judgment of the Court of Chancery is REVERSED.

Some discussion questions:

1. Some states – looking at you, California – do attempt to regulate corporations that were incorporated in other states but do most of their business in that state (calling them "quasi-foreign corporations"). Why would Delaware want a strong internal affairs doctrine in this case?
2. Did it matter that the corporation did a majority of its business in Louisiana?

3. Did it matter that Panamian corporate law is absolutely – and I'm using a legal term of art here – screwy?

4. I'm sorry, what was all that business about the 14th amendment? We fought a whole-assed civil war for ... *this*? Really?

What About Federal Corporate Law?

There's no such thing. The feddy gov decided a long time ago that it would prefer to avoid wading into fights between shareholders and management, where the states had already staked their claims in determining who had what rights and what duties within the corporation. The closest that federal law comes to governing managers and investors in corporations are the Securities Act of 1933 and the Securities Exchange Act of 1934, which regulate the selling of corporate securities (stocks and bonds), and which we will discuss in Chapter 10.[1] Some commentators consider this a form of "stealth" federal corporate law, but, like, c'mon – (a) there ain't nothing stealthy about the Securities and Exchange Commission, and (b) regulating stuff is not inherently illegitimate, I'm sorry.

[1] You can learn all about these laws in a course called Securities Regulation, taught by your law school's most handsome professor.

Incorporation

> "A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it either expressly or as incidental to its very existence."
>
> – Trustees of Dartmouth Coll. v. Woodward, 17 U.S. 518, 636 (1819)

Forming a Corporation

Forming a corporation requires someone (called "an incorporator")[2] to file articles of incorporation with the designated official of the state, and pay a filing fee. The articles of incorporation under the laws of most states require just the name of the corporation, the address of its registered office and agent (for service of process), the number of shares that the corporation is authorized to issue,[3], and the name of its incorporator. Generally speaking, that's pretty much it, though. The specific requirements of Delaware and of Kentucky are listed in the table below.

[2] This does not need to be a natural person, and in fact there is a large cottage industry of firms called "service companies" that will incorporate a business and serve as its process agent for you.

[3] a.k.a. "sell". This is to let investors know exactly how much of a corporation's shares are potentially available. We'll discuss authorized shares in more detail in Chapter 5.

Under the DGCL, 8 Del. C. §102:

1. A name – which must contain “association,” “company,” “corporation,” “club,” “foundation,” “fund,” “incorporated,” “institute,” “society,” “union,” “syndicate,” or “limited,” (or abbreviations thereof, with or without punctuation)
2. The address of registered office and the name of the registered agent
3. The purpose of the corporation – can be "any lawful act or activity"
4. The number of shares that the corporation is authorized to issue
5. The name and address of the incorporator(s)
6. The names and addresses of the initial directors (if not the incorporator(s))

Under Kentucky law, KRS §271B.2-020:

1. A name – which must contain "corporation," "company," or "limited" or the abbreviation "Corp.," "Inc.," "Co.," or "Ltd." or words or abbreviations of like import in another language". KRS §14A.3-010.
2. The number of shares that the corporation is authorized to issue
3. The name and address of the registered office and the registered agent
4. The address of the corporation’s principal office
5. The name and address of the incorporator

Beyond what a corporation **must** have in its articles of incorporation, there are a number of things that state laws permit an incorporator to put in the articles. For example, articles may include:[1]

- The purpose of the corporation.[2]
- Provisions defining or limiting the powers of management and the corporation and its shareholders.
- In many states (including Delaware and Kentucky), a provision eliminating or limiting the personal liability of a director for money damages resulting from a breach of the duty of care stemming from director negligence.[3]
- A provision imposing personal liability for the debts of the corporation on its shareholders.[4]
- In Delaware, a provision granting existing shareholders preemptive rights to any new issuance of stock.

As you can see, the list of optional provisions for the articles of incorporation varies from state to state and can be quite extensive, but the requirements are scant. As such, articles of incorporation tend to be quite short. So short, in fact, that the current operational Certificate of Incorporation[5] for Amazon.com – a globe-spanning behemoth of a corporation worth $1,380,000,000,000 at the time this paragraph was drafted – can be reproduced on a single page of this book.[6]

[1] Not an exhaustive list by any means.

[2] There was an old timey doctrine called "Ultra Vires" that prohibited corporations from taking action outside of their designated corporate purpose. This doctrine is extremely dead now, and most corporations just say "organized for the purpose of any and all lawful activity" if they have to list a purpose at all.

[3] This one is quite popular, as you might imagine.

[4] This one is extremely unpopular, as you might imagine.

[5] The Delaware term for articles of incorporation.

[6] With, admittedly, *extremely small type*.

RESTATED CERTIFICATE OF INCORPORATION
OF
AMAZON.COM, INC.

Amazon.com, Inc., a corporation organized and existing under the General Corporation Law of the State of Delaware, does hereby certify:

1. The original Certificate of Incorporation was filed with the Secretary of State on May 28, 1996.

2. A Certificate of Amendment was filed with the Secretary of State on May 27, 2022, which effectuated a subdivision and reclassification of each issued share of Common Stock into 20 shares of Common Stock.

3. The following Amended and Restated Certificate of Incorporation was duly adopted by the corporation's Board of Directors in accordance with the provisions of Sections 242 and 245 of the General Corporation Law of the State of Delaware and only restates and integrates and does not further amend the provisions of the corporation's Amended and Restated Certificate of Incorporation as heretofore amended and supplemented, and there is no discrepancy between those provisions and the following.

ARTICLE 1. NAME
The name of this corporation is Amazon.com, Inc.

ARTICLE 2. REGISTERED OFFICE AND AGENT
The address of the registered office of this corporation is 251 Little Falls Drive, City of Wilmington, County of New Castle, State of Delaware 19808, and the name of its registered agent at such address is Corporation Service Company.

ARTICLE 3. PURPOSES
The purpose of this corporation is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware.

ARTICLE 4. SHARES
The total authorized stock of the corporation shall consist of 100,000,000,000 shares of Common Stock having a par value of $.01 per share and 500,000,000 shares of Preferred Stock having a par value of $.01 per share. Authority is hereby expressly granted to the Board of Directors to fix by resolution or resolutions any of the designations and the powers, preferences and rights, and the qualifications, limitations or restrictions which are permitted by Delaware General Corporation Law in respect of any class or classes of stock or any series of any class of stock of the corporation. The corporation shall from time to time in accordance with the laws of the State of Delaware increase the authorized amount of its Common Stock if at any time the number of shares of Common Stock remaining unissued and available for issuance shall not be sufficient to permit the conversion of Preferred Stock.

ARTICLE 5. DIRECTORS
The number of Directors of the corporation shall be determined in the manner provided by the Bylaws and may be increased or decreased from time to time in the manner provided therein. Written ballots are not required in the election of Directors.

ARTICLE 6. BY-LAWS
The Board of Directors shall have the power to adopt, amend or repeal the Bylaws of the corporation; provided, however, the Board of Directors may not repeal or amend any bylaw that the stockholders have expressly provided may not be amended or repealed by the Board of Directors. The stockholders shall also have the power to adopt, amend or repeal the Bylaws for this corporation.

ARTICLE 7. PREEMPTIVE RIGHTS
Preemptive rights shall not exist with respect to shares of stock or securities convertible into shares of stock of this corporation.

ARTICLE 8. CUMULATIVE VOTING
The right to cumulate votes in the election of Directors shall not exist with respect to shares of stock of this corporation.

ARTICLE 9. AMENDMENTS TO CERTIFICATE OF INCORPORATION
This corporation reserves the right to amend or repeal, by the affirmative vote of the holders of a majority of the outstanding shares entitled to vote, any of the provisions contained in this Certificate of Incorporation. The rights of the stockholders of the corporation are granted subject to this reservation.

ARTICLE 10. LIMITATION OF DIRECTOR LIABILITY
To the full extent that the Delaware General Corporation Law, as it exists on the date hereof or may hereafter be amended, permits the limitation or elimination of the liability of directors, a director of this corporation shall not be liable to this corporation or its stockholders for monetary damages for breach of fiduciary duty as a director. Any amendment to or repeal of this Article 10 shall not adversely affect any right or protection of a director of this corporation for or with respect to any acts or omissions of such director occurring prior to such amendment or repeal.

ARTICLE 11. ACTION BY STOCKHOLDERS WITHOUT A MEETING
Only action properly brought before the stockholders by or at the direction of the Board of Directors may be taken without a meeting, without prior notice and without a vote, if a written consent setting forth the action so taken is signed by the holders of outstanding shares of capital stock entitled to be voted with respect to the subject matter thereof having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all shares entitled to vote thereon were present and voted.

ARTICLE 12. SPECIAL MEETING OF STOCKHOLDERS
The Chairman of the Board of Directors, the Chief Executive Officer, the President or the Board of Directors may call special meetings of the stockholders for any purpose. A special meeting of the stockholders shall be held if the holders of not less than twenty-five percent (25%) of all the votes entitled to be cast on any issue proposed to be considered at such special meeting have dated, signed and delivered to the Secretary one or more written demands for such meeting, describing the purpose or purposes for which it is to be held.

ARTICLE 13. BUSINESS COMBINATIONS WITH INTERESTED STOCKHOLDERS
The corporation expressly elects not to be governed by Section 203(a) of Title 8 of the Delaware General Corporation Law.

IN WITNESS WHEREOF, the corporation has caused this Restated Certificate of Incorporation to be signed by its duly authorized officer this 27th day of May, 2022.

AMAZON.COM, INC.
By /s/ David Zapolsky
David Zapolsky,
Senior Vice President, Secretary, and General Counsel

Some notes:

1. The original Certificate authorized 25,000,000 common shares and 5,000,000 preferred shares. It was amended on April 18, 1997 to authorize 100,000,000 common shares and 10,000,000 preferred shares. It was amended again on May 10, 2000 to authorize 5,000,000,000 common shares and 500,000,000 preferred shares. It was amended again on May 18, 2020 to reduce the threshold for stockholders to call a special meeting from 30% of outstanding shares to 25% of outstanding shares. Just four amendments in twenty-five years, three of which were to authorize more shares.

2. As to Article 7, Amazon is expressly banning preemptive rights for shareholders, which means it can issue new shares without having to offer them to existing shareholders first.

3. As to Article 10, under §102(b)(7) of the DCGL, Articles can contain "a provision eliminating or limiting the personal liability of a director to the corporation or its shareholders for monetary damages for breach of fiduciary duty as a director, provided that the provision does not eliminate or limit the liability of a director (i) for any breach of the director's duty of loyalty to the corporation or its shareholders, (ii) for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law, (iii) under §174 of this Act, or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring before the date when the provision becomes effective."[1] The comparable section under Kentucky law is KRS §271B.2-020(2)(D).

4. As to Article 13, under §203(a) of the DCGL, "a corporation shall not engage in any business combination with any interested stockholder for a period of 3 years following the time that such stockholder became an interested stockholder", unless the corporation expressly chooses to opt out of the requirement in their articles. Amazon opted out.

Aside from saving on the cost of paper, why keep the articles of incorporation short? One major reason is that – as I mentioned before – the articles can only be amended by vote of the shareholders, whereas the corporation's bylaws can be amended by the board of directors acting alone. As such, in order to maintain maximum flexibility, many of the important decisions for the corporation – the powers of the officers, the voting rights of the shareholders, the number of directors,[2] the procedures for board elections, etc. – get kicked to the bylaws, where management has a greater degree of control.

[1] This provision was added to the Delaware corporate statute as a a direct response to the decision in *Smith v. Van Gorkom*, which we will cover in Chapter 7.

[2] Under both Delaware and Kentucky law, a corporation must have at least one director.

After filing the articles, the incorporator(s)[1] must hold a meeting. At this meeting, the board of directors is elected, the officers are appointed, and the bylaws are adopted.[2] Beyond these formalities, the board also designates a bank account for corporate funds[3] and approves the issuance of stock to the corporation's initial shareholders. This first meeting can be held in-person, on the phone, on a video call, or can be done via the written consent of each of the incorporators and/or initial board members.[4]

[1] Or directors, if the initial directors were named in the articles.

[2] You can get generic bylaws and other corporate forms from whatever service company you use.

[3] Commingling personal and corporate funds is a big no-no.

[4] I don't think it can be done via text message, or group chat, or Instagram DMs, or whatever. Not yet, anyway.

If this all seems pretty straightforward and looks like it should be a quick and easy process – particular if you employ a service company, which I recommend – well, it is. Nevertheless, there are two doctrines of law that I am compelled to explain, even though they very, very rarely arise in the modern era.[5] These are the doctrines of *promoter liability* (liability for pre-incorporation contracts), and *defective incorporation* (liability for a corporation that was never actually incorporated).

[5] In ye olden days, it was a longer and more complicated process to set up a corporation, leading to (1) a period of time in between when a person intended to form a corporation and actually formed the corporation, and (2) some pretty bad screw-ups.

Pre-Incorporation Promoter Liability

Corporations come into existence with the filing of the articles of incorporation. What promoter liability for pre-incorporation transactions presupposes is:[6] what if the corporation doesn't exist yet? In that case, the law of agency's rules about agent liability for a non-existent principal kick in, and a promoter[7] who enters into a contract on behalf of a corporation not-yet-formed is personally liable for that contract. Moreover, even if the corporation (once formed) adopts the contract, the agent is not automatically off the hook.

[6] Read this in Owen Wilson-in-*The Royal Tenenbaums*-voice here.

[7] This always sounds like some sort of carnival barker, but it just means a person who is acting on behalf of a corporation that doesn't exist yet.

In order for a promoter to escape liability, they must contract with the third party and agree that once the contract is novated[8], they are no longer personally liable for the contract and the newly-existing corporation is.

[8] A novation is an agreement between the original parties to a contract and a new party to substitute the new party in for one of the original parties. Consent of errrrrybody is required for a novation.

While some states use a multi-part test for determining the intent of the parties in entering into the pre-incorporation contract, Kentucky uses a blissfully straightforward analysis: if the promoter knew that no corporation existed at the time of the contract, then the promoter is liable on that contract until the parties execute a novation.[9] Bam. Done. Easy.

[9] *See Accord Pierson v. Coffey*, 706 S.W.2d 409 (Ky. App. 1985).

Defective Incorporation

A defective incorporation, by contrast, occurs when both parties (the third party and the agent for the corporation) mistakenly believe that a corporation exists, when in fact it doesn't. The question for courts is whether to impose contractual liability on or equitably hold harmless the agent for the non-existent corporation. There are two doctrines that courts apply to determine this question, but in reality they tend to blend together.

1. *De Facto Corporation*: Under this doctrine, courts will infer limited liability if there has been a good faith attempt to incorporate, the agent was unaware that incorporation had not happened, and the agent used the corporate form with a third party.

2. *Corporation by Estoppel*: Under this doctrine courts will prevent a third party from asserting the promoter's personal liability when there has been no attempt to incorporate but the third party assumes that they are dealing with a corporation.[1] In these cases, not recognizing limited liability would create a windfall for the third party.

[1] Does this remind you of a case we've read? Something involving the purchase of an inordinate amount of salmon?

While there are real differences between these tests – *de facto* corporation looks to the mental state and the actions of the agent, while corporation by estoppel looks to the reasonable beliefs and actions of the third party – courts generally look to whether the agent acted in good faith when it was bargaining with the third parties. If the agent was reasonably innocent of the error, courts will impose liability on the *de facto* corporation instead of the would-be agent.

Kentucky went so far as to codify the *de facto* test, and the resulting statute explicitly says that liability will attach unless the agent had absolutely no knowledge of the defective incorporation.[2] Once again, Kentucky's out here keeping it tight.

[2] "All persons purporting to act as or on behalf of a corporation, knowing there was no incorporation under this chapter, shall be jointly and severally liable for all liabilities created while so acting". KRS §271B.2-040.

The Corporate Lawyer's Responsibilities

Finally, a quick word about lawyering for the corporation. This will hopefully be covered in more detail in whatever Professional Responsibility/Legal Ethics/Please Don't Get Disbarred Before You Donate Money To Us course you take in law school, but when a lawyer signs up to represent a corporation – either pre-formation or post-formation – the most important thing is for that lawyer to know is exactly who they are representing.

There are two understandings of attorney-client relationships in the corporate context. The first is the "entity" theory, in which the lawyer represents the corporation by itself and not any of the founders, managers, etc. This is the least ethically messy approach, as there is no conflict if the lawyer needs to represent the corporation against an individual involved with the corporation. Unfortunately, it is hard to draw and enforce a strict line between the corporation and the corporation's managers/investors, particularly when it comes to forming a corporation.

The other approach is the "aggregate" theory,[1] under which the lawyer represents the corporation and the individuals involved with the business – the incorporators, board members, officers, etc. Because of the possibility of conflict between these parties, the lawyer operating under aggregate representation must get informed consent from each of the parties before embarking on their representation. Aggregate representation does have advantages, though, both in terms of cost savings for the clients but also in that the lawyer can assess and act on behalf of all the parties' interests and negotiate a transaction that benefits all the parties. This is particularly helpful pre-incorporation, where the lawyer can be extremely useful in setting up a corporate structure that meets the needs of all the clients.

[1] Louis Brandeis called this being the "lawyer for the situation".

Regardless of which path the lawyer takes, the lawyer must let everyone know exactly who they are representing – if the potential client has not been specifically told, then the client's "reasonable belief" controls whether there was an attorney-client relationship – and if a conflict arises than that lawyer must withdraw. These issues can arise in a number of circumstances, but they become even more pronounced if a lawyer takes a role in managing the corporation that they also represent – by, for example, taking a seat on that corporation's board. In that case, the lawyer must be clear on who they represent,[2] but also be extremely clear about whether they are offering advice as a lawyer (to a specific client) or in their role as a corporate manager.[3] When a lawyer gets sloppy with this, bad things can happen. What kind of bad things?

[2] The corporation? The board? The individual board members? Everyone?

[3] The former can be privileged, the latter is not.

David Boies and Theranos

On September 21, 2018, James B. Stewart published an article in The New York Times entitled "David Boies Pleads Not Guilty." Prompted by a best-selling exposé on the Theranos scandal by John Carreyrou – "Bad Blood: Secrets and Lies in a Silicon Valley Startup" – Stewart had interviewed Boies at length about his involvement with Theranos and its CEO, Elizabeth Holmes, as well as his representation of Harvey Weinstein (the now-convicted sexual predator).

As recounted by Stewart, Boies began representing Theranos in 2011, having been very impressed by a presentation Holmes made to him regarding the claim that the company could accurately make medical diagnoses from a single blood prick of a person's finger. Boies was so impressed that he agreed to take half of his firm's fees in Theranos stock (approximately 400,000 shares; worth approximately $7 million at the company's high watermark). That constituted issue one – the wisdom of taking a financial stake in a client; does it affect a lawyer's independent/objective judgment? While there is no hard and fast rule against that practice, many "old line" firms prohibit it (at the same time a number of firms with large venture capital practices, especially in the Silicon Valley area, allow it). Well-known NYU Law Professor of Ethics Stephen Gillers has opined that the practice is "not categorically forbidden, but it has to be monitored closely to protect the client." For his part, Boies was not agnostic: "Anything that gives you an incentive to put the client's interest first is good for the client."

Four years later, Boies agreed to join the Theranos board of directors, having been told that "a difficult period [lay ahead] where both Theranos and Ms. Holmes would need the advice of a seasoned lawyer." This conflicts problem – highlighted in my earlier article – is not expressly forbidden by the profession's rules of ethics. The ABA, however, has discouraged this practice, warning about the pitfalls of lawyers serving as directors, and many firms prohibit partners from joining public boards for precisely this reason(s).

In that same year (2015), Carreyrou – a Wall Street Journal journalist – had begun his investigative reporting on Theranos. Boies and his law partners took offensive steps to make life difficult for Carreyrou. Besides having his partners send letters to suspected company leakers/sources threatening lawsuits, Boies wrote a 23-page letter to the Wall Street Journal about Carreyrou's investigative work. Boies, who says he has a policy of not suing media companies (or even threatening to sue them), claims that his letter did not threaten to sue the Journal; Carreyrou expressly disagrees. Suffice it to say the letter demanded that the Journal retain any and all materials that "would doubtless be highly relevant in any lawsuit."

Notwithstanding Boies's efforts, Carreyrou's first article on Theranos – a "bombshell," raising very serious doubt about the efficacy of the finger pricking results, lab research, and methodology – was published in October of 2015. Boies, in response, asked Holmes to have an independent third party verify Theranos's technology and work processes. As the new year started, however, there was no progress on that front. In addition, Holmes started looking for counsel beyond Boies's law firm; she also fired the company's general counsel – a former partner at the Boies firm.

By midsummer, Boies felt increasingly isolated and wanted to resign from the board. Not only did other Theranos directors ask him not to, but (according to Stewart) Boies's "own outside lawyer advised that as a director, he couldn't resign in a way that might damage shareholders." That advice, of course, highlights the tricky conflicts problem that Boies embraced by going on the board in the first place.

Then in August of 2016, Holmes made a rosy presentation to Theranos shareholders without consulting Boies. Boies responded by telling her he could not continue to represent her if she did not follow his advice: "If we are going to risk being at the scene of a serious accident, we want to have the steering wheel in our hands. . . . Because of the very public role we have taken in defense of the company, [my] firm's own credibility is at stake." Within a matter of days thereafter, Boies resigned as counsel. He nonetheless remained as a Theranos director until February of 2017, a month before the SEC charged both Holmes and Theranos with a fraud on shareholders costing more than $700 million.

The SEC was just the beginning for Holmes; as indicated above, she was subsequently indicted for the same alleged conduct. A pretrial ruling on Holmes's right to assert attorney-client privilege in the criminal trial highlights another problem inherent in Boies wearing two hats.

This problem became further complicated when the government made a pretrial motion to have 13 Theranos corporate documents be deemed admissible for trial against Holmes. She opposed the motion on the ground that the materials were confidential, subject to her individual attorney-client privilege. On June 3, 2021, a federal magistrate judge granted the government's motion, with the 13 documents admitted for trial.

As recounted by the magistrate judge, the Boies firm began its representation in 2011 of both Holmes and Theranos in an intellectual property dispute. Thereafter, the Boies firm broadened that dual representation to "a variety of legal services in relation to Theranos' patent portfolio, press interactions, and inquiries from government agencies and departments." Notwithstanding, there was never an engagement letter executed between Holmes and the Boies firm, nor were there "any formal guidelines describing the scope of [the firm's] legal representation" of Holmes. The magistrate judge then noted that "Holmes believed that [Boies and his firm] were her attorneys up to the point when she retained separate counsel to represent her in the Securities and Exchange Commission and Department of Justice investigations into Theranos in 2016."

The magistrate judge ruled that, out of the five prongs [of the legal test for whether a lawyer represents the invididual or the corporation], Holmes failed on the second, fourth, and fifth. The second prong is that Holmes could not demonstrate that she made it clear to Boies that she was seeking his legal advice as an individual rather than as the CEO of Theranos. Key to the magistrate judge's determination was the fact that there was no Holmes-Boies engagement letter. The fourth prong is that Holmes could not demonstrate that her communications with Boies were confidential because the 13 documents reflect communications "between Holmes or other senior Theranos employees, Theranos in-house attorneys, and [the Boies law firm]." And the fifth prong is that Holmes could not demonstrate that the communications "did not concern matters within. . . . the general affairs of the company." Based upon those determinations, and the fact that the entity now in charge of Theranos (the "Assignee") was waiving the corporate privilege, the documents were ruled admissible.

The third prong is whether Boies communicated with Holmes in her individual capacity, knowing that a possible conflict could arise. Missing completely from the magistrate judge's decision is whether Boies in any way met his ethical duty to inform Holmes that Theranos – and not she – was his only client and that any privilege that would attach to their communications would be owned by Theranos, not her. This ethical duty, mandated by Rule 1.13, is properly known as the Corporate Miranda Warning. Such a warning would have been particularly important (i) given that Holmes, in light of her CEO position and her total control of Theranos stock, really was the company, and (ii) given that this warning has been the subject of well-publicized litigation in the Ninth Circuit (case law which was even cited by the magistrate judge). The absence of any record of Holmes being given this warning at any time between 2011 and 2016 is (at a minimum) problematic and gives pause as to whether the magistrate judge was right in not giving sufficient weight to Holmes's subjective belief (in the absence of the Rule 1.13 warning).

Many (but not all) of the foregoing miscues (ethical and otherwise) could have been avoided if Boies had not put on a director hat. But he did, and now he is one of the government's key witnesses against the former CEO of his client (who thought he was her lawyer). We will find out if the trial reveals what benefit(s) accrued to Theranos and Holmes from the "advice of a seasoned lawyer."[1]

[1] C. Evan Stewart, "USA v. Holmes: Why Lawyer-Directors Are a Bad Idea", New York State Bar Assocation (2001).

5. *Corporate Finance*

Now we're rolling – we have a corporation, we have shareholders, we have a board of directors ... mama, we made it! What else, though, does a corporation need? If you said "a bunch of three-quarter zip flannel vests with a company logo" to give to the corporation's employees, you're right! But also: **money**. Corporations need money. How they get money is important not just for the success of the business of the corporation, but also in terms of who gets what sort of say over what the corporation does.

Some economists, being utterly and completely useless at studying things like, say, business, have argued that under ideal circumstances[1] the actual method of financing does not affect the overall value of the company.[2] Any lawyer on earth – or honestly, anyone with a functioning brain stem – could tell you this isn't true, however, as each method comes with various rights and obligations owed to different parties, which can dramatically effect the corporation and its success or failure. To begin, we'll examine the two basic forms of corporation finance: debt and equity.

[1] Assume a can opener ...

[2] Specifically, this was the honest-to-fucking-God theory of an actual famous paper by two future (fake) Nobel-prize-winning economists, Franco Modigliani and Merton Miller. Now, you might ask, isn't it a little unfair to cite a single paper with a howlingly stupid idea at its core and hold it up as emblematic of an entire academic discipline? Wouldn't it be terrible if economists picked a single article from another discipline and used it to levy a generalized critique against an entire field? To which I say: yeah, that would suck, but it would also require an economist to read and cite a paper from outside their field, which means that it will *never fucking happen*.

Franco Modigliani and Merton H. Miller. The Cost of Capital, Corporation Finance and the Theory of Investment. The American Economic Review, 48(3):261–297, 1958

The Capital Structure

A corporation's "capital structure" is a precise accounting of from whom the corporation has gotten money, and to whom – and how – it owes money. This consists of (1) debt (money given as a lump sum with an obligation to pay it back over time and with interest), (2) equity (money given as a lump sum with no obligation to pay it back, but which entitles the equity investor to share in distributions from the corporation), (3) debt that can be converted into equity, and (4) equity that can be converted into debt. That's it: debt, equity, and some liminal spaces in-between. Anyone trying to convince you that it's more complicated than that is trying to sell you something.

Types of Corporate Finance

When a corporation takes on debt or sells equity in itself, it is "issuing corporate securities". Debt securities – i.e., "bonds" or "notes" – give the holder a contractual right to the return of the original money lent to the corporation, a contractual right to some amount of interest,[1] and a superior claim to the corporation's assets in liquidation. Equity securities – i.e., stock – promise the holder a piece of future profits from the business, a vote in determining who gets to run the corporation,[2] and an inferior claim to the corporation's assets in liquidation. Equity securities thus give buyers a greater share of the upside if a business succeeds, as well as more power in determining how a corporation is run; debt securities give buyers a more predictable payout for their money, as well as more power over a corporation's assets if the business fails. While debt is extremely necessary – and arguably forms the basis for civilization[3] – debt is also kind of a downer, so let's discuss it first.

[1] This amount can be zero.

[2] Note that a corporation can sell stock that lacks voting rights, but this tends to be rare, and in any event a corporation cannot convert voting shares to non-voting shares without shareholder consent.

[3] In addition to the fact that any modern economy requires debt to function, there is evidence that the written word developed in various parts of the world out of a need for a system to keep track of debts and payments.

The amount of initial debt the corporation takes out is called the "principal", and the periodic payments the corporation makes to the buyer of the debt security (the "debtholder" or "bondholder") are called "interest". A typical corporate bond requires the corporation to pay out the entirety of the principal on some specified date in the future,[4] while making periodic interest payments (called the "coupon" payments). Other kinds of debt require the borrower to make periodic payments of both interest and principal.[5]

[4] Corporations with really good credit can offer bonds that pay out after a long time period (up to 25 years!), while other corporations make do with shorter time payouts.

[5] This is the way the vindictive bastards who gave you your student loans have structured your payments, just FYI.

Bonds also differ according to the type of interest payments they offer. With a fixed coupon rate, the coupon payments stay the same regardless of changes in market interest rates. Other bonds offer floating rates that are reset periodically; these bonds adjust their interest payments to changes in market interest rates. I'm falling asleep while writing this paragraph.

The terms of a bond are fixed by a contract called an "indenture". Note that while an indenture cannot give the bondholder a vote for management the way that a share gives a shareholder a vote, an indenture can specify certain restrictions (called "covenants") on corporate activity for the duration of the loan.[6] We've seen this sort of thing before (think *Martin v. Peyton*), and bondholders go to great lengths to avoid excessive entanglement in their borrowers' businesses while maintaining a degree of control over how corporate assets are distributed. If a borrower violates the terms of the indenture – through nonpayment or by breaching a covenant – they deemed to be in default, and the bondholder can initiate proceedings against them in order to get their money back.

[6] E.g., no additional debt without bondholder approval, no payouts to shareholders until bond repayment, etc.

SOME IMPORTANT FEATURES OF DEBT:

- Interest payments made on corporate debt are tax-deductible (for the corporation). Distributions to shareholders? Not so much.
- Corporations do not need shareholder approval to take on debt, whereas issuing more stock may require shareholder approval.
- In bankruptcy, creditors have a superior claim to the corporation's assets over lowly shareholders. So, if a company goes bankrupt with $100mm in debt and $80mm in assets, the creditors will get all the assets and the shareholders won't get a dime. This is called "seniority" in bankruptcy, and while debt is always senior to equity, seniority varies among creditors as well.[1]
- Debt can be "secured" or "unsecured". Secured debt is debt where the borrower put up collateral – specific assets of the corporation that the debtholder can seize in event of default on the debt. Unsecured debt (sometimes but not always called a "debenture") is debt where the borrower puts up no collateral, and is essentially telling the debtholder: "I'm good for it, bro." Secured debt is always senior to unsecured debt.
- The directors and officers of the corporation (and the corporation itself, too, for that matter) owe no fiduciary duties to debtholders. The only thing that governs the relationship between the corporation and one of its debtors is the contract they entered into.
- Debt can be convertible, meaning upon some trigger it can be converted into equity by one of the parties.[2]

[1] The ranking of debt by priority is subject to a world-historically stupid naming system. A debt that has the highest priority in bankruptcy is called "first lien". A debt that has the lowest priority in bankruptcy is called "second lien". A debt that is in between those is called "1.5 lien". If you wanted to add some new debt and prioritize it below the existing second lien debt, you'd need to bump the existing second lien up to "1.75 lien" and make the new debt the second lien. What I'm saying is that if you ask someone who works in the bond markets about the number "3", they will look at you quizzically for a few seconds and then politely ask you to leave.

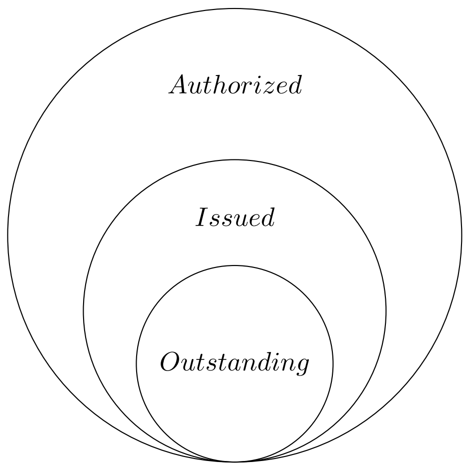
[2] Shareholder approval might be necessary for this, though, if the corporation has run out of available shares to give the bondholder.

I've officially run out of everything I know about debt and bankruptcy and the bond market. Let's move on to equity.

EQUITY SECURITIES come in two basic types: *common* and *preferred* shares, which we'll discuss in a minute. In order to issue – that is, to create and sell – these shares, they must first be *authorized* by the articles of incorporation. If a corporation has already created and sold all the shares authorized by the articles, it cannot create any more shares to sell unless it amends its articles to allow it do so.[3] Shares that a corporation has created and sold are called *issued* shares; shares that a company hasn't yet created are called *authorized but unissued*. Once sold, a corporation can buy back its own shares from shareholders and hold on to them until it wants to sell them again. These shares are *issued but not outstanding*, and are called *treasury shares* – they have been created and issued but they aren't actually held by anyone and cannot be voted or give dividends. The shares that have

[3] This has led to an extremely stupid situation at AMC Entertainment Holdings Inc., which desperately wanted to sell more common shares into a hot market for so-called "meme" stocks but had already sold all of its authorized common shares and couldn't get enough of its existing shareholders to pay attention long enough to amend its articles of incorporation. As of press time, it is currently attempting a quasi-legal end run around this self-inflicted debacle by issuing a batch of special convertible preferred shares that have all of the legal rights of common shares but aren't technically common shares.

been created and sold and are held by investors (and not the corporation) are called *outstanding* shares. Outstanding shares are the shares that can vote, that can be traded among the shareholders, and that receive distributions from the corporation.



As the figure above demonstrates, the number of authorized shares is the cap on the total number of shares that can be issued, and the number of issued shares is the cap on the number than can be outstanding at any given time. Basically, the count of *authorized* shares tell you the number of shares that could potentially matter, and the count of *outstanding* shares tell you the number of shares that actually matter right now.[1]

Outside of the articles of incorporation limiting the number of authorized shares, is there anything restricting the issuance of new shares? Yes and no. Yes, if the corporation is a publicly-traded corporation listed on a national exchange (such as the Nasdaq or the New York Stock Exchange). Those organizations have rules that require that any issuance of new shares that constitutes more than 20% of the existing shares of the corporation be approved by the corporation's shareholders. And also yes, if the corporation is incorporated in a state where the state corporation statute requires a shareholder vote for the issuance of a significant number of new shares (usually subject to the same 20% threshold given by the exchanges). But the answer is no if the corporation is incorporated in Delaware or Kentucky or any of the other states that have no such statutory restrictions (and is also not listed on an exchange). For investors in those corporations, the only way to stop the issuance of new shares is to allege an unlawful dilution of existing shareholders, a concept that we will analyze later in this chapter.

[1] A corporation's market capitalization – or "market cap", a rough assessment of the value of a company – is calculated by multiplying the number of outstanding shares by its current share price. This is – again, very roughly speaking here – the best estimate for the amount of money it would take to buy the corporation from its shareholders outright.

Common Shares, Preferred Shares, and Stock Options

COMMON SHARES are the standard kind of stock. Every corporation issues common shares, and most corporations issue *only* common shares. Common shares entitle the holder to the basic rights and entitlements of a shareholder: the right to vote for management, the standing to sue for breach of duty, the ability to sell, and a pro rata claim to distributions from the corporation – either from dividends[1] or in liquidation. Common shares do not come with extra bells and whistles – there is no right for the corporation to repurchase them, they have the most junior claim on the assets of the corporation in bankruptcy, they do not have the right to convert to debt, etc. – and while they are owed a cut of any distribution, they are not guaranteed to receive any money from the corporation.

[1] Periodic payments to all shareholders from surplus money.

PREFERRED SHARES, by contrast, are shares that come with a different (and usually superior) set of rights and entitlements. The precise terms ("preferences") that apply to a set of preferred shares are determined by the board of directors when they are issued, but some popular features include:

- A dividend preference. This could be a fixed amount of money that is paid yearly or quarterly with each preferred share, or it could be that the preferred shares get a multiple of whatever dividend is paid to the common share. However it is structured, a dividend preference means that the preferred shareholders get paid first, and often more, than common shareholders.
- A liquidation preference. A liquidation preference gives the preferred shareholders a fixed amount of money in case of a sale (or liquidation) of the corporation. Often this is expressed as a multiple,[2] but it could also be a flat amount per share or a specific percentage of return that is paid out to preferred shareholders before common shareholders. Note that preferred shareholders do not get priority over creditors in bankruptcy – only priority over common shareholders.
- A redemption preference. Ordinarily when someone purchases equity in a corporation, that money is gone baby gone, but preferred shares can come with the right to "redeem" – that is, the right to force the corporation to repurchase the shares at some agreed upon price.
- Voting rights. Preferred shares by default have the same voting rights as common shares, but this can be changed. Some preferred

[2] So a "2x" liquidation preference means that the preferred shareholder would get double the money they invested in the case of a sale. In other words, a preferred shareholder who paid $10m to buy preferred shares of a company would get $20m in the sale of that company, with the rest distributed to the other shareholders pro rata.

shares have no voting rights (that's what the money's for!), some give the preferred shareholders the right to elect a specific number of seats on the board, some withhold voting rights unless the corporation fails to pay a dividend, and still others give preferred shareholders the right to vote on specific transactions. The specific restrictions on the right to vote will be determined by the terms set by the board.

- Conversion rights. Often, preferred shares have the right to convert to either common shares (usually at some multiple of the existing preferred shares) or convert to debt upon some triggering event. Typically, an investor would want to convert to common shares when something good is happening for the corporation (such as an initial public offering of the shares), and convert to debt when something bad is happening for the corporation (losing money, change of leadership, etc.).

Preferred shares are often sold in blocks to large investors, usually early in a corporation's lifespan, and require a fair amount of negotiation between the board and the seller. To facilitate this process, many corporations have a "blank check" provision in their articles of incorporation that allows the board to set the terms of the preferred shares at the time they are sold, rather than having to specify them in advance.

Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040 (Del. Ch. 1997)

Allen, J.

The case now under consideration involves a conflict between the financial interests of the holders of a convertible preferred stock with a liquidation preference, and the interests of the common stock. The conflict arises because the company, Genta Incorporated, is on the lip of insolvency and in liquidation it would probably be worth substantially less than the $30 million liquidation preference of the preferred stock. Thus, if the liquidation preference of the preferred were treated as a liability of Genta, the firm would certainly be insolvent now. Yet Genta, a bio-pharmaceutical company that has never made a profit, does have several promising technologies in research and there is some ground to think that the value of products that might be developed from those technologies could be very great. Were that to occur, naturally, a large part of the "upside" gain would accrue to the benefit of the common stock, in equity the residual owners of the firm's net cash flows. (Of course, whatever the source of funds that would enable a nearly insolvent company to achieve that result would also negotiate for a share of those future gains — which is what this case is about). But since the current net worth of the company would be put at risk in such an effort – or more accurately would continue at risk – if Genta continues to try to develop these opportunities, any loss that may eventuate will in effect fall, not on the common stock, but on the preferred stock.

As the story sketched below shows, the Genta board sought actively to find a means to continue the firm in operation so that some chance to develop commercial products from its promising technologies could be achieved. It publicly announced its interest in finding new sources of capital. Contemporaneously, the holders of the preferred stock, relatively few institutional investors, were seeking a means to cut their losses, which meant, in effect, liquidating Genta and distributing most or all of its assets to the preferred. The contractual rights of the preferred stock did not, however, give the holders the necessary legal power to force this course of action on the corporation. Negotiations held between Genta's management and representatives of the preferred stock with respect to the rights of the preferred came to an unproductive and somewhat unpleasant end in January 1997.

Shortly thereafter, Genta announced that a third party source of additional capital had been located and that an agreement had been reached that would enable the corporation to pursue its business plan for a further period. The evidence indicates that at the time set for the closing of that transaction, Genta had available sufficient cash to cover its operations for only one additional week. A Petition in Bankruptcy had been prepared by counsel.

This suit by a lead holder of the preferred stock followed the announcement of the loan transaction. Plaintiff is Equity-Linked Investors, L.P. (together with its affiliate herein referred to as Equity-Linked), one of the institutional investors that holds Genta's Series A preferred stock. Equity-Linked also holds a relatively small amount of Genta's common stock, which it received as a dividend on its preferred. The suit challenges the transaction in which Genta borrowed on a secured basis some $3,000,000 and received other significant consideration from Paramount Capital Asset Management, Inc., a manager of the Aries Fund (together referred to as "Aries") in exchange for a note, warrants exercisable into half of Genta's outstanding stock, and other consideration. The suit seeks an injunction or other equitable relief against this transaction.

While the facts out of which this dispute arises indisputably entail the imposition by the board of (or continuation of) economic risks upon the preferred stock which the holders of the preferred did not want, and while this board action was taken for the benefit largely of the common stock, those facts do not constitute a breach of duty. While the board in these circumstances could have made a different business judgment, in my opinion, it violated no duty owed to the preferred in not doing so. The special protections offered to the preferred are contractual in nature. The corporation is, of course, required to respect those legal rights. But, aside from the insolvency point just alluded to, generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock – as the good faith judgment of the board sees them to be – to the interests created by the special rights, preferences, etc., of preferred stock, where there is a conflict. The facts of this case, as they are explained below, do not involve any violation by the board of any special right or privilege of the Series A preferred stock, nor of any residual right of the preferred as owners of equity.

Genta was started in 1988 by Dr. Thomas Adams who has served since as its CEO and Chairman. It is in the bio-pharmaceutical business with its principal facility in San Diego. It has three components. First, it owns various intellectual property rights with respect to a genetic research area known as "antisense". Its antisense activities involve research, development, and testing directed towards developing a treatment for certain cancers. It has developed no commercial products from its intellectual properties. Second, through a wholly owned subsidiary, JBL, Scientific Inc., Genta manufactures generic chemicals, pharmaceuticals, and intermediate products used by bio-pharmaceutical companies, including its own antisense business. It has a positive cash flow. Thirdly, Genta owns a 50% interest in a joint venture with SkyePharma PLC, which is involved in the development of a new oral drug delivery technology. It has not yet produced a positive cash flow. Indeed, both the antisense and drug delivery products are still entirely at the development stage. The company has never made a profit and has expended almost $100 million on research, development, and overhead since its founding. While this sounds bleak,[1] nevertheless, it is the case that some of its technologies, if they could be developed into marketable products, would be exceptionally useful and valuable.[2]

[1] And it does!

[2] And if a frog had wings ...

The Series A preferred stock was issued in 1993 at $50 per share. It carries a $50 per share liquidation premium ($30 million in total). It had a dividend paid in common stock for the first two years and earns a $5 per share cumulative dividend, payable if, as, and when declared for subsequent years. In the event of a "fundamental change,"[3] holders of Series A preferred stock would have an option to have their shares redeemed by the company at $50 per share, plus accrued dividends.

[3] This included the company delisting from Nasdaq, and a corporate bankruptcy would necessarily involve a delisting.

On December 24, 1996, Mr. Rosen, counsel to [plaintiffs], wrote Dr. Adams a letter expressing frustration that Genta had not yet accepted the proposal that the preferred stock had put forward. In addition to stating that Dr. Adams was causing Genta to "crash and burn," Mr. Rosen stated that:

> [Plaintiffs] will continue to try to bring about a resolution. However, if you wish to drive this bus into a canyon, no one can stop you. Just make sure you are alone when it happens.[1]

[1] Ooooh, threatening!

After Rosen received an update on a December 27 meeting, at which the board analyzed the most recent terms of the restructuring proposal, he again expressed his discontent. Mr. Rosen, obviously unaware that any possibility existed for Genta's board to get the financing necessary to attempt to accomplish its business plan, accused Genta's counsel of waiting for "sugar plum fairies" and of trying to "prolong the process and plunge Genta into Never Never Land."[2]

[2] Do you think this guy is mad? I think this guy is mad.

On December 30, 1996, the Genta board received a formal presentation of the Aries proposal. On January 28, 1997, the Genta board unanimously approved the Aries transaction. Plaintiffs learned of this transaction for the first time when they read a press release disclosing the transaction on the following day.

Pursuant to a January 28 letter of intent, Genta and Aries agreed to enter into a two step financing on the following terms. The first step, which by the time of trial of this case had already occurred, involved Aries loaning Genta $3 million in cash. In exchange, Aries received convertible secured bridge notes immediately convertible into 600,000 shares of Series D convertible preferred stock. In the event that Aries converts this preferred stock, Aries would receive 20 million shares of Genta common stock. Together the transaction offers Aries the right to acquire 40 million shares of Genta common stock – a controlling interest in the company.

Immediately prior to the hearing in this action, [Plaintiff] delivered a proposal to Genta that offered to extend a $3.6 million loan to Genta on the same terms as those reflected in the Aries transaction. This offer appears to have been an attempt by plaintiff to demonstrate that it would have been willing to do the same deal on terms at least as favorable as those offered by Aries.

The broad question is whether the foregoing facts constitute a breach of duty by the directors of Genta. The theory of the original complaint was that the Aries transaction represented a bad faith exercise of corporate power; that the purpose of the transaction was simply to protect the employment of the incumbent officers; and that a sweetheart deal with Aries was arranged in order to do that. Indeed, the discovery here showed that Aries was very much an arm's length negotiator and that there was no comfort offered to (or sought by) existing management. Rather, the evidence tends to show that the majority of the Genta board was motivated by a desire to see the enterprise finally pay-off by developing or participating in a portion of the development of some of its intellectual properties.

Based upon a preponderance of the admissible, credible testimony, it is my opinion, for the reasons set forth in this opinion, that the Genta board fully satisfied its obligations of good faith and attention with respect to the Aries transaction. The directors of Genta did not, therefore, breach a fiduciary duty owed to the corporation or any of its equity security holders.[1] I conclude that with respect to this transaction, the board was independent; it was motivated throughout by a good faith attempt to maximize long-term corporate value; and that the board and senior management were appropriately informed of alternatives available to implement the business plan that the directors sought to achieve. Moreover, if reviewed under a reasonableness criterion, I conclude that the board acted in an entirely reasonable way to achieve its goal and that its goal, although obviously one that reasonable minds could disagree about – was not one that was impermissible.

[1] The duty runs ... **deep sigh** ... to the corporation. The WHOLE POINT of this case is about how managers can choose different shareholder interests ... **rubs temples** ...

Some discussion questions:

1. Did the managers owe a duty to the preferred shareholders? Did they violate a duty?
2. What else could the preferred shareholders have done to protect themselves?
3. Equity-Linked (the plaintiff) makes a last-ditch loan offer – even though they had been pushing for a liquidation this whole time. Why did they do this?
4. Do you think plaintiff's counsel could have jammed any more mixed metaphors in there?

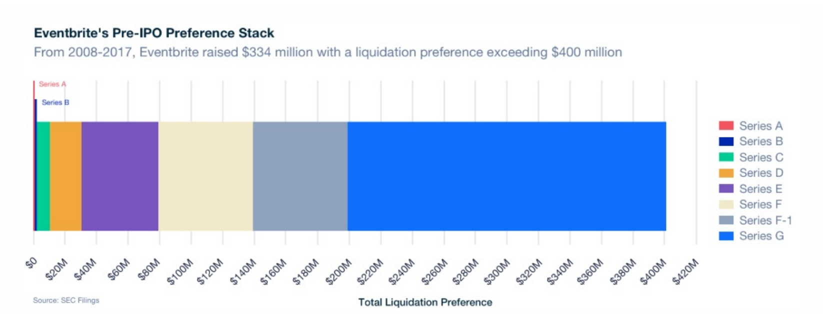
Options are financial instruments that give the holder the right to buy (or sell) a particular stock at a particular price during a particular period. When a corporation issues a stock option, it is giving the holder the right to buy that corporation's stock if the market price of the stock goes above a certain target price.[2] Stock options typically have a vesting period (during which the holder cannot exercise the option) and an expiration date (after which the holder can no longer exercise the option), and the price that triggers the option is called the "strike price". If the stock never hits the strike price during the period that the option is live, then the option expires and is worthless; however, if the stock goes above the strike price during that period, the holder can exercise the option and buy stock at the strike price, locking in a profit.

[2] This is called a "call" option. The opposite – the right to sell a stock if it falls below a certain price – is called a "put" option. Lots and lots of firms will buy and sell put options, but corporations generally do not issue put options on their own stock, as this is functionally a wager against the price of their stock going up, and that's what's legally called a "bad look".

Starting in the post-war period – and initially conceived of as a way to dodge income taxes – corporations began to compensate their managers with stock options in addition to salary. The argument then, and now, is that giving management the option to buy stock at a favorable price if the stock goes up aligns the incentives of shareholders and management, and gives managers an extra incentive to care about the stock price.[1] Over time, corporations began offering stock options to rank-and-file employees, either to entice them to work at a risky start-up or to simply keep them from switching jobs. These stock options typically involve common shares, which means that the interests of employees (common shareholders) may diverge from early investors (preferred shareholders) in the case of a sale of the corporation – something to watch out for, particularly in the case of tech start-ups, as illustrated by the graphic below.[2]

[1] Is it kind of infantilizing to think that a highly compensated CEO needs what is functionally a gratuity to do their job? A little! But also: maybe you might think about kicking me a few bucks when you're a big time fancy corporate lawyer – you know, keep me incentivized to teach this class real well. Think about it!

[2] With a total of $400mm in liquidation preferences already handed out, Eventbrite would need to sell itself for more than that in order for its common shareholders to get anything at all in the sale.



When Is Equity Actually Debt? And Vice Versa?

You might have noticed that both equity and debt can be convertible (that is, certain kinds of equity can become debt and vice versa), and that equity and debt can, through contract, take on characteristics of each other. How do courts determine when the line is crossed and one kind of corporate finance becomes the other kind? This is particularly important in corporate bankruptcies – where the categorization of debt and equity can determine priority – and in terms of taxes – where interest on debt is tax-deductible but payments to shareholders are not. The following case lays out the factors that courts examine when making that call.

Slappey Drive Industrial Park v U.S., 561 F.2d 572 (5th Cir. 1977)

Goldberg, J.

The tax code provides widely disparate treatment of debt and equity. In regard to a typical transfer at issue here, involving an individual's transfer of property to his corporation in exchange for the instrument in question, the classification as debt or equity may affect the taxation of the original transaction, the resulting bases and hence the taxation of subsequent transfers, and the taxation of payments the corporation makes to the shareholder with respect to the instrument. In the case at bar debt classification would greatly benefit the taxpayers.

Unfortunately, the great disparity in the tax treatment of debt and equity does not derive from a clear distinction between those concepts. The problem is particularly acute in the case of close corporations, because the participants often have broad latitude to cast their contributions in whatever form they choose. Taxpayers have often sought debt's advantageous tax treatment for transactions that in substance more closely resembled the kind of arrangement Congress envisioned when it enacted the equity provisions. Thus the labels that parties attach to their transactions provide no guarantee of the appropriate tax treatment.

Articulating the essential difference between the two types of arrangement that Congress treated so differently is no easy task. Generally, shareholders place their money "at the risk of the business" while lenders seek a more reliable return. That statement of course glosses over a good many considerations with which even the most inexperienced investor is abundantly familiar. A purchaser of General Motors stock may bear much less risk than a bona fide lender to a small corporation.

Nevertheless, the "risk of the business" formulation has provided a shorthand description that courts have repeatedly invoked. Contributors of capital undertake the risk because of the potential return, in the form of profits and enhanced value, on their underlying investment. Lenders, on the other hand, undertake a degree of risk because of the expectancy of timely repayment with interest. Because a lender unrelated to the corporation stands to earn only a fixed amount of interest, he usually is unwilling to bear a substantial risk of corporate failure or to commit his funds for a prolonged period. A person ordinarily would not advance funds likely to be repaid only if the venture is successful without demanding the potential enhanced return associated with an equity investment.

These considerations provide only imperfect guidance when the issue relates to a shareholder's purported loan to his own corporation, the usual situation encountered in debt-equity cases. It is well established that shareholders may loan money to their corporations and achieve corresponding tax treatment. When making such loans they could hardly be expected to ignore their shareholder status; their motivations will not match those of potential lenders who have no underlying equity interest. The "risk of the business" standard, though, continues to provide a backdrop for our analysis. While we should not expect a creditor-shareholder to evidence motivations and behavior conforming perfectly to those of a mere creditor, neither should we abandon the effort to determine whether the challenged transaction is in substance a contribution to capital masquerading as debt.

Rather than attempt to measure concrete cases against an abstract formulation of the overriding test, we have identified numerous observable criteria that help place a given transaction on one side of the line or the other. We have always recognized, however, that the various factors are not equally significant. The object of the inquiry is not to count factors, but to evaluate them. Each case turns on its own facts; differing circumstances may bring different factors to the fore.

With that preliminary caveat, we note the factors that prior cases have identified:

1. The names given to the certificates evidencing the indebtedness;
2. The presence or absence of a fixed maturity date;
3. The source of payments;
4. The right to enforce payment of principal and interest;
5. The participation in management flowing as a result;
6. The status of the contribution in relation to regular corporate creditors;
7. The intent of the parties;
8. "Thin" or adequate capitalization;
9. Identity of interest between creditor and stockholder;
10. Source of interest payments;
11. The ability of the corporation to obtain loans from outside lending institutions;
12. The extent to which the advance was used to acquire capital assets; and
13. The failure of the debtor to repay on the due date or to seek a postponement.

SOME THOUGHTS:

1. A lot of this course involves distinguishing one form of business from another. Have we seen any of these factors listed in *Slappey Drive* before?
2. Think about why a corporation would want to take on debt rather than issue equity, even when equity is functionally free money.
3. Think about why an investor would want their equity investment to be treated as debt, even when debt lacks the protection of fiduciary duties.

the famed Slappey Drive

Some Issues With Issuing

Let's say you create a corporation with a few friends of yours, hit on a brilliant idea,[1] and wouldn't you know it? Business is a-booming. You want to raise some more money to expand the business, so you decide to issue new shares in the corporation to outside investors. What kinds of problems might that create?

[1] Here's a free one: how about a USB drive where it doesn't matter whether you put the doohickey in right side up or not? Why is the USB drive basically the only one on your computer that is asymmetrical? Huh?

Dilution

The first thing that would happen upon issuing new shares to outsiders is that every current shareholder would see their proportionate ownership of the outstanding shares of the corporation *diluted*.[1] To put some numbers to this, let's say Corporation X is worth $6m, and that Shareholder A owns 3,000 shares while Shareholder B owns 3,000 shares. To raise money, Corporation X sells 3,000 new shares to Shareholder C for $3m. Shareholder A and B's ownership share has dropped from 50% each to 33% each. Dilution! Oh no!

[1] Another way of saying "reduced proportionally".

But while it is true that the voting power of A and B decreased, have either of them been harmed financially? Prior to the dilution, each of them owned 50% of a business worth $6m, so: $3m apiece. After the dilution, each of them owned 33% of a business worth $6m PLUS the $3m in cash money that the corporation got from the sale of the new shares, for a total value of $9m. 33% of $9m is ... $3m. While the sale of stock did reduce the existing shareholders' voting power in the corporation, it did not damage them financially (and if the price had been above market, they would have come out ahead in the transaction). So long as the board has determined that the compensation for the new shares is adequate, issuing new shares is legally permissible,[2] and absent actual financial harm – such as would occur if the corporation sold new shares at a steep discount to the going price, harming the shareholders' financial position – existing shareholders do not have a cause of action for dilution.

[2] Subject to any rules or statutes regarding shareholder approval, as mentioned earlier in this chapter.

How can a company issue new shares?

- *Through a public offering.* This is when a corporation sells newly issued shares on a stock exchange for purchase by both institutional investors and members of the public (aka "retail investors").
  - If the shares have not yet been publicly traded, this is called an initial public offering, and an underwriter (an investment bank) determines the price of the shares and then makes them all available for sale on a particular day.
  - If the shares are already publicly traded, this is called a secondary offering, and it is usually done "at the market", where an underwriter sells the new shares for their current price.
- *Through a private placement.* This is when a corporation sells a block of newly issued shares to an investor on terms negotiated between the parties. In a publicly-traded corporation, this is a "PIPE" – a private investment in public equity.

Protecting Voting Power

Do shareholders like being diluted, though? Generally speaking the answer is "no", as shareholders would largely prefer to maintain their relative positions within the capital structure, and also because sometimes investors view issuing new shares as a negative signal about the underlying business.[1] There are several ways for existing shareholders to protect their voting power in a corporation, though each of them presents their own challenges and issues.

[1] It should be noted that some shareholders don't mind, either because they are passive investors and don't care about their voting power, or because they simply aren't paying attention. Also, Elon Musk fanboys seem to love it when Tesla issues new shares, probably because of some weird parasocial attachment issues or latent sadomasochistic tendencies or maybe because they just aren't very bright.

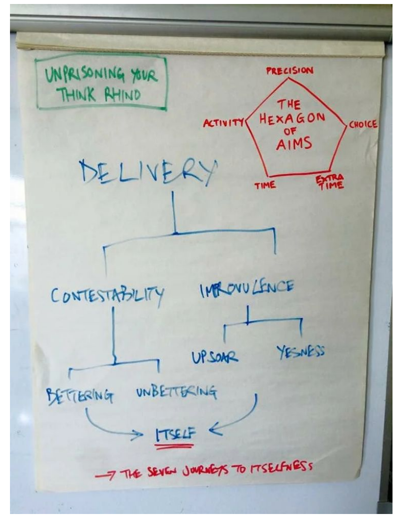
PREEMPTIVE RIGHTS. The old timey way to prevent dilution was through "preemptive rights", which was a common law doctrine that essentially guaranteed existing shareholders the right to maintain their proportionate ownership of shares in a corporation by giving them the right to buy a percentage of any new offering to match their existing percentage. This immediately became a huge headache for corporations and management, and effectively hamstrung new offerings for corporations with large and diffuse shareholder bases. Corporation statutes were modified to give corporations the right to *create* preemptive rights, but they are no longer the default for shareholders.

SHAREHOLDER AGREEMENTS. Another way to preserve power and prevent dilution is for shareholders to enter into agreements with one another. These agreements can give shareholders the right of first refusal over the sale of existing shares to a third party, or give a shareholder the voting power of other shareholders in order to maintain a voting bloc that can control the corporation. For example, when Facebook issued new shares to outsiders, Mark Zuckerberg entered into a shareholder agreement with several of the incoming investors that gave him an irrevocable proxy to vote those investors' shares in any shareholder vote.[2]

[2] A copy of it is on Canvas.

SUPERVOTING CLASSES OF STOCK. Another – and increasingly popular – way to maintain control is to issue supervoting classes of common shares to founders/insiders while issues standard shares to new shareholders. For example, Google (now Alphabet) has three classes of shares: Class A shares that have one vote per share, Class B shares that have ten votes per share, and Class C shares that have no votes per share. The Class B supervoting shares are held by Google's founders and key executives, and do not trade publicly. By virtue of having ten times the power of the regular shares, these insiders can maintain control over the company. These kinds of structures (sometimes called dual-class structures, though you can have more than just two classes) are somewhat controversial, and good corporate governance types often push for shareholder resolutions that abolish them and return to a one-share-one-vote structure. These proposals are always voted down, though, with the supervoting shares providing the margin of victory in favor of ... having supervoting shares.[1]

[1] Remember how earlier in the book, I was extolling the benefits of corporate democracy? Well, about that ...



hat tip: @jasonhazeley

Distributions to Shareholders

No matter what a corporation says its business is – "revolutionizing the concept of ideas" or "investing in the future of the spaces of living" or "unprisoning the think rhino" or whatever – most corporations are in the business of getting money to their shareholders, in what are called “distributions”. There are two main ways that corporations can do this: dividends and stock buybacks.

The first kind of distribution is a dividend (which we’ve talked about before). A dividend goes out to all shareholders, and is usually expressed as an amount-per-share in cash. Dividends do not have to be exclusively in cash, however, as corporations can also give their shareholders stock (in the corporation or in other corporations), property, or some combination of the three.[2] Dividends can be paid out monthly, or quarterly, or annually, or whenever the board wants to. A recurring dividend is called a "regular dividend" and a non-recurring dividend is called a "special dividend", but make no mistake: absent some sort of contractual requirement (such as with preferred shares), there is no legal requirement for the board of directors of a corporation to issue a dividend. Corporations can – and do! – sit on piles of cash instead of giving it back to their shareholders. Shareholders can get angry – and if enough shareholders get angry they can replace the board – but there is no legal avenue to force a dividend payment absent a breach of fiduciary duty.

[2] Also: crypto tokens, because sure, why not?

Kamin v. American Express, 86 Misc. 2d 809 (N.Y. Sup. Ct. 1976)

Greenfield, J.

In this stockholders’ derivative action, the complaint alleges that in 1972 American Express acquired for investment 1,954,418 shares of common stock of Donaldson, Lufken and Jenrette, Inc. (hereafter DLJ), a publicly traded corporation, at a cost of $29,900,000. It is further alleged that the current market value of those shares is approximately $4,000,000. On July 28, 1975, it is alleged, the board of directors of American Express declared a special dividend to all stockholders of record pursuant to which the shares of DLJ would be distributed in kind. Plaintiffs contend further that if American Express were to sell the DLJ shares on the market, it would sustain a capital loss of $25,000,000 which could be offset against taxable capital gains on other investments. Such a sale, they allege, would result in tax savings to the company of approximately $8,000,000, which would not be available in the case of the distribution of DLJ shares to stockholders. It is alleged that on October 8, 1975 and October 16, 1975, plaintiffs demanded that the directors rescind the previously declared dividend in DLJ shares and take steps to preserve the capital loss which would result from selling the shares. This demand was rejected by the board of directors on October 17, 1975.

Examination of the complaint reveals that there is no claim of fraud or self-dealing, and no contention that there was any bad faith or oppressive conduct. The law is quite clear as to what is necessary to ground a claim for actionable wrongdoing. "In actions by stockholders, which assail the acts of their directors or trustees, courts will not interfere unless the powers have been illegally or unconscientiously executed, or unless it be made to appear that the acts were fraudulent or collusive and destructive of the rights of the stockholders. Mere errors of judgment are not sufficient as grounds for equity interference; for the powers of those entrusted with corporate management are largely discretionary."

More specifically, the question of whether or not a dividend is to be declared or a distribution of some kind should be made is exclusively a matter of business judgment for the board of directors. "Courts will not interfere with such discretion unless it be first made to appear that the directors have acted or are about to act in bad faith and for a dishonest purpose. It is for the directors to say, acting in good faith of course, when and to what extent dividends shall be declared."Thus, a complaint must be dismissed if all that is presented is a decision to pay dividends rather than pursuing some other course of conduct. A complaint which alleges merely that some course of action other than that pursued by the board of directors would have been more advantageous gives rise to no cognizable cause of action. Courts have more than enough to do in adjudicating legal rights and devising remedies for wrongs. The directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions which will have an impact on profits, market prices, competitive situations, or tax advantages.

The minutes of the special meeting indicate that the defendants were fully aware that a sale rather than a distribution of the DLJ shares might result in the realization of a substantial income tax saving. Nevertheless, they concluded that there were countervailing considerations primarily with respect to the adverse effect such a sale, realizing a loss of $25,000,000, would have on the net income figures in the American Express financial statement. Such a reduction of net income would have a serious effect on the market value of the publicly traded American Express stock.[1] This was not a situation in which the defendant directors totally overlooked facts called to their attention. They gave them consideration, and attempted to view the total picture in arriving at their decision.

[1] Oh, really? I'll give you three guesses as to how the directors of AmEx are compensated.

What we have here as revealed both by the complaint and by the affidavits and exhibits, is that a disagreement exists between two minority stockholders and a unanimous board of directors as to the best way to handle a loss already incurred on an investment. The directors are entitled to exercise their honest business judgment on the information before them, and to act within their corporate powers. That they may be mistaken, that other courses of action might have differing consequences, or that their action might benefit some shareholders more than others present no basis for the superimposition of judicial judgment, so long as it appears that the directors have been acting in good faith. The court will not interfere unless a clear case is made out of fraud, oppression, arbitrary action, or breach of trust.

Some discussion questions:

1. Why did the board decide to cram this money-losing subsidiary down onto its shareholders?

2. Why give a board the discretion to set dividend policies? Why not make a rule setting the amount of dividends that a corporation must give its shareholders?

3. What if a shareholder has come to rely upon a corporation's dividends, and the corporation suddenly stops making distributions? Does the shareholder have any grounds for action?

The second kind of distribution is called a stock buyback, and it is exactly what it sounds like: the corporation offers to repurchase shares from existing shareholders at a certain price (usually, but not always, the market price). This is an increasingly popular choice for corporations, for several reasons. First, it allows shareholders that want to get out to sell and pay capital gains taxes on the sale (as opposed to income taxes on a dividend), while simultaneously giving greater voting power to shareholders who choose to stay (and shareholders who choose to stay in are generally more excited about the prospects of the company). It also reduces the number of outstanding shares, which can boost the corporations earnings-per-share metric. Finally, it signals to the market that the company is healthy and cool in a way that a boring old dividend apparently doesn't.

From a legal perspective, both cash dividends and stock buybacks are distributions from a corporation's surplus cash,[2] and thus subject

[2] Why do stock buybacks catch a lot of shit from politicians and dividends don't? You got me, dude.

to legal restrictions on distributions. The primary modern restrictions on distributions[1] are state laws prohibiting "unlawful distributions" – distributions that will render the corporation insolvent. The penalty for an unlawful distribution is harsh: if a corporation gives out so much money in a dividend or buyback that it cannot meet its obligations, then the corporation's creditors can go after the directors of the corporation for the amount they can no longer recover from the corporation.

[1] There is a ye olden days concept called "legal capital" that involves a Grandpa Simpson-ass story about filling cattle with water (?) and laws requiring shares to have a "par value" (say, for example, a dollar a share). In this regime, a corporation's legal capital was considered to be total of the par value of its shares, and thus there was a cushion of money that the corporation couldn't distribute to its shareholders. This extremely does not exist anymore, because it was extremely stupid. In states that still require a par value for shares you can set it as low as possible. Nobody cares.

However, it is not always easy to determine exactly when a corporation is insolvent (or when its capital is "impaired" to the point that it cannot pay its debts). In fact, there are many different accounting methods to determine the assets and liabilities of a going concern, as we see in the next case, the last of this chapter.

Klang v. Smith's Food Drug Centers, 702 A.2d 150 (Del. 1997)

Veasey, C.J.

Plaintiff in this purported class action alleges that a corporation's repurchase of shares violated the statutory prohibition against the impairment of capital. No corporation may repurchase or redeem its own shares except out of "surplus," as statutorily defined, or except as expressly authorized by provisions of the statute not relevant here. Balance sheets are not, however, conclusive indicators of surplus or a lack thereof. Corporations may revalue assets to show surplus, but perfection in that process is not required. Directors have reasonable latitude to depart from the balance sheet to calculate surplus, so long as they evaluate assets and liabilities in good faith, on the basis of acceptable data, by methods that they reasonably believe reflect present values, and arrive at a determination of the surplus that is not so far off the mark as to constitute actual or constructive fraud.

On January 29, 1996, Smith's Food and Drug ("SFD") entered into an agreement with The Yucaipa Companies ("Yucaipa"), a California partnership also active in the supermarket industry. Under the agreement, the following would take place:

1. Smitty's Supermarkets, Inc. ("Smitty's"), a wholly-owned subsidiary of Yucaipa that operated a supermarket chain in Arizona, was to merge into Cactus Acquisition, Inc. ("Cactus"), a subsidiary of SFD, in exchange for which SFD would deliver to Yucaipa slightly over 3 million newly-issued shares of SFD common stock;

2. SFD was to undertake a recapitalization, in the course of which SFD would assume a sizable amount of new debt, retire old debt, and offer

to repurchase up to fifty percent of its outstanding shares (other than those issued to Yucaipa) for $36 per share; and

3. SFD was to repurchase 3 million shares of preferred stock from Jeffrey Smith and his family.

SFD hired the investment firm of Houlihan Lokey Howard Zukin ("Houlihan") to examine the transactions and render a solvency opinion. Houlihan eventually issued a report to the SFD Board replete with assurances that the transactions would not endanger SFD's solvency, and would not impair SFD's capital in violation of 8 Del. C. § 160.[1] On May 17, 1996, in reliance on the Houlihan opinion, SFD's Board determined that there existed sufficient surplus to consummate the transactions, and enacted a resolution proclaiming as much. On May 23, 1996, SFD's stockholders voted to approve the transactions, which closed on that day. The self-tender offer was over-subscribed, so SFD repurchased fully fifty percent of its shares at the offering price of $36 per share.

[1] §160 of the DGCL says that a corporation may not "[p]urchase or redeem its own shares of capital stock for cash or other property when the capital of the corporation is impaired or when such purchase or redemption would cause any impairment of the capital of the corporation."

This appeal came to us after an odd sequence of events in the Court of Chancery. On May 22, 1996, the day before the transactions closed, plaintiff Larry F. Klang filed a purported class action in the Court of Chancery against Jeffrey Smith and his family, various members of the SFD Board, Yucaipa, Yucaipa's managing general partner Ronald W. Burkle, Smitty's and Cactus. On May 30, 1996, plaintiff filed an amended complaint as well as a motion to have the transactions voided or rescinded, advancing a variety of claims, only two of which are before us on appeal. First, he contended that the stock repurchases violated 8 Del. C. § 160 by impairing SFD's capital. Second, he alleged that SFD's directors violated their fiduciary duties by failing to disclose material facts relating to the transactions prior to obtaining stockholder approval.

After defendants answered the amended complaint, plaintiff took full discovery. The Court of Chancery heard plaintiff's motion to have the transactions rescinded, and released a Memorandum Opinion dismissing plaintiff's claims in full. Confusion arose out of the last sentence of the trial court's opinion, which reads, "Defendants' motion to dismiss is granted in its entirety." Defendants never filed a motion to dismiss. In effect, the Court of Chancery awarded full relief that was never requested, by granting a motion to dismiss that was never filed.[2]

[2] This is largely irrelevant to the actual legal questions raised by the claim, but I'm including it because it's hilarious. The Court invented a motion to dismiss and then granted it! The legal equivalent of throwing an alley-oop off the backboard to yourself. I'm in awe.

We find that this procedural error was harmless in this case. Although there should have been a more punctilious approach to procedural requirements, plaintiff was at fault for failing to draw to the trial court's attention an obvious mistake that could easily have been cured. It is clear, however, that plaintiff had a full opportunity to present his case, and that the trial court had before it a fully-developed factual record. Therefore, we affirm, notwithstanding this language in the Court of Chancery's opinion.

Plaintiff asked the Court of Chancery to rescind the transactions in question as violative of Section 160. As we understand it, plaintiff's position breaks down into two analytically distinct arguments. First, he contends that SFD's balance sheets constitute conclusive evidence of capital impairment. He argues that the negative net worth that appeared on SFD's books following the repurchase compels us to find a violation of Section 160. Second, he suggests that even allowing the Board to "go behind the balance sheet" to calculate surplus does not save the transactions from violating Section 160. In connection with this claim, he attacks the SFD Board's off-balance-sheet method of calculating surplus on the theory that it does not adequately take into account all of SFD's assets and liabilities. Moreover, he argues that the May 17, 1996 resolution of the SFD Board conclusively refutes the Board's claim that revaluing the corporation's assets gives rise to the required surplus. We hold that each of these claims is without merit.

Plaintiff advances an erroneous interpretation of Section 160. We understand that the books of a corporation do not necessarily reflect the current values of its assets and liabilities. Among other factors, unrealized appreciation or depreciation can render book numbers inaccurate. It is unrealistic to hold that a corporation is bound by its balance sheets for purposes of determining compliance with Section 160.

It is helpful to recall the purpose behind Section 160. The General Assembly enacted the statute to prevent boards from draining corporations of assets to the detriment of creditors and the long-term health of the corporation. That a corporation has not yet realized or reflected on its balance sheet the appreciation of assets is irrelevant to this concern. Regardless of what a balance sheet that has not been updated may show, an actual, though unrealized, appreciation reflects real economic value that the corporation may borrow against or that creditors may claim or levy upon. Allowing corporations to revalue assets and liabilities to reflect current realities complies with the statute and serves well the policies behind this statute.

Plaintiff contends that Houlihan's analysis relied on inappropriate methods to mask a violation of Section 160. Noting that 8 Del. C. § 154 defines "net assets" as "the amount by which total assets exceeds total liabilities," plaintiff argues that Houlihan's analysis is erroneous as a matter of law because of its failure to calculate "total assets" and "total liabilities" as separate variables. In a related argument, plaintiff claims that the analysis failed to take into account all of SFD's liabilities, i.e., that Houlihan neglected to consider current liabilities in its comparison of SFD's "Total Invested Capital" and long-term debt. Plaintiff contends that the SFD Board's resolution proves that adding current liabilities into the mix shows a violation of Section 160.

We believe that plaintiff reads too much into Section 154. The statute simply defines "net assets" in the course of defining "surplus." It does not mandate a "facts and figures balancing of assets and liabilities" to determine by what amount, if any, total assets exceeds total liabilities. The statute is merely definitional. It does not require any particular method of calculating surplus, but simply prescribes factors that any such calculation must include. Although courts may not determine compliance with Section 160 except by methods that fully take into account the assets and liabilities of the corporation, Houlihan's methods were not erroneous as a matter of law simply because they used Total Invested Capital and long-term debt as analytical categories rather than "total assets" and "total liabilities."

In cases alleging impairment of capital under Section 160, the trial court may defer to the board's measurement of surplus unless a plaintiff can show that the directors "failed to fulfill their duty to evaluate the assets on the basis of acceptable data and by standards which they are entitled to believe reasonably reflect present values." In the absence of bad faith or fraud on the part of the board, courts will not "substitute [our] concepts of wisdom for that of the directors." Here, plaintiff does not argue that the SFD Board acted in bad faith. Nor has he met his burden of showing that the methods and data that underlay the board's analysis are unreliable or that its determination of surplus is so far off the mark as to constitute actual or constructive fraud. Therefore, we defer to the board's determination of surplus, and hold that SFD's self-tender offer did not violate 8 Del. C. § 160.

Some discussion questions:

1. The plaintiff in this case is a shareholder who is big mad about the restructuring, but statutes like DGCL §160 exist to protect who, exactly?
2. Why might a company appear insolvent but not actually be insolvent?
3. Does the court seem excited about busting out a spreadsheet and getting into the assets-and-liabilities discussion?

6. *Corporate Management*

As we saw in the previous chapter, corporate boards are given a fair amount of deference in their decisions regarding how to run the corporation (and, in particular, how to manage corporate finances). In this chapter, we examine how boards delegate agency over corporate decisions, how boards take action (both as a single entity and in smaller groups), what happens when boards get deadlocked and cannot act, and what exactly the board is responsible for when it comes to overseeing the business of the corporation.

Corporate Agency

To recap how managerial power is distributed in the corporation, a corporation can be thought of as a (kinda sorta) democracy:

$$\begin{tikzcd} \text{Shareholders (Voters)} \arrow[d] \\ \text{Board of Directors (Elected Officials)} \arrow[d] \\ \text{Officers (Administrators)} \end{tikzcd}$$

The shareholders have the power to elect directors, approve fundamental transactions, and amend the corporation's articles of incorporation and the bylaws. They, however, cannot act on behalf of the corporation.

The board of directors has the power to review and approve corporate transactions, amend the corporation's bylaws, put proposals up for shareholder vote, and appoint officers and agents of the corporation. The board (acting as a whole) has the ultimate power to bind the corporation.

The officers of the corporation are agents of the corporation, and acquire their agent authority through delegation of that power by the board of directors, either in the corporation's bylaws or by specific board action.[1] The scope of the agent authority is determined in the same way, either by specification in the bylaws or by the actions of the board.

[1] The board can issue formal "resolutions" to authorize specific actions or delegate specific authority.

These sections of Amazon's bylaws establish actual authority for their officers:

> *4.6 Chairman of the Board* If elected, the Chairman of the Board shall perform such duties as shall be assigned to him or her by the Board from time to time and shall preside over meetings of the Board and stockholders unless another officer is appointed or designated by the Board as chairman of such meeting.
>
> *4.7 Chief Executive Officer* The Chief Executive Officer shall be the chief executive officer of the corporation, shall preside over meetings of the Board and stockholders in the absence of a Chairman of the Board and, subject to the Board's control, shall supervise and control all of the assets, business and affairs of the corporation. The Chief Executive Officer may sign deeds, mortgages, bonds, contracts or other instruments, except when the signing and execution thereof have been expressly delegated by the Board or by these Bylaws to some other officer or agent of the corporation or are required by law to be otherwise signed or executed by some other officer or in some other manner. In general, the Chief Executive Officer shall perform all duties incident to the office of Chief Executive Officer and such other duties as are prescribed by the Board from time to time.
>
> *4.8 President* In the event of the death of the Chief Executive Officer or his inability to act, the President shall perform the duties of the Chief Executive Officer, except as may be limited by resolution of the Board, with all the powers of and subject to all the restrictions upon the Chief Executive Officer. The President may sign with the Secretary or any Assistant Secretary certificates for shares of the corporation. The President shall have, to the extent authorized by the Chief Executive Officer or the Board, the same powers as the Chief Executive Officer to sign deeds, mortgages, bonds, contracts or other instruments. The President shall perform such other duties as from time to time may be assigned to him or her by the Chief Executive Officer or the Board.
>
> *4.9 Vice President* In the event of the death of the President or his or her inability to act, the Vice President (or if there is more than one Vice President, the Vice President who was designated by the Board as the successor to the President, or if no Vice President is so designated, the Vice President first elected to such office) shall perform the duties of the President, except as may be limited by resolution of the Board, with all the powers of and subject to all the restrictions upon the President. Any Vice President may sign with the Secretary or any Assistant Secretary certificates for shares of the corporation. Vice Presidents shall have, to the extent authorized by the President or the Board, the same powers as the President to sign deeds, mortgages, bonds, contracts or other instruments. Vice Presidents shall perform such other duties as from time to time may be assigned to them by the President or the Board.
>
> *4.10 Secretary* The Secretary shall be responsible for preparation of minutes of meetings of the Board and stockholders, maintenance of the corporation's records and stock registers, and authentication of the corporation's records and shall in general perform all duties incident to the office of Secretary and such other duties as from time to time may be assigned to him or her by the President or the Board. In the absence of the Secretary, an Assistant Secretary may perform the duties of the Secretary.
>
> *4.11 Treasurer* The Treasurer shall have charge and custody of and be responsible for all funds and securities of the corporation; receive and give receipts for moneys due and payable to the corporation from any source whatsoever, and deposit all such moneys in the name of the corporation in banks, trust companies or other depositories selected in accordance with the provisions of these Bylaws; sign certificates for shares of the corporation; and in general perform all of the duties incident to the office of Treasurer and such other duties as from time to time may be assigned to him or her by the President or by the Board. In the absence of the Treasurer, an Assistant Treasurer may perform the duties of the Treasurer.

As we discussed in Chapter 2, however, a person can also become an agent of a corporation through apparent authority, which involves a representation by the principal (here, the corporation) to a third party that the person has the power of an agent (even if no actual authority has been given to that person). Appointing someone as the Chief Executive Officer of the corporation creates a *de facto* apparent agent relationship, as it is always reasonable for a third party to assume that the CEO has the power to bind the corporation. Other corporate officers may have apparent authority depending on the reasonable expectations for their position.[1]

[1] E.g., it is reasonable to expect that the Chief Financial Officer has the power to open a bank account on behalf of the corporation, or that the General Counsel has the power to hire a law firm. The more vague the position – Chief Brand Officer or Corporate Social Responsibility Chief or Digital Prophet (all real job titles, fyi) – the harder it is to establish a reasonable expectation for anything.

Note that board members by themselves – even the chairperson of the board – do not have either actual authority or apparent authority, as it is not reasonable for a third party to assume that a single board member can bind the corporation on their own. That being said, the following case examines precisely what kind of actions can create either actual or apparent agency when someone acts according to the instructions of a corporate board.

Sarissa Capital Domestic Fund LP v. Innoviva, Inc., No. 2017-0309-JRS (Del. Ch. Dec. 8, 2017)

Slights, V.C.

Dissident shareholders of defendant, Innoviva, Inc. ("Innoviva"), mounted a proxy contest[2] earlier this year to elect their director nominees to Innoviva's board of directors ("Board"). This action, arising amid the aftermath, concerns the de jure composition of Innoviva's Board.

[2] Again: a proxy contest is a contested election for board of director positions, and the votes (or "proxies") are counted at the corporation's annual meeting.

The dissident shareholders are plaintiffs, Sarissa Capital Domestic Fund LP, Sarissa Offshore Master Fund LP, Sarissa Capital Fund GP LLC, Sarissa Capital Fund GP LP, Sarissa Capital Offshore Fund LP LLC, Sarissa Capital Management GP LLC and Sarissa Capital Management LP (collectively, "Sarissa").[3] In anticipation of Innoviva's 2017 annual stockholder meeting on April 20, 2017, Sarissa launched a proxy contest to elect three director nominees to Innoviva's seven-member Board.

[3] Remember all that jazz about using a limited liability company as the general partner in a limited partnership? Well, here's what that looks like in action.

Sarissa's proxy contest commenced in February 2017. In its proxy materials,[4] Sarissa charged that Innoviva's incumbent directors were "grossly overpaid ... in the face of poor stock performance" and were "failing to fulfill [their] duty of oversight." Thus, Sarissa reckoned, Innoviva was "not be[ing] run for the benefit of shareholders[.]" These themes continued with various degrees of intensity throughout Sarissa's proxy campaign.

[4] Documents sent out to shareholders to solicit votes for their slate of director nominees.

In early April 2017, three leading proxy advisory firms[5] recommended that Innoviva stockholders vote for Sarissa's director nominees. Following the issuance of those recommendations, the parties began exploring a potential settlement of the proxy contest. The chief negotiators during these discussions were Sarissa's founder and Chief Investment Officer, Alexander Denner ("Denner"), and the then-Vice Chairman of Innoviva's Board, James Tyree ("Tyree").

[5] These are organizations that monitor corporations and their management on behalf of investors, and issue recommendations on shareholder votes.

Two days out from the annual meeting, the proxy solicitors in both camps reported that the vote was too close to call. This uncertainty drove the parties to intensify their settlement discussions. Denner and Tyree reconnected and spoke on the phone several times that day. During those calls, Denner offered that Sarissa would end its proxy campaign if Innoviva would (1) expand its Board from seven members to nine members; (2) appoint two of Sarissa's nominees to the Board as directors; and (3) forgo a "standstill."[1] In response, Tyree indicated that Innoviva would be willing to expand its Board from seven to nine members, and to appoint two of Sarissa's nominees to the Board as directors, but insisted that Sarissa agree to a standstill and the issuance of a conciliatory joint press release announcing the settlement.

[1] A standstill is an agreement that an insurgent shareholder will stop buying up shares in the corporation that they are trying to take over.

Later that day, Tyree provided an update to the Board regarding the settlement discussions. The key area of disagreement at that point was the standstill—from both parties' perspectives, that term was a "deal breaker."

The Board reconvened the next morning and held a series of telephonic meetings regarding the status of the proxy contest and settlement discussions with Sarissa. With less than twenty-four hours to go before the vote, the outcome of the proxy contest still remained in doubt, as several of Innoviva's largest shareholders – including The Vanguard Group, Inc. ("Vanguard") and BlackRock, Inc. ("BlackRock")[2] – had not yet indicated how they would vote at the annual meeting. At this point, "[t]he two assumptions [Innoviva's Board] had ... on the big votes [then] outstanding were that [the Board's nominees] had a higher probability of winning the Vanguard vote and ... a lower probability of winning the BlackRock vote."

[2] These are two of the largest institutional investors in the world, and they hold significant stakes in the biggest publicly-traded companies.

After discussing Innoviva's options, the Board remained adamant that an Innoviva-Sarissa settlement would require a standstill. Innoviva's position changed, however, once it learned – shortly after noon that day – that Vanguard planned to vote for Sarissa's nominees.[3] Having lost Vanguard's vote, Innoviva's Board expected that it would lose BlackRock's vote as well, thereby ensuring that "at least two of Sarissa's three [nominees] would be elected to the Board". The Board expected that the key shareholder votes, including BlackRock's vote, would be known for sure by the "end of the day" on April 19 between 4:00 PM and 5:00 PM. Thus, following Vanguard's indication that it would be voting for Sarissa's nominees, the "clock was ticking down" for Innoviva to reach a settlement with Sarissa and thereby avert an (expected) electoral defeat.

[3] Guess it wasn't that much of a "deal breaker" after all, huh?

The Board reconvened later that afternoon for another telephonic meeting. During that meeting, the Board determined that: (1) Innoviva would settle with Sarissa without a standstill; (2) as part of that settlement, Innoviva would expand its Board from seven to nine members and appoint any two of Sarissa's three nominees to the expanded Innoviva Board; and (3) the settlement would require Sarissa to include a conciliatory quote about Innoviva in a joint press announcing the settlement.[1] At the meeting's close, the Board authorized Tyree to convey to Denner that Innoviva would settle with Sarissa on those terms.

[1] "We'll give you everything you want, but you have to say one nice thing about us, and you have to mean it."

Tyree phoned Denner shortly thereafter to convey Innoviva's revised settlement proposal. Denner promptly accepted, and so confirmed Sarissa's assent to the essential terms of a Sarissa-Innoviva settlement. At the end of their call, Tyree and Denner confirmed they "had a deal" and that they would leave it to others on their respective teams to prepare the "paperwork ... to get it done." Neither Tyree nor Denner indicated, however, that the settlement was contingent upon the execution of the "paperwork."

Following Tyree and Denner's call, the parties' attorneys worked to memorialize the agreed-upon deal in writing and finalize the language of the parties' joint press release. With the confirmatory writing finalized, and the press release nearly finalized, Innoviva learned that BlackRock had voted in favor of the Board's slate of directors,[2] effectively ensuring that the Board's nominees would win election. Having snatched victory from the jaws of defeat, Innoviva's Board changed course. It resolved to cease discussions with Sarissa and proceed with the stockholder vote at Innoviva's annual meeting the following day.[3] Tyree made contact with Denner that evening to advise him, in essence, that the "deal" that had been struck during their phone conversation hours before was now "no deal."[4]

[2] The proxy solicitor emailed "WE GOT BLACKROCK!!!" to the Innoviva board at 4:43pm.

[3] Innoviva's lawyer straight up ghosted his counterpart at Sarissa, testifying later that he "decided to kind of stop communicating with Sarissa after th[e] BlackRock vote came in."

[4] Denner's response: "You cannot back out of an accepted deal. Innoviva agreed to the deal and your lawyers confirmed it. Please call me [ASAP]."

Sarissa filed this action under 8 Del. C. § 225 on the day of the annual meeting. It seeks a declaration that the parties entered into a binding settlement agreement the afternoon of April 19, 2017, during the Denner/Tyree telephone call. According to Sarissa, during that call, Tyree orally bound Innoviva to a settlement agreement with the following terms:

1. Innoviva would expand its Board from seven members to nine, and two of Sarissa's nominees would be added as directors, without requiring a standstill;

2. Sarissa would terminate its proxy contest, withdraw its nomination notice and dismiss its then-pending books-and-records action against Innoviva;

3. Sarissa and Innoviva would announce the settlement in a mutually conciliatory joint press release; and

4. Innoviva would issue new proxy materials with the two Sarissa nominees included on the Board's slate, and Innoviva's 2017 annual meeting

would be adjourned (for no more than thirty days) so that those new materials could be prepared and issued.

An individual corporate director may negotiate a settlement on behalf of the corporation – and bind the corporation to an agreed-upon settlement – provided the director has actual or apparent authority to do so. For the reasons set forth below, I conclude that Tyree had both actual and apparent authority to bind Innoviva to an oral settlement agreement with Sarissa.

1. Tyree Had Actual Authority

Actual authority requires an extant agency relationship. An agency relationship "arises when one person [or entity] (a 'principal') manifests assent to another person [or entity] (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act." Actual authority, then, "is created by a principal's manifestation to an agent that, as reasonably understood by the agent, expresses the principal's assent that the agent take action on the principal's behalf."

Where the principal is a corporation, such assent may be manifested in provisions of the corporation's certificate of incorporation or bylaws, or otherwise through board action. Thus, a corporation's governance documents may grant actual authority to certain of its directors and officers to bind the corporation in contract—whether to a particular contract or type of contract, or more generally. Alternatively, a corporation's board of directors, as such, may cause the corporation to manifest assent that a particular director or officer shall have the power to bind the corporation in contract, provided the corporation's certificate and bylaws do not prohibit such action by the board.

The scope of an agent's actual authority is determined by the agent's reasonable understanding of the principal's manifestations and objectives. Accordingly, "[a]n agent has actual authority to take action designated or implied in the principal's manifestations to the agent and [to take] acts necessary or incidental to achieving the principal's objectives, as the agent reasonably understands the principal's manifestations and objectives when the agent determines how to act."

In this case, Tyree had actual authority to bind Innoviva to an oral settlement agreement with Sarissa within certain parameters. This authority can be traced to the express manifestations of Innoviva's Board (and thus, Innoviva) prior to and during the Board's April 19 afternoon meeting (from 1:30 to 1:47 PM), and Tyree's reasonable understanding of those manifestations. Before that meeting, Innoviva's Board had appointed Tyree to act as Innoviva's "lead negotiator" in settlement discussions with

Sarissa, and Tyree had accepted that appointment, thus creating a specific agency relationship between Tyree and Innoviva. And during that meeting, Innoviva's Board manifested assent that Tyree contact Denner "to negotiate to see if a settlement agreement including a press release between Sarissa and [Innoviva] could be reached.

Under these circumstances, Tyree reasonably understood the Board's (and thus Innoviva's) manifestations to him during the Board's April 19 afternoon meeting to express Innoviva's assent that (1) within the Settlement Agreement Parameters, Tyree was authorized to make an oral settlement offer on Innoviva's behalf; and (2) Denner's oral acceptance of that offer (on Sarissa's behalf) would bind Innoviva to the settlement. And the record reflects that this was, in fact, Tyree's understanding. Accordingly, Tyree had actual authority to convey to Denner an oral settlement offer on behalf of Innoviva (on the terms approved by the Board) and to bind Innoviva to a settlement with Sarissa on those terms.

2. Tyree Had Apparent Authority

Unlike actual authority, apparent authority does not depend on the existence of an underlying agency relationship, and may arise even where no such relationship exists. Apparent authority "is the power held by an agent or other actor to affect a principal's legal relations with third parties when a third party reasonably believes the actor has authority to act on behalf of the principal and that belief is traceable to the principal's manifestations." Thus, even if a person lacks actual authority to bind an entity to a contract with a third party, the person still may have apparent authority to do so. For instance, a non-agent director has apparent authority to bind the corporation to a contract with a third party if (1) the third party reasonably believes that the director has such authority; and (2) that belief is traceable to the corporation's manifestations.

A corporate principal may make a manifestation to a third party concerning an agent's authority "by placing [the] agent in charge of a transaction or situation." In particular, where a corporate principal has designated an agent as its "exclusive channel of communication" with a third party, that designation can "constitute a manifestation of [the corporation's] assent to be bound in accordance with ... communication[s]" made through that channel.

Here, the evidence clearly reveals that Tyree had apparent authority to bind Innoviva to a settlement agreement with Sarissa. First, Denner, Sarissa's principal, believed that Tyree spoke on behalf of Innoviva's Board (and so Innoviva), and thus was authorized to enter into a settlement agreement on Innoviva's behalf. Second, it was reasonable for Denner to believe this. Tyree was Innoviva's "lead negotiator" in settlement discussions with Sarissa and the only Innoviva Board member with whom Denner negotiated during the critical April 18-19 time period. In addition, there is no evidence that Innoviva then communicated (or otherwise indicated) to Denner that Tyree was not authorized to enter into a settlement agreement on Innoviva's behalf. Finally, Denner's reasonable belief that Tyree was authorized to take such action on Innoviva's behalf is traceable to Innoviva's manifestations, namely, (1) Innoviva's having appointed Tyree as Innoviva's "lead negotiator" in settlement discussions with Sarissa; and (2) Innoviva's having permitted Tyree to serve as Innoviva's exclusive channel of settlement-related communications with Denner during the critical April 18-19 time period. For these reasons, I find that Tyree had apparent authority to bind Innoviva to a settlement agreement with Sarissa.

3. There Was No Improper Delegation of the Board's Duties

Innoviva contends that Tyree "did not have authority ... to enter into the alleged oral agreement because this would involve an improper delegation of the Board's fiduciary and statutory duties." Specifically, Innoviva argues that, under 8 Del. C. §§ 141(b), 223(a)(1) and Section 3.9 of Innoviva's Bylaws, "decisions regarding who should fill Board vacancies cannot be delegated to an individual director or a third person, but must be decided by the entire Board acting by majority vote." Innoviva's argument, however, misapprehends the facts proven at trial and the statutory and bylaw provisions upon which it relies.

Section 3.9 of Innoviva's Bylaws is complementary to Section 3.2 of Innoviva's Bylaws, which provides that Board approval (by majority resolution) is required to expand the size of the Board, consistent with 8 Del. C. § 141(b). Section 3.9, in turn, provides that newly created Innoviva directorships may only be filled by a "majority vote of directors then in office," consistent with 8 Del. C. § 223(a)(1). Nothing in this section prohibits a majority of Innoviva's Board from deciding (without a formal vote) who should fill "to-be-created" directorships and, upon reaching a decision in that regard, authorizing an individual director to bind the Board to that decision via contract. In other words, Section 3.9 does not prohibit what happened here.

During the Board's April 19 afternoon meeting, the Board conditionally resolved to expand the size of the Board from seven to nine members, consistent with Section 3.2 of Innoviva's Bylaws This was done in anticipation of Innoviva's entry into a settlement with Sarissa. The Board also authorized Tyree to represent (or offer) to Denner that the Board would appoint (presumably by later vote) any two of Sarissa's three nominees to the Board if the proxy contest was settled. That is to say, if Sarissa accepted Innoviva's settlement proposal, then Innoviva's Board would be expanded from seven to nine members, and "a majority ... of [the seven] directors then in office" would vote to appoint any two of Sarissa's three nominees to fill the resulting Board vacancies—consistent with Section 3.9 of Innoviva's Bylaws.

Here, it was Innoviva's Board that made the foregoing determinations, not Tyree. Indeed, the settlement terms that Tyree was authorized to convey to Denner were Innoviva's settlement terms, i.e., the settlement terms approved by Innoviva's Board. Under these circumstances, as proven by Sarissa at trial, I am satisfied that Tyree's authority to bind Innoviva to an oral settlement agreement with Sarissa on terms approved by Innoviva's Board was entirely consistent with Section 141(b)'s and 223(a)(1)'s requirements that the creation and filling of new directorships be properly authorized by the board of directors in accordance with the corporation's governing documents.

SOME DISCUSSION QUESTIONS:

1. Where does the court look to establish whether Tyree was an agent with actual authority to bind the corporation? What does the court examine to determine whether Tyree was an agent with apparent authority to bind the corporation?

2. If Tyree lacked authority to bind Innoviva, could Sarissa pursue a case against Tyree? (Related: does the answer to this explain why Tyree is referred to as the "the former Vice Chairman" in the opinion?[1])

3. If Innoviva had managed to weasel its way out of the deal with Sarissa, would that be the end of its troubles with its investors? Would Sarissa simply have to go away forever?

4. Why didn't the bylaws prohibit delegating this authority?

Establishing Corporate Authority

As we can see from *Sarissa*, there are several ways to establish corporate authority: the articles, the bylaws, a resolution formally enacted by the board of directors, and the conduct of the board of the directors towards an officer/agent (all of which establish actual authority). Given all this, what are the responsibilities of the third parties to investigate the powers of their counterparts before entering into a deal?[2]

Courts have generally held that unless the transaction has certain red flags, it is reasonable for a third party transacting with an corporate officer to assume that the officer has agency over ordinary transactions within the scope of their position. Those red flags include:

[1] From the opinion: "At a Board meeting later that morning, convened at Tyree's request, Tyree told the other directors that he disagreed with their decision to abandon the settlement with Sarissa, that the decision was "impractical" and that he did not "do business th[at] way." Ultimately, Tyree resigned from Innoviva's Board on June 2, 2017, notwithstanding that he was then being positioned to succeed Waltrip as the Chairman of the Board. Tyree testified that Innoviva's decision to abandon the settlement with Sarissa was a factor in his decision to resign."

[2] Note that a third party could potentially use the lack of authority with regard to a corporate counterparty to cancel a deal it wanted to get out of, but the principals of estoppel and fairness would likely bar an attempt by that third party to get out of the deal after substantial performance.

- An extraordinary transaction. If the transaction is so fundamental to the corporation,[1] or is so far afield from the ordinary business of the officer's position, a third party has an obligation to check the authority of the officer to engage in the transaction.

[1] E.g., if Meta decided to sell Facebook, and pivot to focusing on its doofy VR business.

- A conflicted transaction. If the third party knows that the corporate officer stands to benefit personally from a deal with the corporation that the officer purportedly represents, it should raise enough concerns with the third party such that they have an obligation to investigate the officer's authority.

- A transaction that has been objected to. If an officer is like, "I have this authority" and the corporation is like "nuh uh" and the officer is like "yuh huh" and the corporation is like "in your dreams, loser" ... the third party is effectively on notice that they need to take further steps to check out the formal authority of the officer. Flip side: if the corporation doesn't object to a transaction entered into by an officer lacking authority, they can later be estopped from objecting to it.

So, while counterparties negotiating with a corporate officer of the corporation generally do not have to investigate and confirm that the officer has actual authority, do you think it might be a good idea to check anyway? Yeah, yeah, it is – and as a lawyer, you might be asked to do exactly that. Specifically, you may be asked to produce a "legal opinion" in the course of papering a deal, the contours of which are elaborated on in the next section.

Legal Opinions

In a transaction, lawyers are often called upon to opine on the legality of a particular transaction. This requires the lawyer to investigate and confirm several things, including:

- The corporation's legal existence and good standing (check with state authorities).

- The corporate officer's authority to bind the corporation (check the articles, bylaws, board resolutions, or the minutes of board meetings for particular actions).[2]

- The corporation's ability to enter into the transaction (this requires an examination of the corporation's financial capabilities, contractual obligations, and (sometimes) the legality of the contract itself).

[2] These can be obtained from the corporation's secretary – who is presumed to be a reliable source for corporate documents, and has the apparent authority to certify the documents.

There are three kinds of legal opinions: (1) **unqualified opinions** (opinions that state a clear legal conclusion based on verified facts), (2) **qualified opinions** (opinions that qualify their conclusions by clarifying the sources that were relied upon and noting potential limitations), and (3) **reasoned opinions** (opinions that are more like legal memos, offering the lawyer's subjective interpretations and noting where facts or law are unclear). The most important thing to remember when drafting one of these things[1] is to make crystal clear what materials you relied upon and what knowledge you did or didn't have at the time of drafting the opinion. There is absolutely no downside in listing and footnoting every document you looked at; there is, however, possible liability in stating as fact something you have not confirmed.[2]

[1] Most firms have a designated bunch of suckers – I mean, *committee of partners* – to sign these things on behalf of the firm.

[2] The most important rule of lawyering is the same as the most important rule of boxing: "Protect yourself at all times."

Is this as easy and straightforward a process as it could be? Not really, but other methods of determining who has power in a corporation have their flaws, too. Let's take a look at a particularly wild one!

Corporate Authority in China and "The Chop"

In China, every licensed business has an official seal, which grants authority to the holder to conduct the official business of the corporation. The seal and its distinctive red ink are used to authorize documents paying employees, consummating deals, entering into banking transactions, and handling any other business the corporation needs to conduct. The seal – known as the "chop" – does drastically simplify the process for determining corporate authority (no boring bylaw searches for you!), but it is not without its problems.

From the *Wall Street Journal*:[3]

> In recent months, executives at some of China's most powerful companies have brawled, sued and launched furtive missions to seize control of one of their most valuable assets.
>
> They are rubber stamps.
>
> Also known as corporate chops, the seals themselves cost about $20 each. But under Chinese law, physical possession of the red-ink-stained chop can determine who controls a corporation and the fate of billions of dollars.
>
> In late April, Li Guoqing, who, with his wife Yu Yu, co-founded one of China's largest online booksellers, went to the company's headquarters in Beijing on a mission to retake control from his wife, with whom he is locked in an acrimonious divorce battle. She had taken the reins of the company, Dangdang Inc., once a buzzy startup hailed as the Chinese answer to Amazon.com.

[3] Sha Hua and Stu Woo. The Real Power Brokers In China: Those Who Wield the Rubber Stamps. Wall Street Journal, July 2020

> According to the company, Mr. Li left with almost 50 official ink-stained Dangdang chops stuffed into a shoebox which he vowed not to part with until he found justice.
>
> "I will have sole custody of the chops, tying them to my belt during the day and keeping them under my blanket during the night," Mr. Li announced to his 5.4 million followers the next day on the Chinese social-media service Weibo.

You have to admit that disputes over corporate control would be far more interesting – in a Nic Cage action movie kind of way – if the ultimate authority rested with the One Who Wields The Chop. Of course, laws beings laws, there are ways to get out of this mess ...

From the *Financial Times*:[1]

> Arm faces a months-long wait to regain control over its China business, as the chip design company grapples with the ancient "chop" system that has prevented the UK group from firing [Mr. Wu,] the chief executive of its joint venture in Shenzhen.
>
> The path to resolving disputes over company seals can be long and arduous. Managers can involve the police in the hope that they will forcibly secure the chops. But police are reluctant to wade into corporate disputes and often reject such cases.
>
> Another option is to attempt to re-register the business through China's State Administration for Market Regulation, a process that could take months. If successful, new chops can be issued, rendering the old ones useless.
>
> Arm has gone to the Shenzhen police to apply for a new chop. But for approval, it must produce the company business licence, which Mr. Wu also controls.

... or maybe not.

Board Action

> "[T]here is the meeting which is called not because there is business to be done, but because it is necessary to create the impression that business is being done. Such meetings are more than a substitute for action. They are widely regarded as action."
>
> – John Kenneth Galbraith

In order to take formal action, a board generally must come together at a meeting and vote on a proposal. The general idea is that by deliberating together and sharing their knowledge and their perspectives, the board can make better-informed decisions on behalf of the corporation. This is, of course, an extremely *Schoolhouse Rock*-ass

[1] Don Weinland and Henny Sender. The 'chop' reigns in corporate China. The Financial Times, June 2020

understanding of how boards work. In reality, they largely do whatever the CEO and/or the consultants tell them to do – but courts still hold them to the fantasy, and require them to meet in person (or via video call or telephone) in order to do business.[1]

[1] Many states, including Kentucky, require the participants to be able to hear each other during the meeting. Sorry, no board meetings via group chat.

There are some exceptions to this rule, though:

- Unanimous Director Approval (must be in writing)
- Emergency Situations (where the board must act quickly to protect the interests of the corporation)[2]
- Unanimous Shareholder Approval (at shareholder meetings)

[2] Kentucky law says that a corporate emergency exists if "a quorum of the corporation's directors cannot readily be assembled because of some catastrophic event" and provides absolutely no further elaboration on what that means. Very helpful, KRS §271B.3-030, very helpful.

Each of these are situations in which it can be reasonably presumed that the formal meeting would be unnecessary, for reasons of unanimity, expediency, or the brute force of shareholder voting. When in doubt, though? Call a meeting, and take a vote.

Notice and Quorum

As with shareholder meetings,[3] board meetings have requirements for notice (to avoid surprises) and quorum (to make sure there are enough board members to do business).[4] The default rules are:

[3] We'll get into the specifics of these in Chapter 9.

[4] File this one away for when we cover *Campbell v. Loew's*, a case about a closely divided board where one faction attempted to trick an opposing board member into attending a surprise board meeting.

For Notice, the minimum notice to give for a special meeting is two days (unless the articles or the bylaws say differently). For regularly scheduled meetings, notice isn't strictly required. Any actions taken at a meeting held without appropriate notice is invalid.

For Quorum, the norm is that a majority of the board members must be present for any action taken at the meeting to be valid. The articles or the bylaws may either increase the requirement for a legitimate quorum or lower it to no fewer than one-third of the board members.

Committees

Boards, in addition to delegating their agent authority, can also – under certain circumstances – delegate specifically defined decision-making authority to board committees. These committees can be permanent (to handle ongoing concerns of the corporation) or temporary (to deal with specific issues that arise with the corporation). Some common committees include:

- Executive (handles non-essential transactions)

- Audit (selection of auditors and review of financial information)
- Compensation (saying "yes, sir!" whenever a manager asks for a pay raise)
- Risk (dealing with insurance, regulatory compliance, and security issues)
- Litigation (making decisions regarding litigation brought on behalf of or against the corporation, reviewing shareholder suits)

Committees – whether purely advisory or actively empowered to handle certain decisions – are generally given wide latitude by courts, especially when committee members are chosen because of their subject matter expertise.

Board Inaction

Everything we've discussed so far assumes a board capable of making decisions on behalf of the corporation. But what would happen if a board becomes deadlocked – split evenly so that there is no majority capable of making decisions for the corporation?[1] And what if, either as a cause of or a consequence of this predicament, the board members become actively hostile towards one another and the resulting acrimony threatens the viability of the business? The following two opinions, (coincidentally?) handed down on the same day by different Delaware courts, address precisely that situation, with somewhat different results.

[1] We dealt with this in the chapter on partnerships, but I'll say it again: please put an odd number of people in charge of your business entity. *Please*.

Kleinberg v. Aharon, C.A. No. 12719-VCL (Del. Ch. Feb. 13, 2017)

Laster, V.C.

A voting agreement binds the stockholders of Applied Cleantech, Inc. (the "Company"). The stockholders committed to a board of directors with six seats. The agreement gives defendant Refael Aharon, who is the founder and CEO of the Company, the practical ability to fill three seats. Historically, Aharon only filled two seats. In summer 2016, Aharon feared that a 3- 2 majority had formed against him, so he filled his third seat with his brother-in-law. During a meeting on August 22, 2016, the board split 3-3 on a series of critical issues. The plaintiffs sought a custodian to break the board-level deadlock. This post-trial decision grants their request.

Aharon is a brilliant scientist and inventor who holds a doctorate from the Weizmann Institute of Science in Rehovot, Israel. Approximately a decade ago, Aharon perceived that urban sewage contained harvestable resources, ranging from cellulose that could be used in recycled paper products to particles of precious metals like gold, silver, and bronze. Aharon raised start-up capital from angel investors, including defendant Baruch Dill, and formed an Israeli company called SePage Ltd. He registered patents on his sewage-processing technology and developed a prototype for a machine that extracted cellulose from sewage.

In 2007, Aharon turned to Saturn Partners, a venture capital firm based in Boston, Massachusetts. Saturn liked the sewage-processing technology and agreed to invest $2.5 million. In May 2007, to facilitate the investment, the parties formed the Company as a Delaware corporation. They caused the Company to formed a wholly owned Israeli subsidiary, called Applied Cleantech (Israel) Ltd., to serve as the operating entity.

In return for its investment, Saturn received shares of Series A preferred stock in the Company. The shares originally represented approximately 25% of the equity, but they carried additional preferences that included anti-dilution adjustments and the right to vote on an as-converted basis. Because of problems with the Company's books and records, it is not clear how much of the equity or voting power Saturn holds today.

The parties also entered into an initial version of the voting agreement that contemplated a five-member board. It gave Aharon the right to appoint one director, the investors in SePage the right to appoint two directors, and Saturn the right to appoint two directors. As a practical matter, Aharon appointed the two SePage directors. He made himself a director and filled another seat with Dill. The third seat remained vacant.

Unfortunately, Aharon's success as an inventor did not translate into success as a businessman. Although the trial did not focus in detail on the Company's early efforts, it appears that by 2010, the Company had used up the capital it obtained from Saturn.

In May 2013, the Company gained a new lease on life when plaintiffs Daniel Kleinberg and Tomer Herzog invested approximately $2.5 million in the Company. In return for their investment, Kleinberg and Herzog received Series B preferred stock representing approximately 35% of the Company's equity. The voting agreement was amended to provide for a board with six seats. Kleinberg and Herzog each received the right to fill a seat, and they appointed themselves. Aharon retained the right to fill a seat, and he continued to serve. The investors in SePage continued to have the right to fill two seats, and Aharon continued to have the practical ability to fill them. Dill continued to serve, and the other seat remained vacant. Saturn's appointment rights were reduced from two directors to one,[1] and Lafferty continued as Saturn's lone representative.

When Kleinberg and Herzog initially invested in the Company, they discussed with Aharon the need to bring in an experienced CEO who could

[1] So that's 1, 2, 3, 4, 5 ... 6 total board seats? Oh, no. Oh, no no no.

take the Company to the next level. Aharon appeared supportive as long as the timing was right. The Company's difficulties during 2014 caused Kleinberg and Herzog to believe that the time had come to bring in a new CEO. During 2015, Kleinberg and Herzog introduced potential candidates to the Company. For his part, Aharon felt betrayed. He believed that Kleinberg and Herzog were attacking him personally and that they had become obsessed with replacing him.

pictured: Aharon

Throughout July 2016, Lafferty, Herzog, and Kleinberg pressed Aharon to hold a meeting. During these exchanges, Herzog proposed having Aharon resign as CEO and continuing as the Company's Chief Technology Officer. Aharon volubly refused. Aharon resisted holding a board meeting because he feared that Lafferty had joined forces with Kleinberg and Herzog. Aharon viewed Lafferty as the swing vote between Dill and himself, on the one side, and Kleinberg and Herzog, on the other. Aharon sensed that Lafferty had lost confidence in him and would side with Kleinberg and Herzog to form a 3-2 board majority that could remove him and take other actions contrary to his wishes.

To address this threat, Aharon filled SePage's second seat with his brother-in-law, defendant Boaz Cohen. After Aharon filled the third vacancy, he scheduled a board meeting for August 16, 2016. Aharon advised that during the meeting, he intended to raise the possibility of removing Lafferty from the board for cause due to his alleged breaches of fiduciary duty, fraud, and conflict of interest.

The board finally met on August 22, 2016. It was the first time the directors had met since May. For reasons that the parties did not address, Dill resigned from the board just before the meeting. Aharon appointed David Cohen to fill the resulting vacancy. At the conclusion of the meeting, Aharon stated that the Company was preparing a lawsuit against Lafferty, Herzog, and Kleinberg. Kleinberg responded that the directors had been preparing a lawsuit of their own, which was a reference to this proceeding.

Multiple lawsuits are now pending relating to the Company and its affairs. On September 2, 2016, the plaintiffs filed this action. They sought the appointment of a custodian pursuant to Section 226 of the Delaware General Corporation Law, 8 Del. C. § 226.

Section 226(a)(2) sets forth three conditions before this Court may exercise its authority under the statute. First, the directors must be deadlocked; that is, they must be so divided respecting the management of the affairs of the corporation that the vote required for curative action by the board as a governing body cannot be obtained. The Company's board is plainly deadlocked. Aharon created the deadlock in July 2016 when he appointed a third director to stop the emergent board majority of

Lafferty, Kleinberg, and Herzog from taking action against him. Ironically, despite asserting that "[t]here is no need to appoint a trustee," Aharon has argued that "[w]hat is necessary is double power to the president[1] in the event of a tie vote or, alternatively, the directors must be removed from the company due to their actions." He thus implicitly recognizes that a deadlock exists.

[1] Is this like getting a star in Mario Kart or ... ?

The second statutory requirement is a threat of irreparable harm because of the divisions between the directors. The threat of insolvency is sufficient to raise a possibility of irreparable harm. The necessary harm also can result from damage to a corporation's reputation, goodwill, customer relationships, and employee morale. Unless the deadlock is broken, the Company has no chance of pursuing a new business plan and will become irretrievably insolvent. The Company has suffered and will continue to suffer irreparable harm absent the appointment of a custodian.

The final statutory requirement is that the stockholders must be incapable of breaking the deadlock by themselves. In this case, the stockholders cannot break the deadlock because of the Voting Agreement and the rights it confers, which lock the two competing factions into a 3-3 impasse.

One option would be to decline to appoint a custodian and leave the parties to their own devices. That would be unjust. The Company is in a state of utter dysfunction that has caused the business to suffer and threatens irreparable harm. The best route is to appoint a custodian with the power to vote as a seventh director and the authority to take additional steps to resolve the deadlock.

The custodian will have all of the powers of a director under the Company's certificate of incorporation and bylaws. In addition, and notwithstanding anything to the contrary in the certificate of incorporation or bylaws, the custodian shall have the following powers:

- The custodian shall have the power to call and set the date and time for meetings of the board.

- The custodian shall preside over any board meeting at which the custodian is present.

- As the presiding officer for purposes of the meeting, the custodian shall set the agenda for the meeting and oversee the discussion. The custodian may set time limits for discussion and will determine whether to call for a vote.

- A quorum shall exist for a meeting of the board if the custodian and at least three directors are present.

- The custodian shall be responsible for documenting the actions taken by the board. In the event of a disagreement over what took place during a meeting, the custodian shall document the competing positions and state his view of what occurred.

The court will appoint the custodian by separate order. It will include other provisions and address exculpation, indemnification, and advancement.

Some discussion questions:

1. Does the court set aside the various voting agreements in reaching this decision?
2. Who do you think the custodian is going to vote with? Why not just declare that party the winner and kick the other side out of the corporation?
3. What if, despite the deadlock, the corporation not only continued to be profitable, but became wildly successful even with warring factions refusing to cooperate and constantly bickering? Would there be a need for a court to step in under those circumstances?

Shawe v. Elting, 157 A.3d 152 (Del. 2017)

Seitz, J.

Philip Shawe[1] and his mother, Shirley Shawe, have filed an interlocutory appeal from the Court of Chancery's August 13, 2015 opinion and July 18, 2016 order, and related orders, appointing a custodian under 8 Del. C. § 226 to sell TransPerfect Global, Inc., a Delaware corporation. After a six-day trial filled with unprecedented evidence of a lengthy and seriously dysfunctional relationship between the owners [Philip Shawe and Elizabeth Elting],[2] culminating in Philip Shawe's litigation misconduct, the Court of Chancery issued a 104–page opinion concluding that the warring factions were hopelessly deadlocked as stockholders and directors. The court carefully considered three alternatives to address the dysfunction and deadlock, and in the end decided that the circumstances of the case required the appointment of a custodian to sell the company. On appeal, the Shawes do not challenge the Court of Chancery's many factual findings of serious dysfunction and deadlock. Instead, Philip Shawe claims for the first time on appeal that the court exceeded its statutory authority when it ordered the custodian to sell a solvent company. Alternatively, Shawe contends that less drastic measures were available to address the deadlock.

We disagree with the Shawes and affirm the Court of Chancery's judgment. First, under the custodian statute, the Court of Chancery may

[1] Phil Shawe. Entrepreneur. Global Citizen. Philanthropist. Travel and Technology Enthusiast. CEO of TransPerfect. philshawe.com

[2] Liz Elting. Global CEO. Entrepreneur. Business Leader. Philanthropist. Feminist. lizelting.com

appoint a custodian when the stockholders are unable to elect directors whose terms have expired. Here, the parties stipulated that they were unable to do so. Further, a custodian may be appointed when the corporation's business is suffering from, or is threatened with, irreparable injury because of divisions between the directors, and the stockholders are unable to terminate the division. Here, the director and stockholder deadlock are undisputed, and the Court of Chancery made detailed factual findings of threatened and actual irreparable harm to the company which we will not disturb on appeal. We also agree with the Court of Chancery's conclusion that, in circumstances such as this, when intermediate measures were attempted but failed, the Court of Chancery properly exercised its discretion to sell the company and distribute the proceeds to deadlocked stockholders.

TransPerfect Global, Inc. ("TPG") is a Delaware corporation that acts as a holding company for the main operating company, TransPerfect Translations International, Inc. ("TPI"), a New York corporation. Both entities will be referred to as the "Company." The Company provides translation, website localization, and litigation support services from 92 offices in 86 worldwide cities. It has over 3,500 full-time employees and maintains a network of over 10,000 translators, editors, and proofreaders in about 170 different languages. Elting and Shawe co-founded the Company and are co-chief executive officers and board members.

TPG has 100 shares of common stock issued and outstanding, divided fifty shares to Elting, forty-nine shares to Shawe, and one share to Shirley Shawe. In this Opinion, we refer to Philip Shawe as "Shawe," and Shirley Shawe by her full name. The one share allocated to Shirley Shawe allowed TPG to claim the benefits of being a majority women-owned business.[1] We credit the Court of Chancery's finding, based on evidence introduced at trial, that Shawe "has treated his mother's share as his own property and himself as a 50% co-owner of the Company." After a corporate reorganization in 2007, TPG's bylaws provided for a three member board of directors, or a different number fixed by the stockholders. Elting and Shawe have been the only directors since the Company's reorganization in 2007.[2]

[1] LMFAO.

[2] 1 ... 2 directors? Oh, no. Oh, no no no.

To fully appreciate the personal nature of the long-running discord leading to the Court of Chancery's ruling, we go back to the Company's founding and the troubled romantic relationship between the founders. Elting and Shawe co-founded the business in 1992 while living together in a dormitory room attending New York University's business school. They were engaged in 1996, but Elting called the marriage off in 1997. As the Court of Chancery found, "Shawe did not take the break-up well, and would 'terrorize' her and say 'horrendous things' about her husband, Michael Burlant, whom she married in 1999." On two separate occasions, Shawe responded to the rejection by crawling under Elting's bed and refusing to leave.

... two ... separate ... occasions?

As the Company grew, the founders were not satisfied with their financial success, and brought their simmering personal discontent into the Company's business affairs. The Court of Chancery catalogued the serious clashes over the years between Shawe and Elting and their surrogates before, and remarkably, during the litigation:

- Shawe engaged in a secret campaign to spy on Elting and invade her privacy by intercepting her mail, monitoring her phone calls, accessing her emails (including thousands of privileged communications with her counsel), and entering her locked office without permission on numerous occasions as well as sending his so-called "paralegal" there at 4:47 a.m. on another occasion.
- Shawe co-opted the services of Company advisors to assist him in advancing his personal agenda against Elting.
- Shawe unilaterally hired numerous employees to perform Shared Services functions (Accounting and Finance) and even to work in divisions Elting managed without her knowledge or consent by creating "off book" arrangements and fabricating documents.
- Shawe sought to have Elting criminally prosecuted by referring to her as his ex-fiancée seventeen years after the fact when filing a "Domestic Incident Report" as a result of a seemingly minor altercation in her office.[1]
- Shawe disparaged Elting and tried to marginalize her within the Company by gratuitously disseminating a memorandum (on Gerber's letterhead) to employees in her own division accusing her of collusion and financial improprieties.
- Shawe disparaged Elting publicly by unilaterally issuing a press release in the Company's name containing false and misleading statements.

These were just some of the highlights of the facts found by the Court of Chancery after a lengthy trial. The court also made detailed findings about continuous acrimonious disputes over personal and business expenses, weekly if not daily temper tantrums, and "mutual hostaging" between the founders over proposed acquisitions, stockholder distributions, employee hiring, pay and bonuses, and office locations. The court also found that Shawe bullied Elting and those aligned with her, expressing his desire to "create constant pain" for Elting until she agreed with Shawe's plans. It was common for senior officers to be drawn into their disputes, who were then abused by threatened firings, substantial fines, inappropriate emails, and by withholding compensation and promotions.

[1] "On June 10, 2014, Shawe went to Elting's office to confront her about [a] tax distribution. According to Elting, Shawe would not leave her office despite repeated requests and blocked her from closing the door by putting his foot in it, at which point Elting tried to move it with [her] foot. Curiously, while his foot was in the door, Shawe called one of his attorneys from Sullivan & Cromwell, rather than focus on resolving the situation at hand (i.e., removing his foot from the door). On June 11, 2014, Shawe filed a "Domestic Incident Report" in which he accused Elting of pushing him and kicking him in the ankle the previous day. In a parenthetical at the very end of the report, Shawe identified Elting as his ex-fiancee, even though their engagement ended seventeen years earlier, apparently to ensure that the matter would be treated as a domestic violence incident and require Elting's arrest."

Shawe v. Elting, Index No. 153375-2016, 11 (N.Y. Sup. Ct. 2017).

The Court of Chancery best captured the lengths that Shawe would go to harass Elting in its recounting of Elting's plane trip to Paris in 2014:

> On December 2, 2014, Elting boarded a red eye flight to Paris and discovered, to her surprise, that Shawe was seated across the aisle from her. Shawe claimed to have "no idea" she would be on the flight. In truth, Shawe previously learned that Elting would be on the flight and made arrangements to be seated next to her without her knowledge. Elting changed seats. The next day, Shawe sent a text message to several of his allies, stating: "Was next to Liz on the plane to Paris and she switched seats;)." Two of the recipients of the text message were Nathan Richards and Joe Campbell, both of whom are implicated in events concerning Shawe's alleged spoliation of evidence, which is the subject of a motion for sanctions discussed below.
>
> I find Shawe's characterization of the incident as an attempt to extend an olive branch not to be credible. He did not deny telling Elting that he had "no idea" she would be on the flight, which was not true, and the smiley-face emoticon at the end of his text message suggests he was amused by yet another opportunity to harass Elting, who Shawe knew full well would not welcome his presence on the flight.

While Shawe and Elting continued to harass each other, interfere with the business, and demoralize the employees, they filed four lawsuits against each other. The conflict eventually distilled down to Elting's petition under 8 Del. C. § 226 to declare a deadlock and appoint a custodian to sell TPG.[1]

[1] In Kentucky, a custodian can be appointed to break a board deadlock, but it's a two-step process, and it is not without risk. First, a shareholder must bring an action to dissolve the corporation under KRS §271B.14-300(2)(a) (which has the same three-part test involving deadlock, irreparable harm, and inability to break the deadlock that Delaware applies). Then, under KRS §271B.14-320, a court may choose to appoint either a receiver (to liquidate the corporation) OR a custodian (to keep the business going). The decision is entirely within the court's discretion, so, you know ... good luck.

The court dedicated enormous resources to the dispute. It held twelve hearings, decided sixteen motions, and conducted a six-day trial. Before its final decision, the Court of Chancery took the measured step of appointing a custodian to serve as a mediator to assist Shawe and Elting to try and settle their disputes. The court also delayed its post-trial decision for two months to await the parties' ongoing efforts to resolve the controversy. After the many attempts at settlement failed, the Court of Chancery issued its 104–page decision finding that "the evidence presented at trial warrants the appointment of a custodian to sell the Company to resolve the deadlocks between Shawe and Elting."

First, the Court of Chancery found that Elting had satisfied the requirements of § 226(a)(1) to appoint a custodian for stockholder deadlock because the parties stipulated that they were divided and unable to elect successor directors. Next, the court held that Elting satisfied the three requirements of § 226(a)(2) for appointment of a custodian due to director deadlock. As to the first requirement, the existence of deadlocks, the court reviewed in painstaking detail its many factual findings, now undisputed on appeal, supporting its conclusion that the distrust Shawe and Elting have for each other "strikes at the heart of the palpable dysfunction that exists in the governance of the Company." The Court of

Chancery also held that the second requirement, the stockholders' inability to break the director deadlock, was satisfied by the parties' stipulation of deadlock.

Turning to the final requirement, harm to the business, the Court of Chancery considered the profitability of the Company, but also made the commonsense observation that the statute contemplates appointment of custodians for profitable corporations which, like distressed companies, can suffer or be threatened with irreparable injury. The court then catalogued some of the many examples of actual and threatened irreparable injury to the Company:

- Kevin Obarski (Senior Vice President of Sales) called the feud the "biggest business issue" the Company faces, and bemoaned that the "crazy arbitrary stuff" coming out of it was "the number 1 reason people leave to go to work at competitors."
- Michael Sank (Vice President of Corporate Development) agreed: "it's so obviously the biggest problem the company faces."
- Yu–Kai Ng (Chief Information Officer) identified as a Company goal ... the need to find a way for Shawe and Elting to work together "without negatively impacting everyone else."
- Mark Hagerty (Chief Technology Officer) testified that the conflict "hurts company morale" and "is detrimental to the company."
- Robert DeNoia (former Vice President of Human Resources) expressed his frustration with the "pervasive and continuous hostile environment where inappropriate behavior impacts the morale, health and well-being of myself and the staff."
- Roy Trujillo (Chief Operating Officer), in a letter drafted for submission to a special master appointed in the New York action, attributed the "mass exodus" in Accounting and Finance to "the ongoing disputes and stressful environment created by it." He further stated that "[e]mployees are resigning and leaving these departments at unprecedented rates," that "[t]he morale and retention issue will likely spread," and that "[t]he company's reputation is taking a beating, internally and externally."
- Kai Chu (an Accounting employee), attributed the "plummeting" morale and loss of employees in Accounting to the "diametrically opposed" orders that had been received from Shawe and Elting.
- Fiona Asmah (a Finance employee) testified that the disputes and conflicting directives have caused her and others to feel "caught in the middle," have created an "unhealthy work environment," and have "affected employee morale."

Shawe himself acknowledged "the potential for grievously harming" the Company by his continued feuding with Elting. The Court of Chancery also found that major clients who are free to use competitive services have expressed concerns about the dispute. Shawe and Elting have also been unable to agree on acquisitions which generally accounted for between 16.5–20% of the Company's annual revenue and 8–14% of its annual net profit. The Company has made no acquisitions since 2013. As the Court of Chancery held:

> Although it is true that the Company is and has been a profitable enterprise to date, its governance structure is irretrievably dysfunctional. The Company already has suffered from this dysfunction and, in my view, is threatened with much more grievous harm to its long-term prospects if the dysfunction is not addressed.

The court considered whether to appoint a custodian to serve as a third director or act in some capacity to break the ties between the two factions. He rejected this option because:

> It would enmesh an outsider and, by extension, the Court into matters of internal corporate governance for an extensive period of time. Shawe and Elting are both relatively young. Absent a separation, their tenure as directors and co-CEO's of the Company could continue for decades. It is not sensible for the Court to exercise essentially perpetual oversight over the internal affairs of the Company.

This left the Court of Chancery with a final option: "appoint a custodian to sell the Company so that Shawe and Elting can be separated and the enterprise can be protected from their dysfunctional relationship." The court recognized that the remedy was "unusual," and "should be implemented only as a last resort and with extreme caution." But after reviewing the statute and case law, the court determined that the Court of Chancery "has appointed custodians to resolve deadlocks involving profitable corporations and authorized them to conduct a sale of the corporation."

8 Del. C. § 226(b) provides that:

> A custodian appointed under this section shall have all the powers and title of a receiver appointed under § 291 of this title, but the authority of the custodian is to continue the business of the corporation, and not to liquidate its affairs and distribute its assets, except when the Court shall otherwise order, and except in cases arising under paragraph (a)(3) of this section or § 352(a)(2) of this title.

Section 394 of the Delaware General Corporation Law ("DGCL") provides that all corporations agree to make all provisions of the DGCL part of their charters. Under the express language of the custodian statute, the Court of Chancery has the authority to "otherwise order" the custodian to "liquidate [the Company's] affairs and distribute its assets" rather than "continue the business of the corporation." In other words, the custodian's default duty is to continue the business of the corporation, but the Court of Chancery can displace the default duty by ordering that the company's affairs be liquidated.

The dissent ... points to § 273, a section of the DGCL permitting dissolution of joint venture corporations when two 50% owner-stockholders are deadlocked. In many instances, that statute has been employed to break a deadlock through a sale of the corporation under the auspices of the Court of Chancery and a fiduciary appointed by it for that purpose. Contrary to what the dissent contends, it is by no means unprecedented for the Court of Chancery to have to address the fate of a solvent Delaware corporation by setting up a fair process to have it sold as a going concern, when that outcome is necessary to best protect its constituencies.

As the Chancellor observed, this case "was within a whisker" of § 273. The only novelty here is that this case arises under § 226, because the economic and functional reality of the deadlock does not fall precisely under § 273. But, consistent with the flexible and efficient design of the DGCL, § 226 allows the Court of Chancery to address this situation by using its power to deal with cases on a situational basis. Rather than read the key language "except when the Court shall otherwise order" as having no significance, we read it consistently with the overall design of the statute, and its intention to allow our Court of Chancery the discretion to deal sensibly with corporations that are unable to move forward with governance because their owners cannot take fundamental action to elect a new board. That the Chancellor looked for guidance to the remedies entered in cases under § 273 was not error on his part. Instead, it suggests that the court understood TPG's economic reality as identical to a 50–50 deadlock, and that the tools used to sensibly address those deadlocks would inform his discretion under § 226.

The Court of Chancery's August 13, 2015 opinion and July 18, 2016 order, and the related orders, are affirmed.

Valihura, J., dissenting

The Court of Chancery generally has broad discretion in fashioning certain equitable remedies. Although this might suggest that this Court should defer to the Chancellor who ordered one of the most extreme remedies possible—a sale of a financially successful corporation over the objections of one or more of its three stockholders—our review of the Court of Chancery's order requires construction of a statute, namely, 8 Del. C. § 226 (" Section 226"). Embedded in this choice of remedy is the question of whether a court-appointed custodian has the power to force the sale of a stockholder's stock absent that stockholder's consent. The interpretation of a statute is a question of law which we review de novo. My analysis of the statutory scheme suggests that the answer is "no." Accordingly, I respectfully DISSENT.

Given that we are faced with a question as to the permissible limits of the Court of Chancery's power under Section 226, the flexibility typically afforded the Court of Chancery in fashioning equitable remedies must yield to the more specific principles underlying the relevant statutory provisions and common law interpreting these provisions. The first principle concerns the uncontested fact that, in the DGCL, stock is "personal property" and is generally subject to traditional property law policies favoring free alienation. Generally, where the possibility of defeasance of a stockholder's stock may occur over the stockholder's objection, those restraints on free transferability and alienation of stock are expressly set forth in the relevant statute. That fact strongly suggests that Section 226 should not be so broadly read as to allow for a forced sale or other divestiture of a stockholder's stock by mere implication. The second principle is the longstanding, uncontested common law principle that the involvement of the Court of Chancery and court-appointed custodians in a corporation's business and affairs should be kept to a minimum. This long-standing common law view is reflected in the fact that the parties here cannot point to a single case in the history of our Section 226 jurisprudence where a court has ordered a custodial sale of a company over a stockholder's objections.

SOME THOUGHTS:

1. Philip Shawe is, to put it mildly, fairly litigious.[1] To that end, I want to make it clear that everything in the preceding section – with the exception of the editorial comments in the margins, which are protected expressions of opinion and therefore not defamatory – is taken directly from the published opinions of the Delaware and New York court systems. The author takes no position on the truth or falsity of the claims contained in those opinions, including:

   - Whether Shawe responded to Elting's rejections by crawling under the bed like a puppy in a thunderstorm;
   - Whether Shawe intentionally got on a transatlantic flight with the sole purpose of harassing his ex and then considered his mission such a triumph that he sent a winky-face emoji to his boys; and
   - Whether Shawe responded to being kicked in the ankle by a 90-pound woman in a less dignified manner than Neymar getting tackled in the box.

[1] Here is a copy of a cease and desist letter that Shawe's lawyers sent to SSRN and the *Houston Law Review* over an article written by Ann Lipton, a highly-respected law professor at Tulane, that characterized *Shawe v. Elting* in a manner that Shawe apparently took exception to.

The author does not endorse the truth of those assertions or any other contained in or implied by the court opinions, and has reprinted the text of those opinions for the sole purpose of educating the students reading this casebook on the legal standards and relevant factors that courts consider when ordering the liquidation or sale of a going concern.

2. There were also some discovery issues:

> On Saturday, November 22, 2014, just four days after the Court ordered an expedited trial, Shawe's iPhone allegedly was damaged when Shawe visited his brother Larry at his apartment. I say "allegedly" because, as discussed below, the phone ended up being discarded in a strange episode and was never made available for a forensic examination.
>
> At some point during Shawe's visit, the brothers went into the kitchen, leaving Shawe's phone in the adjacent living room with Larry's five year-old daughter, Ava. Hearing Ava scream, the brothers ran into the living room to find Shawe's iPhone partly submerged in a plastic cup of Diet Coke. The partial submersion, which Larry characterized as a "1 out of 100,000" shot, lasted just a couple of seconds. Shawe retrieved the phone, dried it, charged it, and tried "several techniques with the buttons" to revive it, without success.
>
> The next week, before Thanksgiving, Shawe gave the phone to his "trusted assistant" Joe Campbell, with whom Shawe shared the same office, and instructed Campbell to attempt to revive the phone. Shawe did not say anything to Campbell about the outstanding discovery requests or remind him about the Litigation Hold Notices.
>
> After taking possession of the phone, Campbell tried to recharge it and unsuccessfully searched Google for solutions. He did not contact Apple or visit the Apple Store eight blocks from his office, nor did he solicit aid from TPG's forensics team. After making some modest efforts to revive the phone, Campbell said he put the phone in the drawer of his office desk. The story of what allegedly happened with the phone next is bizarre.
>
> According to Campbell, sometime in December 2014, he opened his desk drawer where he had left Shawe's iPhone and concluded from seeing "some droppings" in the drawer that a rat had invaded the desk—which was located on the 39th floor of a commercial office building at 3 Park Avenue—and chewed on a PowerBar. Campbell claims that, in a "visceral" reaction, he tossed the contents of the drawer, including the iPhone, into the garbage. Campbell had been a paralegal for five years and was a recipient of both Litigation Hold Notices. His claim that he threw out the phone because of rat droppings is inexplicable.

In re Shawe & Elting LLC, 2016 WL 3951339 at *1-2, *13-15 (Del. Ch. Jul. 20, 2016) (holding that "Shawe's actions obstructed discovery, concealed the truth, and impeded the administration of justice.

He needlessly complicated and protracted these proceedings to Elting's prejudice, all while wasting scarce resources of the Court.")

3. Christ, what an asshole.[1]

[1] Also protected opinion.

Board Oversight Responsibility

So far in this chapter, we have seen examples of board action, board action that the board tried to pretend wasn't action (*Sarissa*), and boards unable to act due to internal strife (*Kleinberg* and *Shawe*). But what happens when a board – or a critical board member – simply refuses to act? What responsibilities does the board have – and not to put to fine a point on it here – to do its goddamn job?

Francis v. United Jersey Bank, 87 N.J. 15 (N.J. 1981)

Pollock, J.

The primary issue on this appeal is whether a corporate director is personally liable in negligence for the failure to prevent the misappropriation of trust funds by other directors who were also officers and shareholders of the corporation.

Plaintiffs are trustees in bankruptcy of Pritchard Baird Intermediaries Corp. (Pritchard Baird), a reinsurance broker or intermediary. Defendant Lillian P. Overcash is the daughter of Lillian G. Pritchard and the executrix of her estate. At the time of her death, Mrs. Pritchard was a director and the largest single shareholder of Pritchard Baird. Because Mrs. Pritchard died after the institution of suit but before trial, her executrix was substituted as a defendant. United Jersey Bank is joined as the administrator of the estate of Charles Pritchard, Sr., who had been president, director and majority shareholder of Pritchard Baird.

This litigation focuses on payments made by Pritchard Baird to Charles Pritchard, Jr. and William Pritchard,[2] who were sons of Mr. and Mrs. Charles Pritchard, Sr., as well as officers, directors and shareholders of the corporation.

[2] The fraudulent payments – disguised as loans – in question totaled $4,391,133.21 to Charles, Jr., $5,483,799.02 to William; $33,000 to Lillian Pritchard (the defendant here), $189,194.17 to Charles Sr. and $168,454 for payment of taxes on his estate, and $123,156.51 to the daughter Lillian Overcash.

The initial question is whether Mrs. Pritchard was negligent in not noticing and trying to prevent the misappropriation of funds held by the corporation in an implied trust. A further question is whether her negligence was the proximate cause of the plaintiffs' losses. Both lower courts found that she was liable in negligence for the losses caused by the wrongdoing of Charles, Jr. and William. We affirm.

The matrix for our decision is the customs and practices of the reinsurance industry and the role of Pritchard Baird as a reinsurance broker. Reinsurance involves a contract under which one insurer agrees to indemnify another for loss sustained under the latter's policy of insurance. The reinsurance business was described by an expert at trial as having "a magic aura around it of dignity and quality and integrity." A telephone call which might be confirmed by a handwritten memorandum is sufficient to create a reinsurance obligation. Though separate bank accounts are not maintained for each treaty, the industry practice is to segregate the insurance funds from the broker's general accounts.

When incorporated under the laws of the State of New York in 1959, Pritchard Baird had five directors: Charles Pritchard, Sr., his wife Lillian Pritchard, their son Charles Pritchard, Jr., George Baird and his wife Marjorie. William Pritchard, another son, became director in 1960. The corporation issued 200 shares of common stock. Charles Pritchard, Sr. acquired 120 shares, his sons Charles Pritchard, Jr., 15 and William, 15; Mr. and Mrs. Baird owned the remaining 50. In June 1964, Baird and his wife resigned as directors and sold their stock to the corporation. From that time on the corporation operated as a close family corporation with Mr. and Mrs. Pritchard and their two sons as the only directors. After the death of Charles, Sr. in 1973, only the remaining three directors continued to operate as the board. Lillian Pritchard inherited 72 of her husband's 120 shares in Pritchard Baird, thereby becoming the largest shareholder in the corporation with 48% of the stock.

The corporate minute books reflect only perfunctory activities by the directors, related almost exclusively to the election of officers and adoption of banking resolutions and a retirement plan. None of the minutes for any of the meetings contain a discussion of the loans to Charles, Jr. and William or of the financial condition of the corporation. Moreover, upon instructions of Charles, Jr. that financial statements were not to be circulated to anyone else, the company's statements for the fiscal years beginning February 1, 1970, were delivered only to him.

Contrary to the industry custom of segregating funds, Pritchard Baird commingled the funds of reinsurers and ceding companies with its own funds. All monies (including commissions, premiums and loss monies) were deposited in a single account. Charles, Sr. began the practice of withdrawing funds from the commingled account in transactions identified on the corporate books as "loans." As long as Charles, Sr. controlled the corporation, the "loans" correlated with corporate profits and were repaid at the end of each year. Starting in 1970, however, Charles, Jr. and William begin to siphon ever-increasing sums from the corporation under the guise of loans. As of January 31, 1970, the "loans" to Charles, Jr. were $230,932 and to William were $207,329. At least by January 31, 1973, the annual increase in the loans exceeded annual corporate revenues. By October 1975, the year of bankruptcy, the "shareholders' loans" had metastasized to a total of $12,333,514.47.

The "loans" were reflected on financial statements that were prepared annually as of January 31, the end of the corporate fiscal year. Although an outside certified public accountant prepared the 1970 financial statement, the corporation prepared only internal financial statements from 1971-1975. In all instances, the statements were simple documents, consisting of three or four 8 1/2 X 11 inch sheets.

Those financial statements showed working capital deficits increasing annually in tandem with the amounts that Charles, Jr. and William withdrew as "shareholders' loans." In the last complete year of business (January 31, 1974, to January 31, 1975), "shareholders' loans" and the correlative working capital deficit increased by approximately $3,200,000.

The funding of the "loans" left the corporation with insufficient money to operate. Pritchard Baird could defer payment on accounts payable because its clients allowed a grace period, generally 30 to 90 days, before the payment was due. During this period, Pritchard Baird used the funds entrusted to it as a "float" to pay current accounts payable. By recourse to the funds of its clients, Pritchard Baird not only paid its trade debts, but also funded the payments to Charles, Jr. and William. Thus, Pritchard Baird was able to meet its obligations as they came due only through the use of clients' funds.

Mrs. Pritchard was not active in the business of Pritchard Baird and knew virtually nothing of its corporate affairs. She briefly visited the corporate offices in Morristown on only one occasion, and she never read or obtained the annual financial statements. She was unfamiliar with the rudiments of reinsurance and made no effort to assure that the policies and practices of the corporation, particularly pertaining to the withdrawal of funds, complied with industry custom or relevant law. Although her husband had warned her that Charles, Jr. would "take the shirt off my back,"[1] Mrs. Pritchard did not pay any attention to her duties as a director or to the affairs of the corporation.

[1] "Never in my wildest imagination did I ever dream I would have sons like these."

After her husband died in December 1973, Mrs. Pritchard became incapacitated and was bedridden for a six-month period. She became listless at this time and started to drink rather heavily. Her physical condition deteriorated, and in 1978 she died. The trial court rejected testimony seeking to exonerate her because she "was old, was grief-stricken at the loss of her husband, sometimes consumed too much alcohol and was psychologically overborne by her sons." That court found that she was competent to act and that the reason Mrs. Pritchard never knew what her sons "were doing was because she never made the slightest effort to discharge any of her responsibilities as a director of Pritchard Baird."

The New Jersey Business Corporation Act, which took effect on January 1, 1969, was a comprehensive revision of the statutes relating to business corporations. One section, N.J.S.A. §14A:6-14, concerning a director's general obligation had no counterpart in the old Act. That section makes it incumbent upon directors to discharge their duties in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions.

As a general rule, a director should acquire at least a rudimentary understanding of the business of the corporation. Accordingly, a director should become familiar with the fundamentals of the business in which the corporation is engaged. Because directors are bound to exercise ordinary care, they cannot set up as a defense lack of the knowledge needed to exercise the requisite degree of care. If one feels that he has not had sufficient business experience to qualify him to perform the duties of a director, he should either acquire the knowledge by inquiry, or refuse to act.

Directors are under a continuing obligation to keep informed about the activities of the corporation. Otherwise, they may not be able to participate in the overall management of corporate affairs. Directors may not shut their eyes to corporate misconduct and then claim that because they did not see the misconduct, they did not have a duty to look. The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect.[1]

[1] Counterpoint: what if they're really, really sleepy?

Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies. Accordingly, a director is well advised to attend board meetings regularly. Indeed, a director who is absent from a board meeting is presumed to concur in action taken on a corporate matter, unless he files a dissent with the secretary of the corporation within a reasonable time after learning of such action. The point is that one of the responsibilities of a director is to attend meetings of the board of which he or she is a member.

While directors are not required to audit corporate books, they should maintain familiarity with the financial status of the corporation by a regular review of financial statements. In some circumstances, directors may be charged with assuring that bookkeeping methods conform to industry custom and usage. The extent of review, as well as the nature and frequency of financial statements, depends not only on the customs of the industry, but also on the nature of the corporation and the business in which it is engaged.

A director is not an ornament, but an essential component of corporate governance. Consequently, a director cannot protect himself behind a paper shield bearing the motto, "dummy director." The New Jersey Business Corporation Act, in imposing a standard of ordinary care on all directors, confirms that dummy, figurehead and accommodation directors are anachronisms with no place in New Jersey law. Thus, all directors are responsible for managing the business and affairs of the corporation.

The most striking circumstances affecting Mrs. Pritchard's duty as a director are the character of the reinsurance industry, the nature of the misappropriated funds and the financial condition of Pritchard Baird. The hallmark of the reinsurance industry has been the unqualified trust and confidence reposed by ceding companies and reinsurers in reinsurance brokers. Those companies entrust money to reinsurance intermediaries with the justifiable expectation that the funds will be transmitted to the appropriate parties. Consequently, the companies could have assumed rightfully that Mrs. Pritchard, as a director of a reinsurance brokerage corporation, would not sanction the comingling and the conversion of loss and premium funds for the personal use of the principals of Pritchard Baird.

As a director of a substantial reinsurance brokerage corporation, she should have known that it received annually millions of dollars of loss and premium funds which it held in trust for ceding and reinsurance companies. Mrs. Pritchard should have obtained and read the annual statements of financial condition of Pritchard Baird. Although she had a right to rely upon financial statements prepared in accordance with N.J.S.A. 14A:6-14, such reliance would not excuse her conduct. The reason is that those statements disclosed on their face the misappropriation of trust funds.

From those statements, she should have realized that, as of January 31, 1970, her sons were withdrawing substantial trust funds under the guise of "Shareholders' Loans." The financial statements for each fiscal year commencing with that of January 31, 1970, disclosed that the working capital deficits and the "loans" were escalating in tandem. Detecting a misappropriation of funds would not have required special expertise or extraordinary diligence; a cursory reading of the financial statements would have revealed the pillage. Thus, if Mrs. Pritchard had read the financial statements, she would have known that her sons were converting trust funds. When financial statements demonstrate that insiders are bleeding a corporation to death, a director should notice and try to stanch the flow of blood.

In summary, Mrs. Pritchard was charged with the obligation of basic knowledge and supervision of the business of Pritchard Baird. Under the circumstances, this obligation included reading and understanding financial statements, and making reasonable attempts at detection and prevention of the illegal conduct of other officers and directors. She had a duty to protect the clients of Pritchard Baird against policies and practices that would result in the misappropriation of money they had entrusted to the corporation. She breached that duty.

SOME DISCUSSION QUESTIONS:

1. Do you need to be an expert on the business of the corporation – or an expert in deciphering accounting statements – to be an effective board member?

2. Was Mrs. Pritchard a victim here? What could she have done to avoid being held liable?

3. In determining Pritchard's liability – technically Pritchard's estate's liability – the court examined the impact her negligence had on the ultimate outcome:

> Within Pritchard Baird, several factors contributed to the loss of the funds: commingling of corporate and client monies, conversion of funds by Charles, Jr. and William and dereliction of her duties by Mrs. Pritchard. The wrongdoing of her sons, although the immediate cause of the loss, should not excuse Mrs. Pritchard from her negligence which also was a substantial factor contributing to the loss. Her sons knew that she, the only other director, was not reviewing their conduct; they spawned their fraud in the backwater of her neglect. Her neglect of duty contributed to the climate of corruption; her failure to act contributed to the continuation of that corruption. Consequently, her conduct was a substantial factor contributing to the loss.
>
> Analysis of proximate cause is especially difficult in a corporate context where the allegation is that nonfeasance of a director is a proximate cause of damage to a third party. Where a case involves nonfeasance, no one can say with absolute certainty what would have occurred if the defendant had acted otherwise. Nonetheless, where it is reasonable to conclude that the failure to act would produce a particular result and that result has followed, causation may be inferred. Ibid. We conclude that even if Mrs. Pritchard's mere objection had not stopped the depredations of her sons, her consultation with an attorney and the threat of suit would have deterred them. That conclusion flows as a matter of common sense and logic from the record. Whether in other situations a director has a duty to do more than protest and resign is best left to case-by-case determinations. In this case,

> we are satisfied that there was a duty to do more than object and resign. Consequently, we find that Mrs. Pritchard's negligence was a proximate cause of the misappropriations.
>
> To conclude, by virtue of her office, Mrs. Pritchard had the power to prevent the losses sustained by the clients of Pritchard Baird. With power comes responsibility. She had a duty to deter the depredation of the other insiders, her sons. She breached that duty and caused plaintiffs to sustain damages.

If Pritchard was paying attention to what was going on at the corporation, what could she have done to stop the fraud?

If *Francis* stands for the proposition that directors cannot simply sit back and ignore information coming in about the corporation's finances and inner workings, what kind of affirmative obligations do directors have to find out what is going on in their corporations?

Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78 (Del. 1963)

Wolcott, J.

This is a derivative action on behalf of Allis-Chalmers against its directors and four of its non-director employees. The complaint is based upon indictments of Allis-Chalmers and the four non-director employees named as defendants herein who, with the corporation, entered pleas of guilty to the indictments. The indictments, eight in number, charged violations of the Federal anti-trust laws. The suit seeks to recover damages which Allis-Chalmers is claimed to have suffered by reason of these violations.

The complaint alleges actual knowledge on the part of the director defendants of the anti-trust conduct upon which the indictments were based or, in the alternative, knowledge of facts which should have put them on notice of such conduct.

However, the hearing and depositions produced no evidence that any director had any actual knowledge of the anti-trust activity, or had actual knowledge of any facts which should have put them on notice that anti-trust activity was being carried on by some of their company's employees. The plaintiffs, appellants here, thereupon shifted the theory of the case to the proposition that the directors are liable as a matter of law by reason of their failure to take action designed to learn of and prevent anti-trust activity on the part of any employees of Allis-Chalmers.

The operating policy of Allis-Chalmers is to decentralize by the delegation of authority to the lowest possible management level capable of fulfilling the delegated responsibility. Thus, prices of products are ordinarily set by the particular department manager, except that if the product being priced is large and special, the department manager might confer with the general manager of the division. Products of a standard character involving repetitive manufacturing processes are sold out of a price list which is established by a price leader for the electrical equipment industry as a whole.

Annually, the Board of Directors reviews group and departmental profit goal budgets. On occasion, the Board considers general questions concerning price levels, but because of the complexity of the company's operations the Board does not participate in decisions fixing the prices of specific products.

The Board of Directors of fourteen members, four of whom are officers, meets once a month, October excepted, and considers a previously prepared agenda for the meeting. Supplied to the Directors at the meetings are financial and operating data relating to all phases of the company's activities. The Board meetings are customarily of several hours' duration in which all the Directors participate actively. Apparently, the Board considers and decides matters concerning the general business policy of the company. By reason of the extent and complexity of the company's operations, it is not practicable for the Board to consider in detail specific problems of the various divisions.

There is no evidence in the record that the defendant directors had actual knowledge of the illegal anti-trust actions of the company's employees. Plaintiffs, however, point to two FTC decrees of 1937 as warning to the directors that anti-trust activity by the company's employees had taken place in the past. It is argued that they were thus put on notice of their duty to ferret out such activity and to take active steps to insure that it would not be repeated.

The decrees in question were consent decrees entered in 1937 against Allis-Chalmers and nine others enjoining agreements to fix uniform prices on condensers and turbine generators. The decrees recited that they were consented to for the sole purpose of avoiding the trouble and expense of the proceeding.

None of the director defendants were directors or officers of Allis-Chalmers in 1937. The director defendants and now officers of the company either were employed in very subordinate capacities or had no connection with the company in 1937. At the time, copies of the decrees were circulated to the heads of concerned departments and were explained to the Managers Committee.

Plaintiffs argue that because of the 1937 consent decrees, the directors were put on notice that they should take steps to ensure that no employee of Allis-Chalmers would violate the anti-trust laws. The difficulty the argument has is that only three of the present directors knew of the decrees, and all three of them satisfied themselves that Allis-Chalmers had not engaged in the practice enjoined and had consented to the decrees merely to avoid expense and the necessity of defending the company's position. Under the circumstances, we think knowledge by three of the directors that in 1937 the company had consented to the entry of decrees enjoining it from doing something they had satisfied themselves it had never done, did not put the Board on notice of the possibility of future illegal price fixing.

Plaintiffs have wholly failed to establish either actual notice or imputed notice to the Board of Directors of facts which should have put them on guard, and have caused them to take steps to prevent the future possibility of illegal price fixing and bid rigging. Plaintiffs say that as a minimum in this respect the Board should have taken the steps it took in 1960 when knowledge of the facts first actually came to their attention as a result of the Grand Jury investigation. Whatever duty, however, there was upon the Board to take such steps, the fact of the 1937 decrees has no bearing upon the question, for under the circumstances they were notice of nothing.

The precise charge made against these director defendants is that, even though they had no knowledge of any suspicion of wrongdoing on the part of the company's employees, they still should have put into effect a system of watchfulness which would have brought such misconduct to their attention in ample time to have brought it to an end. On the contrary, it appears that directors are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. If such occurs and goes unheeded, then liability of the directors might well follow, but absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage[1] to ferret out wrongdoing which they have no reason to suspect exists.

[1] Getting a little histrionic here, no?

The duties of the Allis-Chalmers Directors were fixed by the nature of the enterprise which employed in excess of 30,000 persons, and extended over a large geographical area. By force of necessity, the company's Directors could not know personally all the company's employees.[2] The very magnitude of the enterprise required them to confine their control to the broad policy decisions. That they did this is clear from the record. At the meetings of the Board in which all Directors participated, these questions were considered and decided on the basis of summaries, reports and corporate records.

[2] Checkmate, I guess?

In the last analysis, the question of whether a corporate director has become liable for losses to the corporation through neglect of duty is determined by the circumstances. If he has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him. This is not the case at bar, however, for as soon as it became evident that there were grounds for suspicion, the Board acted promptly to end it and prevent its recurrence.

Plaintiffs say these steps should have been taken long before, even in the absence of suspicion, but we think not, for we know of no rule of law which requires a corporate director to assume, with no justification whatsoever, that all corporate employees are incipient law violators who, but for a tight checkrein, will give free vent to their unlawful propensities.

We therefore affirm the Vice Chancellor's ruling that the individual director defendants are not liable as a matter of law merely because, unknown to them, some employees of Allis-Chalmers violated the anti-trust laws thus subjecting the corporation to loss.

Some discussion questions:

1. The court is very concerned about management second-guessing (and spying on?) its subordinates. Why?

2. Allis-Chalmers delegated a ton of authority to its division- and department-level managers. Would attaching strong oversight duties to the board permit this management structure?

3. At the time *Graham* was decided, barely any criminal law applied to corporate activity. By the mid-1990s, however, both the risk of criminal prosecution – in the areas of environmental, anti-trust, labor, and consumer protection law – and the potential financial penalties had increased dramatically. Does that change in the risk to the corporate bottom line change the duties of the board? The next case considers that exact question.

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

Allen, J.

Caremark, a Delaware corporation with its headquarters in Northbrook, Illinois, was created in November 1992 when it was spun-off from Baxter International, Inc. and became a publicly held company listed on the New York Stock Exchange. During the relevant period Caremark was involved in two main health care business segments, providing patient care and managed care services.

A substantial part of the revenues generated by Caremark's businesses is derived from third party payments, insurers, and Medicare and Medicaid reimbursement programs. The latter source of payments are subject to the terms of the Anti-Referral Payments Law ("ARPL") which prohibits health care providers from paying any form of remuneration to induce the referral of Medicare or Medicaid patients. From its inception, Caremark entered into a variety of agreements with hospitals, physicians, and health care providers for advice and services, as well as distribution agreements with drug manufacturers, as had its predecessor prior to 1992. Specifically, Caremark did have a practice of entering into contracts for services (e.g., consultation agreements and research grants) with physicians at least some of whom prescribed or recommended services or products that Caremark provided to Medicare recipients and other patients. Such contracts were not prohibited by the ARPL but they obviously raised a possibility of unlawful "kickbacks."

As early as 1989, Caremark's predecessor issued an internal "Guide to Contractual Relationships" ("Guide") to govern its employees in entering into contracts with physicians and hospitals. The Guide tended to be reviewed annually by lawyers and updated. Each version of the Guide stated as Caremark's and its predecessor's policy that no payments would be made in exchange for or to induce patient referrals.[1] But what one might deem a prohibited quid pro quo was not always clear. Due to a scarcity of court decisions interpreting the ARPL, however, Caremark repeatedly publicly stated that there was uncertainty concerning Caremark's interpretation of the law.

[1] Here's a bunch of illegal stuff that could absolutely help you make a ton of money and advance your career in this company. But don't do it! But here's how you do it. But don't! WINK WINK.

In August 1991, the HHS Office of the Inspector General ("OIG") initiated an investigation of Caremark's predecessor. Caremark's predecessor was served with a subpoena requiring the production of documents, including contracts between Caremark's predecessor and physicians (Quality Service Agreements ("QSAs")). Under the QSAs, Caremark's predecessor appears to have paid physicians fees for monitoring patients under Caremark's predecessor's care, including Medicare and Medicaid recipients. Sometimes apparently those monitoring patients were referring physicians, which raised ARPL concerns.

Caremark began settlement negotiations with federal and state government entities in May 1995. In return for a guilty plea to a single count of mail fraud by the corporation, the payment of a criminal fine, the payment of substantial civil damages,[2] and cooperation with further federal investigations on matters relating to the OIG investigation, the government entities agreed to negotiate a settlement that would permit Caremark to continue participating in Medicare and Medicaid programs. On June 15, 1995, the Board approved a settlement ("Government Settlement Agreement") with the DOJ, OIG, U.S. Veterans Administration, U.S. Federal Employee Health Benefits Program, federal Civilian Health and Medical Program of the Uniformed Services, and related state agen-

[2] Approximately $250 million.

cies in all fifty states and the District of Columbia. No senior officers or directors were charged with wrongdoing in the Government Settlement Agreement or in any of the prior indictments. In fact, as part of the sentencing in the Ohio action on June 19, 1995, the United States stipulated that no senior executive of Caremark participated in, condoned, or was willfully ignorant of wrongdoing in connection with the home infusion business practices.

The complaint [here] charges the director defendants with breach of their duty of attention or care in connection with the on-going operation of the corporation's business. The claim is that the directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance. The complaint thus does not charge either director self-dealing or the more difficult loyalty-type problems arising from cases of suspect director motivation, such as entrenchment or sale of control contexts. The theory here advanced is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.

In 1963, the Delaware Supreme Court in *Graham v. Allis-Chalmers Mfg. Co.*, addressed the question of potential liability of board members for losses experienced by the corporation as a result of the corporation having violated the anti-trust laws of the United States. There was no claim in that case that the directors knew about the behavior of subordinate employees of the corporation that had resulted in the liability. Rather, as in this case, the claim asserted was that the directors ought to have known of it and if they had known they would have been under a duty to bring the corporation into compliance with the law and thus save the corporation from the loss. The Delaware Supreme Court concluded that, under the facts as they appeared, there was no basis to find that the directors had breached a duty to be informed of the ongoing operations of the firm. In notably colorful terms, the court stated that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." The Court found that there were no grounds for suspicion in that case and, thus, concluded that the directors were blamelessly unaware of the conduct leading to the corporate liability.

How does one generalize this holding today? Can it be said today that, absent some ground giving rise to suspicion of violation of law, that corporate directors have no duty to assure that a corporate information gathering and reporting systems exists which represents a good faith attempt to provide senior management and the Board with information respecting material acts, events or conditions within the corporation, including compliance with applicable statutes and regulations? I certainly do not believe so. I doubt that such a broad generalization of the Graham holding would have been accepted by the Supreme Court in 1963. The case can be more narrowly interpreted as standing for the proposition that, absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf.

A broader interpretation of *Graham v. Allis-Chalmers* – that it means that a corporate board has no responsibility to assure that appropriate information and reporting systems are established by management – would not, in any event, be accepted by the Delaware Supreme Court in 1996, in my opinion. In stating the basis for this view, I start with the recognition that in recent years the Delaware Supreme Court has made it clear the seriousness with which the corporation law views the role of the corporate board. Secondly, I note the elementary fact that relevant and timely information is an essential predicate for satisfaction of the board's supervisory and monitoring role under Section 141 of the Delaware General Corporation Law. Thirdly, I note the potential impact of the federal organizational sentencing guidelines on any business organization. Any rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account this development and the enhanced penalties and the opportunities for reduced sanctions that it offers.

In light of these developments, it would, in my opinion, be a mistake to conclude that our Supreme Court's statement in Graham concerning "espionage" means that corporate boards may satisfy their obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.

Obviously the level of detail that is appropriate for such an information system is a question of business judgment. And obviously too, no rationally designed information and reporting system will remove the possibility that the corporation will violate laws or regulations, or that senior officers or directors may nevertheless sometimes be misled or otherwise fail reasonably to detect acts material to the corporation's compliance with the law. But it is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility.

Thus, I am of the view that a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards. I now turn to an analysis of the claims asserted with this concept of the directors duty of care, as a duty satisfied in part by assurance of adequate information flows to the board, in mind.

In order to show that the Caremark directors breached their duty of care by failing adequately to control Caremark's employees, plaintiffs would have to show either (1) that the directors knew or (2) should have known that violations of law were occurring and, in either event, (3) that the directors took no steps in a good faith effort to prevent or remedy that situation, and (4) that such failure proximately resulted in the losses complained of.

1. Knowing violation for statute: Concerning the possibility that the Caremark directors knew of violations of law, none of the documents submitted for review, nor any of the deposition transcripts appear to provide evidence of it. Certainly the Board understood that the company had entered into a variety of contracts with physicians, researchers, and health care providers and it was understood that some of these contracts were with persons who had prescribed treatments that Caremark participated in providing. The board was informed that the company's reimbursement for patient care was frequently from government funded sources and that such services were subject to the ARPL. But the Board appears to have been informed by experts that the company's practices while contestable, were lawful. There is no evidence that reliance on such reports was not reasonable. Thus, this case presents no occasion to apply a principle to the effect that knowingly causing the corporation to violate a criminal statute constitutes a breach of a director's fiduciary duty. It is not clear that the Board knew the detail found, for example, in the indictments arising from the Company's payments. But, of course, the duty to act in good faith to be informed cannot be thought to require directors to possess detailed information about all aspects of the operation of the enterprise. Such a requirement would simple be inconsistent with the scale and scope of efficient organization size in this technological age.

2. Failure to monitor: Since it does appears that the Board was to some extent unaware of the activities that led to liability, I turn to a consideration of the other potential avenue to director liability that the pleadings take: director inattention or "negligence". Generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, as in *Graham* or in

this case, in my opinion only a sustained or systematic failure of the board to exercise oversight —- such as an utter failure to attempt to assure a reasonable information and reporting system exist —- will establish the lack of good faith that is a necessary condition to liability. Such a test of liability —- lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight -— is quite high. But, a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to good faith performance of duty by such directors.

Here the record supplies essentially no evidence that the director defendants were guilty of a sustained failure to exercise their oversight function. To the contrary, insofar as I am able to tell on this record, the corporation's information systems appear to have represented a good faith attempt to be informed of relevant facts. If the directors did not know the specifics of the activities that lead to the indictments, they cannot be faulted.

The liability that eventuated in this instance was huge. But the fact that it resulted from a violation of criminal law alone does not create a breach of fiduciary duty by directors. The record at this stage does not support the conclusion that the defendants either lacked good faith in the exercise of their monitoring responsibilities or conscientiously permitted a known violation of law by the corporation to occur. The claims asserted against them must be viewed at this stage as extremely weak.

Some discussion questions:

1. The court in *Caremark* very clearly says that *Graham* would have been decided differently thirty years later. Why?
2. How does the *Caremark* standard differ from the *Graham* standard?
3. What would a board have to do under *Caremark* to actually face liability?

Having established that board members have basic responsibilities to oversee the finances and workings of the corporation, in the next two chapters, we'll take a closer look at the board's fiduciary duties of care and loyalty, and look at the specific actions that these duties require boards to take – or avoid.

7. Corporate Fiduciary Duties: Care

IF DIRECTORS HAVE AN OBLIGATION TO ACT, as the previous cases have established, what is the standard of review for evaluating their decisions? We have already introduced the two most important doctrines in terms of corporate decisionmaking: the fiduciary duty of care and the Business Judgment Rule.[1] The former requires corporate managers to act with the prudence that a reasonable person in a similar situation would, while the latter is a judicial presumption that corporate managers do exactly that.

[1] The duty of loyalty is extremely important, too, and we examine it in Chapter 8, but it deals primarily with the motives of the decisionmakers and not the quality of the decisions.

More than just a (let's be honest: largely unearned) presumption of competency regarding board decisionmaking – the Business Judgment Rule is also a procedural hurdle for plaintiffs bringing legal challenges against corporate management.[2] It creates a rebuttable presumption that board decisions are reasonable and made in good faith, and requires plaintiffs to overcome that presumption by showing that a given decision was not:

[2] Don't go looking for an explanation of the BJR in a state's corporate statutes, just FYI. As respected as it is by courts in every state, the BJR was not established by statute, but instead is a judge-made rule reflecting the belief that corporate directors are in a better position to make decisions for a corporation than judges are.

- Rational;
- Informed;
- Disinterested; or
- Independent.

If a plaintiff attacking a board decision fails to show that one of these factors was absent, courts will automatically defer to board decisionmaking. But if a plaintiff can credibly attack *any* of these factors, courts are empowered to step in and protect the interests of the corporation, and the onus shifts to the defendant board members to prove that their decision was reasoned and fair.

Overcoming the business judgment rule is more difficult than it might seem, however, as courts grant broad deference both to board decisions and to the rationales boards give for those decisions. This particular point – how courts should treat the reasons that boards give for their decisions – is at the center of the following case.

Shlensky v. Wrigley, 95 Ill. App. 2d 173 (Ill. App. Ct. 1968)

Sullivan, J.

This is an appeal from a dismissal of plaintiff's amended complaint on motion of the defendants. The action was a stockholders' derivative suit against the directors for negligence and mismanagement. The corporation was also made a defendant. Plaintiff sought damages and an order that defendants cause the installation of lights in Wrigley Field and the scheduling of night baseball games.

Plaintiff is a minority stockholder of defendant corporation, Chicago National League Ball Club (Inc.), a Delaware corporation with its principal place of business in Chicago, Illinois. Defendant corporation owns and operates the major league professional baseball team known as the Chicago Cubs. The corporation also engages in the operation of Wrigley Field, the Cubs' home park, the concessionaire sales during Cubs' home games, television and radio broadcasts of Cubs' home games, the leasing of the field for football games and other events and receives its share, as visiting team, of admission moneys from games played in other National League stadia. The individual defendants are directors of the Cubs and have served for varying periods of years. Defendant Philip K. Wrigley is also president of the corporation and owner of approximately 80% of the stock therein.

Plaintiff alleges that since night baseball was first played in 1935 nineteen of the twenty major league teams have scheduled night games. In 1966, out of a total of 1,620 games in the major leagues, 932 were played at night. Plaintiff alleges that every member of the major leagues, other than the Cubs, scheduled substantially all of its home games in 1966 at night, exclusive of opening days, Saturdays, Sundays, holidays and days prohibited by league rules. Allegedly this has been done for the specific purpose of maximizing attendance and thereby maximizing revenue and income.

The Cubs, in the years 1961-65, sustained operating losses from its direct baseball operations. Plaintiff attributes those losses to inadequate attendance at Cubs' home games. He concludes that if the directors continue to refuse to install lights at Wrigley Field and schedule night baseball games, the Cubs will continue to sustain comparable losses and its financial condition will continue to deteriorate.

Plaintiff alleges that, except for the year 1963, attendance at Cubs' home games has been substantially below that at their road games, many of which were played at night. Plaintiff compares attendance at Clubs' games with that of the Chicago White Sox, an American League club, whose weekday games were generally played at night. The weekend attendance figures for the two teams were similar; however, the White Sox week-night games drew many more patrons than did the Cubs' weekday games.

Plaintiff alleges that the funds for the installation of lights can be readily obtained through financing and the cost of installation would be far more than offset and recaptured by increased revenues and incomes resulting from the increased attendance.

Plaintiff further alleges that defendant Wrigley has refused to install lights, not because of interest in the welfare of the corporation but because of his personal opinions "that baseball is a 'daytime sport' and that the installation of lights and night baseball games will have a deteriorating effect upon the surrounding neighborhood." It is alleged that he has admitted that he is not interested in whether the Cubs would benefit financially from such action because of his concern for the neighborhood, and that he would be willing for the team to play night games if a new stadium were built in Chicago.

Plaintiff alleges that the other defendant directors, with full knowledge of the foregoing matters, have acquiesced in the policy laid down by Wrigley and have permitted him to dominate the board of directors in matters involving the installation of lights and scheduling of night games, even though they knew he was not motivated by a good faith concern as to the best interests of defendant corporation, but solely by his personal views set forth above. It is charged that the directors are acting for a reason or reasons contrary and wholly unrelated to the business interests of the corporation; that such arbitrary and capricious acts constitute mismanagement and waste of corporate assets, and that the directors have been negligent in failing to exercise reasonable care and prudence in the management of the corporate affairs.

The question on appeal is whether plaintiff's amended complaint states a cause of action. It is plaintiff's position that fraud, illegality and conflict of interest are not the only bases for a stockholder's derivative action against the directors. Contrariwise, defendants argue that the courts will not step in and interfere with honest business judgment of the directors unless there is a showing of fraud, illegality or conflict of interest.

The cases in this area are numerous and each differs from the others on a factual basis. However, the courts have pronounced certain ground rules which appear in all cases and which are then applied to the given factual situation. The court in *Wheeler v. The Pullman Iron Steel Co.* said:

> "It is, however, fundamental in the law of corporations, that the majority of its stockholders shall control the policy of the corporation, and regulate and govern the lawful exercise of its franchise and business. . . . Every one purchasing or subscribing for stock in a corporation impliedly agrees

> that he will be bound by the acts and proceedings done or sanctioned by a majority of the shareholders, or by the agents of the corporation duly chosen by such majority, within the scope of the powers conferred by the charter, and courts of equity will not undertake to control the policy or business methods of a corporation, although it may be seen that a wiser policy might be adopted and the business more successful if other methods were pursued. The majority of shares of its stock, or the agents by the holders thereof lawfully chosen, must be permitted to control the business of the corporation in their discretion, when not in violation of its charter or some public law, or corruptly and fraudulently subversive of the rights and interests of the corporation or of a shareholder."

The standards set in Delaware are also clearly stated in the cases. In *Davis v. Louisville Gas Electric Co.*, a minority shareholder sought to have the directors enjoined from amending the certificate of incorporation. The court said:

> "We have then a conflict in view between the responsible managers of a corporation and an overwhelming majority of its stockholders on the one hand and a dissenting minority on the other — a conflict touching matters of business policy, such as has occasioned innumerable applications to courts to intervene and determine which of the two conflicting views should prevail. The response which courts make to such applications is that it is not their function to resolve for corporations questions of policy and business management. The directors are chosen to pass upon such questions and their judgment unless shown to be tainted with fraud is accepted as final. The judgment of the directors of corporations enjoys the benefit of a presumption that it was formed in good faith and was designed to promote the best interests of the corporation they serve."

Plaintiff in the instant case argues that the directors are acting for reasons unrelated to the financial interest and welfare of the Cubs. However, we are not satisfied that the motives assigned to Philip K. Wrigley, and through him to the other directors, are contrary to the best interests of the corporation and the stockholders. For example, it appears to us that the effect on the surrounding neighborhood might well be considered by a director who was considering the patrons who would or would not attend the games if the park were in a poor neighborhood. Furthermore, the long run interest of the corporation in its property value at Wrigley Field might demand all efforts to keep the neighborhood from deteriorating. By these thoughts we do not mean to say that we have decided that the decision of the directors was a correct one. That is beyond our jurisdiction and ability. We are merely saying that the decision is one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality or conflict of interest in their making of that decision.

There is no allegation that the night games played by the other nineteen teams enhanced their financial position or that the profits, if any, of those teams were directly related to the number of night games scheduled. There is an allegation that the installation of lights and scheduling of night games in Wrigley Field would have resulted in large amounts of additional revenues and incomes from increased attendance and related sources of income. Further, the cost of installation of lights, funds for which are allegedly readily available by financing, would be more than offset and recaptured by increased revenues. However, no allegation is made that there will be a net benefit to the corporation from such action, considering all increased costs.

Plaintiff claims that the losses of defendant corporation are due to poor attendance at home games. However, it appears from the amended complaint, taken as a whole, that factors other than attendance affect the net earnings or losses. For example, in 1962, attendance at home and road games decreased appreciably as compared with 1961, and yet the loss from direct baseball operation and of the whole corporation was considerably less.

The record shows that plaintiff did not feel he could allege that the increased revenues would be sufficient to cure the corporate deficit. The only cost plaintiff was at all concerned with was that of installation of lights. No mention was made of operation and maintenance of the lights or other possible increases in operating costs of night games and we cannot speculate as to what other factors might influence the increase or decrease of profits if the Cubs were to play night home games.

Finally, we do not agree with plaintiff's contention that failure to follow the example of the other major league clubs in scheduling night games constituted negligence. Plaintiff made no allegation that these teams' night schedules were profitable or that the purpose for which night baseball had been undertaken was fulfilled. Furthermore, it cannot be said that directors, even those of corporations that are losing money, must follow the lead of the other corporations in the field. Directors are elected for their business capabilities and judgment and the courts cannot require them to forego their judgment because of the decisions of directors of other companies. Courts may not decide these questions in the absence of a clear showing of dereliction of duty on the part of the specific directors and mere failure to "follow the crowd" is not such a dereliction.

For the foregoing reasons the order of dismissal entered by the trial court is affirmed.

Some discussion questions:

1. Is there a requirement that a business must act to maximize profits? Why or why not?
2. What factors can a board of directors consider in making decisions on behalf of a corporation? Conversely. what factors would be illegitimate for a board to consider?

3. The Cubs installed lights at Wrigley Field in 1988 – and just twenty-eight years later, they won the World Series. Coincidence? (Also: could a shareholder have sued to stop the Cubs from installing those lights and cited their previous justifications for refusing to install lights?)

4. Have you been to a Cubs game recently? Does it feel like they have a lot of respect for the historic character of the neighborhood?

One of the claims raised by the shareholders in *Shlensky* was that management was engaged in the "waste" of corporate assets. Waste is an extremely high bar for a challenging shareholder to clear in a suit against a board, as waste exists only when "what the corporation has received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth that which the corporation has paid."[1] Instead, courts have consistently held that the business judgment rule applies to shield the board where the board's decision can be attributed to *any* rational business purpose (regardless of whether it turns out to be a smart decision or not). What counts as a rational business purpose? **Almost anything.** Purposes both tangible (increasing profits, reducing tax liabilities, bolstering the stock price) and intangible (customer goodwill, employee morale, corporate reputation) qualify as rational, and as such a wide range of corporate behavior is legally permissible. As well-established this principle is in corporate law, however, the extremely broad definition of a rational business purpose is not without its critics.

[1] *Grobow v. Perot*, 539 A.2d 180 (Del. 1988).

The Unparalleled Genius of Marco Rubio

In 2021, United States Senator Marco Rubio introduced a delightful bill called the Mind Your Own Business Act,[2] which purports to address the most pressing problem in modern corporate governance, namely: businesses using corporate resources to "promote socialism, Marxism, critical race theory, or other un-American ideologies among their workforces or customers".[3]

Brushing aside the "there is no federal corporate law" and "state law, not federal law, creates fiduciary duties for management" concerns, the MYOB Act[4] would create a cause of action under the Securities Exchange Act of 1934[5] for shareholders of large corporations (over $20BN in market cap) to sue corporate managers for, among other things, "material action" that "promotes a covered divisive concept"[6] or "is facially unrelated to the pecuniary interest" of the corporation.

A corporation's pecuniary interest – which, according to the act, presumptively excludes "any reference to diversity, equity, or inclusion

[2] A copy of which can be found here.

[3] Is this why Apple is sitting on more than $200BN in cash rather than distributing it to its shareholders? Because of Karl Marx? Give me that money, you goddamn communists!

[4] Just rolls off the tongue.

[5] Sure, why not.

[6] "Divisive" is defined by some Trump-era executive order that I promise you I will never read.

with respect to the composition of the workforce, management, or board of directors of the issuer[1] or society in general" – by definition does not include:

[1] "Issuer" = "Corporation", here.

(A) the morale of, or ability of the issuer to hire or retain, supervisory employees in general;

(B) the diversity of the board of directors, management, or workforce in general;

(C) the public relations, image, value of marketing, or coverage by the news media of the issuer;

(D) any financial benefit or reduction in cost, including the cost of capital to the issuer, as a result of investment by a third party or its inclusion in an index fund.[2]

[2] This one seems pretty fucking pecuniary to me!

Take that, *rational business purpose*! While on its face this seems like a completely insane list of things to define as **Not Real Business**,[3] the act isn't done yet. The following Not Real Business actions are specifically excluded from liability under the act:

[3] Hiring employees? Press coverage? *Marketing*???

- Charitable contributions[4]
- The exercise of religion
- Anything to do with the armed forces
- Boycotts of the People's Republic of China, the Russian Federation, North Korea, Iran, Syria, Sudan, Venezuela, or Cuba
- Boycotts of any entity that derives revenue through the sale of products or services "of a prurient sexual nature"
- Boycotts of any entity that engages in its own boycott of Israel[5]

[4] So long as they aren't "divisive", I guess?

[5] Note that the corporation boycotting Israel would be in violation of this act, while the boycotter-of-the-boycotter is not – but the boycotter-of-the-boycotter-of-the-boycotter *and* the boycotter-of-the-boycotter-of-the-boycotter-of-the-boycotter would both be in violation of this act. I think? My head hurts.

Whew! Good to know that, like, Cheez-Its can continue to express its deeply-held religious beliefs and also boycott North Korea without being in violation of acting in a disallowed "non-pecuniary interest".

I've included a summary of this doofy bill in this casebook for two reasons. First, is it kind of funny that Chamber of Commerce types spent literal decades advancing the concept of First Amendment rights for corporations, and like five minutes after they finally win recognition for corporate speech rights they turn around and start bitching that the corporations are *too goddamn woke*? Yes, yes it is.[6]

[6] Is it also funny that ostensible liberals respond to attempts to curtail corporate speech by leaping to the defense of the First Amendment rights of soulless multinational conglomerates? Yes, yes it is.

But secondly, and way more importantly, the act illustrates how unbelievably difficult it is (and how nakedly ideological it is) to attempt to draw a boundary around the concept of a rational business purpose, and why courts prefer to just give corporate boards a healthy amount of discretion and authority when it comes to making decisions for the corporation. The Business Judgment Rule is best understood as the "I'm Glad Someone Else Is Making This Judgment Rule".

Anyway, the Mind Your Own Business Act would be completely unworkable and hilariously unconstitutional and would absolutely kneecap pretty much any reasonably run public corporation. As such, we hope and pray it becomes law as soon as possible.

why do you want this to become law?

The Duty of Care

IF THE DUTY OF CARE does not require *good* decisions, only *rational* decisions, do corporate boards have to do any actual work to satisfy their responsibilities? We've already seen in *Francis* that board members have to occasionally check in with the companies they manage. And we've seen in *Caremark* that board members have to create monitoring and reporting systems so that they can learn about problems the corporation may be having. Beyond that, though, when a corporation is faced with an important decision, what exactly do board members *have* to do to comply with the duty of care?

The next case is a seminal case in corporate law, and represents a real paradigm shift[1] in terms of expectations of corporate boards (not unlike *Caremark* in that regard). Quite unexpectedly, the Delaware Supreme Court took a hard look at a particular corporation's internal decisionmaking process, and articulated a standard that remains in force to this day (even if the consequences are no longer viable). It is a long opinion (even by corporate law standards), and it very much goes into the weeds regarding the play-by-play of how the deal developed, but in cases challenging board actions under the duty of care, these details are extremely important.

[1] I'm cringing as I write this.

Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)

Horsey, J.

Trans Union was a publicly-traded, diversified holding company, the principal earnings of which were generated by its railcar leasing business. During the period here involved, the Company had a cash flow of hundreds of millions of dollars annually. However, the Company had difficulty in generating sufficient taxable income to offset increasingly large investment tax credits (ITCs). Accelerated depreciation deductions had decreased available taxable income against which to offset accumulating ITCs.[2] The Company took these deductions, despite their effect on usable

[2] This all sounds super complicated, but it really just boils down to the fact that Trans Union was already writing off so much on its taxes that it didn't have enough income left over to use all the available tax credits. *Berenstain Bears and The Problem of Too Many Tax Breaks* over here.

ITCs, because the rental price in the railcar leasing market had already impounded the purported tax savings.

In the late 1970's, together with other capital-intensive firms, Trans Union lobbied in Congress to have ITCs refundable in cash to firms which could not fully utilize the credit. During the summer of 1980, defendant Jerome W. Van Gorkom, Trans Union's Chairman and Chief Executive Officer, testified and lobbied in Congress for refundability of ITCs and against further accelerated depreciation. By the end of August, Van Gorkom was convinced that Congress would neither accept the refundability concept nor curtail further accelerated depreciation.[1]

[1] You can tell this is an older case because a rich dude personally lobbied Congress for an obscure tax break that would effectively shovel money into his pockets and Congress **didn't** immediately give it to him. Where's Krysyststyn Sinema when you need her?

Beginning in the late 1960's, and continuing through the 1970's, Trans Union pursued a program of acquiring small companies in order to increase available taxable income. In July 1980, Trans Union Management prepared the annual revision of the Company's Five Year Forecast. This report was presented to the Board of Directors at its July, 1980 meeting. The report projected an annual income growth of about 20%. The report also concluded that Trans Union would have about $195 million in spare cash between 1980 and 1985, "with the surplus growing rapidly from 1982 onward." The report referred to the ITC situation as a "nagging problem" and, given that problem, the leasing company "would still appear to be constrained to a tax break even." The report then listed four alternative uses of the projected 1982-1985 equity surplus: (1) stock repurchase; (2) dividend increases; (3) a major acquisition program; and (4) combinations of the above. The sale of Trans Union was not among the alternatives. The report emphasized that, despite the overall surplus, the operation of the Company would consume all available equity for the next several years, and concluded: "As a result, we have sufficient time to fully develop our course of action."

On August 27, 1980, Van Gorkom met with Senior Management of Trans Union. Van Gorkom reported on his lobbying efforts in Washington and his desire to find a solution to the tax credit problem more permanent than a continued program of acquisitions. Various alternatives were suggested and discussed preliminarily, including the sale of Trans Union to a company with a large amount of taxable income.

Donald Romans, Chief Financial Officer of Trans Union, stated that his department had done a "very brief bit of work on the possibility of a leveraged buy-out." This work had been prompted by a media article which Romans had seen regarding a leveraged buy-out by management.[2] The work consisted of a "preliminary study" of the cash which could be generated by the Company if it participated in a leveraged buy-out. As Romans stated, this analysis "was very first and rough cut at seeing whether a cash flow would support what might be considered a high price for this type of transaction."

[2] This is when management borrows a large amount of money, buys out the corporation's shareholders, and effectively transfers that loan to the corporation. It would have solved some of Trans Union's problems, but created a whole host of other problems – including possibly getting Trans Union swept up in a bidding war.

On September 5, at another Senior Management meeting which Van Gorkom attended, Romans again brought up the idea of a leveraged buy-out as a "possible strategic alternative" to the Company's acquisition program. Romans and Bruce S. Chelberg, President and Chief Operating Officer of Trans Union, had been working on the matter in preparation for the meeting. According to Romans: They did not "come up" with a price for the Company. They merely "ran the numbers" at $50 a share and at $60 a share with the "rough form" of their cash figures at the time. Their "figures indicated that $50 would be very easy to do but $60 would be very difficult to do under those figures." This work did not purport to establish a fair price for either the Company or 100% of the stock. It was intended to determine the cash flow needed to service the debt that would "probably" be incurred in a leveraged buy-out, based on "rough calculations" without "any benefit of experts to identify what the limits were to that, and so forth." These computations were not considered extensive and no conclusion was reached.

At this meeting, Van Gorkom stated that he would be willing to take $55 per share for his own 75,000 shares. He vetoed the suggestion of a leveraged buy-out by Management, however, as involving a potential conflict of interest for Management. Van Gorkom, a certified public accountant and lawyer, had been an officer of Trans Union for 24 years, its Chief Executive Officer for more than 17 years, and Chairman of its Board for 2 years. It is noteworthy in this connection that he was then approaching 65 years of age and mandatory retirement.

For several days following the September 5 meeting, Van Gorkom pondered the idea of a sale.[1] He had participated in many acquisitions as a manager and director of Trans Union and as a director of other companies. He was familiar with acquisition procedures, valuation methods, and negotiations; and he privately considered the pros and cons of whether Trans Union should seek a privately or publicly-held purchaser.

[1] I'm not gonna do it ... I'm just *thinking about it* just *thinking about it* just *thinking about it* ...

Van Gorkom decided to meet with Jay A. Pritzker,[2] a well-known corporate takeover specialist and a social acquaintance. However, rather than approaching Pritzker simply to determine his interest in acquiring Trans Union, Van Gorkom assembled a proposed per share price for sale of the Company and a financing structure by which to accomplish the sale. Van Gorkom did so without consulting either his Board or any members of Senior Management except one: Carl Peterson, Trans Union's Controller. Telling Peterson that he wanted no other person on his staff to know what he was doing, but without telling him why, Van Gorkom directed Peterson to calculate the feasibility of a leveraged buy-out at an assumed price per share of $55. Apart from the Company's historic stock market price, and Van Gorkom's long association with Trans Union, the record is devoid of any competent evidence that $55 represented the per

[2] Not to be confused with the philanthropist who founded the Pritzker School of Medicine at the University of Chicago (his father), the former secretary of commerce (his niece), the current governor of Illinois (his nephew), the first openly transgender billionaire (his niece), the Tibetan buddhist lama worth an estimated $1.7BN who lives on a ranch in Montana (another niece), the actress who played Harrison Ford's daughter in *Air Force One* (yet another niece), or one of at least five Pritzker heirs who claim to be documentary filmmakers. He is, however, the namesake of the Pritzker Prize in architecture, the Pritzker Pavilion in downtown Chicago, and the Northwestern Pritzker School of Law.

share intrinsic value of the Company.

Having thus chosen the $55 figure, based solely on the availability of a leveraged buy-out, Van Gorkom multiplied the price per share by the number of shares outstanding to reach a total value of the Company of $690 million. Van Gorkom told Peterson to use this $690 million figure and to assume a $200 million equity contribution by the buyer. Based on these assumptions, Van Gorkom directed Peterson to determine whether the debt portion of the purchase price could be paid off in five years or less if financed by Trans Union's cash flow as projected in the Five Year Forecast, and by the sale of certain weaker divisions identified in a study done for Trans Union by the Boston Consulting Group ("BCG study"). Peterson reported that, of the purchase price, approximately $50-80 million would remain outstanding after five years. Van Gorkom was disappointed, but decided to meet with Pritzker nevertheless.

Van Gorkom arranged a meeting with Pritzker at the latter's home on Saturday, September 13, 1980.[1] Van Gorkom prefaced his presentation by stating to Pritzker: "Now as far as you are concerned, I can, I think, show how you can pay a substantial premium over the present stock price and pay off most of the loan in the first five years. If you could pay $55 for this Company, here is a way in which I think it can be financed."

[1] Van Gorkom and Pritzker were buddies, with shared interests in classic rich guy shit like skiing, the opera, and avoiding taxes at all costs.

Van Gorkom then reviewed with Pritzker his calculations based upon his proposed price of $55 per share. Although Pritzker mentioned $50 as a more attractive figure, no other price was mentioned. However, Van Gorkom stated that to be sure that $55 was the best price obtainable, Trans Union should be free to accept any better offer.[2] Pritzker demurred, stating that his organization would serve as a "stalking horse" for an "auction contest" only if Trans Union would permit Pritzker to buy 1,750,000 shares of Trans Union stock at market price which Pritzker could then sell to any higher bidder. After further discussion on this point, Pritzker told Van Gorkom that he would give him a more definite reaction soon.

[2] To recap: Van Gorkom literally pulled this price out of thin air, and is now defending it to the death. I love this dude.

On Monday, September 15, Pritzker advised Van Gorkom that he was interested in the $55 cash-out merger proposal and requested more information on Trans Union. Van Gorkom agreed to meet privately with Pritzker, accompanied by Peterson, Chelberg, and Michael Carpenter, Trans Union's consultant from the Boston Consulting Group. The meetings took place on September 16 and 17. Van Gorkom was "astounded that events were moving with such amazing rapidity."

"we're all astounded that events are moving with such amazing rapidity"

On Thursday, September 18, Van Gorkom met again with Pritzker. At that time, Van Gorkom knew that Pritzker intended to make a cash-out merger offer at Van Gorkom's proposed $55 per share. Pritzker instructed his attorney, a merger and acquisition specialist, to begin drafting merger documents. There was no further discussion of the $55 price. However, the number of shares of Trans Union's treasury stock to be offered to Pritzker was negotiated down to one million shares; the price was set at $38 — 75 cents above the per share price at the close of the market on September 19. At this point, Pritzker insisted that the Trans Union Board act on his merger proposal within the next three days, stating to Van Gorkom: "We have to have a decision by no later than Sunday [evening, September 21] before the opening of the English stock exchange on Monday morning."[1] Pritzker's lawyer was then instructed to draft the merger documents, to be reviewed by Van Gorkom's lawyer, "sometimes with discussion and sometimes not, in the haste to get it finished."

[1] Literally no reason for this deadline. None.

On Friday, September 19, Van Gorkom, Chelberg, and Pritzker consulted with Trans Union's lead bank regarding the financing of Pritzker's purchase of Trans Union. The bank indicated that it could form a syndicate of banks that would finance the transaction. On the same day, Van Gorkom retained James Brennan, Esquire, to advise Trans Union on the legal aspects of the merger. Van Gorkom did not consult with William Browder, a Vice-President and director of Trans Union and former head of its legal department, or with William Moore, then the head of Trans Union's legal staff.

On Friday, September 19, Van Gorkom called a special meeting of the Trans Union Board for noon the following day. He also called a meeting of the Company's Senior Management to convene at 11:00 a.m., prior to the meeting of the Board. No one, except Chelberg and Peterson, was told the purpose of the meetings. Van Gorkom did not invite Trans Union's investment banker, Salomon Brothers or its Chicago-based partner, to attend.

Of those present at the Senior Management meeting on September 20, only Chelberg and Peterson had prior knowledge of Pritzker's offer. Van Gorkom disclosed the offer and described its terms, but he furnished no copies of the proposed Merger Agreement. Romans announced that his department had done a second study which showed that, for a leveraged buy-out, the price range for Trans Union stock was between $55 and $65 per share. Van Gorkom neither saw the study nor asked Romans to make it available for the Board meeting.

Senior Management's reaction to the Pritzker proposal was completely negative. No member of Management, except Chelberg and Peterson, supported the proposal. Romans objected to the price as being too low; he was critical of the timing and suggested that consideration should be given to the adverse tax consequences of an all-cash deal for low-basis shareholders; and he took the position that the agreement to sell Pritzker one million newly-issued shares at market price would inhibit other offers, as would the prohibitions against soliciting bids and furnishing inside information to other bidders. Romans argued that the Pritzker proposal was a "lock up"[1] and amounted to "an agreed merger as opposed to an offer." Nevertheless, Van Gorkom proceeded to the Board meeting as scheduled without further delay.

[1] A "lock up" is a deal protection device meant to give the agreed-upon buyer something in case the deal doesn't go through. This is pretty clearly a lock-up, as it would give Pritzker a million shares of Trans Union in the event Trans Union accepts a better offer.

Ten directors served on the Trans Union Board, five inside (defendants Bonser, O'Boyle, Browder, Chelberg, and Van Gorkom) and five outside (defendants Wallis, Johnson, Lanterman, Morgan and Reneker). All directors were present at the meeting, except O'Boyle who was ill.[2] Of the outside directors, four were corporate chief executive officers and one was the former Dean of the University of Chicago Business School. None was an investment banker or trained financial analyst. All members of the Board were well informed about the Company and its operations as a going concern. They were familiar with the current financial condition of the Company, as well as operating and earnings projections reported in the recent Five Year Forecast. The Board generally received regular and detailed reports and was kept abreast of the accumulated investment tax credit and accelerated depreciation problem.

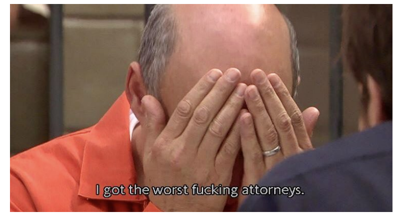
[2] Lucky him!

Van Gorkom began the Special Meeting of the Board with a twenty-minute oral presentation. Copies of the proposed Merger Agreement were delivered too late for study before or during the meeting. He reviewed the Company's ITC and depreciation problems and the efforts theretofore made to solve them. He discussed his initial meeting with Pritzker and his motivation in arranging that meeting. Van Gorkom did not disclose to the Board, however, the methodology by which he alone had arrived at the $55 figure, or the fact that he first proposed the $55 price in his negotiations with Pritzker.

Van Gorkom outlined the terms of the Pritzker offer as follows: Pritzker would pay $55 in cash for all outstanding shares of Trans Union stock upon completion of which Trans Union would be merged into New T Company, a subsidiary wholly-owned by Pritzker and formed to implement the merger; for a period of 90 days, Trans Union could receive, but could not actively solicit, competing offers; the offer had to be acted on by the next evening, Sunday, September 21; Trans Union could only furnish to competing bidders published information, and not proprietary information; the offer was subject to Pritzker obtaining the necessary financing by October 10, 1980; if the financing contingency were met or waived by Pritzker, Trans Union was required to sell to Pritzker one million newly-issued shares of Trans Union at $38 per share.

Van Gorkom took the position that putting Trans Union "up for auction" through a 90-day market test would validate a decision by the Board that $55 was a fair price. He told the Board that the "free market will have an opportunity to judge whether $55 is a fair price." Van Gorkom framed the decision before the Board not as whether $55 per share was the highest price that could be obtained, but as whether the $55 price was a fair price that the stockholders should be given the opportunity to accept or reject.

Attorney Brennan advised the members of the Board that they might be sued if they failed to accept the offer and that a fairness opinion was not required as a matter of law.



Romans attended the meeting as chief financial officer of the Company. He told the Board that he had not been involved in the negotiations with Pritzker and knew nothing about the merger proposal until the morning of the meeting; that his studies did not indicate either a fair price for the stock or a valuation of the Company; that he did not see his role as directly addressing the fairness issue; and that he and his people "were trying to search for ways to justify a price in connection with such a [leveraged buy-out] transaction, rather than to say what the shares are worth." Romans testified:

> "I told the Board that the study ran the numbers at 50 and 60, and then the subsequent study at 55 and 65, and that was not the same thing as saying that I have a valuation of the company at X dollars. But it was a way — a first step towards reaching that conclusion."

Romans told the Board that, in his opinion, $55 was "in the range of a fair price," but "at the beginning of the range."

Chelberg, Trans Union's President, supported Van Gorkom's presentation and representations. He testified that he "participated to make sure that the Board members collectively were clear on the details of the agreement or offer from Pritzker;" that he "participated in the discussion with Mr. Brennan, inquiring of him about the necessity for valuation opinions in spite of the way in which this particular offer was couched;" and that he was otherwise actively involved in supporting the positions being taken by Van Gorkom before the Board about "the necessity to act immediately on this offer," and about "the adequacy of the $55 and the question of how that would be tested."

The Board meeting of September 20 lasted about two hours.[1] Based solely upon Van Gorkom's oral presentation, Chelberg's supporting representations, Romans' oral statement, Brennan's legal advice, and their knowledge of the market history of the Company's stock, the directors approved the proposed Merger Agreement. However, the Board later claimed to have attached two conditions to its acceptance: (1) that Trans Union reserved the right to accept any better offer that was made during the market test period; and (2) that Trans Union could share its proprietary information with any other potential bidders. While the Board now claims to have reserved the right to accept any better offer received after

[1] The run time of *Spider-Man: No Way Home*? Two hours and twenty-eight minutes.

the announcement of the Pritzker agreement (even though the minutes of the meeting do not reflect this), it is undisputed that the Board did not reserve the right to actively solicit alternate offers.

The Merger Agreement was executed by Van Gorkom during the evening of September 20 at a formal social event that he hosted for the opening of the Chicago Lyric Opera. Neither he nor any other director read the agreement prior to its signing and delivery to Pritzker.[1]

[1] lol, c'mon dude

On Monday, September 22, the Company issued a press release announcing that Trans Union had entered into a "definitive" Merger Agreement with an affiliate of the Marmon Group, Inc., a Pritzker holding company. Within 10 days of the public announcement, dissent among Senior Management over the merger had become widespread. Faced with threatened resignations of key officers, Van Gorkom met with Pritzker who agreed to several modifications of the Agreement. Pritzker was willing to do so provided that Van Gorkom could persuade the dissidents to remain on the Company payroll for at least six months after consummation of the merger.

Van Gorkom reconvened the Board on October 8 and secured the directors' approval of the proposed amendments — sight unseen. The Board also authorized the employment of Salomon Brothers, its investment banker, to solicit other offers for Trans Union during the proposed "market test" period.

The next day, October 9, Trans Union issued a press release announcing: (1) that Pritzker had obtained "the financing commitments necessary to consummate" the merger with Trans Union; (2) that Pritzker had acquired one million shares of Trans Union common stock at $38 per share; (3) that Trans Union was now permitted to actively seek other offers and had retained Salomon Brothers for that purpose; and (4) that if a more favorable offer were not received before February 1, 1981, Trans Union's shareholders would thereafter meet to vote on the Pritzker proposal.

It was not until the following day, October 10, that the actual amendments to the Merger Agreement were prepared by Pritzker and delivered to Van Gorkom for execution. As will be seen, the amendments were considerably at variance with Van Gorkom's representations of the amendments to the Board on October 8; and the amendments placed serious constraints on Trans Union's ability to negotiate a better deal and withdraw from the Pritzker agreement. Nevertheless, Van Gorkom proceeded to execute what became the October 10 amendments to the Merger Agreement without conferring further with the Board members and apparently without comprehending the actual implications of the amendments.

On February 10, the stockholders of Trans Union approved the Pritzker merger proposal. Of the outstanding shares, 69.9% were voted in favor of the merger; 7.25% were voted against the merger; and 22.85% were not voted.

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We turn to the issue of the application of the business judgment rule to the September 20 meeting of the Board.

The Court of Chancery concluded from the evidence that the Board of Directors' approval of the Pritzker merger proposal fell within the protection of the business judgment rule. The Court found that the Board had given sufficient time and attention to the transaction, since the directors had considered the Pritzker proposal on three different occasions, on September 20, and on October 8, 1980 and finally on January 26, 1981.[1] On that basis, the Court reasoned that the Board had acquired, over the four-month period, sufficient information to reach an informed business judgment on the cash-out merger proposal.

[1] The board formally approved the final version of the merger on January 26th.

Applying that standard and governing principles of law to the record and the decision of the Trial Court, we conclude that the Court's ultimate finding that the Board's conduct was not "reckless or imprudent" is contrary to the record and not the product of a logical and deductive reasoning process.

Under Delaware law, the business judgment rule is the offspring of the fundamental principle that the business and affairs of a Delaware corporation are managed by or under its board of directors. In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders. The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors. The rule itself "is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Thus, the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one.

Under the business judgment rule there is no protection for directors who have made an unintelligent or unadvised judgment. A director's duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders. Since a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others. Such obligation does not tolerate faithlessness or self-dealing. But fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here.

Thus, a director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty. Here, there were no allegations of fraud, bad faith, or self-dealing, or proof thereof. Hence, it is presumed that the directors reached their business judgment in good faith, and considerations of motive are irrelevant to the issue before us.

The standard of care applicable to a director's duty of care has also been recently restated by this Court. While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.

In the specific context of a proposed merger of domestic corporations, a director has a duty to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders. Certainly in the merger context, a director may not abdicate that duty by leaving to the shareholders alone the decision to approve or disapprove the agreement.

It is against those standards that the conduct of the directors of Trans Union must be tested, as a matter of law and as a matter of fact, regarding their exercise of an informed business judgment in voting to approve the Pritzker merger proposal. The issue of whether the directors reached an informed decision to "sell" the Company on September 20, 1980 must be determined only upon the basis of the information then reasonably available to the directors and relevant to their decision to accept the Pritzker merger proposal.

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On the record before us, we must conclude that the Board of Directors did not reach an informed business judgment on September 20, 1980 in voting to "sell" the Company for $55 per share pursuant to the Pritzker cash-out merger proposal. Our reasons, in summary, are as follows:

The directors (1) did not adequately inform themselves as to Van Gorkom's role in forcing the "sale" of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the "sale" of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency.

As has been noted, the Board based its September 20 decision to approve the cash-out merger primarily on Van Gorkom's representations.

None of the directors, other than Van Gorkom and Chelberg, had any prior knowledge that the purpose of the meeting was to propose a cash-out merger of Trans Union. No members of Senior Management were present, other than Chelberg, Romans and Peterson; and the latter two had only learned of the proposed sale an hour earlier. Both general counsel Moore and former general counsel Browder attended the meeting, but were equally uninformed as to the purpose of the meeting and the documents to be acted upon.

Without any documents before them concerning the proposed transaction, the members of the Board were required to rely entirely upon Van Gorkom's 20-minute oral presentation of the proposal. No written summary of the terms of the merger was presented; the directors were given no documentation to support the adequacy of $55 price per share for sale of the Company; and the Board had before it nothing more than Van Gorkom's statement of his understanding of the substance of an agreement which he admittedly had never read, nor which any member of the Board had ever seen.

Under 8 Del. C. § 141(e), "directors are fully protected in relying in good faith on reports made by officers." However, there is no evidence that any "report," as defined under § 141(e), concerning the Pritzker proposal, was presented to the Board on September 20. Van Gorkom's oral presentation of his understanding of the terms of the proposed Merger Agreement, which he had not seen, and Romans' brief oral statement of his preliminary study regarding the feasibility of a leveraged buy-out of Trans Union do not qualify as § 141(e) "reports" for these reasons: The former lacked substance because Van Gorkom was basically uninformed as to the essential provisions of the very document about which he was talking. Romans' statement was irrelevant to the issues before the Board since it did not purport to be a valuation study. At a minimum for a report to enjoy the status conferred by § 141(e), it must be pertinent to the subject matter upon which a board is called to act, and otherwise be entitled to good faith, not blind, reliance. Considering all of the surrounding circumstances — hastily calling the meeting without prior notice of its subject matter, the proposed sale of the Company without any prior consideration of the issue or necessity therefor, the urgent time constraints imposed by Pritzker, and the total absence of any documentation whatsoever — the directors were duty bound to make reasonable inquiry of Van Gorkom and Romans, and if they had done so, the inadequacy of that upon which they now claim to have relied would have been apparent.

The defendants rely on the following factors to sustain the Trial Court's finding that the Board's decision was an informed one: (1) the magnitude of the premium or spread between the $55 Pritzker offering price and Trans Union's current market price of $38 per share; (2) the amendment of the Agreement as submitted on September 20 to permit the Board to accept any better offer during the "market test" period; (3) the collective experience and expertise of the Board's "inside" and "outside" directors; and (4) their reliance on Brennan's legal advice that the directors might be sued if they rejected the Pritzker proposal. We discuss each of these grounds seriatim:[1]

[1] Just say "one at a time", man ...

(1) A substantial premium may provide one reason to recommend a merger, but in the absence of other sound valuation information, the fact of a premium alone does not provide an adequate basis upon which to assess the fairness of an offering price. Here, the judgment reached as to the adequacy of the premium was based on a comparison between the historically depressed Trans Union market price and the amount of the Pritzker offer. Using market price as a basis for concluding that the premium adequately reflected the true value of the Company was a clearly faulty, indeed fallacious, premise, as the defendants' own evidence demonstrates. The record is clear that before September 20, Van Gorkom and other members of Trans Union's Board knew that the market had consistently undervalued the worth of Trans Union's stock, despite steady increases in the Company's operating income in the seven years preceding the merger. The Board related this occurrence in large part to Trans Union's inability to use its ITCs as previously noted. Van Gorkom testified that he did not believe the market price accurately reflected Trans Union's true worth; and several of the directors testified that, as a general rule, most chief executives think that the market undervalues their companies' stock.

Despite the foregoing facts and circumstances, there was no call by the Board, either on September 20 or thereafter, for any valuation study or documentation of the $55 price per share as a measure of the fair value of the Company in a cash-out context. It is undisputed that the major asset of Trans Union was its cash flow. Yet, at no time did the Board call for a valuation study taking into account that highly significant element of the Company's assets.

We do not imply that an outside valuation study is essential to support an informed business judgment; nor do we state that fairness opinions by independent investment bankers are required as a matter of law. Often insiders familiar with the business of a going concern are in a better position than are outsiders to gather relevant information; and under appropriate circumstances, such directors may be fully protected in relying in good faith upon the valuation reports of their management.

Here, the record establishes that the Board did not request its Chief Financial Officer, Romans, to make any valuation study or review of the proposal to determine the adequacy of $55 per share for sale of the Company. On the record before us: The Board rested on Romans' elicited response that the $55 figure was within a "fair price range" within the context of a leveraged buy-out. No director sought any further information from Romans. No director asked him why he put $55 at the bottom of his range. No director asked Romans for any details as to his study, the reason why it had been undertaken or its depth. No director asked to see the study; and no director asked Romans whether Trans Union's finance department could do a fairness study within the remaining 36-hour period available under the Pritzker offer.

The record also establishes that the Board accepted without scrutiny Van Gorkom's representation as to the fairness of the $55 price per share for sale of the Company — a subject that the Board had never previously considered. The Board thereby failed to discover that Van Gorkom had suggested the $55 price to Pritzker and, most crucially, that Van Gorkom had arrived at the $55 figure based on calculations designed solely to determine the feasibility of a leveraged buy-out. No questions were raised either as to the tax implications of a cash-out merger or how the price for the one million share option granted Pritzker was calculated.

None of the directors, Management or outside, were investment bankers or financial analysts. Yet the Board did not consider recessing the meeting until a later hour that day (or requesting an extension of Pritzker's Sunday evening deadline) to give it time to elicit more information as to the sufficiency of the offer, either from inside Management (in particular Romans) or from Trans Union's own investment banker, Salomon Brothers, whose Chicago specialist in merger and acquisitions was known to the Board and familiar with Trans Union's affairs.

Thus, the record compels the conclusion that on September 20 the Board lacked valuation information adequate to reach an informed business judgment as to the fairness of $55 per share for sale of the Company.

(2) This brings us to the post-September 20 "market test" upon which the defendants ultimately rely to confirm the reasonableness of their September 20 decision to accept the Pritzker proposal. In this connection, the directors present a two-part argument: (a) that by making a "market test" of Pritzker's $55 per share offer a condition of their September 20 decision to accept his offer, they cannot be found to have acted impulsively or in an uninformed manner on September 20; and (b) that the adequacy of the $17 premium for sale of the Company was conclusively established over the following 90 to 120 days by the most reliable evidence available — the marketplace. Thus, the defendants impliedly contend that the "market test" eliminated the need for the Board to perform any other form of fairness test either on September 20, or thereafter.

Again, the facts of record do not support the defendants' argument. There is no evidence: (a) that the Merger Agreement was effectively amended to give the Board freedom to put Trans Union up for auction sale to the highest bidder; or (b) that a public auction was in fact permitted to occur. The minutes of the Board meeting make no reference to any of this. Indeed, the record compels the conclusion that the directors had no rational basis for expecting that a market test was attainable, given the terms of the Agreement as executed during the evening of September 20. We rely upon the following facts which are essentially uncontradicted:

The Merger Agreement, specifically identified as that originally presented to the Board on September 20, has never been produced by the defendants, notwithstanding the plaintiffs' several demands for production before as well as during trial.[1] No acceptable explanation of this failure to produce documents has been given to either the Trial Court or this Court. Significantly, neither the defendants nor their counsel have made the affirmative representation that this critical document has been produced. Thus, the Court is deprived of the best evidence on which to judge the merits of the defendants' position as to the care and attention which they gave to the terms of the Agreement on September 20.

[1] Are you starting to sense why the court might not have a lot of patience with the defendant board members here?

The defendant directors assert that they "insisted" upon including two amendments to the Agreement, thereby permitting a market test: (1) to give Trans Union the right to accept a better offer; and (2) to reserve to Trans Union the right to distribute proprietary information on the Company to alternative bidders. Yet, the defendants concede that they did not seek to amend the Agreement to permit Trans Union to solicit competing offers.

Several of Trans Union's outside directors resolutely maintained that the Agreement as submitted was approved on the understanding that, "if we got a better deal, we had a right to take it." Director Johnson so testified; but he then added, "And if they didn't put that in the agreement, then the management did not carry out the conclusion of the Board. And I just don't know whether they did or not."[2]

[2] I just ... you couldn't have followed up on this? Really?

The logical witness for the defendants to call would have been Trans Union's outside attorney, James Brennan. The defendants' failure, without explanation, to call this witness again permits the logical inference that his testimony would not have been helpful to them. The further fact that the directors adjourned, rather than recessed, the meeting without incorporating in the Agreement these important "conditions" further weakens the defendants' position. As has been noted, nothing in the Board's Minutes supports these claims. No reference to either of the so-called "conditions" or of Trans Union's reserved right to test the market appears in any notes of the Board meeting or in the Board Resolution accepting the Pritzker offer or in the Minutes of the meeting itself. That evening, in the midst of a formal party which he hosted for the opening of the Chicago Lyric Opera, Van Gorkom executed the Merger Agreement without he or any other member of the Board having read the instruments.

The defendants attempt to downplay the significance of the prohibition against Trans Union's actively soliciting competing offers by arguing that the directors "understood that the entire financial community would know that Trans Union was for sale upon the announcement of the Pritzker offer, and anyone desiring to make a better offer was free to do so."[1] Yet, the press release issued on September 22, with the authorization of the Board, stated that Trans Union had entered into "definitive agreements" with the Pritzkers; and the press release did not even disclose Trans Union's limited right to receive and accept higher offers. Accompanying this press release was a further public announcement that Pritzker had been granted an option to purchase at any time one million shares of Trans Union's capital stock at 75 cents above the then-current price per share.

Thus, notwithstanding what several of the outside directors later claimed to have "thought" occurred at the meeting, the record compels the conclusion that Trans Union's Board had no rational basis to conclude on September 20 or in the days immediately following, that the Board's acceptance of Pritzker's offer was conditioned on (1) a "market test" of the offer; and (2) the Board's right to withdraw from the Pritzker Agreement and accept any higher offer received before the shareholder meeting.

(3) The directors' unfounded reliance on both the premium and the market test as the basis for accepting the Pritzker proposal undermines the defendants' remaining contention that the Board's collective experience and sophistication was a sufficient basis for finding that it reached its September 20 decision with informed, reasonable deliberation. Compare *Gimbel v. Signal Companies, Inc.*, 316 A.2d 599 (Del. Ch. 1974). There, the Court of Chancery preliminary enjoined a board's sale of stock of its wholly-owned subsidiary for an alleged grossly inadequate price. It did so based on a finding that the business judgment rule had been pierced for failure of management to give its board the opportunity to make a reasonable and reasoned decision. The Court there reached this result notwithstanding the board's sophistication and experience; the company's need of immediate cash; and the board's need to act promptly due to the impact of an energy crisis on the value of the underlying assets being sold – all of its subsidiary's oil and gas interests. The Court found those factors denoting competence to be outweighed by evidence of gross negligence; that management in effect sprang the deal on the board by negotiating the asset sale without informing the board; that the buyer intended to force a quick decision by the board; that the board meeting

[1] In fact, there was only one other realistic bid presented to the board after the agreement with Pritzer. The private equity firm Kohlberg, Kravis and Roberts ("KKR") of *Barbarians at the Gate* fame was contacted by Romans and other dissatisfied Trans Union managers about the possibility of a leveraged buy-out. KKR developed a proposal "with Van Gorkom's knowledge and apparently grudging consent", and on December 2nd, KKR made a formal offer to purchase all of Trans Union's assets and to assume all of its liabilities for an aggregate cash consideration equivalent to $60 per share. The purchasing group was to include basically all of Trans Union's management, but specifically excluded Van Gorkom, which: lol.

Van Gorkom's response to KKR's move was "completely negative" and he refused KKR's request for a press release announcing the bid. Then:

> Within a matter of hours and shortly before the scheduled Board meeting, Kravis withdrew his letter-offer. He gave as his reason a sudden decision by the Chief Officer of Trans Union's rail car leasing operation to withdraw from the KKR purchasing group. Van Gorkom had spoken to that officer about his participation in the KKR proposal immediately after his meeting with Romans and Kravis. However, Van Gorkom denied any responsibility for the officer's change of mind.

Again: lol. After this suit was filed, Van Gorkom attempted to re-initiate contact with KKR via the corporate equivalent of a "you up?" text, but KKR brushed him off.

was called on only one-and-a-half days' notice; that its outside directors were not notified of the meeting's purpose; that during a meeting spanning "a couple of hours" a sale of assets worth $480 million was approved; and that the Board failed to obtain a current appraisal of its oil and gas interests. The analogy of *Signal* to the case at bar is significant.

(4) Part of the defense is based on a claim that the directors relied on legal advice rendered at the September 20 meeting by James Brennan, Esquire, who was present at Van Gorkom's request. Unfortunately, Brennan did not appear and testify at trial even though his firm participated in the defense of this action. There is no contemporaneous evidence of the advice given by Brennan on September 20, only the later deposition and trial testimony of certain directors as to their recollections or understanding of what was said at the meeting. Since counsel did not testify, and the advice attributed to Brennan is hearsay received by the Trial Court over the plaintiffs' objections, we consider it only in the context of the directors' present claims. In fairness to counsel, we make no findings that the advice attributed to him was in fact given. We focus solely on the efficacy of the defendants' claims, made months and years later, in an effort to extricate themselves from liability.

Several defendants testified that Brennan advised them that Delaware law did not require a fairness opinion or an outside valuation of the Company before the Board could act on the Pritzker proposal. If given, the advice was correct. However, that did not end the matter. Unless the directors had before them adequate information regarding the intrinsic value of the Company, upon which a proper exercise of business judgment could be made, mere advice of this type is meaningless; and, given this record of the defendants' failures, it constitutes no defense here.

A second claim is that counsel advised the Board it would be subject to lawsuits if it rejected the $55 per share offer. It is, of course, a fact of corporate life that today when faced with difficult or sensitive issues, directors often are subject to suit, irrespective of the decisions they make. However, counsel's mere acknowledgement of this circumstance cannot be rationally translated into a justification for a board permitting itself to be stampeded into a patently unadvised act. While suit might result from the rejection of a merger or tender offer, Delaware law makes clear that a board acting within the ambit of the business judgment rule faces no ultimate liability. Thus, we cannot conclude that the mere threat of litigation, acknowledged by counsel, constitutes either legal advice or any valid basis upon which to pursue an uninformed course.

Since we conclude that Brennan's purported advice is of no consequence to the defense of this case, it is unnecessary for us to invoke the adverse inferences which may be attributable to one failing to appear at trial and testify.

We conclude that Trans Union's Board was grossly negligent in that it failed to act with informed reasonable deliberation in agreeing to the Pritzker merger proposal on September 20; and we further conclude that the Trial Court erred as a matter of law in failing to address that question before determining whether the directors' later conduct was sufficient to cure its initial error.

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McNeilly, J., dissenting

The majority opinion reads like an advocate's closing address to a hostile jury. And I say that not lightly. Throughout the opinion great emphasis is directed only to the negative, with nothing more than lip service granted the positive aspects of this case. In my opinion Chancellor Marvel (retired) should have been affirmed. The Chancellor's opinion was the product of well reasoned conclusions, based upon a sound deductive process, clearly supported by the evidence and entitled to deference in this appeal. Because of my diametrical opposition to all evidentiary conclusions of the majority, I respectfully dissent.

It would serve no useful purpose, particularly at this late date, for me to dissent at great length. I restrain myself from doing so, but feel compelled to at least point out what I consider to be the most glaring deficiencies in the majority opinion. The majority has spoken and has effectively said that Trans Union's Directors have been the victims of a "fast shuffle" by Van Gorkom and Pritzker. That is the beginning of the majority's comedy of errors. The first and most important error made is the majority's assessment of the directors' knowledge of the affairs of Trans Union and their combined ability to act in this situation under the protection of the business judgment rule.

Trans Union's Board of Directors consisted of ten men, five of whom were "inside" directors and five of whom were "outside" directors. The "inside" directors were Van Gorkom, Chelberg, Bonser, William B. Browder, Senior Vice-President-Law, and Thomas P. O'Boyle, Senior Vice-President-Administration. At the time the merger was proposed the inside five directors had collectively been employed by the Company for 116 years and had 68 years of combined experience as directors. The "outside" directors were A.W. Wallis, William B. Johnson, Joseph B. Lanterman, Graham J. Morgan and Robert W. Reneker. With the exception of Wallis, these were all chief executive officers of Chicago based corporations that were at least as large as Trans Union. The five "outside" directors had 78 years of combined experience as chief executive officers, and 53 years cumulative service as Trans Union directors.

The inside directors wear their badge of expertise in the corporate affairs of Trans Union on their sleeves. But what about the outsiders?

Dr. Wallis is or was an economist and math statistician, a professor of economics at Yale University, dean of the graduate school of business at the University of Chicago, and Chancellor of the University of Rochester.[1] Dr. Wallis had been on the Board of Trans Union since 1962. He also was on the Board of Bausch Lomb, Kodak, Metropolitan Life Insurance Company, Standard Oil and others.

[1] Just say "nerd", this is taking forever.

William B. Johnson is a University of Pennsylvania law graduate, President of Railway Express until 1966, Chairman and Chief Executive of I.C. Industries Holding Company, and member of Trans Union's Board since 1968.

Joseph Lanterman, a Certified Public Accountant, is or was President and Chief Executive of American Steel, on the Board of International Harvester, Peoples Energy, Illinois Bell Telephone, Harris Bank and Trust Company, Kemper Insurance Company and a director of Trans Union for four years.

Graham Morgan is a chemist, was Chairman and Chief Executive Officer of U.S. Gypsum,[2] and in the 17 and 18 years prior to the Trans Union transaction had been involved in 31 or 32 corporate takeovers.

[2] U.S. Gypsum was one of the largest producers/users of asbestos, and has since gone extremely bankrupt.

Robert Reneker attended University of Chicago and Harvard Business Schools. He was President and Chief Executive of Swift and Company, director of Trans Union since 1971, and member of the Boards of seven other corporations[3] including U.S. Gypsum and the Chicago Tribune.

[3] I get what the dissent is going for here, but does it feel like maybe that's too many boards? Like, maybe his attention might be just a little bit divided here?

Directors of this caliber are not ordinarily taken in by a "fast shuffle". I submit they were not taken into this multi-million dollar corporate transaction without being fully informed and aware of the state of the art as it pertained to the entire corporate panoroma of Trans Union. True, even directors such as these, with their business acumen, interest and expertise, can go astray. I do not believe that to be the case here. These men knew Trans Union like the back of their hands and were more than well qualified to make on the spot informed business judgments concerning the affairs of Trans Union including a 100% sale of the corporation. Lest we forget, the corporate world of then and now operates on what is so aptly referred to as "the fast track". These men were at the time an integral part of that world, all professional business men, not intellectual figureheads.

The majority of this Court holds that the Board's decision, reached on September 20, 1980, to approve the merger was not the product of an informed business judgment, that the Board's subsequent efforts to amend the Merger Agreement and take other curative action were legally and factually ineffectual, and that the Board did not deal with complete candor with the stockholders by failing to disclose all material facts, which they knew or should have known, before securing the stockholders' approval of the merger. I disagree.

At the time of the September 20, 1980 meeting the Board was acutely aware of Trans Union and its prospects. The problems created by accumulated investment tax credits and accelerated depreciation were discussed repeatedly at Board meetings, and all of the directors understood the problem thoroughly. Moreover, at the July, 1980 Board meeting the directors had reviewed Trans Union's newly prepared five-year forecast, and at the August, 1980 meeting Van Gorkom presented the results of a comprehensive study of Trans Union made by The Boston Consulting Group. This study was prepared over an 18 month period and consisted of a detailed analysis of all Trans Union subsidiaries, including competitiveness, profitability, cash throw-off, cash consumption, technical competence and future prospects for contribution to Trans Union's combined net income.

Following the October 8 board meeting of Trans Union, the investment banking firm of Salomon Brothers was retained by the corporation to search for better offers than that of the Pritzkers, Salomon Brothers being charged with the responsibility of doing "whatever possible to see if there is a superior bid in the marketplace over a bid that is on the table for Trans Union". In undertaking such project, it was agreed that Salomon Brothers would be paid the amount of $500,000 to cover its expenses as well as a fee equal to 3/8ths of 1% of the aggregate fair market value of the consideration to be received by the company in the case of a merger or the like, which meant that in the event Salomon Brothers should find a buyer willing to pay a price of $56.00 a share instead of $55.00, such firm would receive a fee of roughly $2,650,000 plus disbursements.

As the first step in proceeding to carry out its commitment, Salomon Brothers had a brochure prepared, which set forth Trans Union's financial history, described the company's business in detail and set forth Trans Union's operating and financial projections. Salomon Brothers also prepared a list of over 150 companies which it believed might be suitable merger partners, and while four of such companies, namely, General Electric, Borg-Warner,[1] Bendix, and Genstar, Ltd. showed some interest in such a merger, none made a firm proposal to Trans Union and only General Electric showed a sustained interest. As matters transpired, no firm offer which bettered the Pritzker offer of $55 per share was ever made.

[1] My former client!

I have no quarrel with the majority's analysis of the business judgment rule. It is the application of that rule to these facts which is wrong. An overview of the entire record, rather than the limited view of bits and pieces which the majority has exploded like popcorn,[2] convinces me that the directors made an informed business judgment which was buttressed by their test of the market.

[2] I'm on / like popcorn / like a Saturday night at the autobahn.

At the time of the September 20 meeting the 10 members of Trans Union's Board of Directors were highly qualified and well informed about the affairs and prospects of Trans Union. These directors were acutely aware of the historical problems facing Trans Union which were caused by the tax laws. They had discussed these problems ad nauseam. In fact, within two months of the September 20 meeting the board had reviewed and discussed an outside study of the company done by The Boston Consulting Group and an internal five year forecast prepared by management. At the September 20 meeting Van Gorkom presented the Pritzker offer, and the board then heard from James Brennan, the company's counsel in this matter, who discussed the legal documents. Following this, the Board directed that certain changes be made in the merger documents. These changes made it clear that the Board was free to accept a better offer than Pritzker's if one was made. The above facts reveal that the Board did not act in a grossly negligent manner in informing themselves of the relevant and available facts before passing on the merger. To the contrary, this record reveals that the directors acted with the utmost care in informing themselves of the relevant and available facts before passing on the merger.

A WHOLE LOT OF DISCUSSION QUESTIONS:

1. Does the court take a position on whether the price is fair?

2. Did the speed with which this came together play a role in the outcome of the case? In other words, does this case stand for the proposition that boards cannot make quick decisions?

3. It seems like the corporation is worth $55 a share to Van Gorkom. Is it worth $55 to Pritzker? Why might the two of them have different valuations for the corporation?

4. The court rules out self-dealing (along with illegality and fraud), focusing instead on the duty of care instead of the duty of loyalty. Is there a case for a duty of loyalty claim here?

5. The dissent rattles off qualification after qualification of the Trans Union board members. Is the argument that such an experienced group of directors shouldn't have their decisions second-guessed, or is there something else going on here?

6. The attorney here was technically correct in that no case or statute explicitly requires the board to get a fairness opinion or an outside valuation. Was this good advice, though? In other words, should you get an outside valuation or a fairness opinion for your corporate transaction?

7. The deal gave Pritzker the option (which he exercised) to buy 1,000,000 shares at slightly above the going market price for Trans Union shares. Why was this valuable to Pritzker?

8. The shareholders ultimately voted to approve the deal. Why wasn't that enough?

9. The board got jacked up as a unit, rather than as individual board members. Is there an argument that some board members were more negligent than others, and should bear more of the liability?

10. Fun fact: the shareholder who filed the case wasn't even mad about the purchase price. He was mad that the merger was all-cash, because for tax reasons he would have preferred to have been paid in stock (which he didn't even get). The result of the case was a $23.5 million settlement, $10 million of which was paid by insurance and $13.5 million of which was paid by Pritzker on behalf of the defendant directors (even though he wasn't even a part of the suit). No director actually had to cough up cash out of their pockets, though several donated money to charities chosen by Pritzker, which is kind of sweet in a weird way.

11. Did this case result in more duty of care lawsuits, or a higher rate of success for duty of care lawsuits? Nope! The duty of care remains the most difficult grounds to challenge board action under. But that doesn't mean the case didn't have an impact ...

The response by business leaders to *Van Gorkom* can best be characterized as ***beet red and throwing up and mad online***.[1] The shock and outrage emanating from corporate offices was immediate; the khaki-and-loafer types were so angry you'd have thought Colin Kaepernick took a knee on the fairway of the 14th hole during the final round of The Masters. Boards, which up until this point had been content to go along to get along, were mortified to learn that they might have to skim a legal memo or sit through a powerpoint presentation before voting however the CEO wanted them to vote.

More importantly, from the perspective of corporate lawyers, the effect of *Van Gorkom* was to reassert the role of the corporation's lawyer (in-house or outside counsel) in guiding boards through the proper procedures for making important decisions. No more would "yeah, you don't need to get an opinion, just wing it, bro" cut it in terms of legal advice – boards[2] now actively seek out legal guidance and outside opinions to do their jobs (or at least look like they're doing their jobs).

Another consequence of the case is that the anguished wailing and gnashing of teeth and rending of garments by business jerks had a

[1] Legal commenters weren't much better. Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 Bus. Law. 1, 1 (1985) ("Atrocious."); Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 Bus. Law. 1437, 1455 (1985) ("One of the worst decisions in the history of corporate law."); Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 Ga. L. Rev. 477 (2000) (self-explanatory).

[2] Or, more accurately, boards that don't want to get sued.

real effect on the law: between 1986 and 1988, forty states (including Delaware) responded to the decision in *Van Gorkom* by amending their corporate statutes to insulate directors from liability for money damages in duty of care cases – a process called "exculpation", which I discuss in the next section.

Protecting Directors

If, as noted corporate law scholar Stephen M. Bainbridge has asserted,[1] the primary tension in corporate law is between authority and accountability, corporations have a number of ways to move their directors and officers further away from the accountability side of that standoff. These methods are *exculpation*, *indemnification*, and *insurance*.

Exculpation

As a response to *Van Gorkom*, many states – including Delaware and Kentucky – passed laws allowing corporations to include exculpation provisions in their articles of incorporation. These provisions eliminated the ability of shareholders to collect monetary damages from directors due to violations of their fiduciary duties – with two major exceptions. First, these provisions do not exculpate violations of the duty of loyalty (only the duty of care). Second, they do not exculpate violations that involve actions taken not in good faith, or intentional misconduct, or knowing violations of law. As a result, cases that might have previously been brought under the duty of care are often instead brought under the duty of loyalty (or they allege bad faith or intentional misconduct) in order to get access to monetary damages. Also important to note: these provisions do not preclude equitable remedies (like corporate dissolution or blocking an impending merger, for example).

Indemnification

Another way for corporations to ease any financial burdens on their directors and officers is through indemnification. You might remember this from our discussion of what principals owe to agents, but indemnification simply means that the corporation will either directly pay for or reimburse its managers for costs incurred due to their actions as managers of the corporation.

Some indemnification is permissive – meaning that the corporation must actively authorize it for their managers.[2] Some indemnification is mandatory – meaning that the corporation must provide it for its

[1] Stephen M. Bainbridge, The Geography of Revlon-Land, 81 FORDHAM L. REV. 3277 (2013); Stephen M. Bainbridge, The Board of Directors as Nexus of Contracts, 88 IOWA L. REV. 1 (2002); Stephen M. Bainbridge, The Business Judgment Rule as Abstention Doctrine, 57 VAND. L. REV. 83 (2004); Stephen M. Bainbridge, The Case for Limited Shareholder Voting Rights, 53 UCLA L. REV. 601 (2006); Stephen M. Bainbridge et al., The Convergence of Good Faith and Oversight, 55 UCLA L. REV. 559 (2008); Stephen M. Bainbridge, Director Primacy in Corporate Takeovers: Preliminary Reflections, 55 STAN. L. REV. 791 (2002); Stephen M. Bainbridge, Director Primacy and Shareholder Disempowerment, 119 HARV. L. REV. 1735 (2006); Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 NW. U. L. REV. 547 (2003); Stephen M. Bainbridge, Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency, 1 J. BUS. & TECH. L. 335 (2007); Stephen M. Bainbridge, Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills, 29 J. CORP. L. 1 (2003); Stephen M. Bainbridge, *Unocal* at 20: Director Primacy in Corporate Takeovers, 31 DEL. J. CORP. L. 769 (2006); Stephen M. Bainbridge, Executive Compensation: Who Decides?, 83 TEX. L. REV. 1615 (2005); STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS (2008).

Wow. I think we get it, dude. (Thanks to Michaela Taylor and Bennett Z. Tuleja for looking these up.)

[2] Litigation costs are permitted to be indemnified, and very often corporations do indemnify managers for these.

managers.[1] Finally, some indemnification is impermissible – meaning the corporation cannot authorize it under any circumstances.[2]

The role of indemnification of corporate boards in corporate governance is to protect directors from personal financial liability for any damages they may incur as a result of their actions while serving on the board. This protection is important because it allows directors to make decisions without fear of personal financial repercussions, which can incentivize them to act in the best interests of the corporation. Indemnification can also help attract and retain qualified directors, as they may be more likely to serve on a board if they know they will be protected from personal financial liability.

Directors and officers can be indemnified in the articles, the bylaws, or through resolutions of the board.

[1] If a director or officer is sued in their capacity as such, and prevails in the lawsuit, the corporation must reimburse their costs.

[2] An example of this would be reimbursement for damages in a derivative suit (a suit brought on behalf of the corporation). Because the recovery is supposed to go to the corporation, indemnification would defeat the purpose of allowing derivative suits.

Insurance

Finally, there are Directors and Officers ("D&O") Insurance policies. These policies — *Hey, where are you going? I know this isn't the most interesting subject, but it's still important! Come back!* — generally cover the straightforward legal claims that managers are often subject to (shareholder claims, securities fraud claims, etc.) and the damages that a corporation must pay on behalf of its indemnified managers, but they also can cover (1) the legal fees that these managers accrue in defense of those claims, and (2) money that directors may have to pay that cannot be indemnified by the corporation (e.g., money in derivative suits or breach of duty of loyalty suits). Most D&O policies exclude dishonest, fraudulent, or criminal activity from coverage, which creates a nice little pain point for enterprising plaintiff's lawyers: settling claims of dishonest and/or fraudulent conduct is covered by the policies, but managers cannot recover if there is a judgment against them regarding that conduct, which creates an incentive for managers to quickly settle claims against them if they think there's even a chance they could have a judgment entered against them.

Some discussion questions:

1. Why should directors of a corporation be protected (three different ways!) from personal liability?
2. Flip it around: would you want to serve on a corporate board if you knew that you could be personally liable for negligent conduct? What kind of corporations would you want to work for? What kind of board members would corporations attract?

8. *Corporate Fiduciary Duties: Loyalty*

The two classic violations of the duty of loyalty are **self-dealing** and **taking a corporate opportunity**. In both cases, the harm to the corporation is that money that could have gone to the corporation has instead flowed into some executive's pockets. As with the duty of care, the role of information is key — but unlike in duty of care cases, liability arises not from a lack of information, but from a lack of disclosure.

Self-Dealing

The simplest way to understand self-dealing is that it occurs when a corporate manager appears on both sides of a deal – on one side in their personal capacity (or representing their personal financial interests) and on the other side as a representative or a decisionmaker for the corporation.[1] The rationale is relatively straightforward: if a manager stands to personally profit from the deal, they will not advocate strongly for the corporation's interests and the corporation will get a worse deal than if they engaged in an arms-length transaction with someone unaffiliated with the corporation.

[1] Another way to think about it is: if the deal goes bad, would an officer/director of the corporation have to sue themselves? File this thought away for when we discuss derivative suits.

There are two ways for managers to avoid liability for self-interested transactions they enter into with the corporations they manage. The first, "safe harbor", involves disclosure and approval by the disinterested directors, and the only downside is that the board might not approve the deal.[2] The second, "entire fairness" review, involves the self-interested manager to explain to the court in excruciating detail why both the process for arriving at the terms of the deal and the terms of the deal itself were completely and utterly fair to the corporation. Guess which one you want?[3]

[2] There is also a safe harbor provision contingent on the approval of the transaction by a majority of disinterested shareholders, which we'll discuss in Chapter 15, but for now we'll focus on disinterested director approval.

[3] While in real life I am much more of a "beg forgiveness" type than an "ask permission" type, in this situation you absolutely want to ask permission.

To get the protection of the statutory safe harbor under DGCL §144:[1]

> The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors.

[1] Same procedure for safe harbor under Kentucky law: "The material facts of the transaction and the director's interest were disclosed or known to the board of directors or a committee of the board of directors and the board of directors or committee authorized, approved, or ratified the transaction." KRS §271B.8-310(1)(a). "[A] conflict of interest transaction shall be considered authorized, approved, or ratified if it receives the affirmative vote of a majority of the directors on the board of directors (or on the committee) who have no direct or indirect interest in the transaction." KRS §271B.8-310(3).

If all this is ringing some bells, it is because in the context of partnership law we have seen both this aspect of the duty of loyalty (where partners in a partnership are generally forbidden from taking a position adverse to the financial interests of the partnership), and this method of curing a breach of the duty of loyalty (disclosure of the interest and approval of the partnership). Same deal here.

What would this sort of process look like in real life? The following case examines it in the context of a director negotiating to buy shares directly from a corporation whose board he serves on.

Benihana of Tokyo, Inc. v. Benihana, Inc., 906 A.2d 114 (Del. 2006)

Berger, J.

In this appeal, we consider whether Benihana, Inc. was authorized to issue $20 million in preferred stock and whether Benihana's board of directors acted properly in approving the transaction. We conclude that the Court of Chancery's factual findings are supported by the record and that it correctly applied settled law in holding that the stock issuance was lawful and that the directors did not breach their fiduciary duties. Accordingly, we affirm.

Rocky Aoki founded Benihana of Tokyo, Inc. (BOT), and its subsidiary, Benihana, which own and operate Benihana restaurants in the United States and other countries. Aoki owned 100% of BOT until 1998, when he pled guilty to insider trading charges. In order to avoid licensing problems created by his status as a convicted felon,[2] Aoki transferred his stock to the Benihana Protective Trust. The trustees of the Trust were Aoki's three children (Kana Aoki Nootenboom, Kyle Aoki and Kevin Aoki)[3] and Darwin Dornbush (who was then the family's attorney, a Benihana director, and, effectively, the company's general counsel).

[2] He was nearly deported as a result of this conviction.

[3] But, weirdly enough, not his youngest son, Steve Aoki, or his youngest daughter, Devon Aoki.

Benihana, a Delaware corporation, has two classes of common stock. There are approximately 6 million shares of Class A common stock outstanding. Each share has 1/10 vote and the holders of Class A common are entitled to elect 25% of the directors. There are approximately 3 million shares of Common stock outstanding. Each share of Common has one vote and the holders of Common stock are entitled to elect the remaining 75% of Benihana's directors. Before the transaction at issue, BOT owned 50.9% of the Common stock and 2% of the Class A stock. The nine member board of directors is classified and the directors serve three-year terms.

In 2003, shortly after Aoki married Keiko Aoki, conflicts arose between Aoki and his children. In August, the children were upset to learn that Aoki had changed his will to give Keiko control over BOT. Joel Schwartz, Benihana's president and chief executive officer, also was concerned about this change in control. He discussed the situation with Dornbush, and they briefly considered various options, including the issuance of sufficient Class A stock to trigger a provision in the certificate of incorporation that would allow the Common and Class A to vote together for 75% of the directors.

The Aoki family's turmoil came at a time when Benihana also was facing challenges. Many of its restaurants were old and outmoded. Benihana hired WD Partners to evaluate its facilities and to plan and design appropriate renovations. The resulting Construction and Renovation Plan anticipated that the project would take at least five years and cost $56 million or more. Wachovia offered to provide Benihana a $60 million line of credit for the Construction and Renovation Plan, but the restrictions Wachovia imposed made it unlikely that Benihana would be able to borrow the full amount. Because the Wachovia line of credit did not assure that Benihana would have the capital it needed, the company retained Morgan Joseph Co. to develop other financing options.

On January 9, 2004, after evaluating Benihana's financial situation and needs, Fred Joseph, of Morgan Joseph, met with Schwartz, Dornbush and John E. Abdo, the board's executive committee. Joseph expressed concern that Benihana would not have sufficient available capital to complete the Construction and Renovation Plan and pursue appropriate acquisitions. Benihana was conservatively leveraged, and Joseph discussed various financing alternatives, including bank debt, high yield debt, convertible debt or preferred stock, equity and sale/leaseback options.

The full board met with Joseph on January 29, 2004. He reviewed all the financing alternatives that he had discussed with the executive committee, and recommended that Benihana issue convertible preferred stock. Joseph explained that the preferred stock would provide the funds needed for the Construction and Renovation Plan and also put the company in a better negotiating position if it sought additional financing from Wachovia.

Joseph gave the directors a board book, marked "Confidential," containing an analysis of the proposed stock issuance (the Transaction). The book included, among others, the following anticipated terms: (i) issuance of $20,000,000 of preferred stock, convertible into Common stock; (ii) dividend of 6% ± 0.5%; (iii) conversion premium of 20% ± 2.5%; (iv) buyer's approval required for material corporate transactions; and (v) one to two board seats to the buyer. At trial, Joseph testified that the terms had been chosen by looking at comparable stock issuances and analyzing the Morgan Joseph proposal under a theoretical model.

The board met again on February 17, 2004, to review the terms of the Transaction. The directors discussed Benihana's preferences and Joseph predicted what a buyer likely would expect or require. For example, Schwartz asked Joseph to try to negotiate a minimum on the dollar value for transactions that would be deemed "material corporation transactions" and subject to the buyer's approval. Schwartz wanted to give the buyer only one board seat, but Joseph said that Benihana might have to give up two. Joseph told the board that he was not sure that a buyer would agree to an issuance in two tranches, and that it would be difficult to make the second tranche non-mandatory. As the Court of Chancery found, the board understood that the preferred terms were akin to a "wish list."

Shortly after the February meeting, Abdo contacted Joseph and told him that BFC Financial Corporation[1] was interested in buying the new convertible stock. In April 2005, Joseph sent BFC a private placement memorandum. Abdo negotiated with Joseph for several weeks. They agreed to the Transaction on the following basic terms: (i) $20 million issuance in two tranches of $10 million each, with the second tranche to be issued one to three years after the first; (ii) BFC obtained one seat on the board, and one additional seat if Benihana failed to pay dividends for two consecutive quarters; (iii) BFC obtained preemptive rights on any new voting securities; (iv) 5% dividend; (v) 15% conversion premium; (vi) BFC had the right to force Benihana to redeem the preferred stock in full after ten years; and (vii) the stock would have immediate "as if converted" voting rights.[2] Joseph testified that he was satisfied with the negotiations, as he had obtained what he wanted with respect to the most important points.

[1] Spoiler alert: Abdo helps run BFC Financial Corporation.

[2] Wow, how did Abdo know exactly what Benihana needed and what Benihana would give a buyer???

On April 22, 2004, Abdo sent a memorandum to Dornbush, Schwartz and Joseph, listing the agreed terms of the Transaction. He did not send the memorandum to any other members of the Benihana board. At its next meeting, held on May 6, 2004, the entire board was officially informed of BFC's involvement in the Transaction. Abdo made a presentation on behalf of BFC and then left the meeting. Joseph distributed an updated board book, which explained that Abdo had approached Morgan Joseph on behalf of BFC, and included the negotiated terms. The trial court found that the board was not informed that Abdo had negotiated the deal on behalf of BFC. But the board did know that Abdo was a principal of BFC. After discussion, the board reviewed and approved the Transaction, subject to the receipt of a fairness opinion.

On May 18, 2004, after he learned that Morgan Joseph was providing a fairness opinion, Schwartz publicly announced the stock issuance. Two days later, Aoki's counsel sent a letter asking the board to abandon the Transaction and pursue other, more favorable, financing alternatives. The letter expressed concern about the directors' conflicts, the dilutive effect of the stock issuance, and its "questionable legality." Schwartz gave copies of the letter to the directors at the May 20 board meeting, and Dornbush advised that he did not believe that Aoki's concerns had merit. Joseph and another Morgan Joseph representative then joined the meeting by telephone and opined that the Transaction was fair from a financial point of view. The board then approved the Transaction.

During the following two weeks, Benihana received three alternative financing proposals. Schwartz asked Becker, Pine and Sturges to act as an independent committee and review the first offer. The committee decided that the offer was inferior and not worth pursuing. Morgan Joseph agreed with that assessment. Schwartz referred the next two proposals to Morgan Joseph, with the same result.

On June 8, 2004, Benihana and BFC executed the Stock Purchase Agreement. On June 11, 2004, the board met and approved resolutions ratifying the execution of the Stock Purchase Agreement and authorizing the stock issuance. Schwartz then reported on the three alternative proposals that had been rejected by the ad hoc committee and Morgan Joseph. On July 2, 2004, BOT filed this action against all of Benihana's directors, except Kevin Aoki, alleging breaches of fiduciary duties; and against BFC, alleging that it aided and abetted the fiduciary violations. The Court of Chancery held a four day trial in November 2004. In December 2005, after post-trial briefing and argument, the trial court issued an opinion holding that Benihana was authorized to issue the preferred stock with preemptive rights, and that the board's approval of the Transaction was a valid exercise of business judgement. This appeal followed.

BOT argues that the Court of Chancery erred: (1) by applying 8 Del. C. § 144(a)(1), because the board did not know all material facts before it approved the Transaction; (2) by applying the business judgment rule, because Abdo breached his fiduciary duties; and (3) by finding that the board's primary purpose in approving the Transaction was not to dilute BOT's voting power.

A. Section 144(a)(1) Approval

Section 144 of the Delaware General Corporation Law provides a safe harbor for interested transactions, like this one, if "[t]he material facts as to the director's ... relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors ... and the board ... in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors." After approval by disinterested directors, courts review the interested transaction under the business judgment rule, which "is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company."

BOT argues that § 144(a)(1) is inapplicable because, when they approved the Transaction, the disinterested directors did not know that Abdo had negotiated the terms for BFC. Abdo's role as negotiator is material, according to BOT, because Abdo had been given the confidential term sheet prepared by Joseph and knew which of those terms Benihana was prepared to give up during negotiations. We agree that the board needed to know about Abdo's involvement in order to make an informed decision. The record clearly establishes, however, that the board possessed that material information when it approved the Transaction on May 6, 2004 and May 20, 2004.

Shortly before the May 6 meeting, Schwartz told Becker, Sturges and Sano that BFC was the proposed buyer. Then, at the meeting, Abdo made the presentation on behalf of BFC. Joseph's board book also explained that Abdo had made the initial contact that precipitated the negotiations. The board members knew that Abdo is a director, vice-chairman, and one of two people who control BFC. Thus, although no one ever said, "Abdo negotiated this deal for BFC," the directors understood that he was BFC's representative in the Transaction. Accordingly, we conclude that the disinterested directors possessed all the material information on Abdo's interest in the Transaction, and their approval at the May 6 and May 20 board meetings satisfies § 144(a)(1).

B. Abdo's alleged fiduciary violation

BOT next argues that the Court of Chancery should have reviewed the Transaction under an entire fairness standard because Abdo breached his duty of loyalty when he used Benihana's confidential information to negotiate on behalf of BFC. This argument starts with a flawed premise. The record does not support BOT's contention that Abdo used any confidential information against Benihana.[1] Even without Joseph's comments at the February 17 board meeting, Abdo knew the terms a buyer could expect to obtain in a deal like this. Moreover, as the trial court found, "the negotiations involved give and take on a number of points" and Benihana "ended up where [it] wanted to be" for the most important terms. Abdo did not set the terms of the deal; he did not deceive the board; and he

[1] We sure about this?

did not dominate or control the other directors' approval of the Transaction. In short, the record does not support the claim that Abdo breached his duty of loyalty.

C. Dilution of BOT's voting power

Finally, BOT argues that the board's primary purpose in approving the Transaction was to dilute BOT's voting control. BOT points out that Schwartz was concerned about BOT's control in 2003 and even discussed with Dornbush the possibility of issuing a huge number of Class A shares. Then, despite the availability of other financing options, the board decided on a stock issuance, and agreed to give BFC "as if converted" voting rights. According to BOT, the trial court overlooked this powerful evidence of the board's improper purpose.

It is settled law that, corporate action may not be taken for the sole or primary purpose of entrenchment. Here, however, the trial court found that "the primary purpose of the ... Transaction was to provide what the directors subjectively believed to be the best financing vehicle available for securing the necessary funds to pursue the agreed upon Construction and Renovation Plan for the Benihana restaurants." That factual determination has ample record support, especially in light of the trial court's credibility determinations. Accordingly, we defer to the Court of Chancery's conclusion that the board's approval of the Transaction was a valid exercise of its business judgment, for a proper corporate purpose.

SOME DISCUSSION QUESTIONS:

1. Did it seem like Abdo had the inside track in getting this investment opportunity from Benihana? Why wasn't that self-dealing?
2. Abdo didn't reveal everything when he disclosed his involvement to the board of Benihana. What was the relevant information and why was that enough?
3. How does the court apply the Business Judgment Rule here?
4. Are there other reasons why the board might have approved Abdo's proposal besides their considered and independent judgment regarding the deal's value to the corporation?

The Corporate Opportunity Doctrine

The second classic violation of the fiduciary duty of loyalty arises under the corporate opportunity doctrine. As the doctrine is formulated, a corporate officer or director (or controlling shareholder) may not take a business opportunity for themselves if it rightfully belongs to the corporation for which they are a fiduciary.[1] The fundamental question, though, is whether the business opportunity does, in fact, belong to the corporation.

[1] This is related to the old partnership law doctrine about the duty to turn over to the partnership all profits made in one's capacity as a partner.

The three factors that courts examine to determine whether an opportunity rightfully belongs to the corporation are:

1. Whether the corporation is financially able to undertake the opportunity;
2. Whether the opportunity is within the corporation's line of business; and
3. Whether the corporation has an interest or expectancy in the opportunity.

Each factor is important, though none are dispositive — and different courts place different weight on each, as we see in the following case.

In re eBay, Inc., C.A. No. 19988-NC, (Del. Ch. Jan. 23, 2004)

Chandler, Ch.

Shareholders of eBay, Inc. filed these consolidated derivative actions against certain eBay directors and officers for usurping corporate opportunities. Plaintiffs allege that eBay's investment banking advisor, Goldman Sachs Group, engaged in "spinning," a practice that involves allocating shares of lucrative initial public offerings of stock to favored clients. In effect, the plaintiff shareholders allege that Goldman Sachs bribed certain eBay insiders, using the currency of highly profitable investment opportunities — opportunities that should have been offered to, or provided for the benefit of, eBay rather than the favored insiders. Plaintiffs accuse Goldman Sachs of aiding and abetting the corporate insiders breach of their fiduciary duty of loyalty to eBay.

The individual eBay defendants, as well as Goldman Sachs, have moved to dismiss these consolidated actions for failure to state a claim and for failure to make a pre-suit demand on eBay's board of directors as required under Chancery Court Rule 23.1. For reasons I briefly discuss below, I deny all of the defendants' motions to dismiss.

The facts, as alleged in the complaint, are straightforward. In 1995, defendants Pierre M. Omidyar and Jeffrey Skoll founded nominal defendant eBay, a Delaware corporation. eBay is a pioneer in online trading platforms, providing a virtual auction community for buyers and sellers to list items for sale and to bid on items of interest. In 1998, eBay retained Goldman Sachs and other investment banks to underwrite an initial public offering of common stock.[1] Goldman Sachs was the lead underwriter. The stock was priced at $18 per share. Goldman Sachs purchased about 1.2 million shares. eBay became immensely profitable during 1998 and 1999, with its stock rising to $175 per share in early April 1999. Around that time, eBay made a secondary offering, issuing 6.5 million shares of common stock at $170 per share for a total of $1.1 billion. Goldman Sachs again served as lead underwriter. Goldman Sachs was asked in 2001 to serve as eBay's financial advisor in connection with an acquisition by eBay of PayPal, Inc. For these services, eBay has paid Goldman Sachs over $8 million.

During this same time period, Goldman Sachs "rewarded" the individual defendants by allocating to them thousands of IPO shares, managed by Goldman Sachs, at the initial offering price. Because the IPO market during this particular period of time was extremely active, prices of initial stock offerings often doubled or tripled in a single day.[2] Investors who were well connected, either to Goldman Sachs or to similarly situated investment banks serving as IPO underwriters, were able to flip these investments into instant profit by selling the equities in a few days or even in a few hours after they were initially purchased.

The essential allegation of the complaint is that Goldman Sachs provided these IPO share allocations to the individual defendants to show appreciation for eBay's business and to enhance Goldman Sachs' chances of obtaining future eBay business. In addition to co-founding eBay, defendant Omidyar has been eBay's CEO, CFO and President. He is eBay's largest stockholder, owning more than 23% of the company's equity. Goldman Sachs allocated Omidyar shares in at least forty IPOs[3] at the initial offering price. Omidyar resold these securities in the public market for millions of dollars in profit. Defendant Whitman[4] owns 3.3% of eBay stock and has been President, CEO and a director since early 1998. Whitman also has been a director of Goldman Sachs since 2001. Goldman Sachs allocated Whitman shares in over a 100 IPOs[5] at the initial offering price. Whitman sold these equities in the open market and reaped millions of dollars in profit. Defendant Skoll, in addition to co-founding eBay, has served in various positions at the company, including Vice-President of Strategic Planning and Analysis and President. He served as an eBay director from December 1996 to March 1998. Skoll is eBay's second largest stockholder, owning about 13% of the company. Goldman Sachs has allocated Skoll shares in at least 75 IPOs[6] at the initial offering price, which Skoll promptly resold on the open market, allowing him to realize millions of dollars in profit. Finally, defendant Robert C. Kagle[7] has served as an eBay director since June 1997. Goldman Sachs allocated Kagle shares in at least 25 IPOs at the initial offering price. Kagle promptly resold these equities, and recorded millions of dollars in profit.

[1] In this context, an underwriter is a bank hired by the corporation to price and sell the stock that they are issuing, often by purchasing (at a discount) the stock themselves and selling it (at market price) to investors.

[2] This isn't super relevant to this case, but while investors love it when this happens, underpricing a corporation's shares can end up hurting the corporation in the end, because the corporation – at least theoretically – could have sold those shares at the higher price and collected more in revenue. It's not at issue here, but something to keep in mind when you see cases involving an "IPO pop" or the like.

[3] 40!

[4] Meg Whitman, who was CEO during the time of eBay's enormous growth, and who became a billionaire in doing so. Her subsequent political career – spending $144MN of her own money to lose a race for the Governor of California by 13 points, endorsing John McCain in 2008, Mitt Romney in 2012, and Hillary Clinton in 2016 – was not quite as successful. She is now the ambassador to Kenya, for some reason.

[5] 100!

[6] Goddamn, there were just a lot of IPOs in the late '90s, huh?

[7] Venture Capitalist. Early investor in eBay, Uber, Jamba Juice, and Zillow. Could buy and sell any of you ten times over.

Plaintiffs have stated a claim that defendants usurped a corporate opportunity of eBay.[1] Defendants insist that Goldman Sachs' IPO allocations to eBay's insider directors were "collateral investments opportunities" that arose by virtue of the inside directors status as wealthy individuals. They argue that this is not a corporate opportunity within the corporation's line of business or an opportunity in which the corporation had an interest or expectancy. These arguments are unavailing.

[1] In a section of the opinion that I have omitted, the court determines that the defendants functionally control the board, so any attempt by the board to get out of the suit is invalid. We'll get into this further in Chapter 9 when we discuss "demand futility".

First, no one disputes that eBay financially was able to exploit the opportunities in question. Second, eBay was in the business of investing in securities. The complaint alleges that eBay "consistently invested a portion of its cash on hand in marketable securities." According to eBay's 1999 10-K, for example, eBay had more than $550 million invested in equity and debt securities. eBay invested more than $181 million in "short-term investments" and $373 million in "long-term investments." Thus, investing was "a line of business" of eBay. Third, the facts alleged in the complaint suggest that investing was integral to eBay's cash management strategies and a significant part of its business. Finally, it is no answer to say, as do defendants, that IPOs are risky investments. It is undisputed that eBay was never given an opportunity to turn down the IPO allocations as too risky.

Defendants also argue that to view the IPO allocations in question as corporate opportunities will mean that every advantageous investment opportunity that comes to an officer or director will be considered a corporate opportunity. On the contrary, the allegations in the complaint in this case indicate that unique, below-market price investment opportunities were offered by Goldman Sachs to the insider defendants as financial inducements to maintain and secure corporate business. This was not an instance where a broker offered advice to a director about an investment in a marketable security. The conduct challenged here involved a large investment bank that regularly did business with a company steering highly lucrative IPO allocations to select insider directors and officers at that company, allegedly both to reward them for past business and to induce them to direct future business to that investment bank. This is a far cry from the defendants' characterization of the conduct in question as merely "a broker's investment recommendations" to a wealthy client.

Nor can one seriously argue that this conduct did not place the insider defendants in a position of conflict with their duties to the corporation. One can realistically characterize these IPO allocations as a form of commercial discount or rebate for past or future investment banking services. Viewed pragmatically, it is easy to understand how steering such commercial rebates to certain insider directors places those directors in an obvious conflict between their self-interest and the corporation's interest. It is noteworthy, too, that the Securities and Exchange Commission has taken the position that "spinning" practices violate the obligations of broker-dealers under the "Free-riding and Withholding Interpretation" rules. As the SEC has explained, "the purpose of the interpretation is to protect the integrity of the public offering system by ensuring that members make a bona fide public distribution of 'hot issue' securities and do not withhold such securities for their own benefit or use the securities to reward other persons who are in a position to direct future business to the member."

Finally, even if one assumes that IPO allocations like those in question here do not constitute a corporate opportunity, a cognizable claim is nevertheless stated on the common law ground that an agent is under a duty to account for profits obtained personally in connection with transactions related to his or her company. The complaint gives rise to a reasonable inference that the insider directors accepted a commission or gratuity that rightfully belonged to eBay but that was improperly diverted to them. Even if this conduct does not run afoul of the corporate opportunity doctrine, it may still constitute a breach of the fiduciary duty of loyalty. Thus, even if one does not consider Goldman Sachs' IPO allocations to these corporate insiders — allocations that generated millions of dollars in profit — to be a corporate opportunity, the defendant directors were nevertheless not free to accept this consideration from a company, Goldman Sachs, that was doing significant business with eBay and which arguably intended the consideration as an inducement to maintaining the business relationship in the future.

Plaintiffs' complaint adequately alleges the existence of a fiduciary relationship, that the individual defendants breached their fiduciary duty and that plaintiffs have been damaged because of the concerted actions of the individual defendants and Goldman Sachs. Goldman Sachs, however, disputes whether it "knowingly participated" in the eBay insiders' alleged breach of fiduciary duty. The allegation, however, is that Goldman Sachs had provided underwriting and investment advisory services to eBay for years and that it knew that each of the individual defendants owed a fiduciary duty to eBay not to profit personally at eBay's expense and to devote their undivided loyalty to the interests of eBay. Goldman Sachs also knew or had reason to know of eBay's investment of excess cash in marketable securities and debt. Goldman Sachs was aware (or charged with a duty to know) of earlier SEC interpretations prohibited steering "hot issue" securities to persons in a position to direct future business to the brokerdealer. Taken together, these allegations allege a claim for aiding and abetting sufficient to withstand a motion to dismiss.

For all of the above reasons, I deny the defendants' motions to dismiss the complaint in this consolidated action.

Some discussion questions:

1. Did anyone involved need the money? And is the answer to that question relevant to the claim or the defense?

2. Which tests does the court examine in this case? Would it have made a difference to choose one or the other?

3. The court suggests that even if this wasn't a corporate opportunity, the defendants may well have still breached their fiduciary duty of loyalty. Why?

If, once again, this is ringing some bells, the question of whether an opportunity belongs to an individual or to an entity was one of the core questions in *Meinhard v. Salmon* (particularly the interest or expectancy bit). Courts, like in *Meinhard*, can order the manager to give the opportunity to the corporation, or can order the manager to disgorge the profits made from the taken opportunity.

Disclosure is key to avoiding liability for taking a corporate opportunity.[1] If a manager identifies and discloses to the corporation an opportunity, and a disinterested and independent board rejects the opportunity, then the manager may take the opportunity for themselves. If, on the other hand, the corporation claims the opportunity, then the manager is foreclosed from acting upon it.

[1] Again like *Meinhard*! It's almost as if this doctrine was lifted lock, stock, and barrel from early partnership cases ...

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

Veasey, C.J.

Robert F. Broz ("Broz") is the President and sole stockholder of RFB Cellular, Inc. ("RFBC"), a Delaware corporation engaged in the business of providing cellular telephone service in the Midwestern United States. At the time of the conduct at issue in this appeal, Broz was also a member of the board of directors of plaintiff below-appellee, Cellular Information Systems, Inc. ("CIS"). CIS is a publicly held Delaware corporation and a competitor of RFBC.

The conduct before the Court involves the purchase by Broz of a cellular telephone service license for the benefit of RFBC. The license in question, known as the Michigan-2 Rural Service Area Cellular License ("Michigan-2"), is issued by the Federal Communications Commission ("FCC") and entitles its holder to provide cellular telephone service to a portion of northern Michigan. CIS brought an action against Broz and RFBC for equitable relief, contending that the purchase of this license by Broz constituted a usurpation of a corporate opportunity properly belonging to CIS, irrespective of whether or not CIS was interested in the Michigan-2 opportunity at the time it was offered to Broz.

The principal basis for the contention of CIS is that PriCellular, Inc. ("PriCellular"), another cellular communications company which was contemporaneously engaged in an acquisition of CIS, was interested in the Michigan-2 opportunity. CIS contends that, in determining whether the Michigan-2 opportunity rightfully belonged to CIS, Broz was required to consider the interests of PriCellular insofar as those interests would come into alignment with those of CIS as a result of PriCellular's acquisition plans.

Broz has been the President and sole stockholder of RFBC since 1992. RFBC owns and operates an FCC license area, known as the Michigan-4 Rural Service Area Cellular License ("Michigan-4"). The license entitles RFBC to provide cellular telephone service to a portion of rural Michigan. Although Broz' efforts have been devoted primarily to the business operations of RFBC, he also served as an outside director of CIS at the time of the events at issue in this case. CIS was at all times fully aware of Broz' relationship with RFBC and the obligations incumbent upon him by virtue of that relationship.

In April of 1994, Mackinac Cellular Corp. ("Mackinac") sought to divest itself of Michigan-2, the license area immediately adjacent to Michigan-4. To this end, Mackinac contacted Daniels Associates ("Daniels") and arranged for the brokerage firm to seek potential purchasers for Michigan-2. In compiling a list of prospects, Daniels included RFBC as a likely candidate. In May of 1994, David Rhodes, a representative of Daniels, contacted Broz and broached the subject of RFBC's possible acquisition of Michigan-2. Broz later signed a confidentiality agreement at the request of Mackinac, and received the offering materials pertaining to Michigan-2.

Michigan-2 was not, however, offered to CIS. Apparently, Daniels did not consider CIS to be a viable purchaser for Michigan-2 in light of CIS' recent financial difficulties. The record shows that, at the time Michigan-2 was offered to Broz, CIS had recently emerged from lengthy and contentious Chapter 11 proceedings. Pursuant to the Chapter 11 Plan of Reorganization, CIS entered into a loan agreement that substantially impaired the company's ability to undertake new acquisitions or to incur new debt. In fact, CIS would have been unable to purchase Michigan-2 without the approval of its creditors.

The CIS reorganization resulted from the failure of CIS' rather ambitious plans for expansion. From 1989 onward, CIS had embarked on a series of cellular license acquisitions. In 1992, however, CIS' financing failed, necessitating the liquidation of the company's holdings and reduction of the company's total indebtedness. During the period from early 1992 until the time of CIS' emergence from bankruptcy in 1994, CIS divested itself of some fifteen separate cellular license systems. CIS contracted to sell four additional license areas on May 27, 1994, leaving CIS with only five remaining license areas, all of which were outside of the Midwest.

On June 13, 1994, following a meeting of the CIS board, Broz spoke with CIS' Chief Executive Officer, Richard Treibick ("Treibick"), concerning his interest in acquiring Michigan-2. Treibick communicated to Broz that CIS was not interested in Michigan-2. Treibick further stated that he had been made aware of the Michigan-2 opportunity prior to the conversation with Broz, and that any offer to acquire Michigan-2 was rejected. After the commencement of the PriCellular tender offer, in August of 1994, Broz contacted another CIS director, Peter Schiff (“Schiff"), to discuss the possible acquisition of Michigan-2 by RFBC. Schiff, like Treibick, indicated that CIS had neither the wherewithal nor the inclination to purchase Michigan-2. In late September of 1994, Broz also contacted Stanley Bloch (“Bloch"), a director and counsel for CIS, to request that Bloch represent RFBC in its dealings with Mackinac. Bloch agreed to represent RFBC, and, like Schiff and Treibick, expressed his belief that CIS was not at all interested in the transaction. Ultimately, all the CIS directors testified at trial that, had Broz inquired at that time, they each would have expressed the opinion that CIS was not interested in Michigan-2.

On June 28, 1994, following various overtures from PriCellular concerning an acquisition of CIS, six CIS directors entered into agreements with PriCellular to sell their shares in CIS at a price of $2.00 per share. These agreements were contingent upon, inter alia, the consummation of a PriCellular tender offer for all CIS shares at the same price. Pursuant to their agreements with PriCellular, the CIS directors also entered into a "standstill" agreement which prevented the directors from engaging in any transaction outside the regular course of CIS' business or incurring any new liabilities until the close of the PriCellular tender offer. On August 2, 1994, PriCellular commenced a tender offer for all outstanding shares of CIS at $2.00 per share. The PriCellular tender offer mirrored the standstill agreements entered into by the CIS directors.

On August 6, September 6 and September 21, 1994, Broz submitted written offers to Mackinac for the purchase of Michigan-2. During this time period, PriCellular also began negotiations with Mackinac to arrange an option for the purchase of Michigan-2. PriCellular's interest in Michigan-2 was fully disclosed to CIS' chief executive, Treibick, who did not express any interest in Michigan-2, and was actually incredulous that PriCellular would want to acquire the license. Nevertheless, CIS was fully aware that PriCellular and Broz were bidding for Michigan-2 and did not interpose CIS in this bidding war.

In late September of 1994, PriCellular reached agreement with Mackinac on an option to purchase Michigan-2. The exercise price of the option agreement was set at $6.7 million, with the option remaining in force until December 15, 1994. Pursuant to the agreement, the right to exercise the option was not transferrable to any party other than a subsidiary of PriCellular. Therefore, it could not have been transferred to CIS. The agreement further provided that Mackinac was free to sell Michigan-2 to any party who was willing to exceed the exercise price of the Mackinac-PriCellular option contract by at least $500,000. On November 14, 1994, Broz agreed to pay Mackinac $7.2 million for the Michigan-2 license, thereby meeting the terms of the option agreement. An asset purchase agreement was thereafter executed by Mackinac and RFBC.

Nine days later, on November 23, 1994, PriCellular completed its financing and closed its tender offer for CIS. Prior to that point, PriCellular owned no equity interest in CIS.

The doctrine of corporate opportunity represents but one species of the broad fiduciary duties assumed by a corporate director or officer. A corporate fiduciary agrees to place the interests of the corporation before his or her own in appropriate circumstances. In light of the diverse and often competing obligations faced by directors and officers, however, the corporate opportunity doctrine arose as a means of defining the parameters of fiduciary duty in instances of potential conflict.

The corporate opportunity doctrine holds that a corporate officer or director may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation. [A] director or officer may take a corporate opportunity if: (1) the opportunity is presented to the director or officer in his individual and not his corporate capacity; (2) the opportunity is not essential to the corporation; (3) the corporation holds no interest or expectancy in the opportunity; and (4) the director or officer has not wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity.

Thus, the contours of this doctrine are well established. No one factor is dispositive and all factors must be taken into account insofar as they are applicable. Cases involving a claim of usurpation of a corporate opportunity range over a multitude of factual settings. Hard and fast rules are not easily crafted to deal with such an array of complex situations. In the instant case, we find that the facts do not support the conclusion that Broz misappropriated a corporate opportunity.

We note at the outset that Broz became aware of the Michigan-2 opportunity in his individual and not his corporate capacity. As the Court of Chancery found, "Broz did not misuse proprietary information that came to him in a corporate capacity nor did he otherwise use any power he might have over the governance of the corporation to advance his own interests." 663 A.2d at 1185. This fact is not the subject of serious dispute. In fact, it is clear from the record that Mackinac did not consider CIS a viable candidate for the acquisition of Michigan-2. Accordingly, Mackinac did not offer the property to CIS. In this factual posture, many of the fundamental concerns undergirding the law of corporate opportunity are not present (e.g., misappropriation of the corporation's proprietary information). The burden imposed upon Broz to show adherence to his fiduciary duties to CIS is thus lessened to some extent. Nevertheless, this fact is not dispositive. The determination of whether a particular fiduciary has usurped a corporate opportunity necessitates a careful examination of the circumstances.

We turn now to an analysis of the factors relied on by the trial court. First, we find that CIS was not financially capable of exploiting the Michigan-2 opportunity. Although the Court of Chancery concluded otherwise, we hold that this finding was not supported by the evidence. Levitt, 287 A.2d at 673. The record shows that CIS was in a precarious financial position at the time Mackinac presented the Michigan-2 opportunity to Broz. Having recently emerged from lengthy and contentious bankruptcy proceedings, CIS was not in a position to commit capital to the acquisition of new assets. Further, the loan agreement entered into by CIS and its creditors severely limited the discretion of CIS as to the acquisition of new assets and substantially restricted the ability of CIS to incur new debt.

Second, while it may be said with some certainty that the Michigan-2 opportunity was within CIS' line of business, it is not equally clear that CIS had a cognizable interest or expectancy in the license. Under the third factor laid down by this Court in Guth, for an opportunity to be deemed to belong to the fiduciary's corporation, the corporation must have an interest or expectancy in that opportunity. Despite the fact that the nature of the Michigan-2 opportunity was historically close to the core operations of CIS, changes were in process. At the time the opportunity was presented, CIS was actively engaged in the process of divesting its cellular license holdings. CIS' articulated business plan did not involve any new acquisitions. Further, as indicated by the testimony of the entire CIS board, the Michigan-2 license would not have been of interest to CIS even absent CIS' financial difficulties and CIS' then current desire to liquidate its cellular license holdings. Thus, CIS had no interest or expectancy in the Michigan-2 opportunity.

Finally, the corporate opportunity doctrine is implicated only in cases where the fiduciary's seizure of an opportunity results in a conflict between the fiduciary's duties to the corporation and the self-interest of the director as actualized by the exploitation of the opportunity. In the instant case, Broz' interest in acquiring and profiting from Michigan-2 created no duties that were inimicable to his obligations to CIS. Broz, at all times relevant to the instant appeal, was the sole party in interest in RFBC, a competitor of CIS. CIS was fully aware of Broz' potentially conflicting duties. Broz, however, comported himself in a manner that was wholly in accord with his obligations to CIS. Broz took care not to usurp any opportunity which CIS was willing and able to pursue. Broz sought only to compete with an outside entity, PriCellular, for acquisition of an opportunity which both sought to possess. Broz was not obligated to refrain from competition with PriCellular. Therefore, the totality of the circumstances indicates that Broz did not usurp an opportunity that properly belonged to CIS.

In concluding that Broz had usurped a corporate opportunity, the Court of Chancery placed great emphasis on the fact that Broz had not formally presented the matter to the CIS board. In so holding, the trial court erroneously grafted a new requirement onto the law of corporate opportunity: the requirement of formal presentation under circumstances where the corporation does not have an interest, expectancy or financial ability.

If the director or officer believes, based on one of the factors articulated above, that the corporation is not entitled to the opportunity, then he may take it for himself. Of course, presenting the opportunity to the board creates a kind of "safe harbor" for the director, which removes the specter of a post hoc judicial determination that the director or officer has improperly usurped a corporate opportunity. Thus, presentation avoids the possibility that an error in the fiduciary's assessment of the situation will create future liability for breach of fiduciary duty. It is not the law of Delaware that presentation to the board is a necessary prerequisite to a finding that a corporate opportunity has not been usurped.

In concluding that Broz usurped an opportunity properly belonging to CIS, the Court of Chancery held that "[f]or practical business reasons CIS' interests with respect to the Mackinac transaction came to merge with those of PriCellular, even before the closing of its tender offer for CIS stock." Based on this fact, the trial court concluded that Broz was required to consider PriCellular's prospective, post-acquisition plans for CIS in determining whether to forego the opportunity or seize it for himself. Had Broz done this, the Court of Chancery determined that he would have concluded that CIS was entitled to the opportunity by virtue of the alignment of its interests with those of PriCellular.

We disagree. Broz was under no duty to consider the interests of PriCellular when he chose to purchase Michigan-2. At the time Broz purchased Michigan-2, PriCellular had not yet acquired CIS. Any plans to do so would still have been wholly speculative. Accordingly, Broz was not required to consider the contingent and uncertain plans of PriCellular in reaching his determination of how to proceed.

In reaching our conclusion on this point, we note that certainty and predictability are values to be promoted in our corporation law. Broz, as an active participant in the cellular telephone industry, was entitled to proceed in his own economic interest in the absence of any countervailing duty. The right of a director or officer to engage in business affairs outside of his or her fiduciary capacity would be illusory if these individuals were required to consider every potential, future occurrence in determining whether a particular business strategy would implicate fiduciary duty concerns. In order for a director to engage meaningfully in business unrelated to his or her corporate role, the director must be allowed to make decisions based on the situation as it exists at the time a given opportunity is presented. Absent such a rule, the corporate fiduciary would be constrained to refrain from exploiting any opportunity for fear of liability based on the occurrence of subsequent events. This state of affairs would unduly restrict officers and directors and would be antithetical to certainty in corporation law.

We hold that Broz did not breach his fiduciary duties to CIS.

Some discussion questions:

1. How did Broz find out about the license that was for sale?
2. Why did CIS sue Broz, and when did they sue him? Who really wanted that corporate opportunity?
3. What test does the court use?
4. What behavior by CIS' management was relevant here?

Loyalty, Oversight and Good Faith: The Issue of Executive Compensation

Both self-dealing and taking corporate opportunities represent clear conflicts of interest between management and the corporation – in both cases the managers is benefiting at the expense of their fiduciary. But not all conflicts of interest are actionable under the duty of loyalty, and the issue of executive compensation – the payment by the corporation of cash and stock to directors and officers in return for their service – has proven challenging for courts to analyze under these traditional frameworks.

In 2021, CEOs at the largest 350 public corporations were paid an average of 351 times a typical worker's annual salary (in 1965 this ratio was 20-to-1, and in 1989 the ratio was 58-to-1). Since 1978, CEO compensation has grown by 1,322% – compared to an 817% growth in the stock market, and an 18% growth in worker wages – and this massive growth has caught the attention of investors, policymakers, and courts.[1]

Do shareholders have any control over how executive compensation is set? Not really. The SEC requires disclosure of executive pay in the corporation's annual report, the Securities Exchange Act prevents certain kinds of payment (undisclosed stock options or loans to corporate insiders), and the Dodd-Frank Act gives shareholders a non-binding, completely symbolic, advisory vote on both annual executive compensation ("say on pay") as well as any special payments that occur in the case of a merger or acquisition (these are often called "golden parachutes"). That's it. Shareholders get to learn what the proposed pay is, and can do the corporate law equivalent of giving management the stink eye, but nothing more.

So how does executive compensation get set? In the usual course of business, a committee of the board that excludes top management (that is, formed of "independent" or "outside" directors) is tasked with setting compensation for management. That committee then hires experts — compensation consultants, lawyers, bankers, etc. — to prepare pay proposals that the committees can then vote to implement. What do the experts look to? They can look to prior pay, stock performance, what other executives are paid, what would incentivize better performance — anything that sounds remotely reasonable within the corporate context.

Even more important than the comparisons they use, however, is what the incentives are for these committees and these consultants. Does a compensation consultant — who is hired by compensation committees — have an incentive to recommend lower pay? Does a compensation committee — who are often either nominated at the recommendation of management, or are themselves management at a different corporation — have an incentive to keep management pay down? Even without any obvious self-dealing or naked corruption, the decision-making structure and the interests of the actors involved favor increasing executive compensation at every point.

It is easy to see how this might seem like fertile ground for a fiduciary violation – parties acting in their self-interest, money leaving the corporation and going into executive pockets – but if a decision is informed and disinterested (and doesn't constitute waste), what duty is there to be violated? The following case is what happens when a vague sense of outrage at executive compensation[2] meets an underdefined legal concept.[3] It is also a cautionary tale about the necessary trade-off between executive authority and executive accountability,

[1] Before you start thinking that there's a let's-solve-inequality, Robin-Hood-steal-from-the-rich angle to all this, the fights over excessive executive compensation are almost always capitalist-vs.-capitalist; the question is whether the money should go to management or to the corporation (and eventually the shareholders).

[2] $130mn for like fourteen months of work!

[3] "good faith"

and what happens when a court tries to address the latter without impinging on the former.

In re Walt Disney Co. Derivative Litigation, 906 A.2d 27 (Del. 2006)

Jacobs, J.

In August 1995, Michael Ovitz and The Walt Disney Company ("Disney") entered into an employment agreement under which Ovitz would serve as President of Disney for five years. In December 1996, only fourteen months after he commenced employment, Ovitz was terminated without cause, resulting in a severance payout to Ovitz valued at approximately $130 million.[1]

[1] A number that is honestly almost quaint now.

In January 1997, several Disney shareholders brought derivative actions in the Court of Chancery, on behalf of Disney, against Ovitz and the directors of Disney who served at the time of the events complained of (the "Disney defendants"). The plaintiffs claimed that the $130 million severance payout was the product of fiduciary duty and contractual breaches by Ovitz, and breaches of fiduciary duty by the Disney defendants, and a waste of assets. After the disposition of several pretrial motions and an appeal to this Court, the case was tried before the Chancellor over 37 days between October 20, 2004 and January 19, 2005. In August 2005, the Chancellor handed down a well-crafted 174 page Opinion and Order, determining that "the director defendants did not breach their fiduciary duties or commit waste." The Court entered judgment in favor of all defendants on all claims alleged in the amended complaint.

The plaintiffs have appealed from that judgment, claiming that the Court of Chancery committed multitudinous errors. We conclude, for the reasons that follow, that the Chancellor's factual findings and legal rulings were correct and not erroneous in any respect. Accordingly, the judgment entered by the Court of Chancery will be affirmed.

We next summarize the facts as found by the Court of Chancery that are material to the issues presented on this appeal. The critical events flow from what turned out to be an unfortunate hiring decision at Disney, a company that for over half a century has been one of America's leading film and entertainment enterprises.

In 1994 Disney lost in a tragic helicopter crash its President and Chief Operating Officer, Frank Wells, who together with Michael Eisner, Disney's Chairman and Chief Executive Officer, had enjoyed remarkable success at the Company's helm. Eisner temporarily assumed Disney's presidency, but only three months later, heart disease required Eisner to undergo quadruple bypass surgery. Those two events persuaded Eisner and Disney's board of directors that the time had come to identify a successor to Eisner.

Eisner's prime candidate for the position was Michael Ovitz, who was the leading partner and one of the founders of Creative Artists Agency ("CAA"), the premier talent agency whose business model had reshaped the entire industry. By 1995, CAA had 550 employees and a roster of about 1400 of Hollywood's top actors, directors, writers, and musicians. That roster generated about $150 million in annual revenues and an annual income of over $20 million for Ovitz, who was regarded as one of the most powerful figures in Hollywood.

Eisner and Ovitz had enjoyed a social and professional relationship that spanned nearly 25 years. Although in the past the two men had casually discussed possibly working together, in 1995 Eisner became seriously interested in recruiting Ovitz to join Disney. Eisner shared that desire with Disney's board members on an individual basis.

[Disney and Ovitz then negotiated over a compensation package whereby Ovitz would make roughly $23mn per year, with a tranche of stock options worth a minimum of $50mn (but which turned out to be worth even more). Importantly, if Disney fired Ovitz for any reason besides gross negligence or criminal malfeasance, Ovitz would get a Non-Fault Termination payment ("NFT") consisting of his salary, any unpaid bonuses, his stock options, and a $10mn cash payment.[1]]

[1] Because why not.

On August 14, Eisner and Ovitz signed a letter agreement, which outlined the basic terms of Ovitz's employment, and stated that the agreement, which would ultimately be embodied in a formal contract (the "OEA"), was subject to approval by Disney's compensation committee and board of directors. Russell[2] called Sidney Poitier,[3] a Disney director and compensation committee member, to inform Poitier of the letter and its terms. Poitier believed that hiring Ovitz was a good idea because of Ovitz's reputation and experience. Watson called Ignacio Lozano, another Disney director and compensation committee member, who felt that Ovitz would successfully adapt from a private company environment to Disney's public company culture. Eisner also contacted each of the other board members by phone to inform them of the impending new hire, and to explain his friendship with Ovitz and Ovitz's qualifications.

[2] The Chair of Disney's competition committee.

[3] THEY CALL ME MR. TIBBS.

That same day, a press release made the news of Ovitz's hiring public. The reaction was extremely positive: Disney was applauded for the decision, and Disney's stock price rose 4.4% in a single day, thereby increasing Disney's market capitalization by over $1 billion.

Ovitz's tenure as President of the Walt Disney Company officially began on October 1, 1995, the date that the OEA was executed. When Ovitz took office, the initial reaction was optimistic, and Ovitz did make some positive contributions while serving as President of the Company. By the fall of 1996, however, it had become clear that Ovitz was "a poor fit with his fellow executives."[1] By then the Disney directors were discussing that the disconnect between Ovitz and the Company was likely irreparable and that Ovitz would have to be terminated.

[1] For the equivalent of NBA supermax extension money, one would think he'd work a little harder to fit in, but oh well.

The Court of Chancery identified three competing theories as to why Ovitz did not succeed:

First, plaintiffs argue that Ovitz failed to follow Eisner's directives, especially in regard to acquisitions, and that generally, Ovitz did very little. Second, Ovitz contends Eisner's micromanaging prevented Ovitz from having the authority necessary to make the changes that Ovitz thought were appropriate. In addition, Ovitz believes he was not given enough time for his efforts to bear fruit. Third, the remaining defendants simply posit that Ovitz failed to transition from a private to a public company, from the "sell side to the buy side,"[2] and otherwise did not adapt to the Company culture or fit in with other executives. In the end, however, it makes no difference why Ovitz was not as successful as his reputation would have led many to expect, so long as he was not grossly negligent or malfeasant.

[2] Totally different skills. "Yes" and "No" mean completely different things. Very confusing.

Although the plaintiffs attempted to show that Ovitz acted improperly (i.e., with gross negligence or malfeasance) while in office, the Chancellor found that the trial record did not support those accusations. Rejecting the plaintiffs' first factual claim that Ovitz was insubordinate, the Court found that although many of Ovitz's efforts failed to produce results, that was because his efforts often reflected a philosophy opposite to "that held by Eisner, Iger, and Roth." That difference did not mean, however, "that Ovitz intentionally failed to follow Eisner's directives or that [Ovitz] was insubordinate."

The Chancellor also rejected the appellants' second claim — that Ovitz was a habitual liar. The Court found no evidence that Ovitz ever told a material falsehood or made any false or misleading disclosures during his tenure at Disney. Lastly, the Chancellor found that the record did not support, and often contradicted, the appellants' third claim — that Ovitz had violated the Company's policies relating to expenses and to reporting gifts he received while President of Disney.

Nonetheless, Ovitz's relationship with the Disney executives did continue to deteriorate through September 1996. In mid-September, [Sanford] Litvack,[3] with Eisner's approval, told Ovitz that he was not working out at Disney and that he should start looking for a graceful exit from Disney and a new job. Litvack reported this conversation to Eisner, who sent Litvack back to Ovitz to make it clear that Eisner no longer wanted Ovitz at Disney and that Ovitz should seriously consider other opportunities, including one then developing at Sony. Ovitz responded by telling Litvack that he was not leaving and that if Eisner wanted him to leave

[3] Disney's general counsel.

Disney, Eisner could tell him that to his face.

Eisner wrote (but never sent) a letter to Ovitz on November 11, in which Eisner attempted to make it clear that Ovitz was no longer welcome at Disney. Instead of sending that letter, Eisner met with Ovitz personally on November 13, and discussed much of what the letter contained. Eisner left that meeting believing that "Ovitz just would not listen to what he was trying to tell him and instead, Ovitz insisted that he would stay at Disney, going so far as to state that he would chain himself to his desk."[1]

[1] He could also crawl under a bed and refuse to leave?

During this period Eisner was also working with Litvack to explore whether they could terminate Ovitz under the OEA for cause. If so, Disney would not owe Ovitz the NFT payment. From the very beginning, Litvack advised Eisner that he did not believe there was cause to terminate Ovitz under the OEA. Litvack's advice never changed.

At the end of November 1996, Eisner again asked Litvack if Disney had cause to fire Ovitz and thereby avoid the costly NFT payment. Litvack proceeded to examine that issue more carefully. He studied the OEA, refreshed himself on the meaning of "gross negligence" and "malfeasance," and reviewed all the facts concerning Ovitz's performance of which he was aware. Litvack also consulted Val Cohen, co-head of Disney's litigation department and Joseph Santaniello, in Disney's legal department. Cohen and Santaniello both concurred in Litvack's conclusion that no basis existed to terminate Ovitz for cause. Litvack did not personally conduct any legal research or request an outside opinion on the issue, because he believed that it "was not a close question, and in fact, Litvack described it as a no brainer." Eisner testified that after Litvack notified Eisner that he did not believe cause existed, Eisner "checked with almost anybody that [he] could find that had a legal degree, and there was just no light in that possibility. It was a total dead end from day one." Although the Chancellor was critical of Litvack and Eisner for lacking sufficient documentation to support his conclusion and the work they did to arrive at that conclusion, the Court found that Eisner and Litvack "did in fact make a concerted effort to determine if Ovitz could be terminated for cause, and that despite these efforts, they were unable to manufacture the desired result."

Litvack also believed that it would be inappropriate, unethical and a bad idea to attempt to coerce Ovitz (by threatening a for-cause termination) into negotiating for a smaller NFT package than the OEA provided. The reason was that when pressed by Ovitz's attorneys, Disney would have to admit that in fact there was no cause, which could subject Disney to a wrongful termination lawsuit. Litvack believed that attempting to avoid legitimate contractual obligations would harm Disney's reputation as an honest business partner and would affect its future business dealings.

The Disney board next met on November 25. By then the board knew Ovitz was going to be fired, yet the only action recorded in the minutes concerning Ovitz was his renomination to a new three-year term on the board. Although that action was somewhat bizarre given the circumstances, Stanley Gold, a Disney director, testified that because Ovitz was present at that meeting, it would have been a "public hanging" not to renominate him.[1] An executive session took place after the board meeting, from which Ovitz was excluded.[2] At that session, Eisner informed the directors who were present that he intended to fire Ovitz by year's end, and that he had asked Gary Wilson, a board member[3] and friend of Ovitz, to speak with Ovitz while Wilson and Ovitz were together on vacation during the upcoming Thanksgiving holiday.

[1] FAKE FRIENDS.

[2] Absolute *Mean Girls* shit.

[3] I've legit lost track of how many people are on the Disney board. Thousands, apparently.

Shortly after the November 25 board meeting and executive session, the Ovitz and Wilson families left on their yacht for a Thanksgiving trip to the British Virgin Islands. Ovitz hoped that if he could manage to survive at Disney until Christmas, he could fix everything with Disney and make his problems go away. Wilson quickly dispelled that illusion, informing Ovitz that Eisner wanted Ovitz out of the Company. At that point Ovitz first began to realize how serious his situation at Disney had become. Reporting back his conversation with Ovitz, Wilson told Eisner that Ovitz was a "loyal friend and devastating enemy," and he advised Eisner to "be reasonable and magnanimous, both financially and publicly, so Ovitz could save face."

Ovitz's termination was memorialized in a letter, dated December 12, 1996, that Litvack signed on Eisner's instruction. The board was not shown the letter, nor did it meet to approve its terms. A press release announcing Ovitz's termination was issued that same day. Before the press release was issued, Eisner attempted to contact each of the board members by telephone to notify them that Ovitz had been officially terminated. None of the board members at that time, or at any other time, objected to Ovitz's termination, and most, if not all, of them thought it was the appropriate step for Eisner to take. Although the board did not meet to vote on the termination, the Chancellor found that most, if not all, of the Disney directors trusted Eisner's and Litvack's conclusion that there was no cause to terminate Ovitz, and that Ovitz should be terminated without cause even though that involved making the costly NFT payment.

A December 27, 1996 letter from Litvack to Ovitz, which Ovitz signed, memorialized the termination, accelerated Ovitz's departure date from January 31, 1997 to December 31, 1996, and informed Ovitz that he would receive roughly $38 million in cash and that the first tranche of three million options would vest immediately. By the terms of that letter agreement, Ovitz's tenure as an executive and a director of Disney officially ended on December 27, 1996. Shortly thereafter, Disney paid Ovitz what was owed under the OEA for an NFT, minus a holdback of $1 million pending final settlement of Ovitz's accounts. One month after Disney paid Ovitz, the plaintiffs filed this action.

As noted earlier, the Court of Chancery rejected all of the plaintiff-appellants' claims on the merits and entered judgment in favor of the defendant-appellees on all counts. The appellants claim that by ruling that the Disney defendants did not breach their fiduciary duty to act with due care or in good faith, the Court of Chancery committed reversible error in numerous respects. Alternatively, the appellants claim that even if the business judgment presumptions apply, the Disney defendants are nonetheless liable, because the NFT payout constituted corporate waste and the Court of Chancery erred in concluding otherwise.

Because no duty of loyalty claim was asserted against the Disney defendants,[1] the only way to rebut the business judgment rule presumptions would be to show that the Disney defendants had either breached their duty of care or had not acted in good faith. At trial, the plaintiff-appellants attempted to establish both grounds, but the Chancellor determined that the plaintiffs had failed to prove either.

[1] Why do you think this is?

The Court of Chancery held that the business judgment rule presumptions protected the decisions of the compensation committee and the remaining Disney directors, not only because they had acted with due care but also because they had not acted in bad faith. That latter ruling, the appellants claim, was reversible error because the Chancellor formulated and then applied an incorrect definition of bad faith.

In its Opinion the Court of Chancery defined bad faith as follows:

> Upon long and careful consideration, I am of the opinion that the concept of intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction in the face of a duty to act is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.

The appellants essentially concede that their proof of bad faith is insufficient to satisfy the standard articulated by the Court of Chancery. That is why they ask this Court to treat a failure to exercise due care as a failure to act in good faith. Unfortunately for appellants, that rule, even if it were accepted, would not help their case. If we were to conflate these two duties and declare that a breach of the duty to be properly informed violates the duty to act in good faith, the outcome would be no different, because, as the Chancellor and we now have held, the appellants failed to establish any breach of the duty of care.

For that reason, our analysis of the appellants' bad faith claim could end at this point. In other circumstances it would.[1] This case, however, is one in which the duty to act in good faith has played a prominent role, yet to date is not a well-developed area of our corporate fiduciary law. Although the good faith concept has recently been the subject of considerable scholarly writing, which includes articles focused on this specific case, the duty to act in good faith is, up to this point relatively uncharted. Because of the increased recognition of the importance of good faith, some conceptual guidance to the corporate community may be helpful.[2] For that reason we proceed to address the merits of the appellants' second argument.

[1] Got that? Sometimes good faith means "the duty of care", other times it means ... whatever the court wants it to. The court is *struggling* here to articulate a standard here that wouldn't upset existing law regarding the duty of care and the duty of loyalty.

[2] Narrator: it was not helpful.

The precise question is whether the Chancellor's articulated standard for bad faith corporate fiduciary conduct — intentional dereliction of duty, a conscious disregard for one's responsibilities — is legally correct. In approaching that question, we note that the Chancellor characterized that definition as "an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith." That observation is accurate and helpful, because as a matter of simple logic, at least three different categories of fiduciary behavior are candidates for the "bad faith" pejorative label.

The first category involves so-called "subjective bad faith," that is, fiduciary conduct motivated by an actual intent to do harm. That such conduct constitutes classic, quintessential bad faith is a proposition so well accepted in the liturgy of fiduciary law that it borders on axiomatic. We need not dwell further on this category, because no such conduct is claimed to have occurred, or did occur, in this case.

The second category of conduct, which is at the opposite end of the spectrum, involves lack of due care — that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent. In this case, appellants assert claims of gross negligence to establish breaches not only of director due care but also of the directors' duty to act in good faith. Although the Chancellor found, and we agree, that the appellants failed to establish gross negligence, to afford guidance we address the issue of whether gross negligence (including a failure to inform one's self of available material facts), without more, can also constitute bad faith. The answer is clearly no.

From a broad philosophical standpoint, that question is more complex than would appear, if only because (as the Chancellor and others have observed) "issues of good faith are (to a certain degree) inseparably and necessarily intertwined with the duties of care and loyalty." But, in the pragmatic, conduct-regulating legal realm which calls for more precise conceptual line drawing, the answer is that grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith. The conduct that is the subject of due care may overlap with the conduct that comes within the rubric of good faith in a psychological sense, but from a legal standpoint those duties are and must remain quite distinct. Both our legislative history and our common law jurisprudence distinguish sharply between the duties to exercise due care and to act in good faith, and highly significant consequences flow from that distinction.

To adopt a definition that conflates the duty of care with the duty to act in good faith by making a violation of the former an automatic violation of the latter, would nullify those legislative protections and defeat the General Assembly's intent. There is no basis in policy, precedent or common sense that would justify dismantling the distinction between gross negligence and bad faith.

That leaves the third category of fiduciary conduct, which falls in between the first two categories of (1) conduct motivated by subjective bad intent and (2) conduct resulting from gross negligence. This third category is what the Chancellor's definition of bad faith — intentional dereliction of duty, a conscious disregard for one's responsibilities — is intended to capture. The question is whether such misconduct is properly treated as a non-exculpable, non-indemnifiable violation of the fiduciary duty to act in good faith. In our view it must be, for at least two reasons.

First, the universe of fiduciary misconduct is not limited to either disloyalty in the classic sense (i.e., preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation) or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith. The Chancellor implicitly so recognized in his Opinion, where he identified different examples of bad faith as follows:

> The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders. A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.

> There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.

Those articulated examples of bad faith are not new to our jurisprudence. Indeed, they echo pronouncements our courts have made throughout the decades.

Second, the legislature has also recognized this intermediate category of fiduciary misconduct, which ranks between conduct involving subjective bad faith and gross negligence. Section 102(b)(7)(ii) of the DGCL expressly denies money damage exculpation for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law." By its very terms that provision distinguishes between "intentional misconduct" and a "knowing violation of law" (both examples of subjective bad faith) on the one hand, and "acts ... not in good faith," on the other. Because the statute exculpates directors only for conduct amounting to gross negligence, the statutory denial of exculpation for "acts ... not in good faith" must encompass the intermediate category of misconduct captured by the Chancellor's definition of bad faith.

For these reasons, we uphold the Court of Chancery's definition as a legally appropriate, although not the exclusive, definition of fiduciary bad faith. We need go no further. To engage in an effort to craft (in the Court's words) "a definitive and categorical definition of the universe of acts that would constitute bad faith" would be unwise and is unnecessary to dispose of the issues presented on this appeal.

Having sustained the Chancellor's finding that the Disney directors acted in good faith when approving the OEA and electing Ovitz as President, we next address the claims arising out of the decision to pay Ovitz the amount called for by the NFT provisions of the OEA.

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To recover on a claim of corporate waste, the plaintiffs must shoulder the burden of proving that the exchange was "so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." A claim of waste will arise only in the rare, "unconscionable case where directors irrationally squander or give away corporate assets." This onerous standard for waste is a corollary of the proposition that where business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be "attributed to any rational business purpose."

The claim that the payment of the NFT amount to Ovitz, without more, constituted waste is meritless on its face, because at the time the NFT amounts were paid, Disney was contractually obligated to pay them.

The payment of a contractually obligated amount cannot constitute waste, unless the contractual obligation is itself wasteful. Accordingly, the proper focus of a waste analysis must be whether the amounts required to be paid in the event of an NFT were wasteful ex ante.

Appellants claim that the NFT provisions of the OEA were wasteful because they incentivized Ovitz to perform poorly in order to obtain payment of the NFT provisions. Specifically, the OEA gave Ovitz every incentive to leave the Company before serving out the full term of his contract. The appellants urge that although the OEA may have induced Ovitz to join Disney as President, no contractual safeguards were in place to retain him in that position. In essence, appellants claim that the NFT provisions of the OEA created an irrational incentive for Ovitz to get himself fired.

That claim does not come close to satisfying the high hurdle required to establish waste. The approval of the NFT provisions in the OEA had a rational business purpose: to induce Ovitz to leave CAA, at what would otherwise be a considerable cost to him, in order to join Disney. The Chancellor found that the evidence does not support any notion that the OEA irrationally incentivized Ovitz to get himself fired. Ovitz had no control over whether or not he would be fired, either with or without cause. To suggest that at the time he entered into the OEA Ovitz would engineer an early departure at the cost of his extraordinary reputation in the entertainment industry and his historical friendship with Eisner, is not only fanciful but also without proof in the record. Indeed, the Chancellor found that it was "patently unreasonable to assume that Ovitz intended to perform just poorly enough to be fired quickly, but not so poorly that he could be terminated for cause."

We agree. Because the appellants have failed to show that the approval of the NFT terms of the OEA was not a rational business decision, their waste claim must fail.

SOME DISCUSSION QUESTIONS:

1. Wait, why isn't this a violation of the duty of loyalty? Is good faith a kind of loyalty or nah?

2. What distinguishes good faith – which heretofore had not been a standalone duty – from oversight? Or care?

3. What kind of process for awarding executive compensation *would* be considered a violation of a duty?

4. When Sundar Pichai became CEO of Google in 2015, his pay package the first year on the job included $650,000 in salary and

$198,700,000 in grants of stock. Do you think that happens if the court in 2006 lays down a rule that subjects management salaries to a higher level of scrutiny?

The independent duty of good faith established in *Disney* lasted all of five months before the Delaware Supreme Court retconned it out of existence in *Stone v. Ritter*[1]:

[1] 911 A.2d 362 (Del. 2006)

> It is important, in this context, to clarify a doctrinal issue that is critical to understanding fiduciary liability under *Caremark* as we construe that case. The phraseology used in *Caremark* and that we employ here — describing the lack of good faith as a "necessary condition to liability" — is deliberate. The purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, ipso facto, in the direct imposition of fiduciary liability. The failure to act in good faith may result in liability because the requirement to act in good faith "is a subsidiary element[,]" i.e., a condition, "of the fundamental duty of loyalty." It follows that because a showing of bad faith conduct, in the sense described in *Disney* and *Caremark*,[2] is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.
>
> This view of a failure to act in good faith results in two additional doctrinal consequences. First, although good faith may be described colloquially as part of a "triad" of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith.
>
> We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the 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. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.

[2] The court is also subtly suggesting that *Disney* was, in actuality, a case about board oversight liability.

The court's triple-bank-shot logic is this: a lack of good faith (the intentional dereliction of duty, or a conscious disregard for one's responsibilities) is necessary to establish board oversight liability (which occurs when a board either ignores a violation of law, or fails to implement or use a reporting or information system), which is itself a breach of the fiduciary duty of loyalty. Is this way more complicated than it needs to be? Yes, yes, it is. But in spite of itself, and in spite of more than a little intellectual incoherence, the Delaware Supreme Court has cobbled together a mostly workable framework for board oversight and director liability. The next case is an example of how the court has applied these standards in the context of a corporation's "business risk".

In re Citigroup Inc. Shareholder, 964 A.2d 106 (Del. Ch. 2009)

Chandler, Ch.

This is a shareholder derivative action brought on behalf of Citigroup Inc. ("Citigroup" or the "Company"), seeking to recover for the Company its losses arising from exposure to the subprime lending market. Plaintiffs, shareholders of Citigroup, brought this action against current and former directors and officers of Citigroup, alleging, in essence, that the defendants breached their fiduciary duties by failing to properly monitor and manage the risks the Company faced from problems in the subprime lending market and for failing to properly disclose Citigroup's exposure to subprime assets. Plaintiffs allege that there were extensive "red flags" that should have given defendants notice of the problems that were brewing in the real estate and credit markets and that defendants ignored these warnings in the pursuit of short term profits and at the expense of the Company's long term viability.

Plaintiffs allege that since as early as 2006, defendants have caused and allowed Citigroup to engage in subprime lending that ultimately left the Company exposed to massive losses by late 2007. Beginning in late 2005, house prices, which many believe were artificially inflated by speculation and easily available credit, began to plateau, and then deflate. Adjustable rate mortgages issued earlier in the decade began to reset, leaving many homeowners with significantly increased monthly payments. Defaults and foreclosures increased, and assets backed by income from residential mortgages began to decrease in value. By February 2007, subprime mortgage lenders began filing for bankruptcy and subprime mortgages packaged into securities began experiencing increasing levels of delinquency. In mid-2007, rating agencies downgraded bonds backed by subprime mortgages.

Much of Citigroup's exposure to the subprime lending market arose from its involvement with collateralized debt obligations ("CDOs") — repackaged pools of lower rated securities that Citigroup created by acquiring asset-backed securities, including residential mortgage backed securities "RMBSs"), and then selling rights to the cash flows from the securities in classes, or tranches, with different levels of risk and return.

Included with at least some of the CDOs created by Citigroup was a "liquidity put" — an option that allowed the purchasers of the CDOs to sell them back to Citigroup at original value.

According to plaintiffs, Citigroup's alleged $55 billion subprime exposure was in two areas of the Company's Securities Banking Unit. The first portion totaled $11.7 billion and included securities tied to subprime loans that were being held until they could be added to debt pools for investors. The second portion included $43 billion of super-senior securities, which are portions of CDOs backed in part by RMBS collateral. By late 2007, it was apparent that Citigroup faced significant losses on its subprime-related assets.

Plaintiffs allege that defendants are liable to the Company for breach of fiduciary duty for (1) failing to adequately oversee and manage Citigroup's exposure to the problems in the subprime mortgage market, even in the face of alleged "red flags" and (2) failing to ensure that the Company's financial reporting and other disclosures were thorough and accurate. As will be more fully explained below, the "red flags" alleged in the eighty-six page Complaint are generally statements from public documents that reflect worsening conditions in the financial markets, including the subprime and credit markets, and the effects those worsening conditions had on market participants, including Citigroup's peers. By way of example only, plaintiffs' "red flags" include the following:

- May 27, 2005: Economist Paul Krugman of the New York Times said he saw "signs that America's housing market, like the stock market at the end of the last decade, is approaching the final, feverish stages of a speculative bubble."
- May 2006: Ameriquest Mortgage, one of the United States' leading wholesale subprime lenders, announced the closing of each of its 229 retail offices and reduction of 3,800 employees.
- February 12, 2007: ResMae Mortgage, a subprime lender, filed for bankruptcy. According to Bloomberg, in its Chapter 11 filing, ResMae stated that "[t]he subprime mortgage market has recently been crippled and a number of companies stopped originating loans and United States housing sales have slowed and defaults by borrowers have risen."
- April 18, 2007: Freddie Mac announced plans to refinance up to $20 billion of loans held by subprime borrowers who would be unable to afford their adjustable-rate mortgages at the reset rate.
- July 10, 2007: Standard and Poor's and Moody's downgraded bonds backed by subprime mortgages.
- August 1, 2007: Two hedge funds managed by Bear Stearns that invested heavily in subprime mortgages declared bankruptcy.

- August 9, 2007: American International Group, one of the largest United States mortgage lenders, warned that mortgage defaults were spreading beyond the subprime sector, with delinquencies becoming more common among borrowers in the category just above subprime.
- October 18, 2007: Standard and Poor's cut the credit ratings on $23.35 billion of securities backed by pools of home loans that were offered to borrowers during the first half of the year. The downgrades even hit securities rated AAA, which was the highest of the ten investment-grade ratings and the rating of government debt.

Plaintiffs' argument is based on a theory of director liability famously articulated by former-Chancellor Allen in *In re Caremark*. Before *Caremark*, in *Graham v. Allis-Chalmers*, the Delaware Supreme Court, in response to a theory that the Allis-Chalmers directors were liable because they should have known about employee violations of federal anti-trust laws, held that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." Over thirty years later, in the context of approval of a settlement of a class action, former-Chancellor Allen took the opportunity to revisit the duty to monitor under Delaware law. In *Caremark*, the plaintiffs alleged that the directors were liable because they should have known that certain officers and employees were violating the federal Anti-Referral Payments Law. In analyzing these claims, the Court began, appropriately, by reviewing the duty of care and the protections of the business judgment rule.

With regard to director liability standards, the Court distinguished between (1) "a board decision that results in a loss because that decision was ill advised or negligent" and (2) "an unconsidered, failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss." In the former class of cases, director action is analyzed under the business judgment rule, which prevents judicial second guessing of the decision if the directors employed a rational process and considered all material information reasonably available — a standard measured by concepts of gross negligence.[1]

[1] The court here is describing the duty of care, basically to point out that this is not a duty of care case, but a *Caremark* case.

In *Stone v. Ritter*, the Delaware Supreme Court approved the *Caremark* standard for director oversight liability and made clear that liability was based on the concept of good faith, which the *Stone* Court held was embedded in the fiduciary duty of loyalty and did not constitute a freestanding fiduciary duty that could independently give rise to liability. As the *Stone* Court explained:

> *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the 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. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.

Thus, to establish oversight liability a plaintiff must show that the directors knew they were not discharging their fiduciary obligations or that the directors demonstrated a conscious disregard for their responsibilities such as by failing to act in the face of a known duty to act. The test is rooted in concepts of bad faith; indeed, a showing of bad faith is a necessary condition to director oversight liability.

Plaintiffs' theory of how the director defendants will face personal liability is a bit of a twist on the traditional *Caremark* claim. In a typical *Caremark* case, plaintiffs argue that the defendants are liable for damages that arise from a failure to properly monitor or oversee employee misconduct or violations of law. In contrast, plaintiffs' *Caremark* claims are based on defendants' alleged failure to properly monitor Citigroup's business risk, specifically its exposure to the subprime mortgage market. In their answering brief, plaintiffs allege that the director defendants are personally liable under *Caremark* for failing to "make a good faith attempt to follow the procedures put in place or fail[ing] to assure that adequate and proper corporate information and reporting systems existed that would enable them to be fully informed regarding Citigroup's risk to the subprime mortgage market." Plaintiffs point to so-called "red flags" that should have put defendants on notice of the problems in the subprime mortgage market and further allege that the board should have been especially conscious of these red flags because a majority of the directors (1) served on the Citigroup board during its previous Enron related conduct[1] and (2) were members of the Audit and Risk Management Committee and considered financial experts.

[1] Real unlucky, these directors.

Although these claims are framed by plaintiffs as *Caremark* claims, plaintiffs' theory essentially amounts to a claim that the director defendants should be personally liable to the Company because they failed to fully recognize the risk posed by subprime securities. When one looks past the lofty allegations of duties of oversight and red flags used to dress up these claims, what is left appears to be plaintiff shareholders attempting to hold the director defendants personally liable for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company. Delaware Courts have faced these types of claims many times and have developed doctrines to deal with them — the fiduciary duty of care and the business judgment rule. These doctrines properly focus on the decision-making process rather than on a substantive evaluation of the merits of the decision. This follows from the inadequacy of the Court, due in part to a concept known as hindsight bias, to properly evaluate whether corporate decision-makers made a "right" or "wrong" decision.

Turning now specifically to plaintiffs' *Caremark* claims, one can see a similarity between the standard for assessing oversight liability and the standard for assessing a disinterested director's decision under the duty of care when the company has adopted an exculpatory provision pursuant to § 102(b)(7). In either case, a plaintiff can show that the director defendants will be liable if their acts or omissions constitute bad faith. A plaintiff can show bad faith conduct by, for example, properly alleging particularized facts that show that a director consciously disregarded an obligation to be reasonably informed about the business and its risks or consciously disregarded the duty to monitor and oversee the business.

The Delaware Supreme Court made clear in Stone that directors of Delaware corporations have certain responsibilities to implement and monitor a system of oversight; however, this obligation does not eviscerate the core protections of the business judgment rule — protections designed to allow corporate managers and directors to pursue risky transactions without the specter of being held personally liable if those decisions turn out poorly. Accordingly, the burden required for a plaintiff to rebut the presumption of the business judgment rule by showing gross negligence is a difficult one, and the burden to show bad faith is even higher. Additionally, as former-Chancellor Allen noted in *Caremark*, director liability based on the duty of oversight "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." The presumption of the business judgment rule, the protection of an exculpatory § 102(b)(7) provision, and the difficulty of proving a *Caremark* claim together function to place an extremely high burden on a plaintiff to state a claim for personal director liability for a failure to see the extent of a company's business risk.

To the extent the Court allows shareholder plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk, the Court risks undermining the well settled policy of Delaware law by inviting Courts to perform a hindsight evaluation of the reasonableness or prudence of directors' business decisions. Risk has been defined as the chance that a return on an investment will be different that expected. The essence of the business judgment of managers and directors is deciding how the company will evaluate the trade-off between risk and return. Businesses — and particularly financial institutions — make returns by taking on risk; a company or investor that is willing to take on more risk can earn a higher return. Thus, in almost any business transaction, the parties go into the deal with the knowledge that, even if they have evaluated the situation correctly, the return could be different than they expected.

It is almost impossible for a court, in hindsight, to determine whether the directors of a company properly evaluated risk and thus made the "right" business decision. In any investment there is a chance that returns will turn out lower than expected, and generally a smaller chance that they will be far lower than expected. When investments turn out poorly, it is possible that the decision-maker evaluated the deal correctly but got "unlucky" in that a huge loss — the probability of which was very small — actually happened. It is also possible that the decision-maker improperly evaluated the risk posed by an investment and that the company suffered large losses as a result.

Business decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future. To impose liability on directors for making a "wrong" business decision would cripple their ability to earn returns for investors by taking business risks. Indeed, this kind of judicial second guessing is what the business judgment rule was designed to prevent, and even if a complaint is framed under a *Caremark* theory, this Court will not abandon such bedrock principles of Delaware fiduciary duty law.

Director oversight duties are designed to ensure reasonable reporting and information systems exist that would allow directors to know about and prevent wrongdoing that could cause losses for the Company. There are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company's business risk. Directors should, indeed must under Delaware law, ensure that reasonable information and reporting systems exist that would put them on notice of fraudulent or criminal conduct within the company. Such oversight programs allow directors to intervene and prevent frauds or other wrongdoing that could expose the company to risk of loss as a result of such conduct. While it may be tempting to say that directors have the same duties to monitor and oversee business risk, imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different. Citigroup was in the business of taking on and managing investment and other business risks. To impose oversight liability on directors for failure to monitor "excessive" risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors. Oversight duties under Delaware law are not designed to subject directors, even expert directors, to personal liability for failure to predict the future and to properly evaluate business risk.

Instead of alleging facts that could demonstrate bad faith on the part of the directors, by presenting the Court with the so called "red flags," plaintiffs are inviting the Court to engage in the exact kind of judicial second guessing that is proscribed by the business judgment rule. In any business decision that turns out poorly there will likely be signs that one could point to and argue are evidence that the decision was wrong. Indeed, it is tempting in a case with such staggering losses for one to think that they could have made the "right" decision if they had been in the directors' position. This temptation, however, is one of the reasons for the presumption against an objective review of business decisions by judges, a presumption that is no less applicable when the losses to the Company are large.

Citigroup has suffered staggering losses, in part, as a result of the recent problems in the United States economy, particularly those in the subprime mortgage market. It is understandable that investors, and others, want to find someone to hold responsible for these losses, and it is often difficult to distinguish between a desire to blame someone and a desire to force those responsible to account for their wrongdoing. Our law, fortunately, provides guidance for precisely these situations in the form of doctrines governing the duties owed by officers and directors of Delaware corporations. This law has been refined over hundreds of years, which no doubt included many crises, and we must not let our desire to blame someone for our losses make us lose sight of the purpose of our law. Ultimately, the discretion granted directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses. This doctrine also means, however, that when the company suffers losses, shareholders may not be able to hold the directors personally liable.

SOME DISCUSSION QUESTIONS:

1. The court distinguishes between general red flags about the market and the company-specific information that boards have a responsibility under *Caremark* to monitor. Why not expand director responsibility to include broader economic information? That sort of information is relevant to businesses, particularly banks like Citigroup.

2. Many financial institutions melted down during the financial crisis because they went along with everyone else in exposing themselves to risky assets like the ones in question here. In fact, it was Citigroup's policy to follow trends in the market – their CEO, Charles Prince, said that "[a]s long as the music is playing, you've got to get up and dance"[1]. Should attitudes like that be subject to the presumption of careful, measured analysis that the Business Judgment

[1] DealBook. Citi Chief on Buyouts: 'We're Still Dancing'. New York Times, July 2007

Rule is intended to protect?

3. Two recent cases – *Marchand v. Barnhill*, 212 A.3d 805 (2019) and *In Re The Boeing Company*, C.A. No. 2019-0907-MTZ (Del. Ch. Sept. 7, 2021) – have applied *Caremark* to impose liability on boards for a failure to oversee "mission-critical" risks. Both of these cases involved product safety risks – *Marchand* involved a listeria outbreak caused by an ice cream company, while *Boeing* involved crashes of their 737 MAX airplane – while *Citigroup* involved "business risk". What factors should go into determining which risks corporate boards should be tasked with monitoring and which risks boards are not responsible for?

The Bottom Line on the Duty of Loyalty

The two classic breaches of the duty of loyalty are self-dealing (liability for which can be avoided by disclosure, abstention, and approval by an independent and disinterested board) and the taking of a corporate opportunity (liability for which can be avoided by presenting the opportunity to the corporation, and having an independent and disinterested board decline the opportunity). Both of these can and do present opportunities for shareholders to sue on behalf of the corporation to recover for the corporation profits that should have rightfully gone to the corporation.

Furthermore, Delaware courts apparently understand board oversight duties be a subset of the duty of loyalty,[1] rather than their own independent duty. The standards for board oversight liability remain the same: liability for the board results from either (1) knowledge that there was a violation of the law followed by inaction (*Graham*), or (2) an utter failure to implement and use a reasonable information and reporting system (*Caremark*).

[1] As confusing as this is, it's relatively straightforward when bringing a board oversight claim to plead a breach of the duty of loyalty and then argue the claim under *Caremark*'s analysis. Still: annoying.

Finally, courts have largely rejected the idea of an independent duty of good faith, preferring to fold the concept of "bad faith" into their analysis of whether a duty has been violated. Showing that a manager did not act in good faith – aka they abandoned their duties – is evidence that the manager has been disloyal, and if harm to the corporation arises from this bad faith behavior, a director may be liable for a breach of the duty of loyalty.

In the next chapters, we'll shift our focus to a corporation's shareholders. While shareholders have been present throughout this discussion of corporate management – primarily as litigants – we will take a closer look at (1) what shareholders can do without bringing a lawsuit, (2) what kinds of lawsuits shareholders can bring, and (3) what rights and remedies shareholders have when corporate managers make false statements about the corporations they manage.

9. *Shareholder Rights and Actions*

So far, this book has tediously pointed out all the things that shareholders cannot do – manage the corporation directly, act as the corporation's agent, use corporate property, demand distributions, second-guess management, do anything for love but not that, etc., etc. – but we have yet to explore the intricacies of what shareholders *can* do. One of the important things a shareholder can do – sue either on their behalf or on behalf of the corporation – we'll cover in the next chapter. This chapter will focus on the other important things that a shareholder can do: **vote** and **be really, really annoying**.

Specifically, this chapter will cover shareholder voting (the matters that shareholders can vote on, the procedures for voting), shareholder initiatives (binding changes to the corporation's bylaws, director removal and replacement, and the conflicts with management that can arise), shareholder campaigns (the use of shareholder information rights, non-binding shareholder proposals, and the role of activist investors) — and how beliefs about what a corporation *is* can influence debates about all of these .

We begin, however, with a tale of shareholder rebellion at Exxon Mobil, the largest oil company in the United States, from the absolutely essential Matt Levine at *Bloomberg*.

Exxon Lost A Climate Proxy Fight

Let's say you are the chief executive officer of Exxon Mobil Corp., and your second-biggest shareholder, BlackRock Inc., comes in for a meeting. "We would like you to drill less oil, spend more time on renewable energy and commit to being carbon-neutral by 2050," the BlackRock team says. "Absolutely not, get out of my office," you say. What can BlackRock do about it?

Actually let's sharpen the hypothetical a bit. BlackRock owns about 6.6% of Exxon's stock. Let's say that you, the Exxon CEO, had a meeting with the Vanguard Group right before your BlackRock meeting, and another one with State Street Corp. right after, and they say the exact same things as BlackRock. Combined, those three own about 20% of your stock. Let's say you had meetings with a few dozen other shareholders who also say the same things, and in total they add up to 50.1% of your stock. They all want you to drill less oil and do more renewables and commit to carbon neutrality, and you laugh at all of them and throw them out of your office. What can they do?

Of course they can call up the board of directors of Exxon, your bosses, and say "fire this guy, he's being mean to shareholders," but let us assume for this hypothetical that the board is aligned with you and will do what you want rather than what shareholders want. What else can they do?

Well, they can do lots of things. Let's list some:

- They can put out press releases saying that you are bad, which is embarrassing for you though it does not actually force your hand.

- They can vote for nonbinding shareholder resolutions asking you to prepare reports on your climate impact, which is also embarrassing for you. But you don't technically have to do the report even if the shareholders vote for it (the proposal is nonbinding), and even if you do the report that doesn't mean you have to change your strategy.

- Each year you ask them to approve your pay package and the pay of your other senior executives, and they could vote no. If they vote no, that will also be embarrassing for you, though technically the vote is nonbinding and you still get paid.

- Each year your board of directors is up for election, and they could vote against the directors. This perhaps sounds more important than it is, because the directors generally run unopposed. If they get a majority of the votes cast, they are re-elected. If a majority of shares are voted against a director, then, under Exxon's corporate governance guidelines, that director is required to submit a resignation letter to the rest of the board. "Within 90 days after certification of the election results, the Board of Directors will decide, through a process managed by the Board Affairs Committee and excluding the nominee in question, whether to accept the resignation. Absent a compelling reason for the director to remain on the Board, the Board shall accept the resignation." So if a majority of shareholders vote against the directors, they probably should leave the board, but they don't strictly have to. If a majority of shareholders votes against all the directors then presumably the directors could just decide not to accept each other's resignations.

- Exxon's directors and senior executives might be, or want to be, on the boards of directors of *other* companies. BlackRock et al. are also big shareholders of those other companies, and they might vote against the Exxon people on their other boards, and that might lead to the Exxon people losing some cushy directorships.

I am sure I am missing some. None of these things are trivial. They are very important! Most big corporate CEOs want to be liked and respected. (The previous CEO of Exxon went on to become the U.S. secretary of state!) They want to think that they're doing a good job and creating shareholder value; they don't want all their shareholders to be mad at them. They are members of corporate and philanthropic boards and golf clubs with other executives and investors, and they want to be respected by their peers. These symbolic indications of investor displeasure matter a lot to almost all public companies, and they give BlackRock and other big shareholders enormous influence. We talk about this influence all the time. People *worry* about it all the time; they worry that these big shareholders have *too much* power over all of the companies.

Still none of these things are exactly "the shareholders can fire you," are they?

Another thing that the shareholders can do is:

- They can sell their stock: "This CEO doesn't listen to us and isn't doing what we want, so we don't want to own Exxon anymore." If enough of them sell their stock then the price of the stock will go down. This is embarrassing for you — you want to think you're doing a good job and creating shareholder value, etc. — but it also affects you economically, because you own a bunch of Exxon stock personally and get paid in Exxon stock and options and so when the stock goes down you are less rich.[1]

That is an important incentive, but it is mitigated here because your biggest shareholders — Vanguard and BlackRock and State Street — run a lot of index money and can't sell the stock. You are in the index, they have to own the index, they have to own you. This is not really a threat they can make.

Okay now let's do the big ones. What is the endgame? How do the shareholders go from expressing displeasure to firing the CEO?

There are two classic answers, two binding ways for shareholders to fire the CEO. One is a hostile takeover. Some corporate raider, strategic rival or sharp-elbowed private equity firm notices the stock-price decline and dissatisfied shareholders and says "hey I could buy this company cheap, do what the market wants it to do, and make a profit." The raider offers a premium to the current price (which is depressed due to shareholder dissatisfaction), the disgusted shareholders happily sell to the raider, the

[1] Also of course if you need money to do projects, you'll have a harder time raising it if your investors are disgruntled and your stock price is depressed. I have relegated this to a footnote because, in most cases, large U.S. public companies do not actually fund their projects by selling stock.

raider fires the board and CEO and makes the changes that the shareholders were calling for.[1] This is sometimes called "the market for corporate control," and it is in general the main reason for corporate CEOs to worry about losing their jobs if their shareholders are unhappy.

[1] Or doesn't: The raider owns the company now and does whatever she wants. Bu tpresumably this is all easier to do if the shareholders are *right* and there is some sort of value-add strategic change that the company could make. Also the raider might *be* one of the existing, disgusted shareholders, or might get financing from them.

In general. In our particular hypothetical, though, Exxon happens to be a $250 billion oil company. No one is going to do a hostile takeover of Exxon. This is not a very compelling threat for a giant company.

The other classic answer is a proxy fight. Some activist hedge fund (or corporate raider) notices the stock-price decline and dissatisfied shareholders and says "hey I could buy like 8% of this company cheap, force it to do what the market wants it to do, and make a profit." The activist buys stock, nominates directors and runs a proxy fight to get them elected to the board. This is different from the usual uncontested director elections and nonbinding shareholder proposals: In a proxy fight, the activist writes her own proxy statement, pays to send it to shareholders, and spends a lot of time and money trying to get her nominees elected. If she wins — if her nominees get more votes than the company's nominees — then she wins, for real. It's not advisory or nonbinding or we-submit-a-resignation-letter-and-think-about-it; it's just the nominees who get more votes get on the board.

There are occasionally proxy fights like this at giant companies. There are impediments, though. One problem is that classic activists like to buy a lot of stock; my 8% number above is a reasonable order of magnitude.[2] Contested proxy fights are risky and expensive for the activist. Buying a lot of stock makes it more likely that the activist will win, because she gets to vote her own shares; starting with 8% of the vote is better than starting with less. Also, though, the activist is hoping that if she does win the stock will go up and she will make money. The more shares she owns, the more money she will make; also, if she owns more shares she will capture a greater percentage of the value she adds. If her ideas add $1 billion of value to the company and she owns 8% of the stock, she will make $80 million. If she owns 0.1% of the stock, she will make $1 million. A successful activist with a large stake is creating a lot of value for herself; a successful activist with a small stake is creating value mostly for other people out of, like, selfless philanthropy. You do not expect to see a ton of selfless philanthropy among activist hedge-fund managers.

[2] The ideal is "as much as possible while staying safely below 10%"; bad things happen under U.S. securities law if you go above 10%.

Again, Exxon is a $250 billion company. If an activist wants to buy 8% of it she'll need $20 billion, probably too big a check for any specialized activist.

Another problem here is that, for an activist hedge fund to spend time and money on a proxy fight, she needs to have a good economic thesis. "If we elect my directors and do my strategy, the company will make a ton more money and the stock will go up and I will get rich." If the shareholders are disgruntled about management for non-economic reasons — because they think that management is too focused on profits and not enough on environmental, social and governance issues — then that will be a less appealing situation for an activist than if the shareholders are disgruntled about underperformance that the activist thinks she can fix.

I don't want to overstate this: If lots of shareholders care about ESG and are disgruntled with management, then the stock price will be depressed, and if an activist wins a proxy fight and declares "we'll do more ESG now" then the stock will go up and the activist will make money from that alone. Also of course it is reasonable and popular to believe that ESG factors are economic factors, that a company that cares about environmental sustainability and social issues will be worth more in the long run — will have larger and more enduring future profits — than one that doesn't. When BlackRock is in your office asking you to focus on renewables, they're not asking you to do it out of a sense of social responsibility and shared sacrifice; they're telling you "if you focus more on renewables your long-term cash flows will be higher and less risky and so the stock price will be higher."

Still, there is a stereotype that activist investors are "short-termist," that they care about maximizing short-run cash flows and financial engineering to juice the stock price now, that they undervalue expensive long-term investments that won't pay off for years. This stereotype is not entirely correct, but it probably is helpful for a classic activist hedge fund to have some near-term catalyst, some reason to think that her thesis will pay off earlier than, you know, 2050. Carl Icahn just isn't in the business of telling companies that they need to be carbon-neutral by 2050.

So when BlackRock sits in your office and tells you to cut oil drilling, invest more in renewables and commit to long-term carbon neutrality, you might reasonably say "nope." And they might reasonably say "sir, I say, sir," and you might reasonably say "what are you gonna do about it?" And they might say "we'll vote against you on some nonbinding resolutions," and you might say "pfft." And they might say "we'll sell our stock," and you might say "no you won't, we're in the index." And they might say "we'll support a hostile takeover bid," and you might say "ha, from whom?" And they might say "we'll support an activist running a proxy fight," and you might say "we're a $250 billion company and you want us to reduce our near-term cash flows to invest in the long-term health of the planet, what activist investor is going to touch that?"[1]

[1] An obvious response would be for BlackRock to say "fine, we'll do the proxy fight ourselves," but they don't really do that. It's not really a specialization of the big asset managers, and it would probably get them a lot of negative attention from other companies.

I want to be clear that this is all hypothetical, and I don't think that the actual conversations between Exxon CEO Darren Woods and his big shareholders ever went like that. I assume that Woods is like every other big-company CEO in that he cares about what his shareholders want, he wants to look respectable and win all those nonbinding votes, and he listens to what his shareholders say and tries to be responsive. Still at the end of the day he runs the business and they don't, and there is a wide range of latitude between "do what they ask" and "rudely ignore them." He could say "ah yes, renewables, here are the renewables things we're doing," and the shareholders could say "do more," and he could say "I will give that a lot of thought" and then give it no thought.

And he could take the risk that they might get a little frustrated with him, because, realistically, what were they going to do about it? The hypotheticals that I have gone through here form the very real background to the relationship between shareholders and managers. If their differences ever become irreconcilable, either the shareholders can realistically replace the managers or they can't; if they can't — or if it's very hard or vanishingly unlikely — then the managers have a much freer hand to ignore or slow-walk investor demands.

This is a *big deal*:

> **Exxon Mobil Corp. CEO Darren Woods was dealt a stunning defeat by shareholders when a tiny activist investment firm snagged at least two board seats and promised to push the crude driller to diversify beyond oil and fight climate change.**
>
> **The vote was unprecedented in the rarefied world of Big Oil and underscores how vulnerable the industry has suddenly become as governments around the globe demand an acceleration of the shift away from fossil fuels. It's also a sign that institutional investors are increasingly willing to force corporations to actively participate in that transition.**
>
> **Tiny activist investor Engine No. 1, with just a 0.02% stake and no history of activism in oil and natural gas, secured two seats on Exxon's board in Wednesday's vote. A third seat may yet fall into the firm's hands when the final results are tallied. That would put Woods in the tricky position of leading a board that's 25% under the control of outsiders. Last-minute efforts by Woods and his team to appease climate-conscious investors and rebuff Engine No.1's assault were to no avail.**
>
> **"Darren Woods has come from a long line of CEOs that have been very straightforward: it's our ball, it's our bat and we're going to do what we want," said Mark Stoeckle, chief executive of Adams Express Co., which oversees $2.8 billion in assets. "When you're the biggest and the baddest you can get away with that. But you have to change with the times. The messaging has been terrible."**

That doesn't exactly give Engine No. 1 control of Exxon, it doesn't exactly put Woods's job in jeopardy, it doesn't exactly mean that Engine No. 1 can go implement its plans to invest in renewables and become carbon-neutral. It does give Engine No. 1's directors seats in the boardroom, though, and power to influence Exxon's strategy.

More important, perhaps, it shows that *this can work*. Shareholders — even shareholders of Exxon — can do this. If Woods and the other Exxon directors decide to ignore Engine No. 1's plans, keep doing what they were doing, and stick their fingers in their ears and shout "I can't hear you" whenever the Engine No. 1 nominees speak at board meetings, then next year Engine No. 1 will run a proxy fight for all of the board seats and win. Exxon's CEO and directors have to take this shareholder vote seriously, because it proves that the shareholders are willing and able to fire them. You might think that that would be obvious — that the shareholders' "ownership" of the corporation, and their voting rights, of course meant that they could fire officers and directors whom they didn't like — but I don't think it was obvious, and I think in practice it often wasn't true. Now it is.[1]

[1] Matt Levine. Exxon Lost a Climate Proxy Fight. Bloomberg, May 2021

Shareholder Voting

THE CLASSIC VENUE FOR SHAREHOLDER VOTING is the *annual meeting* (as we discussed in *Schnell* and *Stahl*, and where the surprising vote to oust Exxon board members occurred). Corporations must hold an annual meeting at least once every 13 months (under Delaware law) or every 15 months (under Kentucky law).[2] At these meetings, shareholders vote on:

[2] This, annoyingly, means that a corporation could technically hold 4 "annual" meetings in 5 years and be a-okay under Kentucky law. Most corporations hold them, you know, annually.

- Nominees for the board seats that are up for election.
  - The default rule is that every member of the board is up for election every year.
  - However, corporations can choose to have a "staggered" or "classified" board where the board members serve multi-year terms (3 years is the most common, but it can be any reasonable number of years) by designating so in their bylaws (or their articles if they are super-serious about it). With this structure, only a fraction of the board seats are up for election in a given year.
- Changes to the articles of incorporation that the board recommends.[3]
- Changes to the bylaws that the board recommends.
- Changes to the bylaws that a shareholder has proposed.
- Recommendations to the board that a shareholder has proposed.

[3] Note that while a shareholder vote is necessary to amend the articles, a shareholder cannot propose the amendment – it must be done via board action first.

- The non-binding, completely symbolic, entirely advisory vote on executive compensation that we discussed in the previous chapter.
- The approval of the appointment of the corporation's auditor.[1]

[1] This is related to the series of accounting scandals that rocked the corporate world back in the early '00s.

Another venue for shareholder voting is a *special meeting*, which can be called at any time by the board or by a shareholder (or shareholders) authorized in the articles or bylaws to call such a meeting.[2] Some states — but not Delaware — give shareholders a statutory right to call a special meeting.[3] Special meetings are often called to approve *fundamental transactions.* Fundamental transactions include:

[2] Amazon's articles allow any group of shareholders with more than 25% of the outstanding shares of the corporation to call a special meeting.

[3] In Kentucky, the statutory threshold is ownership of 33 $\frac{1}{3}$% of outstanding shares. KRS §271B.7-020

- The merger of the corporation with another corporation (there is an exception for a corporation merging with one of its own subsidiaries, however)
- The sale of the corporation's assets (or a significant amount of the assets of the business)
- Voluntary dissolution

Along with amendments to the articles of incorporation, shareholder approval is strictly required for fundamental transactions.[4]

[4] In most fundamental transactions, the corporation is either going away or changing significantly, so they require shareholder approval.

The final way for shareholders to vote is through *written consent* in lieu of a meeting. Some states only allow written consent when shareholders act unanimously, other states allow it for supermajorities of shareholders,[5] and Delaware allows action through written consent if shareholders representing a majority of outstanding shares approve (though this can be changed in the articles).

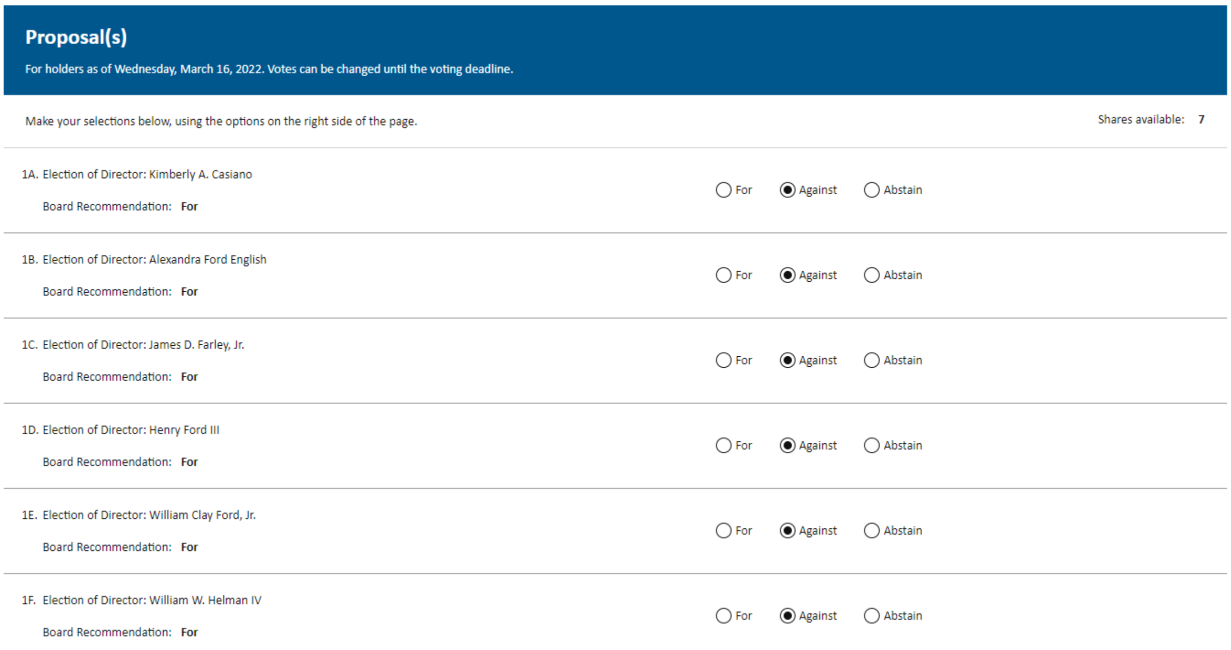
[5] In Kentucky, the statutory threshold is written consent from shareholders holding a minimum of 80 % of the outstanding shares. KRS §271B.7-040

Thresholds for Shareholder Approval

Shareholder voting is by default one-share-one-vote, but – as we've discussed previously – corporations can issue different classes of shares with different voting rights. Regardless of what number of votes the shares come with, there are different vote thresholds for shareholder approval that a corporation can require.

For the election of directors, the default rule is *plurality voting*, which means that for any open position, the nominee with the most votes wins. In an uncontested election, where the only choices a shareholder has are "for" and "against", a director nominee could win with a single vote "for" under plurality voting. Corporations may choose instead to use *majority voting*, where a director must receive a majority of the votes cast (even in an uncontested election) or else they must resign. Many large public corporations (including Exxon, as detailed in the *Bloomberg* piece) have a majority voting requirement for board elections.

Here is what the vote for a slate of directors (here, the nominees for the board of directors of the Ford Corporation) in an uncontested election looks like:



Proposal(s)

For holders as of Wednesday, March 16, 2022. Votes can be changed until the voting deadline.

Make your selections below, using the options on the right side of the page. Shares available: 7

Proposal			
1A. Election of Director: Kimberly A. Casiano Board Recommendation: **For**	For	◉ Against	Abstain
1B. Election of Director: Alexandra Ford English Board Recommendation: **For**	For	◉ Against	Abstain
1C. Election of Director: James D. Farley, Jr. Board Recommendation: **For**	For	◉ Against	Abstain
1D. Election of Director: Henry Ford III Board Recommendation: **For**	For	◉ Against	Abstain
1E. Election of Director: William Clay Ford, Jr. Board Recommendation: **For**	For	◉ Against	Abstain
1F. Election of Director: William W. Helman IV Board Recommendation: **For**	For	◉ Against	Abstain

I voted "against" because I'm a hater. I'm sure my seven whole shares made a huge difference.

FOR CHANGES TO THE BYLAWS or to approve shareholder proposals, state laws generally permit corporations to require only a *simple majority*, which is the majority of votes cast at the meeting. Corporations are free to ratchet up this requirement, however, and can either (1) require a super-majority of all the votes cast (e.g., require $\frac{2}{3}$ of all shares to approve a proposal), or (2) require an *absolute majority*, which means the majority of all outstanding shares that are entitled to cast a vote (regardless of whether or not they actually voted).

FOR CHANGES TO THE ARTICLES or to approve fundamental transactions, most states (including Delaware[1]) specifically require an absolute majority – a much higher bar for shareholder approval,[2] which is justified by the fact that the corporation itself is changing in a significant way.

[1] And Kentucky. KRS §271B.11-030

[2] To put this in perspective, Joe Biden received the votes of about 34% of all eligible voters, which is easily the highest absolute proportion of votes to voting-eligible voters that any presidential candidate has gotten in the past century.

The Rules of Shareholder Voting

Voting at a shareholder meeting (whether annual or special) requires:

- NOTICE — Notice must go out to shareholders entitled to vote no fewer than 10 days and no more than 60 days in advance of a meeting, and must describe the time, date, location, and purpose of the meeting. Notice for votes on fundamental transactions must be sent no fewer than 20 days in advance of the meeting, and shareholders must receive a description of what it is they're voting on.

- QUORUM – A quorum of at least a majority of outstanding shares entitled to vote must be voted at the meeting (though under Delaware law, this can be reduced to 33 $\frac{1}{3}$%.

- RECORD DATE – A record date is the date on which anyone holding the shares of the corporation is entitled to vote in the meeting. If someone sells their shares after the record date, they are still entitled to vote those shares; if someone purchases shares after the record date, they are not entitled to vote those shares.[1] The record date is set in the notice to shareholders.

- PROXIES – Shareholders can technically show up at a meeting and vote in person, but who in their right mind would do that? Instead, shareholders overwhelmingly vote by "proxy", designating some agent (often the broker who holds their shares) to vote for them, usually through an online voting process. Proxy holders can be directed to vote a particular way, or to vote however the proxy holder thinks is best. Proxies are generally designated for a particular shareholder vote, and can be withdrawn or changed at the discretion of the shareholder. By contrast, an "irrevocable proxy" is entered into through a shareholder agreement, where one shareholder permanently gives another the power to vote their shares. The use of proxies in shareholder voting is why contested board elections are called "proxy contests" – as both existing management and insurgent nominees fight to get the proxies of shareholders.

- INSPECTOR – Some dork or group of dorks appointed by the corporation to count the votes as they come in, and certify the results. Required under Delaware law.

This might seem nitpicky — and it is! — but there are real consequences for failures of process. Corporate action taken without a

[1] The potential for monkey business, chicanery and even tomfoolery has been noted by many commentators – imagine if a short seller bought a bunch of shares before the record date, sold them, and then voted at the meeting to do something dastardly! – but has yet to actually come to pass. Still, boards generally set the record date in the near past in order to avoid any potential manipulation.

proper vote can be voided, shareholders can sue to enforce their fundamental right to vote, and a failure to follow corporate formalities can lead to manager (or shareholder) liability.

IF A CORPORATION IS PUBLICLY-TRADED, there are an additional set of rules for shareholder votes promulgated by the Securities and Exchange Commission that the corporation must abide by. The SEC requires that anyone – management, shareholders, insurgent nominees, you, me, MTV's Dan Cortese – who solicits proxies (aka votes) from shareholders must provide to shareholders a "proxy statement"[1] describing board candidates, executive compensation, the specific language of amendments or proposals that shareholders will vote on, the board's reasoning for their recommendation on those proposals, and (if directors are being elected at the meeting) the corporation's annual report.

[1] This is also filed with and can be reviewed by the SEC.

Moreover, §14 of the Securities Exchange Act of 1934 and SEC Rule 14a-9 prohibit false or misleading statements of material fact in these proxy solicitations, and empower both the SEC and private actors to sue to enforce that prohibition. The elements of a claim under 14a-9 mirror the elements of securities fraud that we will discuss in Chapter 10: materiality (show that the statement was important), reliance (show that shareholders relied on the statement in deciding how to vote — though this is presumed if the statement was material), and causation (show that loss resulted from the approval of the action). In reality, cases involving managers lying to shareholders to induce a fraudulent vote are usually brought as violations of state law fiduciary duties, which carry heftier penalties and a lower bar for causation than federal claims under 14a-9. Still, the option is there.

Board Resistance to Shareholder Initiatives

Ideally, a corporation's management and its shareholders would be perfectly aligned, with management implementing courses of action favored by the shareholders and with the shareholders re-electing management so they can carry out their vision. The business world, however, is far from ideal and shareholder-initiated actions can bring the interests of shareholders (or certain groups of shareholders) into conflict with the board of directors. These conflicts include shareholder proposals to amend the corporation's bylaws against the wishes of management, attempts by shareholders to remove and replace managers, and attempts by current management to limit the powers of their potential replacements. The following cases explore each of these issues, and this section concludes with an examination of *Blasius v.*

Atlas, the most important Delaware case on shareholder voting rights and director fiduciary duties.

Amending the Bylaws

Shareholders have the inalienable power to amend the corporation's bylaws, and — unlike other shareholder actions — doing so does not require board action or approval. Shareholders can use this power to change things like the number of seats on the board, the procedures for electing and replacing board members, voting thresholds, and other process-oriented issues that relate to corporate governance. They cannot, however, infringe on the board of directors' powers to manage the business affairs of the corporation.[1] Where, though, is the line between permissible process-based rulemaking and impermissible commands to the board?

[1] So a shareholder could not amend the bylaws to specify that a corporation purchase a specific product or appoint a specific person as an officer, for example.

CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227 (Del. 2008)

Jacobs, J.

This proceeding arises from a certification by the United States Securities and Exchange Commission (the "SEC"), to this Court, of two questions of law.

CA, Inc. is a Delaware corporation whose board of directors consists of twelve persons, all of whom sit for reelection each year. AFSCME, a CA stockholder, is associated with the American Federation of State, County and Municipal Employees. On March 13, 2008, AFSCME submitted a proposed stockholder bylaw (the "Bylaw" or "proposed Bylaw") for inclusion in the Company's proxy materials for its 2008 annual meeting of stockholders. The Bylaw, if adopted by CA stockholders, would amend the Company's bylaws to provide as follows:

> The board of directors shall cause the corporation to reimburse a stockholder or group of stockholders (together, the "Nominator") for reasonable expenses ("Expenses") incurred in connection with nominating one or more candidates in a contested election of directors to the corporation's board of directors, including, without limitation, printing, mailing, legal, solicitation, travel, advertising and public relations expenses, so long as (a) the election of fewer than 50% of the directors to be elected is contested in the election, (b) one or more candidates nominated by the Nominator are elected to the corporation's board of directors, (c) stockholders are not permitted to cumulate their votes for directors, and (d) the election occurred, and the Expenses were incurred, after this bylaw's adoption.

It is undisputed that the decision whether to reimburse election expenses is presently vested in the discretion of CA's board of directors, subject to their fiduciary duties and applicable Delaware law.

The two questions certified to us by the SEC are as follows:

1. Is the AFSCME Proposal a proper subject for action by shareholders as a matter of Delaware law?
2. Would the AFSCME Proposal, if adopted, cause CA to violate any Delaware law to which it is subject?

First, the DGCL empowers both the board of directors and the shareholders of a Delaware corporation to adopt, amend or repeal the corporation's bylaws.

It is well-established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made. Traditionally, the bylaws have been the corporate instrument used to set forth the rules by which the corporate board conducts its business. To this end, the DGCL is replete with specific provisions authorizing the bylaws to establish the procedures through which board and committee action is taken. [T]here is a general consensus that bylaws that regulate the process by which the board acts are statutorily authorized.

The context of the Bylaw at issue here is the process for electing directors — a subject in which shareholders of Delaware corporations have a legitimate and protected interest. The purpose of the Bylaw is to promote the integrity of that electoral process by facilitating the nomination of director candidates by stockholders or groups of stockholders. Generally, and under the current framework for electing directors in contested elections, only board-sponsored nominees for election are reimbursed for their election expenses. Dissident candidates are not, unless they succeed in replacing at least a majority of the entire board.[1] The Bylaw would encourage the nomination of non-management board candidates by promising reimbursement of the nominating stockholders' proxy expenses if one or more of its candidates are elected. In that the shareholders also have a legitimate interest, because the Bylaw would facilitate the exercise of their right to participate in selecting the contestants.

[1] Key, key point here.

The shareholders are entitled to facilitate the exercise of that right by proposing a bylaw that would encourage candidates other than board-sponsored nominees to stand for election. The Bylaw would accomplish that by committing the corporation to reimburse the election expenses of shareholders whose candidates are successfully elected. That the implementation of that proposal would require the expenditure of corporate funds will not, in and of itself, make such a bylaw an improper subject matter for shareholder action. Accordingly, we answer the first question certified to us in the affirmative.

That, however, concludes only part of the analysis. The DGCL also requires that the Bylaw be "not inconsistent with law." Accordingly, we turn to the second certified question, which is whether the proposed Bylaw, if adopted, would cause CA to violate any Delaware law to which it is subject.

In answering the first question, we have already determined that the Bylaw does not facially violate any provision of the DGCL or of CA's Certificate of Incorporation. The question thus becomes whether the Bylaw would violate any common law rule or precept. Were this issue being presented in the course of litigation involving the application of the Bylaw to a specific set of facts, we would start with the presumption that the Bylaw is valid and, if possible, construe it in a manner consistent with the law. The certified questions, however, request a determination of the validity of the Bylaw in the abstract. Therefore, in response to the second question, we must necessarily consider any possible circumstance under which a board of directors might be required to act. Under at least one such hypothetical, the board of directors would breach their fiduciary duties if they complied with the Bylaw. Accordingly, we conclude that the Bylaw, as drafted, would violate the prohibition, which our decisions have derived from Section 141(a),[1] against contractual arrangements that commit the board of directors to a course of action that would preclude them from fully discharging their fiduciary duties to the corporation and its shareholders.

[1] "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."

This Court has previously invalidated contracts that would require a board to act or not act in such a fashion that would limit the exercise of their fiduciary duties. This case involves a binding bylaw that the shareholders seek to impose involuntarily on the directors in the specific area of election expense reimbursement. Although this case is distinguishable in that respect, the distinction is one without a difference. The reason is that the internal governance contract — which here takes the form of a bylaw — is one that would also prevent the directors from exercising their full managerial power in circumstances where their fiduciary duties would otherwise require them to deny reimbursement to a dissident slate. That this limitation would be imposed by a majority vote of the shareholders rather than by the directors themselves, does not, in our view, legally matter.

AFSCME argues that it is unfair to claim that the Bylaw prevents the CA board from discharging its fiduciary duty where the effect of the Bylaw is to relieve the board entirely of those duties in this specific area. That response, in our view, is more semantical than substantive. No matter how artfully it may be phrased, the argument concedes the very proposition that renders the Bylaw, as written, invalid: the Bylaw mandates reimbursement of election expenses in circumstances that a proper application of fiduciary principles could preclude. That such circumstances could arise is not far fetched. Under Delaware law, a board may expend corporate funds to reimburse proxy expenses "[w]here the controversy is concerned with a question of policy as distinguished from personnel o[r] management." But in a situation where the proxy contest is motivated by personal or petty concerns, or to promote interests that do not further, or are adverse to, those of the corporation, the board's fiduciary duty could compel that reimbursement be denied altogether.

It is in this respect that the proposed Bylaw, as written, would violate Delaware law if enacted by CA's shareholders.

SOME DISCUSSION QUESTIONS:

1. The court points out that the incumbent board nominees get reimbursed for their election-related expenses by the corporation, but the insurgent board nominees have to pay out of pocket for their expenses. How was this bylaw going to address that imbalance?

2. So the subject matter was permissible, but the execution was not? Where did the proposal go wrong?

3. The court is concerned with potential scenarios in which the board violates its fiduciary duties in reimbursing costs for insurgent board nominees. Do these scenarios seem likely to happen?

4. How could the drafters of the bylaws have addressed this problem?

AND WHILE SHAREHOLDERS HAVE THE INALIENABLE POWER to amend the corporation's bylaws (within certain limits), they do not have the *exclusive* power to do so. The board of directors almost always has the power — either via state statute or via a provision in the articles of incorporation — to amend a corporation's bylaws, too.[1] A corporation cannot, however, take that power away from shareholders, meaning that both the board and the shareholders simultaneously hold the power to amend the bylaws. What, then, if they disagree?

[1] The articles of incorporation can take away this power, though they rarely do.

It is conceivable that shareholders could pass an amendment to a corporation's bylaws, only for the board to immediately pass its own amendment undoing that action.[2] This would be an annoying situation, and probably embarrassing, but — outside of a court finding some impermissible purpose for the board action — it could happen.

[2] Kinda sorta like how Florida voters passed a constitutional amendment restoring voting rights to non-violent felons, only to have the legislature and the governor functionally nullify it.

Does it happen, though? Almost never. The reason we don't often see a silly back-and-forth like this is that any shareholder base fired up enough to amend the corporation's bylaws is a shareholder base fired up enough to get rid of a stubborn board at their first available opportunity. Board members that defy their shareholders' express wishes aren't board members for long.[1]

[1] Kentucky law provides for a nice solution to this dilemma. In Kentucky, when shareholders amend or repeal a particular bylaw, they may "provide expressly that the board of directors may not amend or repeal that bylaw", thus preventing this sort of bylaw amendment ping-pong. KRS §271B.10-200

Director Removal

IF SHAREHOLDERS CAN ELECT DIRECTORS, can they also remove them? You better believe it. The following cases explain the why and the how of shareholder actions to kick the bums out.

Auer v. Dressel, 306 N.Y. 427 (N.Y. 1954)

Desmond, J.

This proceeding was brought by Class A stockholders of appellant R. Hoe Co., Inc.,[2] for an order to compel the president of Hoe to comply with a positive duty imposed on him by the corporation's by-laws. Section 2 of article I of those by-laws says that "It shall be the duty of the President to call a special meeting whenever requested in writing so to do, by stockholders owning a majority of the capital stock entitled to vote at such meeting". On October 16, 1953, petitioners submitted to the president written requests for a special meeting of Class A stockholders, which writings were signed in the names of the holders of record of slightly more than 55% of the Class A stock. The president failed to call the meeting and, after waiting a week, the petitioners brought the present proceeding.

[2] They made printing presses, but are no longer in business — either because print is dead or because of that unfortunate name. Maybe both?

The petition was opposed on the alleged ground that none of the four purposes for which petitioners wished the meeting called was a proper one for such a Class A stockholders' meeting. Those four stated purposes were these: (A) to vote upon a resolution endorsing the administration of petitioner Joseph L. Auer, who had been removed as president by the directors, and demanding that he be reinstated as such president; (B) voting upon a proposal to amend the charter and by-laws to provide that vacancies on the board of directors, arising from the removal of a director by stockholders or by resignation of a director against whom charges have been preferred, may be filled, for the unexpired term, by the stockholders only of the class theretofore represented by the director so removed or so resigned; (C) voting upon a proposal that the stockholders hear certain charges preferred, in the requests, against four of the directors, determine whether the conduct of such directors or any of them was inimical to the corporation and, if so, to vote upon their removal and vote for the election of their successors; and (D) voting upon a proposal to amend the by-laws so as to provide that half of the total number of directors in office and, in any event, not less than one third of the whole authorized number of directors constitute a quorum of the directors.[1]

[1] This last one is extremely not important.

The Hoe certificate of incorporation provides for eleven directors, of whom the Class A stockholders, more than a majority of whom join in this petition, elect nine and the common stockholders elect two. The obvious purpose of the meeting here sought to be called (aside from the endorsement and reinstatement of former president Auer) is to hear charges against four of the Class A directors, to remove them if the charges be proven, to amend the by-laws so that the successor directors be elected by the Class A stockholders, and further to amend the by-laws so that an effective quorum of directors will be made up of no fewer than half of the directors in office and no fewer than one third of the whole authorized number of directors. No reason appears why the Class A stockholders should not be allowed to vote on any or all of those proposals.

The stockholders, by expressing their approval of Mr. Auer's conduct as president and their demand that he be put back in that office, will not be able, directly, to effect that change in officers, but there is nothing invalid in their so expressing themselves and thus putting on notice the directors who will stand for election at the annual meeting. As to purpose (B), that is, amending the charter and by-laws to authorize the stockholders to fill vacancies as to Class A directors who have been removed on charges, it seems to be settled law that the stockholders who are empowered to elect directors have the inherent power to remove them for cause.[2] Of course, there must be the service of specific charges, adequate notice and full opportunity of meeting the accusations, but there is no present showing of any lack of any of those in this instance. Since these particular stockholders have the right to elect nine directors and to remove them on proven charges, it is not inappropriate that they should use their further power to amend the by-laws to elect the successors of such directors as shall be removed after hearing. Such a change in the by-laws, dealing with Class A directors only, has no effect on the voting rights of the common stockholders, which rights have to do with the selection of the remaining two directors only. True, the certificate of incorporation authorizes the board of directors to remove any director on charges, but we do not consider that provision as an abdication by the stockholders of their own traditional, inherent power to remove their own directors. Rather, it provides an additional method. Were that not so, the stockholders might find themselves without effective remedy in a case where a majority of the directors were accused of wrongdoing and, obviously, would be unwilling to remove themselves from office.

[2] This is the "I brought you into this world and I can take you out" rule.

We fail to see, in the proposal to allow Class A stockholders to fill vacancies as to Class A directors, any impairment or any violation of paragraph (h) of article Third of the certificate of incorporation, which says that Class A stock has exclusive voting rights with respect to all matters "other than the election of directors".[1] That negative language should not be taken to mean that Class A stockholders, who have an absolute right to elect nine of these eleven directors, cannot amend their by-laws to guarantee a similar right in the Class A stockholders, and to the exclusion of common stockholders, to fill vacancies in the Class A group of directors.

[1] This language gives Class A, and not the common stockholders, the right to vote on fundamental transactions.

Van Voorhis, J., dissenting

An examination of the request for a special meeting by these stockholders indicates that none of the proposals could be voted upon legally at the projected meeting. Purpose A is described as "Voting upon a resolution endorsing the administration of Joseph L. Auer, as President of the corporation, and demanding his immediate reinstatement as President." For the stockholders to vote on this proposition would be an idle gesture, since the business of a corporation shall be managed by its board of directors. The directors of Hoe have been elected by the stockholders for stated terms which have not expired, and it is their function and not that of the stockholders to appoint the officers of the corporation.

Proposal B is interwoven with the Proposal C, which is to remove four directors from office before the expiration of their terms in order to alter the control of the corporation. Proposal B must be read in the context that the certificate of incorporation provides for eleven directors, of whom the class A stockholders elect nine and the common stockholders two. So long as any class A shares are outstanding, the voting rights with respect to all matters "other than the election of directors" are vested exclusively in the holders of class A stock. This means that the common stockholders are entitled to participate directly in the election of two directors, who, in turn, are authorized by the certificate to vote to fill vacancies occurring among the directors elected by the class A shareholders. This proposed amendment would deprive the directors elected by the common stockholders of the power to participate in filling the vacancies which petitioners hope to create among the class A directors, four of whom they seek to remove by proposal C. Such an alteration would impair the existing right of the common stockholders to participate in filling vacancies upon the board of directors and could not be legally adopted at this meeting demanded by petitioners from which the common stockholders are excluded.

Petitioners have instituted this proceeding on the theory that although no power is conferred upon the stockholders by the certificate or the by-laws to remove directors before the expiration of their terms, with or without cause, power to do so for cause is inherent in them as the body authorized to elect the directors. The petition fails to state facts on account of which the remaining directors would be disqualified to hear and decide whatever charges may be presented against the four directors above named, nor has any reason been shown why the delegation of this power to the directors in the corporate charter does not preclude the exercise of the same power by the stockholders. If petitioners' position be correct, separate trials on the same charges might be conducted by both the board of directors and by the stockholders, with conflicting results.

SOME DISCUSSION QUESTIONS:

1. If one of the directors resigned, could the shareholders in this case pass a proposal directing the board to appoint Auer to the vacant seat?

2. The dissent seems pretty miffed on behalf of the common shareholders – how does this maneuver deprive them of any right or power? Is that a power inherent to their position?

3. Did you notice anything weird about Proposal B, the one that would amend the articles and bylaws to give Class A shareholders the power to elect board replacements?

Campbell v. Loew's, Inc., 36 Del. Ch. 563 (Del. Ch. 1957)

Seitz, J.

This is the decision on plaintiff's request for a preliminary injunction to restrain the holding of a stockholders' meeting or alternatively to prevent the meeting from considering certain matters or to prevent the voting of certain proxies.

Some background is in order if the many difficult and novel issues are to be understood. Two factions have been fighting for control of Loew's. One faction is headed by Joseph Tomlinson (hereafter "Tomlinson faction") while the other is headed by the President of Loew's, Joseph Vogel (hereafter "Vogel faction"). At the annual meeting of stockholders last February a compromise was reached by which each nominated six directors and they in turn nominated a thirteenth or neutral director. But the battle had only begun. Passing by much of the controversy, we come to the July 17-18 period of this year when two of the six Vogel directors and the thirteenth or neutral director resigned. A quorum is seven.

On the 19th of July the Tomlinson faction asked that a directors' meeting be called for July 30 to consider, inter alia, the problem of filing director vacancies. On the eve of this meeting one of the Tomlinson directors resigned. This left five Tomlinson directors and four Vogel directors in office. Only the five Tomlinson directors attended the July 30 meeting. They purported to fill two of the director vacancies and to take other action. This Court has now ruled that for want of a quorum the two directors were not validly elected and the subsequent action taken at that meeting was invalid.

On July 29, the day before the noticed directors' meeting, Vogel, as president, sent out a notice calling a stockholders' meeting for September 12 for the following purposes:

1. To fill director vacancies.
2. To amend the by-laws to increase the number of the board from 13 to 19; to increase the quorum from 7 to 10 and to elect six additional directors.
3. To remove Stanley Meyer and Joseph Tomlinson as directors and to fill such vacancies.

Plaintiff contends that the president had no authority in fact to call a special meeting of stockholders to act upon policy matters which have not been defined by the board of directors. Defendant says that the by-laws specifically authorize the action taken.

Section 7 of Article I provides:

> "Special meetings of the stockholders for any purpose or purposes, other than those regulated by statute, may be called by the President"

Section 2 of Article IV reads:

> "The President ... shall have power to call special meetings of the stockholders ... for any purpose or purposes"

It is true that Section 8(11) of Article II also provides that the board of directors may call a special meeting of stockholders for any purpose. But, in view of the explicit language of the by-laws above quoted, can this Court say that the president was without authority to call this meeting for the purposes stated? I think not.

Plaintiff next argues that the shareholders of a Delaware corporation have no power to remove directors from office even for cause and thus the call for that purpose is invalid. The defendant naturally takes a contrary position.

While there are some cases suggesting the contrary, I believe that the stockholders have the power to remove a director for cause. This power must be implied when we consider that otherwise a director who is guilty of the worst sort of violation of his duty could nevertheless remain on the board. It is hardly to be believed that a director who is disclosing the corporation's trade secrets to a competitor would be immune from removal by the stockholders. Other examples, such as embezzlement of corporate funds, etc., come readily to mind.

But plaintiff correctly states that there is no provision in our statutory law providing for the removal of directors by stockholder action. In contrast he calls attention to § 142 of 8 Del. C., dealing with officers, which specifically refers to the possibility of a vacancy in an office by removal. He also notes that the Loew's by-laws provide for the removal of officers and employees but not directors. From these facts he argues that it was intended that directors not be removed even for cause. I believe the statute and by-law are of course some evidence to support plaintiff's contention. But when we seek to exclude the existence of a power by implication, I think it is pertinent to consider whether the absence of the power can be said to subject the corporation to the possibility of real damage. I say this because we seek intention and such a factor would be relevant to that issue. Considering the damage a director might be able to inflict upon his corporation, I believe the doubt must be resolved by construing the statutes and by-laws as leaving untouched the question of director removal for cause. This being so, the Court is free to conclude on reason that the stockholders have such inherent power.

I therefore conclude that as a matter of Delaware corporation law the stockholders do have the power to remove directors for cause. I need not and do not decide whether the stockholders can by appropriate charter or by-law provision deprive themselves of this right.

I turn next to plaintiff's charges relating to procedural defects and to irregularities in proxy solicitation by the Vogel group.

Plaintiff's first point is that the stockholders can vote to remove a director for cause only after such director has been given adequate notice of charges of grave impropriety and afforded an opportunity to be heard.

I am inclined to agree that if the proceedings preliminary to submitting the matter of removal for cause to the stockholders appear to be legal and if the charges are legally sufficient on their face, the Court should ordinarily not intervene. The sufficiency of the evidence would be a matter for evaluation in later proceedings. But where the procedure adopted to remove a director for cause is invalid on its face, a stockholder can attack such matters before the meeting. This conclusion is dictated both by the desirability of avoiding unnecessary and expensive action and by the importance of settling internal disputes, where reasonably possible, at the earliest moment. Otherwise a director could be removed and his successor could be appointed and participate in important board action before the illegality of the removal was judicially established. This seems undesirable where the illegality is clear on the face of the proceedings.

Turning now to plaintiff's contentions, it is certainly true that when the shareholders attempt to remove a director for cause, "there must be the service of specific charges, adequate notice and full opportunity of meeting the accusation".[1] The power of removal cannot be exercised in an arbitrary manner. The accused director would be entitled to be heard in his own defense.

[1] The court is quoting *Auer* here.

Plaintiff asserts that no specific charges have been served upon the two directors sought to be ousted; that the notice of the special meeting fails to contain a specific statement of the charges; that the proxy statement which accompanied the notice also failed to notify the stockholders of the specific charges; and that it does not inform the stockholders that the accused must be afforded an opportunity to meet the accusations before a vote is taken.

Matters for stockholder consideration need not be conducted with the same formality as judicial proceedings. The proxy statement specifically recites that the two directors are sought to be removed for the reasons stated in the president's accompanying letter. Both directors involved received copies of the letter. Under the circumstances I think it must be said that the two directors involved were served with notice of the charges against them. It is true, as plaintiff says, that the notice and the proxy statement failed to contain a specific statement of charges. But as indicated, I believe the accompanying letter was sufficient compliance with the notice requirement.

I next consider plaintiff's contention that the charges against the two directors do not constitute "cause" as a matter of law. It would take too much space to narrate in detail the contents of the president's letter. I must therefore give my summary of its charges. First of all, it charges that the two directors (Tomlinson and Meyer) failed to cooperate with Vogel in his announced program for rebuilding the company; that their purpose has been to put themselves in control; that they made baseless accusations against him and other management personnel and attempted to divert him from his normal duties as president by bombarding him with correspondence containing unfounded charges and other similar acts; that they moved into the company's building, accompanied by lawyers and accountants, and immediately proceeded upon a planned scheme of harassment. They called for many records, some going back twenty years, and were rude to the personnel. Tomlinson sent daily letters[2] to the directors making serious charges directly and by means of innuendos and misinterpretations.

[2] As someone who considers getting any sort of mail to be a personal attack, I can't even imagine how unpleasant *daily letters* must have been.

Are the foregoing charges, if proved, legally sufficient to justify the ouster of the two directors by the stockholders? I am satisfied that a charge that the directors desired to take over control of the corporation is not a reason for their ouster. Standing alone, it is a perfectly legitimate objective which is a part of the very fabric of corporate existence. Nor is a charge of lack of cooperation a legally sufficient basis for removal for cause.

The next charge is that these directors, in effect, engaged in a calculated plan of harassment to the detriment of the corporation. Certainly a director may examine books, ask questions, etc., in the discharge of his duty, but a point can be reached when his actions exceed the call of duty and become deliberately obstructive. In such a situation, if his actions constitute a real burden on the corporation then the stockholders are entitled to relief. The charges in this area made by the Vogel letter are legally sufficient to justify the stockholders in voting to remove such directors. In so concluding I of course express no opinion as to the truth of the charges.

I therefore conclude that the charge of "a planned scheme of harassment" as detailed in the letter constitutes a justifiable legal basis for removing a director.

I next consider whether the directors sought to be removed have been given a reasonable opportunity to be heard by the stockholders on the charges made.

When Vogel as president caused the notice of meeting to be sent, he accompanied it with a letter requesting proxies granting authority to vote for the removal of the two named directors. It is true that the proxy form also provided a space for the stockholder to vote against such removal. However, only the Vogel accusations accompanied the request for a proxy. Thus, while the stockholder could vote for or against removal, he would be voting with only one view-point presented. This violates every sense of equity and fair play in a removal for cause situation.

[T]o the extent the matter is to be voted upon by the use of proxies, such proxies may be solicited only after the accused directors are afforded an opportunity to present their case to the stockholders. This means, in my opinion, that an opportunity must be provided such directors to present their defense to the stockholders by a statement which must accompany or precede the initial solicitation of proxies seeking authority to vote for the removal of such director for cause. If not provided then such proxies may not be voted for removal. And the corporation has a duty to see that this opportunity is given the directors at its expense. Admittedly, no such opportunity was given the two directors involved. Indeed, the corporation admittedly refused to supply them with a stockholders' list.

To require anything less than the foregoing is to deprive the stockholders of the opportunity to consider the case made by both sides before voting and would make a mockery of the requirement that a director sought to be removed for cause is entitled to an opportunity to be heard before the stockholders vote.

I therefore conclude that the procedural sequence here adopted for soliciting proxies seeking authority to vote on the removal of the two directors is contrary to law. The result is that the proxy solicited by the Vogel group, which is based upon unilateral presentation of the facts by those in control of the corporate facilities, must be declared invalid insofar as they purport to give authority to vote for the removal of the directors for cause.

Some discussion questions:

1. What was Vogel trying to do in putting this before the shareholders as a proposal?
2. What authority does the court rely on for the finding that shareholders have inherent power to remove? For the finding that directors are entitled to present a defense before a shareholder vote?
3. What counts as "cause"?
4. The threshold that is eventually established for shareholders to remove directors is an affirmative majority – which can differ from the threshold for electing directors in corporations that use plurality voting. So not only do shareholders have to demonstrate cause, and provide an opportunity for a defense, but also the standard for director removal may be higher than the standard for director election. Why might that be desirable?

The "Dead Hand" of the Old Board

If a board of directors gets worried that shareholders might oust them – either through the removal and replacement process outlined in *Auer* and *Campbell*, or through a contested director election at the annual meeting – they could be tempted to limit the powers of the incoming board. Restricting the authority of the next board can be justified as a way to protect the corporation from the nefarious plans of a dangerous corporate raider,[1] but it is better understood as a maneuver that makes the corporation less attractive to a party that wants to take control of it. When does limiting the power of the next board infringe on the rights of shareholders to elect a fully empowered board? The next case examines that question.

[1] This is certainly what I'd tell the board to say when asked why they did it.

Quickturn Design Systems v. Shapiro, 721 A.2d 1281 (Del. 1998)

Holland, J.

The dispute arises out of an ongoing effort by Mentor Graphics Corporation ("Mentor"), a hostile bidder, to acquire Quickturn Design Systems, Inc. ("Quickturn"), the target company. The plaintiffs-appellees are Mentor and an unaffiliated stockholder of Quickturn. The named defendants-appellants are Quickturn and its directors.

Mentor (the hostile bidder) is an Oregon corporation, headquartered in Wilsonville, Oregon, whose shares are publicly traded on the NASDAQ national market system. Mentor manufactures, markets, and supports electronic design automation ("EDA") software and hardware.

Quickturn, the target company, is a Delaware corporation, headquartered in San Jose, California. Quickturn invented, and was the first company to successfully market, logic emulation technology, which is used to verify the design of complex silicon chips and electronics systems. Quickturn is currently the market leader in the emulation business, controlling an estimated 60% of the worldwide emulation market and an even higher percentage of the United States market.

Since 1989, Quickturn has historically been a growth company, having experienced increases in earnings and revenues during the past seven years. Those favorable trends were reflected in Quickturn's stock prices, which reached a high of $15.75 during the first quarter of 1998, and generally traded in the $15.875 to $21.25 range during the year preceding Mentor's hostile bid.

After Quickturn's stock price began to decline in May 1998, however, Gregory Hinckley, Mentor's Executive Vice President, told Dr. Walden Rhines, Mentor's Chairman, that "the market outlook being very weak due to the Asian crisis made it a good opportunity" to try acquiring Quickturn for a cheap price.

On August 12, 1998, Mentor announced an unsolicited cash tender offer for all outstanding common shares of Quickturn at $12.125 per share.[1] Mentor also announced its intent to solicit proxies to replace the board at a special meeting. Relying upon Quickturn's then-applicable by-law provision governing the call of special stockholders meetings, Mentor began soliciting agent designations from Quickturn stockholders to satisfy the by-law's stock ownership requirements to call such a meeting.

[1] A tender offer is an offer to buy a corporation's shares directly from the shareholders, with no board approval required.

At the August 21 board meeting, the Quickturn board adopted two defensive measures in response to Mentor's hostile takeover bid. First, the By-Law Amendment provides that if any such special meeting is requested by shareholders, the corporation (Quickturn) would fix the record date for, and determine the time and place of, that special meeting, which must take place not less than 90 days nor more than 100 days after the receipt and determination of the validity of the shareholders' request.

Second, the board amended Quickturn's shareholder Rights Plan[1] by eliminating its "dead hand" feature and replacing it with the Deferred Redemption Provision, under which no newly elected board could redeem the Rights Plan for six months after taking office, if the purpose or effect of the redemption would be to facilitate a transaction with an "Interested Person" (one who proposed, nominated or financially supported the election of the new directors to the board). Mentor would be an Interested Person.

[1] Also called a "poison pill", a shareholder rights plan stops unwanted buyers from buying up a corporation's shares by issuing new shares to other shareholders and diluting the purchaser. It can be "redeemed" – aka turned off – at any time by the board. Here, the board is attempting to prevent the next board from redeeming the plan for a set period of time.

The effect of the By-Law Amendment would be to delay a shareholder-called special meeting for at least three months. The effect of the DRP would be to delay the ability of a newly-elected, Mentor-nominated board to redeem the Rights Plan or "poison pill" for six months, in any transaction with an Interested Person. Thus, the combined effect of the two defensive measures would be to delay any acquisition of Quickturn by Mentor for at least nine months.

In this appeal, Mentor argues that the Delayed Redemption Provision is invalid as a matter of Delaware law. According to Mentor, the Delayed Redemption Provision will impermissibly deprive any newly elected board of both its statutory authority to manage the corporation under 8 Del. C. § 141(a) and its concomitant fiduciary duty pursuant to that statutory mandate. We agree.

One of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation. Section 141(a) requires that any limitation on the board's authority be set out in the certificate of incorporation. The Quickturn certificate of incorporation contains no provision purporting to limit the authority of the board in any way. The Delayed Redemption Provision, however, would prevent a newly elected board of directors from completely discharging its fundamental management duties to the corporation and its stockholders for six months. While the Delayed Redemption Provision limits the board of directors' authority in only one respect, the suspension of the Rights Plan, it nonetheless restricts the board's power in an area of fundamental importance to the shareholders — negotiating a possible sale of the corporation. Therefore, we hold that the Delayed Redemption Provision is invalid under Section 141(a), which confers upon any newly elected board of directors full power to manage and direct the business and affairs of a Delaware corporation.

In discharging the statutory mandate of Section 141(a), the directors have a fiduciary duty to the corporation and its shareholders. This unremitting obligation extends equally to board conduct in a contest for corporate control. The Delayed Redemption Provision prevents a newly elected board of directors from completely discharging its fiduciary duties to protect fully the interests of Quickturn and its stockholders.

This Court has recently observed that "although the fiduciary duty of a Delaware director is unremitting, the exact course of conduct that must be charted to properly discharge that responsibility will change in the specific context of the action the director is taking with regard to either the corporation or its shareholders." This Court has held "[t]o the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable." The Delayed Redemption Provision "tends to limit in a substantial way the freedom of [newly elected] directors' decisions on matters of management policy." Therefore, "it violates the duty of each [newly elected] director to exercise his own best judgment on matters coming before the board."

The Delayed Redemption Provision would prevent a new Quickturn board of directors from managing the corporation by redeeming the Rights Plan to facilitate a transaction that would serve the stockholders' best interests, even under circumstances where the board would be required to do so because of its fiduciary duty to the Quickturn stockholders. Because the Delayed Redemption Provision impermissibly circumscribes the board's statutory power under Section 141(a) and the directors' ability to fulfill their concomitant fiduciary duties, we hold that the Delayed Redemption Provision is invalid.

SOME DISCUSSION QUESTIONS:

1. Who is being harmed here? And does the harm seem severe enough to interfere with what is really a managerial decision? Where's the good ol' Business Judgment Rule?

2. What's the problem with an exiting board creating a "dead hand" provision that binds the next board? Can the new board simply overrule the old board?

3. You ever hear of the concept of pre-commitment?

COURTS WILL INTERVENE TO PROTECT THE SHAREHOLDER FRANCHISE — even going beyond the specific statutory requirements to prevent boards from unfairly favoring themselves in a vote, as we have seen in cases like *Schnell*. The following case involves not just the shareholder right to vote, or what constitutes a fair process for shareholder voting, but the question of what duties a board has to ensure that a shareholder vote is effective.

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

Allen, Ch.

Blasius is a new stockholder of Atlas. It began to accumulate Atlas shares for the first time in July, 1987. On October 29, it filed a Schedule 13D with the Securities Exchange Commission disclosing that, with affiliates, it then owed 9.1% of Atlas' common stock. It stated in that filing that it intended to encourage management of Atlas to consider a restructuring of the Company or other transaction to enhance shareholder values. It also disclosed that Blasius was exploring the feasibility of obtaining control of Atlas, including instituting a tender offer or seeking "appropriate" representation on the Atlas board of directors.

On December 30, 1987, Blasius caused Cede Co. (the registered owner of its Atlas stock) to deliver to Atlas a signed written consent (1) adopting a precatory resolution recommending that the board develop and implement a restructuring proposal,[1] (2) amending the Atlas bylaws to, among other things, expand the size of the board from seven to fifteen members — the maximum number under Atlas' charter, and (3) electing eight named persons to fill the new directorships.

[1] The restructuring proposal would have given Blasius and the other shareholders a big pile of cash.

The reaction was immediate. Mr. Weaver conferred with Mr. Masinter, the Company's outside counsel and a director, who viewed the consent as an attempt to take control of the Company. They decided to call an emergency meeting of the board, even though a regularly scheduled meeting was to occur only one week hence, on January 6, 1988. The point of the emergency meeting was to act on their conclusion (or to seek to have the board act on their conclusion) "that we should add at least one and probably two directors to the board". At that meeting, the board voted to amend the bylaws to increase the size of the board from seven to nine and appointed John M. Devaney and Harry J. Winters, Jr. to fill those newly created positions. Atlas' Certificate of Incorporation creates staggered terms for directors; the terms to which Messrs. Devaney and Winters were appointed would expire in 1988 and 1990, respectively.

In increasing the size of Atlas' board by two and filling the newly created positions, the members of the board realized that they were thereby precluding the holders of a majority of the Company's shares from placing a majority of new directors on the board through Blasius' consent solicitation, should they want to do so. Indeed the evidence establishes that that was the principal motivation in so acting.

Plaintiff attacks the December 31 board action as a selfishly motivated effort to protect the incumbent board from a perceived threat to its control of Atlas. Their conduct is said to constitute a violation of the principle, applied in such cases as *Schnell v. Chris Craft Industries*, that directors hold legal powers subjected to a supervening duty to exercise such powers in good faith pursuit of what they reasonably believe to be in the corporation's interest.

Defendants, of course, contest every aspect of plaintiffs' claims. They claim the formidable protections of the business judgment rule.

One of the principal thrusts of plaintiffs' argument is that, in acting to appoint two additional persons of their own selection, including an officer of the Company, to the board, defendants were motivated not by any view that Atlas' interest (or those of its shareholders) required that action, but rather they were motivated improperly, by selfish concern to maintain their collective control over the Company. That is, plaintiffs say that the evidence shows there was no policy dispute or issue that really motivated this action, but that asserted policy differences were pretexts for entrenchment for selfish reasons. If this were found to be factually true, one would not need to inquire further.

While I am satisfied that the evidence is powerful, indeed compelling, that the board was chiefly motivated on December 31 to forestall or preclude the possibility that a majority of shareholders might place on the Atlas board eight new members sympathetic to the Blasius proposal, it is less clear with respect to the more subtle motivational question: whether the existing members of the board did so because they held a good faith belief that such shareholder action would be self-injurious and shareholders needed to be protected from their own judgment.

On balance, I cannot conclude that the board was acting out of a self-interested motive in any important respect on December 31. I conclude rather that the board saw the "threat" of the Blasius recapitalization proposal as posing vital policy differences between itself and Blasius. It acted, I conclude, in a good faith effort to protect its incumbency, not selfishly, but in order to thwart implementation of the recapitalization that it feared, reasonably, would cause great injury to the Company.

The real question the case presents, to my mind, is whether, in these circumstances, the board, even if it is acting with subjective good faith (which will typically, if not always, be a contestable or debatable judicial conclusion), may validly act for the principal purpose of preventing the shareholders from electing a majority of new directors. The question thus posed is not one of intentional wrong (or even negligence), but one of authority as between the fiduciary and the beneficiary (not simply legal authority, i.e., as between the fiduciary and the world at large).

It is established in our law that a board may take certain steps — such as the purchase by the corporation of its own stock — that have the effect of defeating a threatened change in corporate control, when those steps are taken advisedly, in good faith pursuit of a corporate interest, and are reasonable in relation to a threat to legitimate corporate interests posed by the proposed change in control. Does this rule — that the reasonable exercise of good faith and due care generally validates, in equity, the exercise of legal authority even if the act has an entrenchment effect — apply to action designed for the primary purpose of interfering with the effectiveness of a stockholder vote? Our authorities, as well as sound principles, suggest that the central importance of the franchise to the scheme of corporate governance, requires that, in this setting, that rule not be applied and that closer scrutiny be accorded to such transaction.

The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests. Generally, shareholders have only two protections against perceived inadequate business performance. They may sell their stock (which, if done in sufficient numbers, may so affect security prices as to create an incentive for altered managerial performance), or they may vote to replace incumbent board members.

It has, for a long time, been conventional to dismiss the stockholder vote as a vestige or ritual of little practical importance. It may be that we are now witnessing the emergence of new institutional voices and arrangements that will make the stockholder vote a less predictable affair than it has been. Be that as it may, however, whether the vote is seen functionally as an unimportant formalism, or as an important tool of discipline, it is clear that it is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own. Thus, when viewed from a broad, institutional perspective, it can be seen that matters involving the integrity of the shareholder voting process involve consideration not present in any other context in which directors exercise delegated power.

The distinctive nature of the shareholder franchise context also appears when the matter is viewed from a less generalized, doctrinal point of view. From this point of view, as well, it appears that the ordinary considerations to which the business judgment rule originally responded are simply not present in the shareholder voting context. That is, a decision by the board to act for the primary purpose of preventing the effectiveness of a shareholder vote inevitably involves the question who, as between the principal and the agent, has authority with respect to a matter of internal corporate governance. That, of course, is true in a very specific way in this case which deals with the question who should constitute the board of directors of the corporation, but it will be true in every instance in which an incumbent board seeks to thwart a shareholder majority. A board's decision to act to prevent the shareholders from creating a majority of new board positions and filling them does not involve the exercise of the corporation's power over its property, or with respect to its rights or obligations; rather, it involves allocation, between shareholders as a class and the board, of effective power with respect to governance of the corporation. Action designed principally to interfere with the effectiveness of a vote inevitably involves a conflict between the board and a shareholder majority. Judicial review of such action involves a determination of the legal and equitable obligations of an agent towards his principal. This is not, in my opinion, a question that a court may leave to the agent finally to decide so long as he does so honestly and competently; that is, it may not be left to the agent's business judgment.

Plaintiff argues for a rule of *per se* invalidity once a plaintiff has established that a board has acted for the primary purpose of thwarting the exercise of a shareholder vote.

A *per se* rule that would strike down, in equity, any board action taken for the primary purpose of interfering with the effectiveness of a corporate vote would have the advantage of relative clarity and predictability. It also has the advantage of most vigorously enforcing the concept of corporate democracy. The disadvantage it brings along is, of course, the disadvantage a *per se* rule always has: it may sweep too broadly.

In two recent cases dealing with shareholder votes, this court struck down board acts done for the primary purpose of impeding the exercise of stockholder voting power. In doing so, a *per se* rule was not applied. Rather, it was said that, in such a case, the board bears the heavy burden of demonstrating a compelling justification for such action.

In my view, our inability to foresee now all of the future settings in which a board might, in good faith, paternalistically seek to thwart a shareholder vote, counsels against the adoption of a *per se* rule invalidating, in equity, every board action taken for the sole or primary purpose of thwarting a shareholder vote, even though I recognize the transcending significance of the franchise to the claims to legitimacy of our scheme of corporate governance. It may be that some set of facts would justify such extreme action. This, however, is not such a case.

The board was not faced with a coercive action taken by a powerful shareholder against the interests of a distinct shareholder constituency (such as a public minority). It was presented with a consent solicitation by a 9% shareholder. Moreover, here it had time (and understood that it had time) to inform the shareholders of its views on the merits of the proposal subject to stockholder vote. The only justification that can, in such a situation, be offered for the action taken is that the board knows better than do the shareholders what is in the corporation's best interest. While that premise is no doubt true for any number of matters, it is irrelevant (except insofar as the shareholders wish to be guided by the board's recommendation) when the question is who should comprise the board of directors. The theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters. It may be that the Blasius restructuring proposal was or is unrealistic and would lead to injury to the corporation and its shareholders if pursued. Having heard the evidence, I am inclined to think it was not a sound proposal. The board certainly viewed it that way, and that view, held in good faith, entitled the board to take certain steps to evade the risk it perceived. It could, for example, expend corporate funds to inform shareholders and seek to bring them to a similar point of view. But there is a vast difference between expending corporate funds to inform the electorate and exercising power for the primary purpose of foreclosing effective shareholder action. A majority of the shareholders, who were not dominated in any respect, could view the matter differently than did the board. If they do, or did, they are entitled to employ the mechanisms provided by the corporation law and the Atlas certificate of incorporation to advance that view. They are also entitled, in my opinion, to restrain their agents, the board, from acting for the principal purpose of thwarting that action.

I therefore conclude that, even finding the action taken was taken in good faith, it constituted an unintended violation of the duty of loyalty that the board owed to the shareholders. I note parenthetically that the concept of an unintended breach of the duty of loyalty is unusual but not novel. That action will, therefore, be set aside by order of this court.

Some discussion questions:

1. Did Atlas' board have the power to do what it did under its articles and bylaws? Was there anything technically illegal about what it did?
2. If this had just involved an inquiry into the "good faith" of the board, would Blasius have been able to prevail? What compelled the court to find a violation of a fiduciary duty here?
3. Were any shareholders actually prevented from voting?
4. What line does the court draw?

Information Rights

Shareholders also have the right to get information from the corporations in which they invest. While similar to the right for partners to get information about their partnerships and the duty for an agent to account to the principal in principal-agent relationships, the shareholder has more of an arms-length relationship to the corporation, so their right to information is slightly different. Specifically, the law draws an important distinction between information about corporate management (which a shareholder always has the right to demand), and more specialized information about the business of the corporation (which a shareholder must demonstrate a "proper purpose" for their inquiry in order to obtain).

The routine information about the governance of the corporation includes:

- The articles of incorporation and all amendments currently in effect.
- The bylaws and all amendments to them currently in effect.
- Resolutions adopted by its board of directors creating classes or series of shares.
- The minutes of all shareholders' meetings and records of all action taken by shareholders without a meeting.
- Written communications to shareholders.
- The names and business addresses of its current directors and officers.
- The most recent annual report.

Corporations will often provide some or all of these documents on their websites under "Investor Relations".

The second category of information includes corporate ledgers, stockholder lists, and the corporation's accounting books and records. Shareholders have a statutory right to these documents so long as the request is for a "proper purpose". The relevant Delaware statute, DGCL §220 says:

> Any stockholder, in person or by attorney or other agent, shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose, and to make copies and extracts from ... [t]he corporation's stock ledger, a list of its stockholders, and its other books and records.[1]

What on Earth qualifies as a "proper purpose"? (Or, more helpfully, what's an "improper purpose"?) Well, I'm glad you asked.

[1] Kentucky law says that a shareholder may inspect and copy these kinds of records if:

(a) His demand is made in good faith and for a proper purpose;

(b) He describes with reasonable particularity his purpose and the records he desires to inspect;

(c) The records are directly connected with his purpose.

KRS §271B.16-020.

State ex Rel. Pillsbury v. Honeywell, Inc., 291 Minn. 322 (1971)

Kelly, J.

Petitioner appeals from an order and judgment of the district court denying all relief prayed for in a petition for writ of mandamus to compel respondent, Honeywell, Inc., ("Honeywell") to produce its original shareholder ledger, current shareholder ledger, and all corporate records dealing with weapons and munitions manufacture. We must affirm.

Petitioner attended a meeting on July 3, 1969, of a group involved in what was known as the "Honeywell Project." Participants in the project believed that American involvement in Vietnam was wrong, that a substantial portion of Honeywell's production consisted of munitions used in that war, and that Honeywell should stop this production of munitions. Petitioner had long opposed the Vietnam war, but it was at the July 3rd meeting that he first learned of Honeywell's involvement. He was shocked at the knowledge that Honeywell had a large government contract to produce anti-personnel fragmentation bombs.[1] Upset because of knowledge that such bombs were produced in his own community by a company which he had known and respected, petitioner determined to stop Honeywell's munitions production.

[1] Land mines.

On July 14, 1969, petitioner ordered his fiscal agent to purchase 100 shares of Honeywell. He admits that the sole purpose of the purchase was to give himself a voice in Honeywell's affairs so he could persuade Honeywell to cease producing munitions. Apparently not aware of that purpose, petitioner's agent registered the stock in the name of a Pillsbury family nominee — Quad Co. Upon discovering the nature of the registration, petitioner bought one share of Honeywell in his own name on August 11, 1969.

During July 1969, subsequent to the July 3, 1969, meeting and after he had ordered his agent to purchase the 100 shares of Honeywell stock, petitioner inquired into a trust which had been formed for his benefit by his grandmother. The purpose of the inquiry was to discover whether shares of Honeywell were included in the trust. It was then, for the first time, that petitioner discovered that he had a contingent beneficial interest under the terms of the trust in 242 shares of Honeywell.

Prior to the instigation of this suit, petitioner submitted two formal demands to Honeywell requesting that it produce its original shareholder ledger, current shareholder ledger, and all corporate records dealing with weapons and munitions manufacture. Honeywell refused.

On November 24, 1969, a petition was filed for writs of mandamus ordering Honeywell to produce the above mentioned records. In response, Honeywell answered the petition and served a notice of deposition on petitioner, who moved that the answer be stricken as procedurally premature and that an order be issued to limit the deposition. After a hearing, the trial court denied the motion, and the deposition was taken on December 15, 1969.

In the deposition petitioner outlined his beliefs concerning the Vietnam war and his purpose for his involvement with Honeywell. He expressed his desire to communicate with other shareholders in the hope of altering Honeywell's board of directors and thereby changing its policy. To this end, he testified, business records are necessary to insure accuracy.

A hearing was held on January 8, 1970, during which Honeywell introduced the deposition, conceded all material facts stated therein, and argued that petitioner was not entitled to any relief as a matter of law. On April 8, 1970, the trial court dismissed the petition, holding that the relief requested was for an improper and indefinite purpose. Petitioner contends in this appeal that the dismissal was in error.

Petitioner contends that a stockholder who disagrees with management has an absolute right to inspect corporate records for purposes of soliciting proxies. He would have this court rule that such solicitation is per se a "proper purpose." Honeywell argues that a "proper purpose" contemplates concern with investment return. We agree with Honeywell.

This court has had several occasions to rule on the propriety of shareholders' demands for inspection of corporate books and records. While inspection will not be permitted for purposes of curiosity, speculation, or vexation, adverseness to management and a desire to gain control of the corporation for economic benefit does not indicate an improper purpose.

The act of inspecting a corporation's shareholder ledger and business records must be viewed in its proper perspective. In terms of the corporate norm, inspection is merely the act of the concerned owner checking on what is in part his property.[1] In the context of the large firm, inspection can be more akin to a weapon in corporate warfare. The effectiveness of the weapon is considerable:

[1] Is ... this ... true?

> "Considering the huge size of many modern corporations and the necessarily complicated nature of their bookkeeping, it is plain that to permit their thousands of stockholders to roam at will through their records would render impossible not only any attempt to keep their records efficiently, but the proper carrying on of their businesses."

Because the power to inspect may be the power to destroy, it is important that only those with a bona fide interest in the corporation enjoy that power.

That one must have proper standing to demand inspection has been recognized by statutes in several jurisdictions. Courts have also balked at compelling inspection by a shareholder holding an insignificant amount of stock in the corporation.[2]

[2] Why is this? It's still a real financial interest, no?

Petitioner's standing as a shareholder is quite tenuous. He only owns one share in his own name, bought for the purposes of this suit. He had previously ordered his agent to buy 100 shares, but there is no showing of investment intent. While his agent had a cash balance in the $400,000 portfolio, petitioner made no attempt to determine whether Honeywell was a good investment or whether more profitable shares would have to be sold to finance the Honeywell purchase. Furthermore, petitioner's agent had the power to sell the Honeywell shares without his consent. Petitioner also had a contingent beneficial interest in 242 shares. Courts are split on the question of whether an equitable interest entitles one to inspection. Indicative of petitioner's concern regarding his equitable holdings is the fact that he was unaware of them until he had decided to bring this suit.

Petitioner had utterly no interest in the affairs of Honeywell before he learned of Honeywell's production of fragmentation bombs. Immediately after obtaining this knowledge, he purchased stock in Honeywell for the sole purpose of asserting ownership privileges in an effort to force Honeywell to cease such production. But for his opposition to Honeywell's policy, petitioner probably would not have bought Honeywell stock, would not be interested in Honeywell's profits and would not desire to communicate with Honeywell's shareholders. His avowed purpose in buying Honeywell stock was to place himself in a position to try to impress his opinions favoring a reordering of priorities upon Honeywell management and its other shareholders. Such a motivation can hardly be deemed a proper purpose germane to his economic interest as a shareholder.

The fact that petitioner alleged a proper purpose in his petition will not necessarily compel a right to inspection. Conversely, a company cannot defeat inspection by merely alleging an improper purpose. From the deposition, the trial court concluded that petitioner had already formed strong opinions on the immorality and the social and economic wastefulness of war long before he bought stock in Honeywell. His sole motivation was to change Honeywell's course of business because that course was incompatible with his political views. If unsuccessful, petitioner indicated that he would sell the Honeywell stock.

We do not mean to imply that a shareholder with a bona fide investment interest could not bring this suit if motivated by concern with the long- or short-term economic effects on Honeywell resulting from the production of war munitions. Similarly, this suit might be appropriate when a shareholder has a bona fide concern about the adverse effects of abstention from profitable war contracts on his investment in Honeywell.

In the instant case, however, the trial court, in effect, has found from all the facts that petitioner was not interested in even the long-term well-being of Honeywell or the enhancement of the value of his shares.

His sole purpose was to persuade the company to adopt his social and political concerns, irrespective of any economic benefit to himself or Honeywell. This purpose on the part of one buying into the corporation does not entitle the petitioner to inspect Honeywell's books and records.

Petitioner argues that he wishes to inspect the stockholder ledger in order that he may correspond with other shareholders with the hope of electing to the board one or more directors who represent his particular viewpoint.

While a plan to elect one or more directors is specific and the election of directors normally would be a proper purpose, here the purpose was not germane to petitioner's or Honeywell's economic interest. Instead, the plan was designed to further petitioner's political and social beliefs. Since the requisite propriety of purpose germane to his or Honeywell's economic interest is not present, the allegation that petitioner seeks to elect a new board of directors is insufficient to compel inspection.

Some discussion questions:

1. The statute says *any* proper purpose, which seems pretty broad. What does the court take "proper" to mean here?
2. Is there a way to get the motivation of this plaintiff into the "proper purpose" zone? Could he have framed this in a way to invoke a business motive or made this into a shareholder wealth maximization argument?
3. Is seeking a change of control an "improper purpose"?
4. Is fishing around for information to file a lawsuit against management a "proper purpose"? Let's find out!

Saito v. McKesson HBOC, Inc., 806 A.2d 113 (Del. 2002)

Berger, J.

In this appeal, we consider the limitations on a stockholder's statutory right to inspect corporate books and records. The statute, 8 Del. C. § 220, enables stockholders to investigate matters "reasonably related to [their] interest as [stockholders]" including, among other things, possible corporate wrongdoing. It does not open the door to the wide ranging discovery that would be available in support of litigation. For this statutory tool to be meaningful, however, it cannot be read narrowly to deprive a stockholder of necessary documents solely because the documents were prepared by third parties or because the documents predate the stockholder's first investment in the corporation. A stockholder who demands inspection for a proper purpose should be given access to all of the documents in the corporation's possession, custody or control, that are necessary to satisfy that proper purpose. Thus, where a § 220 claim is based on alleged corporate wrongdoing, and assuming the allegation is meritorious, the stockholder should be given enough information to effectively address the problem, either through derivative litigation or through direct contact with the corporation's directors and/or stockholders.

On October 17, 1998, McKesson Corporation entered into a stock-for-stock merger agreement with HBO Company ("HBOC").[1] On October 20, 1998, appellant, Noel Saito, purchased McKesson stock. The merger was consummated in January 1999 and the combined company was renamed McKesson HBOC, Incorporated. HBOC continued its separate corporate existence as a wholly-owned subsidiary of McKesson HBOC.

[1] Not the *Game of Thrones* HBO. This one is a boring health care software provider.

Starting in April and continuing through July 1999, McKesson HBOC announced a series of financial restatements triggered by its year-end audit process. During that four month period, McKesson HBOC reduced its revenues by $327.4 million for the three prior fiscal years. The restatements all were attributed to HBOC accounting irregularities.[2] The first announcement precipitated several lawsuits, including a derivative action pending in the Court of Chancery, captioned Ash v. McCall, Civil Action No. 17132. Saito was one of four plaintiffs in the Ash complaint, which alleged that: (i) McKesson's directors breached their duty of care by failing to discover the HBOC accounting irregularities before the merger; (ii) McKesson's directors committed corporate waste by entering into the merger with HBOC; (iii) HBOC's directors breached their fiduciary duties by failing to monitor the company's compliance with financial reporting requirements prior to the merger; and (iv) McKesson HBOC's directors failed in the same respect during the three months following the merger.[3] Although the Court of Chancery granted defendants' motion to dismiss the complaint, the dismissal was without prejudice as to the pre-merger and post-merger oversight claims.

[2] The early 2000s were wild. Low-rise jeans, wars of aggression, and non-stop accounting irregularities. You had to be there.

[3] I've hit on this point before, but notice how the different counts relate to specific conduct — information, waste, oversight, etc. — rather than to a specific duty. Always plead conduct first, breach of duty second.

In its decision on the motion to dismiss, the Court of Chancery specifically suggested that Saito and the other plaintiffs "use the 'tools at hand,' most prominently § 220 books and records actions, to obtain information necessary to sue derivatively." Saito was the only Ash plaintiff to follow that advice. The stated purpose of Saito's demand was:

> (1) to further investigate breaches of fiduciary duties by the boards of directors of HBO Co., Inc., McKesson, Inc., and/or McKesson HBOC, Inc. related to their oversight of their respective company's accounting procedures and financial reporting; (2) to investigate potential claims against advisors engaged by McKesson, Inc. and HBO Co., Inc. to the acquisition of HBO Co., Inc. by McKesson, Inc.; and (3) to gather information relating to the above in order to supplement the complaint in Ash v. McCall, et al., in accordance with the September 15, 2000 Opinion of the Court of Chancery.

Saito demanded access to eleven categories of documents, including those relating to Arthur Andersen's pre-merger review and verification of HBOC's financial condition;[1] communications between or among HBOC, McKesson, and their investment bankers and accountants concerning HBOC's accounting practices; and discussions among members of the Boards of Directors of HBOC, McKesson, and/or McKesson HBOC concerning reports published in April 1997 and thereafter about HBOC's accounting practices or financial condition.

[1] Arthur Andersen was the accountant for Enron and WorldCom and numerous other massive frauds. It got criminally indicted and imploded spectacularly.

After trial, the Court of Chancery found that Saito stated a proper purpose for the inspection of books and records — to ferret out possible wrongdoing in connection with the merger of HBOC and McKesson. But the court held that Saito's proper purpose only extended to potential wrongdoing after the date on which Saito acquired his McKesson stock. The court also held that Saito did not have a proper purpose to inspect documents relating to potential claims against third party advisors who counseled the boards in connection with the merger. Finally, the court held that Saito was not entitled to HBOC documents because Saito was not a stockholder of pre-merger HBOC, and, with respect to post-merger HBOC, he did not establish a basis on which to disregard the separate existence of the wholly-owned subsidiary.[2]

[2] Note that while this was the law at the time, the relevant Delaware statute was revised after this case to allow inspection of the records of a corporation's wholly-owned subsidiaries. Because this is no longer relevant law, I'm going to omit the part of the opinion that reviews this lower court holding.

Stockholders of Delaware corporations enjoy a qualified common law and statutory right to inspect the corporation's books and records. Inspection rights were recognized at common law because, "[a]s a matter of self-protection, the stockholder was entitled to know how his agents were conducting the affairs of the corporation of which he or she was a part owner." The common law right is codified in 8 Del. C. § 220, which provides in relevant part:

> (b) Any stockholder ... shall, upon written demand under oath stating the purpose thereof, have the right . . . to inspect for any proper purpose the corporation's stock ledger, a list of its stockholders, and its other books and records, and to make copies or extracts therefrom. A proper purpose shall mean a purpose reasonably related to such person's interest as a stockholder.

Once a stockholder establishes a proper purpose under § 220, the right to relief will not be defeated by the fact that the stockholder may have secondary purposes that are improper. The scope of a stockholder's inspection, however, is limited to those books and records that are necessary and essential to accomplish the stated, proper purpose.

After trial, the Court of Chancery found "credible evidence of possible wrongdoing," which satisfied Saito's burden of establishing a proper purpose for the inspection of corporate books and records. But the Court of Chancery limited Saito's access to relevant documents in three respects.

First, it held that, since Saito would not have standing to bring an action challenging actions that occurred before he purchased McKesson stock, Saito could not obtain documents created before October 20, 1998. Second, the court concluded that Saito was not entitled to documents relating to possible wrongdoing by the financial advisors to the merging companies. Third, the court denied Saito access to any HBOC documents, since Saito never was a stockholder of HBOC. We will consider each of these rulings in turn.

A. The Standing Limitation

By statute, stockholders who bring derivative suits[1] must allege that they were stockholders of the corporation "at the time of the transaction of which such stockholder complains." The Court of Chancery decided that this limitation on Saito's ability to maintain a derivative suit controlled the scope of his inspection rights. As a result, the court held that Saito was "effectively limited to examining conduct of McKesson and McKesson HBOC's boards following the negotiation and public announcement of the merger agreement."

[1] Suits on behalf of the corporation. We discuss these in the next chapter.

Although we recognize that there may be some interplay between the two statutes, we do not read [the standing requirement] as defining the temporal scope of a stockholder's inspection rights under § 220. The books and records statute requires that a stockholder's purpose be one that is "reasonably related" to his or her interest as a stockholder. If a stockholder wanted to investigate alleged wrongdoing that substantially predated his or her stock ownership, there could be a question as to whether the stockholder's purpose was reasonably related to his or her interest as a stockholder, especially if the stockholder's only purpose was to institute derivative litigation. But stockholders may use information about corporate mismanagement in other ways, as well. They may seek an audience with the board to discuss proposed reforms or, failing in that, they may prepare a stockholder resolution for the next annual meeting, or mount a proxy fight to elect new directors.

Even where a stockholder's only purpose is to gather information for a derivative suit, the date of his or her stock purchase should not be used as an automatic "cut-off" date in a § 220 action. First, the potential derivative claim may involve a continuing wrong that both predates and postdates the stockholder's purchase date. In such a case, books and records from the inception of the alleged wrongdoing could be necessary and essential to the stockholder's purpose. Second, the alleged post-purchase date wrongs may have their foundation in events that transpired earlier. In this case, for example, Saito wants to investigate McKesson's apparent failure to learn of HBOC's accounting irregularities until months after the merger was consummated. Due diligence documents generated before the merger agreement was signed may be essential to that investigation. In sum, the date on which a stockholder first acquired the corporation's stock does not control the scope of records available under § 220. If activities that occurred before the purchase date are "reasonably related" to the stockholder's interest as a stockholder, then the stockholder should be given access to records necessary to an understanding of those activities.

B. The Financial Advisors' Documents

The Court of Chancery denied Saito access to documents in McKesson-HBOC's possession that the corporation obtained from financial and accounting advisors, on the ground that Saito could not use § 220 to develop potential claims against third parties. On appeal, Saito argues that he is seeking third party documents for the same reason he is seeking McKesson HBOC documents — to investigate possible wrongdoing by McKesson and McKesson HBOC. Since the trial court found that to be a proper purpose, Saito argues that he should not be precluded from seeing documents that are necessary to his purpose, and in McKesson HBOC's possession, simply because the documents were prepared by third party advisors.

We agree that, generally, the source of the documents in a corporation's possession should not control a stockholder's right to inspection under § 220. It is not entirely clear, however, that the trial court restricted Saito's access on that basis.

The Court of Chancery decided that Saito's interest in pursuing claims against McKesson HBOC's advisors was not a proper purpose. It recognized that a secondary improper purpose usually is irrelevant if the stockholder establishes his need for the same documents to support a proper purpose. But the court apparently concluded that the categories of third party documents that Saito demanded did not support the proper purpose of investigating possible wrongdoing by McKesson and McKesson HBOC.

We cannot determine from the present record whether the Court of Chancery intended to exclude all third party documents, but such a blanket exclusion would be improper. The source of the documents and the manner in which they were obtained by the corporation have little or no bearing on a stockholder's inspection rights. The issue is whether the documents are necessary and essential to satisfy the stockholder's proper purpose. In this case, Saito wants to investigate possible wrongdoing relating to McKesson and McKesson HBOC's failure to discover HBOC's accounting irregularities. Since McKesson and McKesson HBOC relied on financial and accounting advisors to evaluate HBOC's financial condition and reporting, those advisors' reports and correspondence would be critical to Saito's investigation.

Some discussion questions:

1. What if a shareholder has both a proper purpose and an improper purpose? Does the court weigh the interests against one another?

2. What other purposes besides litigation could a shareholder like Saito have been seeking this information for?

3. The court mentions that shareholders have both a statutory right and a common law right to information. Are these coterminous or is some information covered by one and some information is covered by the other?

4. Hey now, could a corporation's "books and records" include legal advice from the corporation's lawyers?

A couple of points are worth mentioning here. First: despite the court in *Honeywell*'s focus on the number of shares and the manner of purchase, shareholder information rights are not dependent on the size of the shareholder or even the net financial position of the purchaser. Specifically, Delaware courts have declined to hold that shareholders who have both a "long"[1] and a "short"[2] position in a corporation still have the rights to information under §220. The threshold is "any proper purpose", and having a financial interest in the corporation doing well is sufficient.

[1] Meaning they stand to profit if the corporation does well.

[2] Meaning they stand to profit if the corporation does poorly.

Second: A shareholder seeking this information must first demand it from the corporation. It is only after the corporation receives a demand for books and records, and either declines to provide them or ignores the request that a shareholder may bring a suit against the corporation. Once initiated, the burden of proof splits: the corporation has the burden of proof to show that a shareholder request for a list of shareholders is improper, but the shareholder has the burden of proof to show that their request for accounting books and records is proper. There's a simple and obvious reason for this dichotomy and it's that – HEY LOOK OVER THERE!

Third: while the court in *Honeywell* also goes into whether a shareholder has rights when they are merely a "beneficial" owner (as opposed to someone who specifically owns the shares in their name), this distinction is completely irrelevant when it comes to modern stock ownership. Nowadays, the most common stockholder of record — the legal owner of the shares of a corporation — is an organization called the Depository Trust Company, which holds shares on behalf of brokerages, who themselves buy and sell shares on behalf of their customers. In other words, the Depository Trust Company stands as a representative of entities who are themselves representatives of the people and institutions who are the corporation's actual shareholders, and whose identities are often obscured to the corporation itself. This structure — sometimes called "street name" ownership — makes buying and selling shares easier, but makes finding the actual, factual shareholders more complicated. Given the advent of electronic stock exchanges, internet brokerages, and advanced communication technologies, you would think that such a ridiculous structure would have been replaced by now, but there are good reasons for it to still exist, namely — HEY LOOK OVER THERE AGAIN!

Active vs. Passive Investors

FOR THE LONGEST TIME, it was an article of faith that shareholders were functionally unable to dislodge management in a large, public corporation. Proxy fights to take over a corporate board were too expensive, shareholders were too passive and diffuse to organize, and the powers delegated to shareholders were too weak to meaningfully threaten management. Even if a single shareholder were to accumulate a meaningful amount of voting power in a corporation, campaigns against management would still suffer from collective action problems like free riding (passive, uninformed shareholders get to reap the benefit of any successful change in management just as much as active shareholders, so why bother doing anything at all?) and divided loyalties (many large shareholders have business relationships with corporate management,[1] so why rock the boat?).

This was either considered a very bad, no good, horrible thing (a view most associated with the scholars Adolf Berle and Gardiner Means[2]), because it meant that the board was largely unaccountable and shareholders had little to no control over the entity they'd invested in – or this was a terrific, very good, desirable thing (a view associated with the scholars Henry Manne and Stephen Bainbridge) because centralized decisionmaking is necessary for effective decisionmaking and investors interfering with board members is inefficient and downright rude.

For people in the former camp, the answer to the problem of unaccountable corporate management was to bind corporate boards with strong fiduciary duties, and (to a lesser extent) empower shareholders by making shareholder democracy more functional and less costly. For people in the latter camp (particularly Manne), the answer to the problem of unaccountable corporate management was to let the market sort out good management from bad management. In this "market for corporate control", a poorly run corporation would be undervalued

[1] This is particularly true for big investors like mutual funds (who manage retirement money for corporations) and insurance companies (who sell insurance to corporations).

[2] You just don't get names like these anymore, for obviously different reasons.

and be an easy target for takeover by another firm, guaranteeing that inefficient management would be sorted out of the market.

Who ended up winning this fight? Well, nobody, really — at least not for the reasons that they would have thought. In the 1980s, the market for corporate control suddenly became quite hot, as leveraged buyout funds[1] launched a number of high-profile corporate takeovers. This was received rather coolly in corporate boardrooms, and boards developed legal strategies to stymie takeovers and protect existing management.[2] So much for the market deciding.

Shareholder democracy, meanwhile, continued to suffer from the same problems identified by Berle and Means – a cumbersome electoral process, passive shareholder base, and large investors unwilling or unable to agitate for change. Strengthening fiduciary duties for directors and officers — which cases like *Smith v. Van Gorkon*, *In re Caremark*, and *Blasius v. Atlas* did — seemed like the only viable strategy to hold management accountable.

Recently, though, the emergence of large institutional funds (like BlackRock, Vanguard and State Street) has changed the game for shareholder activism. As detailed in the Levine piece at the start of this chapter, these funds are enormous (together, just those three funds have 20% or so of the 500 largest corporations) and diversified (most of their money is from people or entities investing in an entire swath of companies).[3] All of a sudden, in every public corporation there was a giant pile of votes held by a small number of funds who were willing and able to act in a way that their investors couldn't.[4]

This fact did not escape the notice of hedge funds (the traditional activist investors) or state and union pension plan managers (a new type of activist investor, with often overtly political priorities and no need to play nice with corporate management), who could now ally with these institutional investors to force change (as they did with Exxon). Corporate management, so empowered by the decline of organized labor, is now threatened by the rise of these organized shareholders.

So far in this chapter, we have reviewed cases where organized and motivated shareholders have banded together to make non-binding proposals to management, amend the corporation's bylaws, remove the corporation's directors, and elect new directors. In the next sections, we review the ground rules for shareholder activism regarding contested board elections (proxy contests) and the mechanics of getting shareholder proposals on the corporation's proxy statement.

[1] Funds that would borrow a lot of cash, buy public corporations with that borrowed money (hence: leverage), and break up the corporation to sell to other investors. This would either lead to a windfall for the fund (since they get all the profits from the sale) or lead to a corporate bankruptcy (which, whatever, man – it's not their company or their money).

[2] We'll discuss these in Chapter 14.

[3] Corporations are often organized into collections called "indexes" (the S&P 500, the Dow Jones Industrial, the Nasdaq 1000, etc.) and funds that buy a piece of every corporation in those indexes are called — you guessed it — index funds. The popularity of these funds is due to the fact that (a) they track the broader market, so investors don't have to try to pick winners, and (b) they have low, low fees.

[4] Collective action gets results? Who knew?!?

Proxy Contests

Trying to unseat an incumbent board is — among other things — pretty expensive. In the Exxon proxy fight, the activist fund Engine No. 1 spent between $12.5 million and $30 million (depending on how you count) to wage its successful fight for seats on Exxon's board.[1] In *CA, Inc. v . AFSCME*, we saw shareholders attempt — and fail — to amend a corporation's bylaws to require the corporation to reimburse a partially successful insurgent for their costs in waging a proxy contest. If a mandatory reimbursement rule is no good, what about *permissive* reimbursement for proxy contest expenses?

[1] Exxon spent an estimated $35 million in its losing effort.

Rosenfeld v. Fairchild Engine Airplane Corp., 309 N.Y. 168 (1955)

Froessel, J.

In a stockholder's derivative action brought by plaintiff, an attorney, who owns 25 out of the company's over 2,300,000 shares, he seeks to compel the return of $261,522, paid out of the corporate treasury to reimburse both sides in a proxy contest for their expenses. The Appellate Division has unanimously affirmed a judgment of an Official Referee dismissing plaintiff's complaint on the merits, and we agree.

Of the amount in controversy $106,000 were spent out of corporate funds by the old board of directors while still in office in defense of their position in said contest; $28,000 were paid to the old board by the new board after the change of management following the proxy contest, to compensate the former directors for such of the remaining expenses of their unsuccessful defense as the new board found was fair and reasonable; payment of $127,000, representing reimbursement of expenses to members of the prevailing group, was expressly ratified by a 16 to 1 majority vote of the stockholders.

Other jurisdictions and our own lower courts have held that management may look to the corporate treasury for the reasonable expenses of soliciting proxies to defend its position in a *bona fide* policy contest. It should be noted that plaintiff does not argue that the aforementioned sums were fraudulently extracted from the corporation; indeed, his counsel conceded that "the charges were fair and reasonable", but denied "they were legal charges which may be reimbursed for". This is therefore not a case where a stockholder challenges specific items, which, on examination, the trial court may find unwarranted, excessive or otherwise improper. Had plaintiff made such objections here, the trial court would have been required to examine the items challenged.

If directors of a corporation may not in good faith incur reasonable and proper expenses in soliciting proxies in these days of giant corporations with vast numbers of stockholders, the corporate business might be seriously interfered with because of stockholder indifference and the difficulty of procuring a quorum, where there is no contest. In the event of a proxy contest, if the directors may not freely answer the challenges of outside groups and in good faith defend their actions with respect to corporate policy for the information of the stockholders, they and the corporation may be at the mercy of persons seeking to wrest control for their own purposes, so long as such persons have ample funds to conduct a proxy contest. The test is clear. When the directors act in good faith in a contest over policy, they have the right to incur reasonable and proper expenses for solicitation of proxies and in defense of their corporate policies, and are not obliged to sit idly by. The courts are entirely competent to pass upon their *bona fides* in any given case, as well as the nature of their expenditures when duly challenged.

It is also our view that the members of the so-called new group could be reimbursed by the corporation for their expenditures in this contest by affirmative vote of the stockholders. With regard to these ultimately successful contestants, as the Appellate Division below has noted, there was, of course, "no duty to set forth the facts, with corresponding obligation of the corporation to pay for such expense". However, where a majority of the stockholders chose — in this case by a vote of 16 to 1 — to reimburse the successful contestants for achieving the very end sought and voted for by them as owners of the corporation, we see no reason to deny the effect of their ratification nor to hold the corporate body powerless to determine how its own moneys shall be spent.

The rule then which we adopt is simply this: In a contest over policy, as compared to a purely personal power contest, corporate directors have the right to make reasonable and proper expenditures, subject to the scrutiny of the courts when duly challenged, from the corporate treasury for the purpose of persuading the stockholders of the correctness of their position and soliciting their support for policies which the directors believe, in all good faith, are in the best interests of the corporation. The stockholders, moreover, have the right to reimburse successful contestants for the reasonable and *bona fide* expenses incurred by them in any such policy contest, subject to like court scrutiny. That is not to say, however, that corporate directors can, under any circumstances, disport themselves in a proxy contest with the corporation's moneys to an unlimited extent. Where it is established that such moneys have been spent for personal power, individual gain or private advantage, and not in the belief that such expenditures are in the best interests of the stockholders and the corporation, or where the fairness and reasonableness of the amounts allegedly expended are duly and successfully challenged, the courts will not hesitate to disallow them.

Van Voorhis, J., dissenting[1]

[1] This dude just loved dissenting.

The decision of this appeal is of far-reaching importance insofar as concerns payment by corporations of campaign expenses by stockholders in proxy contests for control. This is a stockholder's derivative action to require directors to restore to a corporation moneys paid to defray expenses of this nature, incurred both by an incumbent faction and by an insurgent faction of stockholders. The insurgents prevailed at the annual meeting, and payments of their own campaign expenses were attempted to be ratified by majority vote. It was a large majority, but the stockholders were not unanimous. Regardless of the merits of this contest, we are called upon to decide whether it was a corporate purpose (1) to make the expenditures which were disbursed by the incumbent or management group in defense of their acts and to remain in control of the corporation, and (2) to defray expenditures made by the insurgent group, which succeeded in convincing a majority of the stockholders.

No resolution was passed by the stockholders approving payment to the management group. It has been recognized that not all of the $133,966 in obligations paid or incurred by the management group was designed merely for information of stockholders. This outlay included payment for all of the activities of a strenuous campaign to persuade and cajole in a hard-fought contest for control of this corporation. It included, for example, expenses for entertainment, chartered airplanes and limousines, public relations counsel and proxy solicitors. However legitimate such measures may be on behalf of stockholders themselves in such a controversy, most of them do not pertain to a corporate function but are part of the familiar apparatus of aggressive factions in corporate contests.

What expenses of the incumbent group should be allowed and what should be disallowed should be remitted to the trial court to ascertain, after taking evidence, in accordance with the rule that the incumbent directors were required to assume the burden of going forward in the first instance with evidence explaining and justifying their expenditures. Only such as were reasonably related to informing the stockholders fully and fairly concerning the corporate affairs should be allowed. The concession by plaintiff that such expenditures as were made were reasonable in amount does not decide this question. By way of illustration, the costs of entertainment for stockholders may have been, and it is stipulated that they were, at the going rates for providing similar entertainment. That does not signify that entertaining stockholders is reasonably related to the purposes of the corporation. The Appellate Division, as above stated, found that the management group incurred a substantial amount of needless expense. That fact being established, it became the duty of the incumbent directors to unravel and explain these payments.

Regarding the $127,556 paid by the new management to the insurgent group for their campaign expenditures, the question immediately arises whether that was for a corporate purpose. Some expenditures may concededly be made by a corporation represented by its management so as to inform the stockholders, but there is a clear distinction between such expenditures by management and by mere groups of stockholders. The latter are under no legal obligation to assume duties of managing the corporation. They may endeavor to supersede the management for any reason, regardless of whether it be advantageous or detrimental to the corporation but, if they succeed, that is not a determination that the company was previously mismanaged or that it may not be mismanaged in the future.

The way is open and will be kept open for stockholders and groups of stockholders to contest corporate elections, but if the promoters of such movements choose to employ the costly modern media of mass persuasion, they should look for reimbursement to themselves and to the stockholders who are aligned with them. If the law be that they can be recompensed by the corporation in case of success, and only in that event, it will operate as a powerful incentive to persons accustomed to taking calculated risks to increase this form of high-powered salesmanship to such a degree that, action provoking reaction, stockholders' meetings will be very costly. To the financial advantages promised by control of a prosperous corporation, would be added the knowledge that the winner takes all insofar as the campaign expenses are concerned. To the victor, indeed, would belong the spoils.

Some discussion questions:

1. Why did the new board (the victorious insurgents) need to get shareholder approval for their expenses but not for the expenses of the old board? What issues would there be if they just voted themselves the money? (Hint: D_TY O_ _OY___TY.)

2. What's the difference between purely personal and policy reasons for contesting corporate control?

3. The dissent (who we have seen previously honked off about shareholder proposals) seems pretty honked off about spending the corporation's money on this proxy contest. What kind of expenses does the dissent think are allowable for reimbursement? How would you draw that line?

4. Could Engine No. 1 seek reimbursement for its expenses from Exxon? What would it need to do?

PROXY CONTESTS NECESSARILY INVOLVE COMMUNICATIONS to shareholders — which is one reason why they are so expensive to mount — and with publicly-traded corporations those communications are tightly regulated by the SEC. Information provided by the corporation to its shareholders is called a "proxy statement" and it must conform to a specific format (Schedule 14A), must contain mandatory disclosures about management and must fully describe all the proposals on the ballot, must be submitted to the SEC for prior approval, and must be disseminated to all of the corporation's shareholders. Information that shareholders send to other shareholders to win votes for their nominees or proposals, by contrast, is called a "proxy solicitation" and it is subject to the filing and disseminating requirements of a proxy statement, though it does not have the mandatory format and disclosure requirements.[1] Both kinds of communications are subject to the previously discussed rules regarding material misstatements.

[1] A proxy solicitation does not need to be a formal request for the shareholder's proxy; any communication reasonably calculated to solicit proxies counts.

The line between ordinary communications (protected by the First Amendment unless Sam Alito says they aren't) and proxy solicitations (regulated by the SEC to protect investors from cads and scoundrels) is not always clear, as the next case shows.

Long Island Lighting Co. v. Barbash, 779 F.2d 793 (2d Cir. 1985)

Cardamone, C.J.

A Long Island utility, Long Island Lighting Company (LILCO), furnishing that area with power has scheduled a stockholders meeting for Thursday December 12, 1985. It has been embroiled in public controversy over its construction of the Shoreham Nuclear Power Plant and adverse publicity intensified recently because of extended loss of service to customers arising from damages to the transmission system caused by Hurricane Gloria.

LILCO is a New York electric company serving Nassau and Suffolk Counties on Long Island, New York. Defendant John W. Matthews was an unsuccessful candidate for Nassau County Executive in the election held November 5, 1985. During the campaign he strongly opposed LILCO and its operation of the Shoreham Nuclear Power Plant. As an owner of 100 shares of LILCO's preferred stock and a manager of an additional 100 shares of common stock held by his company, Island Insulation Corp., Matthews initiated a proxy contest for the purpose of electing a majority of LILCO's Board of Directors. The stated purpose of the other defendants, the Citizens Committee, is to replace LILCO with a municipally owned utility company. The Citizens Committee was formed prior to this litigation, in order to challenge LILCO's construction of the Shoreham atomic energy plant, its service and its rates.

LILCO filed its complaint on October 21, 1985 alleging that defendants published a materially false and misleading advertisement in Newsday, a Long Island newspaper, and ran false and misleading radio advertisements throughout the New York area. The ads criticized LILCO's management and encouraged citizens to replace LILCO with a state-run company. The complaint sought an injunction against further alleged solicitation of LILCO shareholders until the claimed false and misleading statements had been corrected and an official proxy solicitation had been filed.

On October 30, 1985 Chief Judge Weinstein adjourned the hearing until November 6 in order to prevent interference with Matthews' political campaign. The district court directed the defendants to bring the requested documents to the hearing on that date and told Matthews and others whom LILCO wished to depose to be available for such discovery. At the November 6 hearing the district judge directed LILCO's counsel to question Matthews under oath and overruled counsel's objections that he was unprepared to examine Matthews and that he had no prior opportunity to review the defendants' documents. The trial court also refused LILCO's request to question other defendants and told counsel that it must limit its questions to the alleged "conspiracy" between Matthews and the other defendants.[1] Two days after this hearing the district court issued its Preliminary Memorandum Dismissing Complaint. Treating defendant's motion to dismiss as one for summary judgment, the district court granted summary judgment in favor of defendants on the ground that the proxy rules did not apply to the advertisements. This appeal followed.

[1] "Such handling only demonstrates again that in the law it is wise — even when expeditious action is required — to make haste slowly."

LILCO argues first, that in view of the necessity in every case to determine whether a communication constitutes a "solicitation" under the proxy rates, the district court abused its discretion by limiting LILCO's opportunity for discovery. Second, LILCO asserts that the district court erroneously held that communications to shareholders through general and indirect publications can in no circumstances constitute "solicitations" under the proxy rules. Finally, LILCO contests the district court's view that this construction of the proxy rules is necessary to render them compatible with the First Amendment.

Regulation 14(a) of the Securities Exchange Act governs the solicitation of proxies with respect to the securities of publicly held companies, with enumerated exceptions set forth in the rules. 17 C.F.R. § 240.14a-1 et seq. Proxy rules promulgated by the Securities Exchange Commission (SEC) regulate as proxy solicitations:

1. any request for a proxy whether or not accompanied by or included in a form of proxy;
2. any request to execute or not to execute, or to revoke, a proxy; or

3. the furnishing of a form of proxy or other communications to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.

These rules apply not only to direct requests to furnish, revoke or withhold proxies, but also to communications which may indirectly accomplish such a result or constitute a step in a chain of communications designed ultimately to accomplish such a result.

The question in every case is whether the challenged communication, seen in the totality of circumstances, is "reasonably calculated" to influence the shareholders' votes. Determination of the purpose of the communication depends upon the nature of the communication and the circumstances under which it was distributed.

Deciding whether a communication is a proxy solicitation does not depend upon whether it is "targeted directly" at shareholders. As the SEC correctly notes in its amicus brief, it would "permit easy evasion of the proxy rules" to exempt all general and indirect communications to shareholders, and this is true whether or not the communication purports to address matters of "public interest." The SEC's authority to regulate proxy solicitations has traditionally extended into matters of public interest.

The extent to which the activities of the defendants amount to a solicitation of the proxies of shareholders of LILCO may determine whether or not their actions are protected by the First Amendment. Therefore, it is unnecessary to express an opinion on any claim of privilege under the First Amendment until there has been a determination of the "solicitation" issue as a result of further proceedings in the district court.

Because discovery here was so abbreviated and the district court's determination was predicated on a mistaken notion of what constitutes a proxy solicitation and on the relationship between the proxy rules and the First Amendment, the case must be remanded to the district court.

Winter, C.J., dissenting

On October 15 the Citizens to Replace LILCO published the newspaper advertisement that has given rise to the present litigation. That advertisement accused LILCO of mismanagement and of attempting to pass through to ratepayers needless costs relating to construction of the nuclear power plant. It also noted that a publicly owned power authority would not have to pay dividends to stockholders. The advertisement argued strenuously that ratepayers would be better off if a Long Island Power Authority were created to replace LILCO as a supplier of power. It asked readers to join the Committee and to give it financial support.

The content of the Committee's advertisement is of critical importance. First, it is on its face addressed solely to the public. Second, it makes no mention either of proxies or of the shareholders' meeting demanded by Matthews. Third, the issues the ad addresses are quintessentially matters of public political debate, namely, whether a public power authority would provide cheaper electricity than LILCO. Claims of LILCO mismanagement are discussed solely in the context of their effect on its customers. Finally, the ad was published in the middle of an election campaign in which LILCO's future was an issue.

On these facts, therefore, LILCO's claim raises a constitutional issue of the first magnitude. It asks nothing less than that a federal court act as a censor, empowered to determine the truth or falsity of the ad's claims about the merits of public power and to enjoin further advocacy containing false claims.

Where advertisements are critical of corporate conduct but are facially directed solely to the public, in no way mention the exercise of proxies, and debate only matters of conceded public concern, I would construe federal proxy regulation as inapplicable, whatever the motive of those who purchase them. This position, which is strongly suggested by relevant case law, maximizes public debate, avoids embroiling the federal judiciary in determining the rightness or wrongness of conflicting positions on public policy, and does not significantly impede achievement of Congress' goal that shareholders exercise proxy rights on the basis of accurate information.

Some discussion questions:

1. Why not just let it be a free-for-all and police misstatements or omissions after the fact? (This is, in fact, how other forms of corporate disclosure work.)

2. Under the current Supreme Court's rules regarding the First Amendment, would this count as an impermissible restraint of speech?[1]

3. The SEC later made it clear that (a) just discussing how you planned to vote in an upcoming election and (b) solicitations by parties who are not actually seeking proxy authority (i.e., third parties who support a particular side in a proxy contest but who themselves are not part of the contest) are not subject to these regulations. Your God-given right as an American to yell at somebody about how you voted remains intact.

[1] LOL, just kidding — the current Supreme Court has no rules regarding the First Amendment.

Shareholder Proposals

Back in ye olden days, a shareholder wanting to put a proposal in front of other shareholders would have had to shoulder the expense of submitting that proposal to shareholders for their votes. In 1942, the SEC promulgated Rule 14a-8, which allows shareholders who meet the proper criteria to submit their proposal to shareholders on the corporation's proxy statement. So when a corporation sends out its proxy statement to its shareholders for its annual election of directors, the materials will often include shareholder proposals and the ballot sent to shareholders (the "proxy card") will ask shareholders to vote on those proposals.

Eligibility

In order to put a proposal on the proxy statement, a shareholder must hold a certain amount of stock for a certain amount of time. Namely:

- $2,000, if the shareholder held such minimum position for at least three years;
- $15,000, if the shareholder held such minimum position for at least two but less than three years; or
- $25,000, if the shareholder held such minimum position for at least one year but less than two years.

The shareholder may only submit one proposal, regardless of whether it is in his or her capacity as a shareholder or as a representative on behalf of a another shareholder, and it may not exceed 500 words. The proposal must be submitted no fewer than 120 days before the proxy statement deadline (which is set in the previous year's proxy statement).

Inclusion or Exclusion

The corporation can choose to allow the proposal to go on the proxy statement, in which case it has the opportunity to make a recommendation (they always recommend against) and explain their reasoning. If the coproation decides to exclude the proposal, it does so by notifying the SEC and giving their reason for exclusion (this often involves an opinion from their legal counsel). The SEC then reviews this filing (and any reply by the shareholder proponent), and if they agree with the corporation they issue a "no-action" letter and let them know that they won't pursue enforcement against the corporation. If the SEC reviews the filing and decides that the proposal was proper, they inform the corporation of their decision and the corporation will almost always put the proposal on their proxy statement. If the corporation again declines to include the proposal, even after SEC review, either the SEC or the shareholder proponent or both can sue the corporation — but, again, it almost never comes to this.

On what grounds can a corporation exclude a proposal as improper? Historically, the rule was that a proposal had to be a "proper subject" for consideration by shareholders. So, for example, a process-oriented proposal to amend corporate bylaws would be a "proper subject" for shareholder action, and could therefore qualify to get on the corporation's proxy statement — though a proposal to amend bylaws in a way that infringes on the power of the board would be improper and could be excluded. The idea of what is "proper" when it comes to shareholder proposals regarding a corporation's business, however, is much less clear.

The History of "Proper Subject": Peck v. Greyhound

James Peck, who attended Harvard but never graduated, is the only person to have participated in the 1947 Journey of Reconciliation as well as the 1961 Freedom Rides. The April 1947 Journey of Reconciliation was a form of activism designed to challenge segregation on interstate buses. The Journey involved a two-week trip with sixteen men (eight black and eight white) who rode on buses throughout southern states in the United States. During the Journey, either blacks sat in the front of the bus while whites sat in the back, or the two groups sat side by side. Although the seating arrangement violated state law in the South, which mandated segregation, such integrated seating had been declared constitutional and thus lawful by a recent 1946 Supreme Court decision declaring segregation in interstate travel an unconstitutional burden on commerce. During the Journey, Peck was attacked by an angry white mob, and left with bruises, none of which required stitches.

The attack did not dissuade Peck from his activism. In May 1961, Peck participated in the Freedom Rides, another bus journey, believed to have been inspired by the Journey of Reconciliation. Like the participants in the Journey, Freedom Riders — as the bus riders became known — rode on buses throughout the South with whites in the back and blacks in the front or blacks and whites seated side by side. And like the Journey, such a seating arrangement violated state laws but had been sanctioned by federal law. Not only had the Interstate Commerce Commission explicitly concluded in 1955 that segregated busing on the interstate was unlawful, but in 1960 the Supreme Court, essentially for the second time, also declared segregated busing in interstate travel illegal.

Thus for his second time, and as the only holdover from the Journey, Peck participated in a bus journey aimed at forcing southern states and their businesses to comply with federal law. The first Freedom Ride began on May 4, 1961 and lasted for more than seven months. Two buses began the journey, which started in Washington, D.C. and were to travel through Georgia, Alabama, and Mississippi and end in Louisiana. The first bus to depart from Washington, D.C. was a Greyhound Corporation ("Greyhound") bus, which never completed the journey. On Mother's Day, May 14, 1961, a mob of Klansmen bombed the Greyhound bus when it arrived in Alabama. Pictures of the Greyhound bus — bombed and on fire — were splashed across the nation and have now become an iconic symbol of the violence with which some were willing to resist desegregation.

Peck's participation in the 1961 Freedom Rides gained him a certain level of notoriety. Part of that notoriety stemmed from the fact that Peck was white, and in fact, it was later discovered that Klansmen had singled out white Freedom Riders for especially vicious beatings. Like the bus burning, pictures of a beaten Peck and his fellow Freedom Riders were splashed across newspapers and televisions.

Alas, this engagement with the Greyhound bus system was not Peck's first. Ten years earlier, in 1951, Peck was involved in another act of activism with Greyhound and its bus system. [On] February 13, 1951, when Greyhound sent a letter to the Securities and Exchange Commission (SEC) informing the SEC of its intention to exclude Peck's shareholder proposal from the proxy statement related to Greyhound's upcoming annual shareholders meeting. The proposal submitted by Peck was straightforward: "A Recommendation that Management Consider the Advisability of Abolishing the Segregated Seating System in the South." It is certainly worth noting that Peck submitted this proposal after the Journey of Reconciliation, and thus after the U.S. Supreme Court had found such a segregated seating system to be unconstitutional.

Greyhound indicated that it intended to exclude Peck's proposal from its proxy statement because the proposal was "not a proper subject" for shareholder action. The Assistant Director of Corporate Finance at the SEC agreed, noting that while the subject (busing) clearly related to Greyhound's business, in his view, it was also clear that the shareholder (Peck) was interested in "advancing a cause" and as a result the proposal was deemed not a proper subject.

Peck then went to the courts and sought a temporary injunction to delay the annual meeting and to give him time to get the proposal on the proxy statement.[1] In refusing Peck's efforts to temporarily enjoin the meeting, a District Court relied on administrative procedure issues to ef-

[1] *Peck v. Greyhound Corp.*, 97 F. Supp. 679 (S.D.N.Y. 1951).

fectively sanction Greyhound's actions. In so doing, the court indicated that it was "unable to conclude that the denial of this temporary injunction will work irreparable harm and damage to the plaintiff." I suspect Peck and the Freedom Riders on the Greyhound bus would disagree.

In 1952, the SEC altered the shareholder proposal rule to exclude proposals made "primarily for the purpose of promoting general economic, political, racial, religious, social or similar causes." The SEC did not reference Peck or otherwise acknowledge that its actions were prompted by Peck's proposal. Instead, the SEC indicated that its change simply reflected a codification of a position the SEC staff had taken in 1945.

Today, the shareholder proposal rule has evolved, giving way to several amendments that now enable shareholders to submit proposals on the proxy statement that involve significant policy issues that transcend economic significance to the corporation. Nevertheless, we continue to grapple with the underlying corporate governance issues raised by Peck's proposal. Those issues center around at least two questions: First, what constitutes proper subjects for corporate action? Second, what should be the shareholder's role in advancing those subjects?[1]

[1] Lisa M. Fairfax. Social Activism through Shareholder Activism Civil Rights and Shareholder Activism Symposium. Washington and Lee Law Review, 76(3):1129–1166, 2019

NOTE THAT PECK'S PROPOSAL was a non-binding resolution, so it raised no concerns with the separation of powers between management and shareholders. Instead the court focused on the distinction between "advancing a cause" and the business of a corporation, with the latter being considered an "improper subject".[2] The SEC now lists what exactly counts as grounds for exclusion, though many of the thirteen (!) enumerated grounds do not exactly provide clarity to the matter. Under via Rule 14a-8(i), a proposal may be excluded if it is:

[2] Shades of *Honeywell*, here.

1. Improper under state law: If the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization;

2. Violation of law: If the proposal would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject;

3. Violation of proxy rules: If the proposal or supporting statement is contrary to any of the Commission's proxy rules, including § 240.14a-9, which prohibits materially false or misleading statements in proxy soliciting materials;

4. Personal grievance; special interest: If the proposal relates to the redress of a personal claim or grievance against the company or any other person, or if it is designed to result in a benefit to you,

or to further a personal interest, which is not shared by the other shareholders at large;

5. Relevance: If the proposal relates to operations which account for less than 5 percent of the company's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business;

6. Absence of power/authority: If the company would lack the power or authority to implement the proposal;

7. Management functions: If the proposal deals with a matter relating to the company's ordinary business operations;

8. Director elections: If the proposal: (i) Would disqualify a nominee who is standing for election; (ii) Would remove a director from office before his or her term expired; (iii) Questions the competence, business judgment, or character of one or more nominees or directors; (iv) Seeks to include a specific individual in the company's proxy materials for election to the board of directors; or (v) Otherwise could affect the outcome of the upcoming election of directors.[1]

[1] Note that a shareholder can still do all of these things, they just don't get to do it through the corporation's proxy statement.

9. Conflicts with company's proposal: If the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting;

10. Substantially implemented: If the company has already substantially implemented the proposal;

11. Duplication: If the proposal substantially duplicates another proposal previously submitted to the company by another proponent that will be included in the company's proxy materials for the same meeting;

12. Resubmissions. If the proposal addresses substantially the same subject matter as a proposal, or proposals, previously included in the company's proxy materials within the preceding five calendar years if the most recent vote occurred within the preceding three calendar years and the most recent vote was: (i) Less than 5 percent of the votes cast if previously voted on once; (ii) Less than 15 percent of the votes cast if previously voted on twice; or (iii) Less than 25 percent of the votes cast if previously voted on three or more times.

13. Specific amount of dividends: If the proposal relates to specific amounts of cash or stock dividends.

What a delightful grab bag of the very specific (the thresholds for proposal resubmissions) and the totally vague ("substantially implemented"?); of the completely reasonable (don't violate the law) and the surprisingly petty (no questioning the competence of management!). I love it. Anyway, some of these pertain to protecting the business judgment of management (improper under state law (aka fiduciary duties), management functions, dividends, etc.), some are trying to make sure that proposals are important (relevance, absence of power to implement, personal grievances, etc.), and some are trying to keep the voting process fair and clean (proxy rules, duplication, conflicts with company proposals, etc.).[1]

[1] Number 8 — keeping director removal proposals or insurgent nominations off of proxy statements — seemingly exists only to make proxy contests harder for activists. Proposals to reverse this exclusion and allow access to the proxy statement for board fights have been shot down.

Still, even with this refinement of the "improper purpose" standard, questions remain about the contours of the grounds for the exclusion of shareholder proposals. Remember how I said these things rarely get litigated? Well ...

Lovenheim v. Iroquois Brands, Ltd., 618 F. Supp. 554 (D.D.C. 1985)

Gasch, J.

Plaintiff Peter C. Lovenheim, owner of two hundred shares of common stock in Iroquois Brands, Ltd. (hereinafter "Iroquois"), seeks to bar Iroquois from excluding from the proxy materials being sent to all shareholders in preparation for an upcoming shareholder meeting information concerning a proposed resolution he intends to offer at the meeting. Mr. Lovenheim's proposed resolution relates to the procedure used to force-feed geese for production of paté de foie gras in France, a type of paté imported by Iroquois. Specifically, his resolution calls upon the Directors of Iroquois to:

> form a committee to study the methods by which its French supplier produces paté de foie gras, and report to the shareholders its findings and opinions, based on expert consultation, on whether this production method causes undue distress, pain or suffering to the animals involved and, if so, whether further distribution of this product should be discontinued until a more humane production method is developed.

Iroquois has refused to allow information concerning Mr. Lovenheim's proposal to be included in proxy materials being sent in connection with the next annual shareholders meeting. In doing so, Iroquois relies on an exception to the general requirement of Rule 14a-8. That exception provides that an issuer of securities "may omit a proposal and any statement in support thereof" from its proxy statement and form of proxy:

> if the proposal relates to operations which account for less than 5 percent of the issuer's total assets at the end of its most recent fiscal year, and

> for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the issuer's business.

Iroquois's reliance on the argument that this exception applies is based on the following information contained in the affidavit of its president: Iroquois has annual revenues of $141 million with $6 million in annual profits and $78 million in assets. In contrast, its paté de foie gras sales were just $79,000 last year, representing a net loss on paté sales of $3,121. Iroquois has only $34,000 in assets related to paté. Thus none of the company's net earnings and less than .05 percent of its assets are implicated by plaintiff's proposal. These levels are obviously far below the five percent threshold set forth in the first portion of the exception claimed by Iroquois.

Plaintiff does not contest that his proposed resolution relates to a matter of little economic significance to Iroquois. Nevertheless he contends that the exception is not applicable as it cannot be said that his proposal "is not otherwise significantly related to the issuer's business" as is required by the final portion of that exception. In other words, plaintiff's argument that Rule 14a-8 does not permit omission of his proposal rests on the assertion that the rule and statute on which it is based do not permit omission merely because a proposal is not economically significant where a proposal has "ethical or social significance."

Iroquois challenges plaintiff's view that ethical and social proposals cannot be excluded even if they do not meet the economic or five percent test. Instead, Iroquois views the exception solely in economic terms as permitting omission of any proposals relating to a de minimis share of assets and profits. Iroquois asserts that since corporations are economic entities, only an economic test is appropriate.

The Court would note that the applicability of the exception to Mr. Lovenheim's proposal represents a close question given the lack of clarity in the exception itself. In effect, plaintiff relies on the word "otherwise," suggesting that it indicates the drafters of the rule intended that other noneconomic tests of significance be used. Iroquois relies on the fact that the rule examines other significance in relation to the issuer's business. Because of the apparent ambiguity of the rule, the Court considers the history of the shareholder proposal rule in determining the proper interpretation of the most recent version of that rule.

Prior to 1983, paragraph (5) excluded proposals "not significantly related to the issuer's business" but did not contain an objective economic significance test such as the five percent of sales, assets, and earnings specified in the first part of the current version. Although a series of SEC decisions through 1976 allowing issuers to exclude proposals challenging compliance with the Arab economic boycott of Israel allowed exclusion if the issuer did less than one percent of their business with Arab countries or Israel, the Commission stated later in 1976 that it did "not believe that subparagraph (5) should be hinged solely on the economic relativity of a proposal." Thus the Commission required inclusion "in many situations in which the related business comprised less than one percent" of the company's revenues, profits or assets "where the proposal has raised policy questions important enough to be considered 'significantly related' to the issuer's business."

As indicated above, the 1983 revision adopted the five percent test of economic significance in an effort to create a more objective standard. Nevertheless, in adopting this standard, the Commission stated that proposals will be includable notwithstanding their "failure to reach the specified economic thresholds if a significant relationship to the issuer's business is demonstrated on the face of the resolution or supporting statement." Thus it seems clear based on the history of the rule that "the meaning of 'significantly related' is not limited to economic significance."[1]

[1] So the test about economic significance is not limited to economic significance. Gotcha.

The only decision in this Circuit cited by the parties relating to the scope of section 14 and the shareholder proposal rule is *Medical Committee for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970). That case concerned an effort by shareholders of Dow Chemical Company to advise other shareholders of their proposal directed at prohibiting Dow's production of napalm. Dow had relied on the counterpart of the paragraph (5) exemption then in effect to exclude the proposal from proxy materials and the SEC accepted Dow's position without elaborating on its basis for doing so. In remanding the matter back to the SEC for the Commission to provide the basis for its decision, the Court noted what it termed "substantial questions" as to whether an interpretation of the shareholder proposal rule "which permitted omission of [a] proposal as one motivated primarily by general political or social concerns would conflict with the congressional intent underlying section 14(a)."

[T]he Court cannot ignore the history of the rule which reveals no decision by the Commission to limit the determination to the economic criteria relied on by Iroquois. The Court therefore holds that in light of the ethical and social significance of plaintiff's proposal and the fact that it implicates significant levels of sales, plaintiff has shown a likelihood of prevailing on the merits with regard to the issue of whether his proposal is "otherwise significantly related" to Iroquois's business.

Some discussion questions:

1. If foie gras was such an insignificant part of their business, why go to the trouble of fighting this?[2]

[2] You see, it's the principle of the whole thing. There's principalities in this.

2. I would have thought that the whole 5% of the business standard was pretty cut and dried. How did the court interpret that provision to reach this outcome?

3. Is everything that is a “bad look” a proper subject for a shareholder proposal? What counts as a bad look, anyway? Is there any chance that this whole process — which, I will remind you, is for **non-binding recommendations** could be politicized in increasingly stupid ways?

Next up: when shareholders who have had just about enough of this bullshit finally screw their courage to the sticking place and sue the hell out of management.

10. Shareholder Litigation

Previous chapters covered some of the grounds under which a shareholder may sue – specifically, we covered the fiduciary duties of management and what happens when they are breached.[1] This chapter deals with the procedure of bringing a shareholder suit against management, and introduces another ground for shareholder suits: securities fraud, a federal law cause of action that shareholders can bring against managers for misstatements regarding their investments.

[1] These are state law claims, and are usually brought in state court.

Direct v. Derivative

The very first step in determining what kind of suit a shareholder will bring is figuring out whether the shareholder can bring it on behalf of themselves (direct) or on behalf of the corporation in which they hold shares (derivative).

In a derivative suit, a shareholder plaintiff steps into the shoes of the corporation and brings a suit (usually against the management of the corporation) for the damage done to the corporation. The logic behind the derivative suit is that it is necessary to allow a shareholder to assert the rights of the corporation when the management of the corporation is either unwilling or unable to do so. Consider *In re eBay*, which we read in Chapter 8. In that case, a plaintiff brought a suit on behalf of the corporation to recover profits from corporate opportunities improperly appropriate by management.[2]

[2] The name of the case is often a clue: direct suits are styled "So-and-So v. Such-and-Such", whereas derivative suits are styled "In re Whoever". Note that cases are sometimes filed as one type of suit and amended to allege another type of suit, so the name is not always indicative.

In a direct suit, a shareholder plaintiff is suing on their on behalf to enforce their own rights as shareholder and/or recover damages for the consequences of management misconduct. These can be brought individually or as class actions on behalf of similarly-situated shareholders (which can result in very large damage awards, depending on the size of the class). Consider *Blasius v. Atlas*, where the shareholder plaintiffs brought a suit against management to enforce their voting rights. The most common kind of direct suit is a securities fraud suit, where shareholders claim that management misconduct damaged their financial position by making false claims, and we will discuss these suits later in this chapter.

The distinction between direct and derivative suits turns on two interrelated questions: who has been hurt by the alleged misconduct: the shareholder or the corporation? And between those two, who would recover?

Tooley v. Donaldson, Lufkin, Jenrette, 845 A.2d 1031 (Del. 2004)

Veasey, C.J.

Plaintiff-stockholders brought a purported class action in the Court of Chancery, alleging that the members of the board of directors of their corporation breached their fiduciary duties by agreeing to a 22-day delay in closing a proposed merger. Plaintiffs contend that the delay harmed them due to the lost time-value of the cash paid for their shares. The Court of Chancery granted the defendants' motion to dismiss on the sole ground that the claims were, "at most," claims of the corporation being asserted derivatively. They were, thus, held not to be direct claims of the stockholders, individually. Thereupon, the Court held that the plaintiffs lost their standing to bring this action when they tendered their shares in connection with the merger.

Although the trial court's legal analysis of whether the complaint alleges a direct or derivative claim reflects some concepts in our prior jurisprudence, we believe those concepts are not helpful and should be regarded as erroneous. We set forth in this Opinion the law to be applied henceforth in determining whether a stockholder's claim is derivative or direct. That issue must turn solely on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)?

Patrick Tooley and Kevin Lewis are former minority stockholders of Donaldson, Lufkin Jenrette, Inc. (DLJ), a Delaware corporation engaged in investment banking. DLJ was acquired by Credit Suisse Group (Credit Suisse) in the Fall of 2000. Before that acquisition, AXA Financial, Inc. (AXA), which owned 71% of DLJ stock, controlled DLJ. Pursuant to a stockholder agreement between AXA and Credit Suisse, AXA agreed to exchange with Credit Suisse its DLJ stockholdings for a mix of stock and cash.

The tender offer price was set at $90 per share in cash. The tender offer was to expire 20 days after its commencement. The merger agreement, however, authorized two types of extensions. First, Credit Suisse could unilaterally extend the tender offer if certain conditions were not met, such as SEC regulatory approvals or certain payment obligations. Alternatively, DLJ and Credit Suisse could agree to postpone acceptance by Credit Suisse of DLJ stock tendered by the minority stockholders.

Credit Suisse availed itself of both types of extensions to postpone the closing of the tender offer. The tender offer was initially set to expire on October 5, 2000, but Credit Suisse invoked the five-day unilateral extension provided in the agreement. Later, by agreement between DLJ and Credit Suisse, it postponed the merger a second time so that it was then set to close on November 2, 2000.Plaintiffs challenge the second

extension that resulted in a 22-day delay. They contend that this delay was not properly authorized and harmed minority stockholders while improperly benefiting AXA. They claim damages representing the time-value of money lost through the delay.[1]

[1] How much could this possibly be???

The order of the Court of Chancery dismissing the complaint, and the Memorandum Opinion upon which it is based, state that the dismissal is based on the plaintiffs' lack of standing to bring the claims asserted therein. Thus, when plaintiffs tendered their shares, they lost standing under the contemporaneous holding rule. The ruling before us on appeal is that the plaintiffs' claim is derivative, purportedly brought on behalf of DLJ. The Court of Chancery, relying upon our confusing jurisprudence on the direct/derivative dichotomy, based its dismissal on the following ground: "Because this delay affected all DLJ shareholders equally, plaintiffs' injury was not a special injury, and this action is, thus, a derivative action, at most."

Plaintiffs argue that they have suffered a "special injury" because they had an alleged contractual right to receive the merger consideration of $90 per share without suffering the 22-day delay arising out of the extensions under the merger agreement.

In our view, the concept of "special injury" that appears in some Supreme Court and Court of Chancery cases is not helpful to a proper analytical distinction between direct and derivative actions. We now disapprove the use of the concept of "special injury" as a tool in that analysis.

The analysis must be based solely on the following questions: Who suffered the alleged harm — the corporation or the suing stockholder individually — and who would receive the benefit of the recovery or other remedy? This simple analysis is well embedded in our jurisprudence, but some cases have complicated it by injection of the amorphous and confusing concept of "special injury."

The Chancellor, correctly points this out and strongly suggests that we should disavow the concept of "special injury." In a scholarly analysis of this area of the law, he also suggests that the inquiry should be whether the stockholder has demonstrated that he or she has suffered an injury that is not dependent on an injury to the corporation. In the context of a claim for breach of fiduciary duty, the Chancellor articulated the inquiry as follows: "Looking at the body of the complaint and considering the nature of the wrong alleged and the relief requested, has the plaintiff demonstrated that he or she can prevail without showing an injury to the corporation?" We believe that this approach is helpful in analyzing the first prong of the analysis: what person or entity has suffered the alleged harm? The second prong of the analysis should logically follow.

The derivative suit has been generally described as "one of the most interesting and ingenious of accountability mechanisms for large formal organizations." It enables a stockholder to bring suit on behalf of the corporation for harm done to the corporation. Because a derivative suit is being brought on behalf of the corporation, the recovery, if any, must go to the corporation. A stockholder who is directly injured, however, does retain the right to bring an individual action for injuries affecting his or her legal rights as a stockholder. Such a claim is distinct from an injury caused to the corporation alone. In such individual suits, the recovery or other relief flows directly to the stockholders, not to the corporation.

Determining whether an action is derivative or direct is sometimes difficult and has many legal consequences, some of which may have an expensive impact on the parties to the action. For example, if an action is derivative, the plaintiffs are then required to comply with the requirements of Court of Chancery Rule 23.1, that the stockholder: (a) retain ownership of the shares throughout the litigation; (b) make presuit demand on the board; and (c) obtain court approval of any settlement. Further, the recovery, if any, flows only to the corporation. The decision whether a suit is direct or derivative may be outcome-determinative. Therefore, it is necessary that a standard to distinguish such actions be clear, simple and consistently articulated and applied by our courts.

In this case it cannot be concluded that the complaint alleges a derivative claim. There is no derivative claim asserting injury to the corporate entity. There is no relief that would go the corporation. Accordingly, there is no basis to hold that the complaint states a derivative claim.

But, it does not necessarily follow that the complaint states a direct, individual claim. While the complaint purports to set forth a direct claim, in reality, it states no claim at all. The trial court analyzed the complaint and correctly concluded that it does not claim that the plaintiffs have any rights that have been injured. Their rights have not yet ripened. The contractual claim is nonexistent until it is ripe, and that claim will not be ripe until the terms of the merger are fulfilled, including the extensions of the closing at issue here. Therefore, there is no direct claim stated in the complaint before us.

Accordingly, the complaint was properly dismissed.

SOME DISCUSSION QUESTIONS:

1. What was the alleged injury here?

2. The court rejects the idea of a "special injury" (aka an injury to some but not all shareholders) in order to sustain a direct action instead of a derivative action. Why?

3. Remember the duty of care case *Smith v. Van Gorkon* — was that a direct or a derivative suit? Who was injured? Did the shareholder plaintiffs in that case suffer a special injury?

If a shareholder is bringing a suit to enforce their rights as a shareholder, that will always be a direct suit. These direct suits can involve:

- Voting Rights (think compelling an annual meeting in *Schnell*)
- Information Rights (think getting books and records in *Saito*)
- Governance Rights (think appointing a guardian in *Kleinberg*)
- Minority Shareholder Rights (we'll cover closely-held corporations in Chapter 13)
- Merger Rights (we'll cover shareholder rights to challenge mergers in Chapter 14)

A DERIVATIVE SUIT has requirements that a direct suit does not. A shareholder plaintiff in a derivative action must have been a shareholder at the time that the misconduct occurred, and must hold shares in the corporation throughout the suit. A shareholder plaintiff must act in the interest of the corporation during the derivative suit[1], and the settlement of derivative suits requires court approval. These requirements are annoying, but doable. The real limitation to derivative suits is the requirement that the shareholder plaintiff make a "demand" upon the board before filing the derivative lawsuit on behalf of the corporation. This requirement — and the circumstances under which it can be excused — is explored further in the next section.

[1] E.g., they cannot settle the suit for personal gain.

Demand Requirement

A plaintiff bringing a derivative suit must show that they made "efforts ... to obtain the action plaintiff desires from the directors" or explain to the court why they didn't do so. This "demand requirement" was developed to balance the traditional deference to a board's business judgment and the obvious conflict of interest inherent in asking a corporate board of directors to sue its own members. In practice, shareholder plaintiffs do not actually present a demand on the board, as this would put the question of whether to pursue the litigation within the ambit of the business judgement rule. Instead, the plaintiffs will simply file the derivative action and in the pleadings claim that demand should be excused because the board is so conflicted that making a demand to bring this litigation would be futile.

This puts the judge in the position of determining, based on the pleadings, whether the shareholders have a reasonable claim that a board has failed to exercise independent judgment (nullifying the business judgment rule) and thus demand should be excused, or whether the shareholders have failed to meet this burden and demand is required (functionally ending the lawsuit). Courts have rejected bare assertions that because the derivative suit is filed against individual directors, the board is too conflicted to make a decision about the viability of the suit.[1] If a conflict of interest on paper is not enough to excuse the demand requirement, what then is the standard for "demand futility" that shareholder plantiffs must meet?

[1] Applying this as a standard would functionally make every derivative suit excused from demand, which you have to admit would obviate the point of having the demand requirement in the first place.

Aronson v. Lewis, 473 A.2d 805 (Del. 1984)

Moore, J.

In the wake of *Zapata Corp. v. Maldonado*, this Court left a crucial issue unanswered: when is a stockholder's demand upon a board of directors, to redress an alleged wrong to the corporation, excused as futile prior to the filing of a derivative suit? We granted this interlocutory appeal to the defendants, Meyers Parking System, Inc. (Meyers), a Delaware corporation, and its directors, to review the Court of Chancery's denial of their motion to dismiss this action, pursuant to Chancery Rule 23.1, for the plaintiff's failure to make such a demand or otherwise demonstrate its futility. The Vice Chancellor ruled that plaintiff's allegations raised a "reasonable inference" that the directors' action was unprotected by the business judgment rule. Thus, the board could not have impartially considered and acted upon the demand.

We cannot agree with this formulation of the concept of demand futility. In our view demand can only be excused where facts are alleged with particularity which create a reasonable doubt that the directors' action was entitled to the protections of the business judgment rule. Because the plaintiff failed to make a demand, and to allege facts with particularity indicating that such demand would be futile, we reverse the Court of

Chancery and remand with instructions that plaintiff be granted leave to amend the complaint.

The issues of demand futility rest upon the allegations of the complaint. The plaintiff, Harry Lewis, is a stockholder of Meyers. The defendants are Meyers and its ten directors, some of whom are also company officers.

In 1979, Prudential Building Maintenance Corp. (Prudential) spun off its shares of Meyers to Prudential's stockholders. Prior thereto Meyers was a wholly owned subsidiary of Prudential. Meyers provides parking lot facilities and related services throughout the country. Its stock is actively traded over-the-counter.

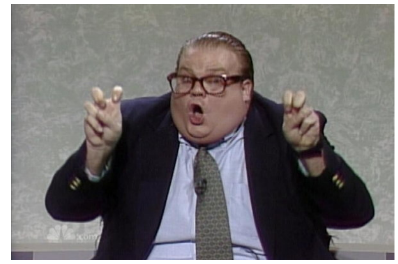
This suit challenges certain transactions between Meyers and one of its directors, Leo Fink, who owns 47% of its outstanding stock. Plaintiff claims that these transactions were approved only because Fink personally selected each director and officer of Meyers.

Prior to January 1, 1981, Fink had an employment agreement with Prudential which provided that upon retirement he was to become a consultant to that company for ten years. This provision became operable when Fink retired in April 1980. Thereafter, Meyers agreed with Prudential to share Fink's consulting services and reimburse Prudential for 25% of the fees paid Fink. Under this arrangement Meyers paid Prudential $48,332 in 1980 and $45,832 in 1981.

On January 1, 1981, the defendants approved an employment agreement between Meyers and Fink for a five year term with provision for automatic renewal each year thereafter, indefinitely. Meyers agreed to pay Fink $150,000 per year, plus a bonus of 5% of its pre-tax profits over $2,400,000. Fink could terminate the contract at any time, but Meyers could do so only upon six months' notice. At termination, Fink was to become a consultant to Meyers and be paid $150,000 per year for the first three years, $125,000 for the next three years, and $100,000 thereafter for life. Death benefits were also included. Fink agreed to devote his best efforts and substantially his entire business time to advancing Meyers' interests. The agreement also provided that Fink's compensation was not to be affected by any inability to perform services on Meyers' behalf. Fink was 75 years old when his employment agreement with Meyers was approved by the directors. There is no claim that he was, or is, in poor health.

Additionally, the Meyers board approved and made interest-free loans to Fink totalling $225,000. These loans were unpaid and outstanding as of August 1982 when the complaint was filed. At oral argument defendants' counsel represented that these loans had been repaid in full.

The complaint charges that these transactions had "no valid business purpose", and were a "waste of corporate assets" because the amounts to be paid are "grossly excessive", that Fink performs "no or little services", and because of his "advanced age" cannot be "expected to perform any such services". The plaintiff also charges that the existence of the Prudential consulting agreement with Fink prevents him from providing his "best efforts" on Meyers' behalf. Finally, it is alleged that the loans to Fink were in reality "additional compensation" without any "consideration" or "benefit" to Meyers.



The complaint alleged that no demand had been made on the Meyers board because:

> [S]uch 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.

The relief sought included the cancellation of the Meyers-Fink employment contract and an accounting by the directors, including Fink, for all damage sustained by Meyers and for all profits derived by the directors and Fink.

By its very nature the derivative action impinges on the managerial freedom of directors. Hence, the demand requirement of Chancery Rule 23.1 exists at the threshold, first to insure that a stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits. Thus, by promoting this form of alternate dispute resolution, rather than immediate recourse to litigation, the demand requirement is a recognition of the fundamental precept that directors manage the business and affairs of corporations.

In our view the entire question of demand futility is inextricably bound to issues of business judgment and the standards of that doctrine's applicability. The business judgment rule is an acknowledgment of the managerial prerogatives of directors. It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.

The function of the business judgment rule is of paramount significance in the context of a derivative action. It comes into play in several ways — in addressing a demand, in the determination of demand futility, in efforts by independent disinterested directors to dismiss the action as inimical to the corporation's best interests, and generally, as a defense to the merits of the suit. However, in each of these circumstances there are certain common principles governing the application and operation of the rule.

First, its protections can only be claimed by disinterested directors whose conduct otherwise meets the tests of business judgment. From the standpoint of interest, this means that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally. Thus, if such director interest is present, and the transaction is not approved by a majority consisting of the disinterested directors, then the business judgment rule has no application whatever in determining demand futility.

Second, to invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties. While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.

However, it should be noted that the business judgment rule operates only in the context of director action. Technically speaking, it has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act. But it also follows that under applicable principles, a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule.

The trial court correctly recognized that demand futility is inextricably bound to issues of business judgment, but stated the test to be based on allegations of fact, which, if true, "show that there is a reasonable inference" the business judgment rule is not applicable for purposes of a pre-suit demand.

The problem with this formulation is the concept of reasonable inferences to be drawn against a board of directors based on allegations in a complaint. As is clear from this case, and the conclusory allegations upon which the Vice Chancellor relied, demand futility becomes virtually automatic under such a test. Bearing in mind the presumptions with which director action is cloaked, we believe that the matter must be approached in a more balanced way.

Our view is that in determining demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. Hence, the Court of Chancery must make two inquiries, one into the independence and disinterestedness of the directors and the other into the substantive nature of the challenged transaction and the board's approval thereof.

As to the latter inquiry the court does not assume that the transaction is a wrong to the corporation requiring corrective steps by the board. Rather, the alleged wrong is substantively reviewed against the factual background alleged in the complaint. As to the former inquiry, directorial independence and disinterestedness, the court reviews the factual allegations to decide whether they raise a reasonable doubt, as a threshold matter, that the protections of the business judgment rule are available to the board. Certainly, if this is an "interested" director transaction, such that the business judgment rule is inapplicable to the board majority approving the transaction, then the inquiry ceases. In that event futility of demand has been established by any objective or subjective standard."We recognize that drawing the line at a majority of the board may be an arguably arbitrary dividing point. Critics will charge that we are ignoring the structural bias common to corporate boards throughout America, as well as the other unseen socialization processes cutting against independent discussion and decisionmaking in the boardroom. The difficulty with structural bias in a demand futile case is simply one of establishing it in the complaint for purposes of Rule 23.1. We are satisfied that discretionary review by the Court of Chancery of complaints alleging specific facts pointing to bias on a particular board will be sufficient for determining demand futility."

However, the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge either the independence or disinterestedness of directors, although in rare cases a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists. In sum the entire review is factual in nature. The Court of Chancery in the exercise of its sound discretion must be satisfied that a plaintiff has alleged facts with particularity which, taken as true, support a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment. Only in that context is demand excused.

Having outlined the legal framework within which these issues are to be determined, we consider plaintiff's claims of futility here: Fink's domination and control of the directors, board approval of the Fink-Meyers employment agreement, and board hostility to the plaintiff's derivative action due to the directors' status as defendants.

Plaintiff's claim that Fink dominates and controls the Meyers' board is based on: (1) Fink's 47% ownership of Meyers' outstanding stock, and (2) that he "personally selected" each Meyers director. Plaintiff also alleges that mere approval of the employment agreement illustrates Fink's domination and control of the board. In addition, plaintiff argued on appeal that 47% stock ownership, though less than a majority, constituted control given the large number of shares outstanding, 1,245,745.

Such contentions do not support any claim under Delaware law that these directors lack independence. "Stock ownership alone, at least when it amounts to less than a majority, is not sufficient proof of domination or control." Moreover, in the demand context even proof of majority ownership of a company does not strip the directors of the presumptions of independence, and that their acts have been taken in good faith and in the best interests of the corporation. There must be coupled with the allegation of control such facts as would demonstrate that through personal or other relationships the directors are beholden to the controlling person.

The requirement of director independence inheres in the conception and rationale of the business judgment rule. The presumption of propriety that flows from an exercise of business judgment is based in part on this unyielding precept. Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences. While directors may confer, debate, and resolve their differences through compromise, or by reasonable reliance upon the expertise of their colleagues and other qualified persons, the end result, nonetheless, must be that each director has brought his or her own informed business judgment to bear with specificity upon the corporate merits of the issues without regard for or succumbing to influences which convert an otherwise valid business decision into a faithless act.

Thus, it is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election. That is the usual way a person becomes a corporate director. It is the care, attention and sense of individual responsibility to the performance of one's duties, not the method of election, that generally touches on independence.

We conclude that in the demand-futile context a plaintiff charging domination and control of one or more directors must allege particularized facts manifesting "a direction of corporate conduct in such a way as to comport with the wishes or interests of the corporation (or persons) doing the controlling." The shorthand shibboleth of "dominated and controlled directors" is insufficient.

Here, plaintiff has not alleged any facts sufficient to support a claim of control. The personal-selection-of-directors allegation stands alone, unsupported. At best it is a conclusion devoid of factual support. The causal link between Fink's control and approval of the employment agreement is alluded to, but nowhere specified. The director's approval, alone, does not establish control, even in the face of Fink's 47% stock ownership. The claim that Fink is unlikely to perform any services under the agreement, because of his age, and his conflicting consultant work with Prudential, adds nothing to the control claim. Therefore, we cannot conclude that the complaint factually particularizes any circumstances of control and domination to overcome the presumption of board independence, and thus render the demand futile.

Turning to the board's approval of the Meyers-Fink employment agreement, plaintiff's argument is simple: all of the Meyers directors are named defendants, because they approved the wasteful agreement; if plaintiff prevails on the merits all the directors will be jointly and severally liable; therefore, the directors' interest in avoiding personal liability automatically and absolutely disqualifies them from passing on a shareholder's demand.

Such allegations are conclusory at best. In Delaware mere directorial approval of a transaction, absent particularized facts supporting a breach of fiduciary duty claim, or otherwise establishing the lack of independence or disinterestedness of a majority of the directors, is insufficient to excuse demand. Here, plaintiff's suit is premised on the notion that the Meyers-Fink employment agreement was a waste of corporate assets. So, the argument goes, by approving such waste the directors now face potential personal liability, thereby rendering futile any demand on them to bring suit. Unfortunately, plaintiff's claim falls in its initial premise. The complaint does not allege particularized facts indicating that the agreement is a waste of corporate assets. Indeed, the complaint as now drafted may not even state a cause of action, given the directors' broad corporate power to fix the compensation of officers.

In essence, the plaintiff alleged a lack of consideration flowing from Fink to Meyers, since the employment agreement provided that compensation was not contingent on Fink's ability to perform any services. The bare assertion that Fink performed "little or no services" was plaintiff's conclusion based solely on Fink's age and the existence of the Fink-Prudential employment agreement. As for Meyers' loans to Fink, beyond the bare allegation that they were made, the complaint does not allege facts indicating the wastefulness of such arrangements. Again, the mere existence of such loans, given the broad corporate powers conferred by Delaware law, does not even state a claim.

Plaintiff's final argument is the incantation that demand is excused because the directors otherwise would have to sue themselves, thereby placing the conduct of the litigation in hostile hands and preventing its effective prosecution. This bootstrap argument has been made to and dismissed by other courts. Its acceptance would effectively abrogate Rule 23.1 and weaken the managerial power of directors. Unless facts are alleged with particularity to overcome the presumptions of independence and a proper exercise of business judgment, in which case the directors could not be expected to sue themselves, a bare claim of this sort raises no legally cognizable issue under Delaware corporate law.

SOME DISCUSSION QUESTIONS:

1. What duty is the plaintiff alleging was breached by the board?

2. The court says that plaintiffs could escape the demand requirement by alleging facts that create a reasonable doubt that the directors are disinterested and independent. The court also says that plaintiffs could escape the demand requirement by alleging facts that create a reasonable doubt that the challenged transaction is the product of a valid exercise of business judgment. Are these the same test or different tests?

3. What could establish a link between the composition of the board (which was controlled by Fink) and the decision of the board to approve the agreement?

Special Litigation Committees

One way that corporations respond to derivative suits is by creating a special litigation committee. The premise of a special litigation committee is that it will be independent (no personal interest in the litigation) and informed, and will thus be able to fairly judge the merits of the pending derivative action against the corporation. A special litigation committee typically hires outside counsel and investigates the allegations in the derivative complaint. Ideally, the the committee analyzes both the legal merits of the suit, but also the role of the defendant board members, the costs of fighting the suit, and the potential damage to the corporation's reputation. If this seems like the sort of process-oriented box-checking that a board uses when making decisions on behalf of the corporation, ding ding ding, gold star for you.

After going through the motions of an investigation, the committee decides whether to pursue the claims (effectively supplanting the shareholder plaintiff and their attorneys), settle them, or seek their dismissal. If the committee concludes that litigating the suit is not in the best interests of the corporation — and you're not gonna believe this, but this is often exactly what special litigation committees conclude — it will move on behalf of the corporation to dismiss the claims and explain its reasoning in the pleadings.

Once the special litigation committee has made its decision, the litigation shifts to a fight over whether the committee's determination deserves the protection of the business judgment rule or if the committee itself was so conflicted that it couldn't reach an independent judgment on the issue. Courts have taken different approaches to this question, with some courts granting a special litigation committee the full protection of the BJR,[1] and other courts conducting what looks like a shot-for-shot remake of the demand futility analysis with the independence of the *committee* as the main inquiry instead of the independence of the *board*.[2] The most typical approach is for courts to give some scrutiny to the independence of the special litigation committee. Do the same factors play a role in that analysis as they do in assessing independence for the purposes of demand futility or self-dealing? They sure do.

[1] *Auerbach v. Bennett*, 393 N.E.2d994 (N.Y. 1979).

[2] *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981) (using a two-step analysis that focuses on — stop me if you've heard this one — independence and business judgment).

Einhorn v. Culea, 235 Wis. 2d 646 (Wis. 2000)

Abrahamson, C.J.

The circuit court dismissed the derivative shareholder action of Stephen Einhorn, a minority shareholder and member of the board of directors of Northern Labs. The circuit court concluded that the threshold for determining whether a member of the special litigation committee is independent is "extremely low" and found that the special litigation committee was independent. Accordingly, the circuit court dismissed Einhorn's derivative action.

The issue raised in the present case is ... whether a member of a special litigation committee is independent. The issue is not whether the derivative action will succeed, but whether the derivative action should be dismissed on the basis of the decision of the special litigation committee. For the reasons set forth, we conclude that the circuit court and the court of appeals erred in declaring that the threshold in determining whether a member of a special litigation committee is independent is "extremely low." We further conclude that in deciding whether members of the special litigation committee are independent, the circuit court should determine whether, considering the totality of the circumstances, a reasonable person in the position of the member of the special litigation committee can base his or her decision on the merits of the issue rather than on extraneous considerations or influences. In other words, the test is whether a member of the committee has a relationship with an individual defendant or the corporation that would reasonably be expected to affect the member's judgment with respect to the litigation at issue. Because the circuit court did not make sufficient findings of fact and did not apply the correct legal standard to determine whether the members of the special litigation committee were independent, we reverse the decision of the court of appeals and remand the cause to the circuit court for further proceedings not inconsistent with this decision.

In December 1985, James D. Culea (the defendant), Stephen Einhorn (the plaintiff), and Einhorn's business partner, Orville Mertz, acquired Northern Labs. The Northern Labs stock was distributed as follows: Culea 56.09%, Einhorn 20.60% and Mertz 20.06%. The remaining stock was owned by other managers and directors. Culea has served as president, manager, director and majority shareholder of Northern Labs since 1986. Einhorn has been a director and minority shareholder.

At the time of its acquisition in 1985, Northern Labs had annual sales of $16 million and generated little profit. During the period between 1986 and 1992, Northern Labs' sales and profits increased. In the 1993 fiscal year, Northern Labs generated $33 million in sales and $1.9 million in profits.

In 1992, Culea sought a retroactive performance bonus, asserting that he had been undercompensated in the years following the acquisition. In May 1992, he sent a notice to the directors scheduling a compensation committee meeting and a board of directors meeting for July 29, 1992. At that time the board of directors consisted of Culea, his wife Shelly Culea, Einhorn, Mertz, and the company's vice president of finance, Robert Bonk. Culea, Mertz and Bonk comprised the compensation committee.

On July 29, 1992, the compensation committee unanimously approved a retroactive bonus to Culea of approximately $300,000, a portion of which was to be paid with Northern Labs stock. A board of directors meeting was held immediately after the compensation committee meeting. The four directors in attendance — Culea, Mertz, Bonk and Shelly Culea – voted unanimously to ratify the compensation committee's decisions. Einhorn did not attend the July 29, 1992, board of directors meeting. Following Culea's stock compensation, the stock was allocated as follows: Culea 76%, Einhorn 22%, and Bonk 2%.[1]

[1] Mertz had been bought out by this point.

On December 9, 1993, Einhorn filed a direct action against Culea, alleging that Culea had willfully breached his fiduciary duty to Einhorn by participating in and causing the corporation to award a self-dealing retroactive bonus to Culea of $300,000 and to issue stock for no consideration or at a grossly inadequate price. Einhorn alleged that he had been "damaged by the dilution of his percentage of ownership in the companies and by a reduction in the value of his interest in the companies." Einhorn sought a judgment ordering Culea to surrender stock to Northern Labs and to reimburse Northern Labs for all cash payments received by him for the retroactive bonus.

On May 3, 1994, Culea filed a motion for summary judgment arguing, among other things, that Einhorn improperly filed his suit as a direct action instead of a derivative action. The circuit court agreed with Culea and gave Einhorn 30 days to amend his complaint.

Einhorn amended his complaint in November 1994 to state a derivative action with allegations similar to those in his original complaint. The members of the board of directors in November 1994 were, pursuant to a stock agreement, appointees of Culea and Einhorn. In addition to himself and his wife, Culea appointed his neighbor Dwight Chewning, Northern Labs CFO Robert Bonk, and Lolita Chua, a friend of Shelly Culea. Einhorn appointed himself and his business partner, John Beagle.[1]

[1] These are some great goddamn names.

Following Einhorn's amended complaint, on December 9, 1994, Culea issued a notice of a special meeting of the board of directors for December 16, 1994. Culea's notice indicated that Chewning and Chua were new members of the board and that the board would be voting on whether the maintenance of Einhorn's derivative action was in the best interests of the corporation. Einhorn requested to bring an attorney to the meeting but his request was denied by the corporate counsel for Northern Labs. Corporate counsel's firm represented Culea in the action filed by Einhorn.

The board of directors met as scheduled on December 16, 1994. Northern Labs' corporate counsel advised that because Einhorn, Culea and Shelly Culea had an interest in the dispute, they should not participate in any vote, whether as directors or as potential members of any special litigation committee. The board then created a special litigation committee composed of Chewning, Bonk, Chua and Beagle.

After five months of meetings[2] and approximately 500 hours of inquiry, the special litigation committee voted three to one[3] that continuation of Einhorn's derivative action was not in the best interests of the corporation. Based on this vote, Culea moved the circuit court to dismiss Einhorn's derivative action.

[2] Good lord.

[3] Culea's friends voted no, Einhorn's friend voted yes.

After a seven-day trial to the circuit court on the issue of whether the members of the special litigation committee were independent, the circuit court concluded that the threshold established by the legislature in determining whether members of the special litigation committee were independent is "extremely low." The circuit court found that the members of the committee were independent, that they acted in good faith and that they made their determination from conclusions based upon a reasonable inquiry. The circuit court dismissed the derivative action. The court of appeals affirmed the judgment of the circuit court.

The present case is a derivative action. A derivative action differs from ordinary commercial litigation and from a representative action such as a class action. In a derivative action, the claims belong to the corporation, not to the complaining shareholder. The complaining shareholder is challenging, on behalf of the corporation that has been unwilling to bring the suit, specific corporate conduct.

A derivative action reflects competing interests: On the one hand, the action allows shareholders to assert the corporation's rights when corporate management refuses to do so. On the other hand, the board of directors or majority shareholders of a corporation, not the courts or minority shareholders, should resolve internal conflicts. A derivative action raises the specter of undue judicial interference with the business judgment of corporate management. In other words, a derivative action is a means to curb managerial misconduct, yet it also undermines the basic principle of corporate governance that the decisions of a corporation, including the decision to initiate litigation, should be made by the board of directors.

Courts and legislatures have allowed corporations to use special litigation committees to dismiss derivative actions in an attempt to balance the competing interests at issue: the shareholders' need to protect the corporation and the corporation's need to prevent meritless or harmful litigation. If the special litigation committee is independent from the alleged wrongdoers, acts in good faith and conducts a reasonable inquiry upon which its conclusion is based, the committee's recommendation not to proceed with a derivative action is viewed as a proper exercise of the directors' business judgment and the court will dismiss the action.

The concept of the special litigation oversight committee flows from the business judgment rule, a judicially created doctrine that limits judicial review of corporate decision-making when corporate directors make business decisions on an informed basis, in good faith and in the honest belief that the action taken is in the best interests of the company. The business judgment rule shields, to a large extent, the substantive bases for a corporate decision from judicial inquiry. The business judgment rule also ensures that management remains in the hands of the board of directors and protects courts from becoming too deeply implicated in internal corporate matters.

The most common challenge to the decision of a special litigation committee, and the one made in the present case, is that the members are not independent. Given the finality of the ultimate decision of the committee to dismiss the action, judicial oversight is necessary to ensure that the special litigation committee is independent so that it acts in the corporation's best interest. At issue is whether the special litigation committee created in the present case was composed of independent directors as required by statute.

[The relevant law] provides as follows:

> (3) Whether a director is independent for purposes of this section may not be determined solely on the basis of any one or more of the following factors: (a) The nomination or election of the director by persons who are defendants in the derivative proceeding or against whom action is demanded. (b) The naming of the director as a defendant in the derivative proceeding or as a person against whom action is demanded. (c) The approval by the director of the act being challenged in the derivative proceeding or demand if the act resulted in no personal benefit to the director.

The statute requires judicial adherence to the decision of a special litigation committee that is independent and is operating in accordance with the statute.[1] Judicial review to determine whether the members of the committee are independent and whether the committee's procedure complies with the statute is of utmost importance, because the court is bound by the substantive decision of a properly constituted and acting committee. The power of a corporate defendant to obtain a dismissal of an action by the ruling of a committee of independent directors selected by the board of directors is unique in the law. The threshold established to determine whether members of a committee are independent is decidedly not "extremely low," as the circuit court stated.

[1] Some states like Wisconsin (not Kentucky, though) have codified this whole rigmarole. In those states, the plaintiff has to deliver a demand to the board, the board has to consider and make a decision on the demand, and then the court will review that decision and determine whether or not to allow the derivative litigation to continue.

The Model Business Corporation Act builds on the law relating to special litigation committees developed by a number of states. We are therefore informed by the case law of other states, and we derive from this case law the following test to determine whether a member of a special litigation committee is independent.

Whether members are independent is tested on an objective basis as of the time they are appointed to the special litigation committee. Considering the totality of the circumstances, a court shall determine whether a reasonable person in the position of a member of a special litigation committee can base his or her decision on the merits of the issue rather than on extraneous considerations or influences. In other words, the test is whether a member of a committee has a relationship with an individual defendant or the corporation that would reasonably be expected to affect the member's judgment with respect to the litigation in issue. The factors a court should examine to determine whether a committee member is independent include, but are not limited to, the following:

1. A committee member's status as a defendant and potential liability. Optimally members of a special litigation committee should not be defendants in the derivative action and should not be exposed to personal liability as a result of the action.

2. A committee member's participation in or approval of the alleged wrongdoing or financial benefits from the challenged transaction. Optimally members of a special litigation committee should not have been members of the board of directors when the transaction in question occurred or was approved. Nor should they have participated in the transaction or events underlying the derivative action. Innocent or pro forma involvement does not necessarily render a member not independent, but substantial participation or approval or personal financial benefit should.

3. A committee member's past or present business or economic dealings with an individual defendant. Evidence of a committee member's employment and financial relations with an individual defendant should be considered in determining whether the member is independent.

4. A committee member's past or present personal, family, or social relations with individual defendants. Evidence of a committee member's non-financial relations with an individual defendant should be considered in determining whether the member is independent. A determination of whether a member is independent is affected by the extent to which a member is directly or indirectly dominated by, controlled by or beholden to an individual defendant.

5. A committee member's past or present business or economic relations with the corporation. For example, if a member of the special litigation committee was outside counsel or a consultant to the corporation, this factor should be considered in determining whether the member is independent.

6. The number of members on a special litigation committee. The more members on a special litigation committee, the less weight a circuit court may assign to a particular disabling interest affecting a single member of the committee.

7. The roles of corporate counsel and independent counsel. Courts should be more likely to find a special litigation committee independent if the committee retains counsel who has not represented individual defendants or the corporation in the past.

Some courts and commentators have suggested that a "structural bias" exists in special litigation committees that taints their decisions. They argue that members of a committee, appointed by the directors of the corporation, are instinctively sympathetic and empathetic towards their colleagues on the board of directors and can be expected to vote for dismissal of any but the most egregious charges. They assert that the committees are inherently biased and untrustworthy.

A court should not presuppose that a special litigation committee is inherently biased. Although members of a special litigation committee may have experiences similar to those of the defendant directors and serve with them on the board of directors, the legislature has declared that independent members of a special litigation committee are capable of rendering an independent decision. The test we set forth today is designed, as is the statute, to overcome the effects of any "structural bias."

We briefly explore the relations of the members of the special litigation committee to the corporation and the defendant Culea. In this case no member of the special litigation committee is a named defendant in the derivative action.

Bonk is an employee of the corporation, is a subordinate of Culea and considers Culea a friend. Bonk acknowledged that it would be "very difficult for [him] to even consider the possibility that Mr. Culea would do something improper." Bonk's ability to independently evaluate the litigation may have been compromised by his own admission.

Outside counsel retained by the special litigation committee questioned whether Robert Bonk was independent: "[Bonk's] independence is questionable. . . . Because his interests in the financial outcome was affected but it is such a small amount. The input of [Bonk] throughout the process may taint the vote because his independence may be questioned." Whether Bonk was independent should be determined on the basis of his employment status, his financial interest in the outcome and his personal relation with Culea.

Another member of the committee, John Beagle, was characterized by the circuit court as Einhorn's "right-hand man." Beagle admitted that he and Einhorn "have a very good business relationship" and are "also very good friends." Beagle wrote, in explaining his lone vote to maintain the derivative action, that "the special litigation committee is not, and never was, unbiased or independent ... each of us is too close to one party or the other to have a chance at being independent." John Beagle, plaintiff Einhorn's good friend and close business partner, openly admits that he was not independent.

The other two members of the special litigation committee had personal and social relationships with Culea and Culea's wife. Einhorn argues strenuously that Culea's neighbor and friend, Dwight Chewning, and Culea's wife's friend, Lolita Chua, were not independent. The exact extent of these friendships is vigorously contested by the parties, but the existence of some relationship is evidenced in the record. As we stated previously, mere acquaintanceship and social interaction are not per se bars to finding a member independent. Relationships with an individual defendant and the corporation are, however, factors the circuit court must consider in the totality of circumstances.

Einhorn also argues strenuously that the role of the corporation's counsel tainted the formation of the special litigation committee, in that the corporation's counsel was acting both as Culea's personal counsel and as the corporation's counsel. Relatively late in its investigation the special litigation committee retained a separate law firm from Washington, D.C., to act as its counsel. But the exact extent of the corporation's counsel's role in advising the special litigation committee is contested. The circuit court did not make findings about the roles of the corporation's counsel and outside counsel. The role of the corporation's counsel should be considered as one of the circumstances in determining whether the committee is independent. Several courts have stated that retention of objectively independent counsel is highly recommended, although failure to do so does not necessarily prevent a special litigation committee from being independent.

The circuit court did not apply the totality of the circumstances standard to determine whether a reasonable person in the position of the member of the special litigation committee could base his or her decision on the merits of the issue rather than on extraneous conditions or influences. Considered together, the relationships in the present case raise significant questions concerning whether the members of the special litigation committee were independent. The decision of this court is not intended to cast doubt on any committee member's integrity, honesty or hard work on the special litigation committee. Rather, we are concerned that, at the time of the formation of the special litigation committee, the members of the committee had relationships with the individual defendant and the corporation that call into question whether a reasonable person could base his or her decision on the merits of the issue rather than on extraneous considerations or influences.

Accordingly, we remand the cause to the circuit court to make findings of fact and to apply the proper legal standard to the facts of this case.

SOME DISCUSSION QUESTIONS:

1. Why wasn't this a direct action? Also: in direct actions, the shareholder recovers; why did Einhorn pursue this as a derivative claim even if he wouldn't receive any of the recovery?

2. What's the starting point for the court's analysis? What presumptions does the court begin with?

3. Does the potential for structural bias show up in the factors that the court examines for independence?

Requirements for Shareholder Plaintiffs

In this section, we examine two additional requirements that shareholder plaintiffs must satisfy: adequacy and timing.

Adequacy

In addition to the demand requirement, there is a requirement that the named plaintiffs in derivative suits be capable of litigating the suit. Specifically, under both federal law and state law procedural requirements, plaintiffs must be capable of adequately and fairly representing the interests of the shareholders of the corporation in the litigation.[1] What does adequacy mean in this context? Let's find out.

[1] There is a similar requirement for plaintiffs in federal securities fraud actions under the Private Securities Litigation Reform Act (which we discuss later in this chapter). The PSLRA solves by designating the plaintiff with the greatest financial stake as the most capable; derivative suits handle the question differently, and focus on plaintiff adequacy.

In re Fuqua Industries, Inc., 752 A.2d 126 (Del. Ch. 1999)

Chandler, Ch.

In the eighth year of this protracted derivative litigation, defendants deposed the two derivative plaintiffs in whose names this litigation is prosecuted, Virginia Abrams and Alan Freberg.[2] In the course of the depositions, defendants determined that Abrams and Freberg were unfamiliar with many of the facts and allegations involved in this lawsuit. Defendants now point to plaintiffs' alleged unfamiliarity and ask this Court to disqualify Abrams and Freberg because they cannot adequately and fairly protect the interests of Fuqua Industries, Inc. and its shareholders.The question I must answer is whether I should disqualify a derivative plaintiff who is unfamiliar with the basic facts of his or her lawsuit and who exercises little, if any, control over the conduct of such suit?

[2] Tastefully named.

In order to meet the adequacy requirements of Rules 23 or 23.1, a representative plaintiff must not hold interests antagonistic to the class, retain competent and experienced counsel to act on behalf of the class and, finally, possess a basic familiarity with the facts and issues involved in the lawsuit. Defendants do not allege that either Abrams or Freberg is burdened by a disabling conflict of interest; nor do they allege that class counsel is incompetent or inexperienced. Rather, defendants predicate their entire claim on plaintiffs' alleged ignorance of the lawsuit's facts.

These cases are musty with age and neglect. Mrs. Abrams filed her first complaint in February 1991. Consolidated soon thereafter with two other complaints, plaintiffs filed a consolidated amended derivative and class action complaint naming directors of Fuqua and its principal shareholder, Triton Group, Inc., as defendants. Approximately four years and nearly thirty continuances later, plaintiffs filed a second amended complaint in December 1995.

The second amended complaint alleged what was described by defense counsel in oral argument as a "dog's breakfast" of fiduciary breaches and various other wrongful or illegal conduct. The foundation of this multitude of alleged wrongs was a claim that Triton and Fuqua's directors engaged in a series of transactions designed to entrench Fuqua's board. In May 1997, this Court dismissed all of plaintiffs' class claims and all their derivative claims save one. The surviving derivative claim concerns the decision of Fuqua directors to exempt Triton from 8 Del. C. § 203[1] and to repurchase 4.9 million Fuqua shares, both for the alleged purpose of increasing Triton's control over Fuqua, entrenching Fuqua's board and, consequently, denying Fuqua shareholders a change of control premium.

[1] Prohibiting business combinations with interested shareholders.

Shortly after plaintiffs filed their third amended complaint in 1998 against Fuqua and six former directors of Fuqua, defendants moved to disqualify Abrams and Freberg as inadequate plaintiffs to prosecute this derivative action. Narrowly stated, defendants contend that because plaintiffs are demonstrably unfamiliar with many of the facts and allegations of the suit prosecuted in their names and because they exercise little, if any, control over the suit, they should be disqualified as derivative plaintiffs on adequacy grounds.

Mrs. Abrams has held Fuqua shares (since converted to Metromedia) for over thirty years. The decision to purchase Fuqua shares, as most all of Abrams' investment decisions, was made jointly with her husband, Burton Abrams, a retired trial attorney.

In an affidavit, Mr. Abrams states that before the institution of this action, he directed a number of oral and written communications to Fuqua officers and directors complaining of managerial misconduct. After receiving no responses or dismissive responses, Mr. and Mrs. Abrams decided to pursue legal redress. In light of Mr. Abrams' experience as an attorney, he apparently took primary responsibility for finding and communicating with counsel to represent Mrs. Abrams.

During the long pendency of this litigation Mrs. Abrams fell ill. As she concedes, her memory and faculties have suffered as a result. In a 1998 deposition, it was evident that Mrs. Abrams lacked a meaningful grasp of the facts and allegations of the case prosecuted in her name. While at times she appeared able to provide a general understanding of her claim, she was unable to articulate the understanding with any particularity and she was obviously confused about basic facts regarding her lawsuit.

Mrs. Abrams deposition testimony suggests an attention span deficit and fatigue.[2] More troubling then her confusion about certain facts and

[2] SEEN.

allegations in the pleadings, however, was the conduct of Abrams' attorney in defending the deposition. Through the use of frequent interruptions, objections, hints, handwritten notes, gestures to documents, leading questions, unauthorized counseling, and even direct testimony asserted on behalf of Abrams, her attorney improperly hampered opposing counsel's efforts to gather evidence. In so doing, her attorney did neither himself, nor his client, any service.

Alan Freberg, the second derivative plaintiff in this action, purchased twenty-five Fuqua shares in 1989. In 1991, presumably upon concluding that Fuqua directors and Triton had engaged in self-dealing transactions (for the complementary purposes of enriching Triton and Fuqua directors at the expense of public shareholders and entrenching Fuqua's directors), Freberg retained counsel and filed his first complaint. Freberg's complaint was amended and consolidated with the Abrams complaint.

Freberg's deposition testimony evidences that his knowledge of the case is at best elliptical. Defendants argue that before his "cram" session immediately before the deposition, Freberg knew absolutely nothing about this matter.[1] Defendants also point out (with much scorn) Freberg's general ignorance of the six or seven other lawsuits in which he was, or still is, the named representative plaintiff. The subtext of defendants' motion is that Freberg has no knowledge of this case because he has no real economic interest at stake. In defendants' view, Freberg is a puppet for his fee-hungry lawyers.

The Court of Chancery will not bar a representative plaintiff from the courthouse for lack of proficiency in matters of law and finance and poor health so long as he or she has competent support from advisors and attorneys and is free from disabling conflicts.[2] This conclusion is both just and sensible.

Plaintiffs cite *Surowitz v. Hilton Hotel Corp.*,[3] as the seminal case this Court should follow on Rule 23.1 adequacy requirements. The facts of Surowitz are noteworthy. Mrs. Surowitz, a Polish immigrant with no formal education who spoke little or no English. purchased shares of Hilton Hotel Corp. at the behest of her son-in-law. When Surowitz stopped receiving dividend checks and discovered that her shares had substantially decreased in value, she informed her son-in-law, Mr. Brilliant.*No, really, that was his name.* Upon investigation, Brilliant determined that Hilton had likely violated federal securities laws and essentially filed and prosecuted a lawsuit on his mother-in-law's behalf.

Before Hilton filed an answer, the district court granted Hilton leave to depose Surowitz. In the course of that deposition, it became apparent that she had no real knowledge of the complaint, thus calling her verification of the complaint into question. The district court dismissed her case

[1] Let the attorney who didn't learn the rule against perpetuities two weeks before the bar exam cast the first stone.

[2] In support of this, the court cites to a case involving the tastefully named Alan Kahn, a serial litigator who has filed numerous corporate law claims using his family members as plaintiffs, and who also happens to be a sophisticated and successful investment professional.

[3] 383 U.S. 363 (1966)

on this basis and the court of appeals affirmed.

Justice Black, writing for a unanimous Supreme Court, reversed the lower court decision, holding that in verifying the complaint initiating the action, Surowitz's reliance on her son-in-law was not grounds for dismissal. Justice Black emphasized that it was Surowitz who "discovered" her cause of action and brought it to the attention of her trusted son-in-law who prosecuted the case with diligence and good faith.

Defendants' attack on Abrams' and Freberg's adequacy raises serious concerns. The allegation that attorneys bring actions through puppet plaintiffs while the real parties in interest are the attorneys themselves in search of fees is an oft-heard complaint from defendants in derivative suits. Sometimes, no doubt, the allegation rings true.

By the same token, however, the mere fact that lawyers pursue their own economic interest in bringing derivative litigation cannot be held as grounds to disqualify a derivative plaintiff. To do so is to impeach a cornerstone of sound corporate governance. Our legal system has privatized in part the enforcement mechanism for policing fiduciaries by allowing private attorneys to bring suits on behalf of nominal shareholder plaintiffs. In so doing, corporations are safeguarded from fiduciary breaches and shareholders thereby benefit. Through the use of cost and fee shifting mechanisms, private attorneys are economically incentivized to perform this service on behalf of shareholders.

To be sure, a real possibility exists that the economic motives of attorneys may influence the remedy sought or the conduct of the litigation. This influence, however, is inherent in private enforcement mechanisms and does not necessarily vitiate the substantial beneficial impact upon the conduct of fiduciaries.

Nonetheless, in some instances, the attorney in pursuit of his own economic interests may usurp the role of the plaintiff and exploit the judicial system entirely for his own private gain. These agency costs should not be borne by society, defendant corporations, directors or the courts.

I cannot say that either Abrams or Freberg is an inadequate plaintiff in this case. Contrary to defendants' assertions, Freberg does in fact understand the basic nature of the derivative claims brought in his name, even if barely so. As I have repeated throughout, this case has a drawn-out procedural history. When questioned about many of the specific allegations in various iterations of the complaint at issue, particularly the first version filed nearly ten years ago, Freberg confused the timing of the claims as well as some of the factual information supporting them. Still, he was able to articulate a basic understanding of the entrenchment claim and the facts supporting it.

As defendants have adduced no evidence that Freberg has interests antagonistic to the interests he purports to represent, or that class counsel is incompetent or inexperienced, I conclude that Freberg meets Rule 23.1's minimum adequacy requirements. Interestingly, much of defendants' brief is devoted to demonstrating Freberg's surprising level of ignorance with respect to other lawsuits in which he is a representative plaintiff. For better or worse, however, no limit exists on the number of lawsuits one individual can bring in a lifetime. Thus, this fact alone is insufficient to disqualify Freberg.

Like Mrs. Surowitz with the aid of her son-in-law, Mrs. Abrams discovered her injury and filed this lawsuit with the aid of her husband. Even though the defendant in Surowitz demonstrated that Mrs. Surowitz did not "understand" her complaint and did not make any decisions with respect to the prosecution of the litigation, a unanimous Supreme Court did not dismiss her case; nor did it disqualify her as an inadequate plaintiff. I am reluctant to do differently here.

Abrams has been a substantial holder of Fuqua stock for thirty years. When she and her husband grew dissatisfied with Fuqua management, Mr. Abrams wrote letters to Fuqua's board demanding that certain measures be taken to improve the company's share price. His letters were disregarded. Determining that she had suffered legally cognizable harm, Mr. and Mrs. Abrams retained counsel in an effort to redress their grievances. They placed their trust and confidence in their lawyers as clients have always done.

Our legal system has long recognized that lawyers take a dominant role in prosecuting litigation on behalf of clients. A conscientious lawyer should indeed take a leadership role and thrust herself to the fore of a lawsuit. This maxim is particularly relevant in cases involving fairly abstruse issues of corporate governance and fiduciary duties.

Abrams is elderly and has suffered health problems in recent years. While her lawyers sat on her claim, her health and memory have deteriorated and now she cannot remember very many things about her lawsuit. I do not fault her for this. Her lawyers may indeed have been remiss in not pressing her claim more diligently. Simply because an elderly and not entirely healthy plaintiff does not have the stamina to constantly monitor her lawyers, I cannot, for this reason, dismiss her potentially meritorious claim.

I also note that defendants have not suffered any great burden throughout the course of plaintiffs' requests for repeated continuances. If they had, they need only have spoken up and the Court would have gladly pressed the matter with greater urgency. Defendants, in this fashion, were perhaps complicit in neglecting the matter before the Court. This case has indeed sat far too long. It is time to reach the merits and bring it to a close.

SOME DISCUSSION QUESTIONS:

1. What problem are the adequacy requirements for class action and derivative plaintiffs designed to address?

2. In a case involving the malfeasance of corporate management, what exactly is the role of the plaintiff? What's the most important decision that a plaintiff in these sorts of cases makes?

3. The court refers to agency costs — what are those and who bears them?

4. The citation to a Supreme Court case in this opinion is the first time in this book that we've seen any reference to the Supreme Court. This makes a fair amount of sense — questions of corporate law are under the jurisdiction of the state of incorporation, and even corporate law cases brought in federal court under diversity jurisdiction rarely present the sort of questions that the Supreme Court will weigh in on. However, the purchase or sale of shares of corporations (as "securities") is regulated by federal law, so starting in this chapter — and again in Chapters 16 and 17 — we'll see some of the nation's most prominent ~~idiotic partisan hacks~~ Supreme Court jurists wrestle with laws regarding a corporation and its shareholders. It's about to get a lot stupider, is what I'm saying.

Timing and Standing

YET ANOTHER REQUIREMENT FOR PLAINTIFFS is the timing of their shareholding: they must hold shares at the time of the misconduct and must hold those shares throughout the litigation in order to have standing. Essentially, shareholders cannot buy their way into a corporation and then bring a derivative suit to challenge a management decision that occurred prior to their purchase.[1]

The final case we examine deals with plaintiff standing issues against the backdrop of a quintessential late '90s tech company scandal.[2] The case also gives us a glimpse into some jurisdictional issues that arise in derivative suits. As we learned in the discussion of internal affairs, the substantive law that will be applied in derivative suits is the law of the state in which the corporation is incorporated. However, shareholders alleging injury to the corporation can and do live in jurisdictions other than the state of incorporation and can and do file

[1] This was discussed in *Saito*, where the court pointed out that a shareholder can books and records that predate their purchase even if they can't bring a derivative claim over conduct that predates their purchase

[2] Options backdating. Now the quintessential tech company scandal is, like, abetting a genocide.

derivative suits in the name of the corporation in the venues in which they live.[1] This case demonstrates how courts deal with issues of appropriate jurisdiction in addition to issues of shareholder timing — and for good measure provides us with a speed run through demand futility, good faith, and the statute of limitations.

[1] Hence the importance of federal procedural law in this area — these cases are often filed by residents outside of Delaware against Delaware corporations, so they are usually removed to and litigated in federal courts.

Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007)

Chandler, Ch.

On March 18, 2006, The Wall Street Journal sparked controversy throughout the investment community by publishing a one-page article, based on an academic's statistical analysis of option grants, which revealed an arguably questionable compensation practice. Commonly known as backdating, this practice involves a company issuing stock options to an executive on one date while providing fraudulent documentation asserting that the options were actually issued earlier. These options may provide a windfall for executives because the falsely dated stock option grants often coincide with market lows. Such timing reduces the strike prices and inflates the value of stock options, thereby increasing management compensation. This practice allegedly violates any stock option plan that requires strike prices to be no less than the fair market value on the date on which the option is granted by the board. Further, this practice runs afoul of many state and federal common and statutory laws that prohibit dissemination of false and misleading information.

After the article appeared in the Journal, Merrill Lynch issued a report demonstrating that officers of numerous companies, including Maxim Integrated Products, Inc., had benefited from so many fortuitously timed stock option grants that backdating seemed the only logical explanation. The report engendered this action.

Maxim Integrated Products, Inc. is a technology leader in design, development, and manufacture of linear and mixed-signal integrated circuits used in microprocessor-based electronic equipment. From 1998 to mid-2002 Maxim's board of directors and compensation committee granted stock options for the purchase of millions of shares of Maxim's common stock to John F. Gifford, founder, chairman of the board, and chief executive officer, pursuant to shareholder-approved stock option plans filed with the Securities and Exchange Commission. Under the terms of these plans, Maxim contracted and represented that the exercise price of all stock options granted would be no less than the fair market value of the company's common stock, measured by the publicly traded closing price for Maxim stock on the date of the grant. Additionally, the plan identified the board or a committee designated by the board as administrators of its terms.

Plaintiff Walter E. Ryan is a shareholder of Maxim and has continuously held shares since his Dallas Semiconductor Incorporated shares were converted to Maxim shares upon Maxim's acquisition of Dallas Semiconductor on April 11, 2001. Ryan alleges that nine specific grants were backdated between 1998 and 2002, as these grants seem too fortuitously timed to be explained as simple coincidence. All nine grants were dated on unusually low (if not the lowest) trading days of the years in question, or on days immediately before sharp increases in the market price of the company.

As practices surrounding the timing of options grants for public companies began facing increased scrutiny in early 2006, Merrill Lynch conducted an analysis of the timing of stock option grants from 1997 to 2002 for the semiconductor and semiconductor equipment companies that comprise the Philadelphia Semiconductor Index. Merrill Lynch measured the aggressiveness of timing of option grants by examining the extent to which stock price performance subsequent to options pricing events diverges from stock price performance over a longer period of time. "Specifically, it looked at annualized stock price returns for the twenty day period subsequent to options pricing in comparison to stock price returns for the calendar year in which the options were granted." In theory, companies should not generate systematic excess return in comparison to other investors as a result of the timing of options pricing events. "[I]f the timing of options grants is an arm's length process, and companies have [not] systematically taken advantage of their ability to back-date options within the [twenty] day windows that the law provided prior to the implementation of Sarbanes Oxley in 2002, there shouldn't be any difference between the two measures."

With regard to Maxim, Merrill Lynch found that the twenty-day return on option grants to management averaged 14% over the five-year period, an annualized return of 243%, or almost ten times higher than the 29% annualized market returns in the same period.

The Merrill Lynch report formed the bases for other derivative lawsuits. Robert McKinney filed a federal action in the Northern District of California on May 22, 2006, three weeks before this action was filed. Eugene Horkay, Jr. followed suit, filing an identical action in the same court two days later. The Northern District of California entered an order on June 14, 2006, consolidating these suits and all subsequently filed suits. The federal action is similar to the Delaware action. The federal plaintiffs posit claims of backdating based on the Merrill Lynch report. They specifically challenge ten option grants, alleging that backdating occurred. Further, they contend that this violation of their options plan exposes Maxim to adverse tax consequences.

Plaintiff contends that all defendants breached their fiduciary duties to Maxim and its shareholders.[1] Plaintiff alleges that from 1998 to 2002, the board actively allowed Maxim to backdate at least nine option grants issued to Gifford, in violation of shareholder-approved plans, and to purposefully mislead shareholders regarding its actions. As a result of the active violations of the plan and the active deceit, plaintiff contends that Maxim received lower payments upon exercise of the options than would have been received had they not been backdated. Further, Maxim suffers adverse effects from tax and accounting rules. The options priced below the stock's fair market value on the date of the grant allegedly bring the recipient an instant paper gain. At the time, such compensation had to be treated as a cost to the company, thereby reducing reported earnings and resulting in overstated profits. This likely necessitates revision of the company's financial statements and tax reporting. Moreover, Gifford, the recipient of the backdated options, is allegedly unjustly enriched due to receipt of compensation in clear violation of the shareholder-approved plans.

[1] They don't have a duty to their shareholders! And any duties — if they existed, which they don't — would be irrelevant in a derivative suit, where the injured party is a corporation! I'm punching a wall right now.

MOTION TO STAY

Defendants move to stay this action [under the first-filed rule, in favor of the federal case in California]. The Supreme Court of Delaware strongly encourages this Court to freely exercise its discretion "in favor of the stay when there is a prior action pending elsewhere, in a court capable of doing prompt and complete justice, involving the same parties and the same issues." Further, it recognizes that "considerations of comity and the necessities of an orderly and efficient administration of justice" often require that "litigation should be confined to the forum in which it first commenced, and a defendant should not be permitted to defeat the plaintiffs choice of forum in pending suit." The application of this doctrine, however, presents great difficulty in shareholder derivative actions.

A shareholder plaintiff does not sue for his direct benefit. Instead, he alleges injury to and seeks redress on behalf of the corporation. Further, the board or any shareholder with standing may represent the injured party. Thus, this Court places less emphasis on the celerity of such plaintiffs and grants less deference to the speedy plaintiffs choice of forum. Because the plaintiff is not the directly injured party, this Court proceeds cautiously when faced with the question of whether to defer to a first-filed derivative suit, "examin[ing] more closely the relevant factors bearing on where the case should best proceed, using something akin to a forum non conveniens analysis."

A similarly important factor in determining whether a stay is appropriate in a derivative action is a court's ability to render justice. Rendering justice necessarily entails accurately applying controlling law, in this case Delaware law. In many instances, this Court has recognized without hesitation that sister state courts and federal courts are capable of applying

Delaware law and providing complete justice to parties. At the same time, however, Delaware courts have a "significant and substantial interest in overseeing the conduct of those owing fiduciary duties to shareholders of Delaware corporations." This interest increases greatly in actions addressing novel issues.

The allegations in this case involve backdating option grants and whether such practice violates one or more of Delaware's common law fiduciary duties. This question is one of great import to the law of corporations. It encompasses numerous issues, including the propriety of this type of executive compensation, requisite disclosures that must accompany such compensation, and the legal implications of intentional non-compliance with shareholder-approved plans (if such practices are deemed non-compliant), to name only a few. Investors are challenging this very practice in many courts throughout the United States, including this Court. Delaware courts have not as yet addressed these fundamental issues. Nevertheless, Delaware law directly controls and affects many of the option backdating cases. An answer regarding the legality of these practices pursuant to Delaware law plainly will affect not only the parties to this action, but also parties in other civil and criminal proceedings where Delaware law controls or applies. By directly stating the fiduciary principles applicable in this context, Delaware courts may remove doubt regarding Delaware law and avoid inconsistencies that might arise in the event other state or federal courts, in applying Delaware law, reach differing conclusions. Because Delaware has an overwhelming interest in resolving questions of first impression under Delaware law, I deny defendants' stay request.

MOTION TO DISMISS

A. Failure to Make Demand

Defendants state that plaintiff has failed to make demand or prove demand futility. That is, defendants contend that the complaint lacks particularized facts that either establish that a majority of directors face a "substantial likelihood" of personal liability for the wrongdoing alleged in the complaint or render a majority of the board incapable of acting in an independent and disinterested fashion regarding demand.

When a shareholder seeks to maintain a derivative action on behalf of a corporation, Delaware law requires that shareholder to first make demand on that corporation's board of directors, giving the board the opportunity to examine the alleged grievance and related facts and to determine whether pursuing the action is in the best interest of the corporation. This demand requirement works "to curb a myriad of individual shareholders from bringing potentially frivolous lawsuits on behalf of the corporation, which may tie up the corporation's governors in constant litigation and diminish the board's authority to govern the affairs of the corporation."

This Court has recognized, however, that in some cases demand would prove futile. Where the board's actions cause the shareholders' complaint, "a question is rightfully raised over whether the board will pursue these claims with 100% allegiance to the corporation, since doing so may require that the board sue itself on behalf of the corporation." Thus, in an effort to balance the interest of preventing "strike suits motivated by the hope of creating settlement leverage through the prospect of expensive and time-consuming litigation discovery [with the interest of encouraging] suits reflecting a reasonable apprehension of actionable director malfeasance that the sitting board cannot be expected to objectively pursue on the corporation's behalf," Delaware law recognizes two instances where a plaintiff is excused from making demand. Failure to make demand may be excused if a plaintiff can raise a reason to doubt that: (1) a majority of the board is disinterested or independent or (2) the challenged acts were the product of the board's valid exercise of business judgment.

Because the compensation committee attacked by plaintiff constitutes a majority of the board, the business judgment analysis under the second prong may be readily applied. Plaintiffs may prove demand futility by raising a reason to doubt whether the challenged transactions were a valid exercise of business judgment.

Plaintiff alleges that the challenged transactions raise a reason to doubt whether the option grants were a valid exercise of business judgment. Specifically, plaintiff states that the terms of the stock option plans required that "[t]he exercise price of each option shall be not less than one hundred percent (100%) of the fair market value of the stock subject to the option on the date the option is granted." The board had no discretion to contravene the terms of the stock option plans. Altering the actual date of the grant so as to affect the exercise price contravenes the plan. Thus, knowing and intentional violations of the stock option plans, according to the plaintiff, cannot be an exercise of business judgment. I conclude that the unusual facts alleged raise a reason to doubt that the challenged transactions resulted from a valid exercise of business judgment.

Plaintiff supports his breach of fiduciary duty claim and his assertion that demand is futile by pointing to the board's decision to ignore limitations set out in the company's stock options plans. The plans do not grant the board discretion to alter the exercise price by falsifying the date on which options were granted. Thus, the alleged facts suggest that the director defendants violated an express provision of two option plans and exceeded the shareholders' grant of express authority.

Plaintiff here points to specific grants, specific language in option plans, specific public disclosures, and supporting empirical analysis to allege knowing and purposeful violations of shareholder plans and intentionally fraudulent public disclosures. Such facts, in my opinion, provide sufficient particularity in the pleading to survive a motion to dismiss for failure to make demand.

B. Failure to State a Claim

Defendants assert that plaintiff fails to state a claim for breach of fiduciary duty. This defense, stripped to its essence, states that in order to survive a motion to dismiss on a fiduciary duty claim, the complaint must rebut the business judgment rule. That is, plaintiff must raise a reason to doubt that the directors were disinterested or independent. Where the complaint does not rebut the business judgment rule, plaintiff must allege waste. Plaintiff here, argue the defendants, fails to do either. Further, there is no evidence that the defendants acted intentionally, in bad faith, or for personal gain. Therefore, so the argument goes, plaintiff fails to plead facts sufficient to rebut the business judgment rule and cannot maintain an action for breach of fiduciary duties.

Plaintiff responds that the same facts that establish demand futility — that is, the directors' purposeful failure to honor an unambiguous provision of a shareholder approved stock option plan — also rebuts the business judgment rule for the purpose of a motion to dismiss for failure to state a claim upon which relief can be granted.

Based on the allegations of the complaint, and all reasonable inferences drawn therefrom, I am convinced that the intentional violation of a shareholder approved stock option plan, coupled with fraudulent disclosures regarding the directors' purported compliance with that plan, constitute conduct that is disloyal to the corporation and is therefore an act in bad faith. Plaintiffs allege the following conduct: Maxim's directors affirmatively represented to Maxim's shareholders that the exercise price of any option grant would be no less than 100% of the fair value of the shares, measured by the market price of the shares on the date the option is granted. Maxim shareholders, possessing an absolute right to rely on those assurances when determining whether to approve the plans, in fact relied upon those representations and approved the plans. Thereafter, Maxim's directors are alleged to have deliberately attempted to circumvent their duty to price the shares at no less than market value on the option grant dates by surreptitiously changing the dates on which the options were granted. To make matters worse, the directors allegedly failed to disclose this conduct to their shareholders, instead making false representations regarding the option dates in many of their public disclosures.

I am unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, is anything but an act of bad faith. It certainly cannot be said to amount to faithful and devoted conduct of a loyal fiduciary. Well-pleaded allegations of such conduct are sufficient, in my opinion, to rebut the business judgment rule and to survive a motion to dismiss.

C. Standing

Defendants move to dismiss seven of the nine claims asserted in plaintiffs complaint on the grounds that plaintiff lacks standing to assert these claims. According to defendants, plaintiff must have continuous ownership from the time of the transaction in question through the completion of the lawsuit in order to sustain a derivative action. It is unchallenged that plaintiff never owned stock in Maxim before 2001, and plaintiff acquired his stock through a merger, not by operation of law. Only two of the nine challenged transactions occurred while plaintiff held shares. Accordingly, defendant argues that dismissal of all claims arising before April 11, 2001, is proper pursuant to 8 Del. C. § 327.

Section 327 of the DGCL exists to prevent the purchasing of shares in order to maintain a derivative action attacking transactions that occurred before the purchase. It provides that a stockholder seeking to assert a (derivative action on behalf of a corporation must have been a stockholder at the time of the transaction complained of, or his shares must have devolved upon him by operation of law. Additionally, he must continuously hold stock through completion of the litigation.

Plaintiff became a shareholder on April 11, 2001, by way of a merger, not by operation of law. Therefore, he lacks standing to assert claims arising before April 11, 2001. The cases where this Court has applied section 327 with some leniency are not applicable here. For example, in the case of Helfand v. Gambee, plaintiff lost standing by virtue of reorganization. To the contrary, plaintiff here argues that he gained standing by virtue of a merger. The law here is settled. Plaintiff may not assert claims arising before his ownership interest materialized on April 11, 2001.

D. Statute Of Limitations

Defendants contend that the statute of limitations of 10 Del. C. § 8106 bars plaintiffs claims because none of the challenged transactions occurred within the past three years. Plaintiff asserts that the doctrine of fraudulent concealment tolls the statute of limitations in this case.

The allegations in the complaint satisfy the requirements of the doctrine of fraudulent concealment. Defendants allegedly caused Maxim to falsely represent that the exercise price of all the stock options it granted pursuant to its stock option plans was no less than the fair market value of Maxim's common stock, measured by the publicly traded closing price for Maxim stock on the date of the grant. To the extent that the date on which the grant was issued is not the same as the date that the defendants, in public filings, represented that the grant was issued, defendants affirmatively acted to conceal a fact that prevented plaintiff from gaining material relevant knowledge in an attempt to put plaintiff off the trail of inquiry. Plaintiff may rely on public filings and accept them as true, and need not assume that directors and officers will falsify such filings. Accordingly, where plaintiff alleges that defendants intentionally falsified public disclosures, defendants may not rely on the statute of limitations as a defense until plaintiff is placed on inquiry notice that such filings were fraudulent.

Defendants argue that there is no fraudulent concealment since Merrill Lynch based its report on public disclosures and plaintiff bases his complaint on the Merrill Lynch report. That is, defendants insist that Ryan, through investigation, could have discovered the same information that Merrill Lynch discovered. This defense is unconvincing. Shareholders may be expected to exercise reasonable diligence with respect to their shares, but this diligence does not require a shareholder to conduct complicated statistical analysis in order to uncover alleged malfeasance. The above-mentioned facts, in conjunction with an alleged affirmative cover up, convince me that the actions were fraudulently concealed and, thus, defendants may not rely on the statute of limitations as a defense. Inaccurate public representations as to whether directors are in compliance with shareholder-approved stock option plans constitute fraudulent concealment of wrongdoing sufficient to toll the statute of limitations.

For the foregoing reasons, I grant defendants' motion to dismiss all claims arising before April 11, 2001. I deny defendants' motion to stay or dismiss with respect to all other claims.

Some discussion questions:

1. As with the eBay directors, does it seem like the directors of this corporation needed the money? What would it have cost them to use the agreed-upon strike price?

2. Which duty is involved here? Who is harmed? How?

3. What if the plaintiff had owned shares throughout the entire period, but had an equal or larger position against the corporation (by shorting the shares, or by selling put options)? Would that have satisfied the standing requirement even though the shareholder would arguably have had very little skin in the game?

Securities Fraud

As fun and exciting as derivative actions regarding breaches of fiduciary duty or direct actions brought to enforce shareholder rights can be, the real workhorse of the plaintiff-side bar is the securities fraud case. Securities fraud, in a nutshell, is a direct claim brought under federal law[1] that false statements made by a corporation or its management led to investment decisions that damaged shareholders' investment in the corporation. In 2020, plaintiffs filed 234 new class action securities fraud cases against companies and their managers, and in the same year 77 previously-filed class action securities fraud were settled for a total of $4.3 billion in value.[2] Securities fraud is big business.

[1] Specifically, the Securities Exchange Act of 1934

[2] The median settlement was $10.8BN, as the overall value is skewed by a handful of very large settlements.

In this section, we examine the history of federal securities fraud and its development into its modern incarnation, review the procedures and standing requirements to bring a claim, and lay out the individual elements that plaintiffs must meet for a successful securities fraud case.

Statutory Authority, Regulatory Origins, and Judicial Development

Statutory authority for federal securities law comes from §10(b) of the Securities Exchange Act of 1934, codified at 15 U.S.C. § 78j, which makes it unlawful:

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

There was more than a little bit of uncertainty about what exactly this covered, so in 1942, under the powers granted to it by the '34 Act, the Securities and Exchange Commission (the "SEC") promulgated Rule 10b-5 defining the rules against fraud in the securities markets:[3]

[3] The SEC apparently drafted and approved this language over the course of an afternoon, and the only reported deliberation of the commission was a comment attributed to a commissioner named Sumner Pike, who said:

> ***"Well, we're against fraud, aren't we?"***

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

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

in connection with the purchase or sale of any security.[1]

Well, that cleared things right up! Rule 10b-5 allowed the SEC to bring civil cases of securities fraud and federal law enforcement authorities to bring criminal cases of securities fraud,[2] but that's not all. 10b-5 has also been interpreted to create a private right of action whereby shareholders can bring civil claims — on their own or as part of a larger class of injured shareholders — alleging they relied on untrue statements of material fact in connection with the purchase or sale of a corporation's shares, and seeking to recover the money they lost as a result of their investment decision.[3] Was any of this intended? Explicit in the text? Of course not! But remember: corporate law is not the law you wanted, it is the law you deserve.

Over time, courts developed a workable set of procedures, standing requirements, and elements for a shareholder securities fraud claim under Rule 10b-5; in the words of noted proponent of school segregation and deceased Supreme Court justice William Rehnquist, the 10b-5 private right of action is a "judicial oak that grew from little more than a legislative acorn".[4] One would think that federal courts inventing, modifying, and elaborating on a general principle through caselaw could fairly be called a type of federal common law, but every time I try to learn what "federal common law" means I get a nosebleed.

Left for decades to its own devices, the Supreme Court defined *standing*, developed a standard for *materiality*, invented out of whole cloth a requirement for *scienter*, and created a presumption for *reliance* in 10b-5 suits. In 1995, Congress arose from a Rip Van Winkle-esque slumber and decided to do something about securities fraud litigation. In the same legislative term that saw Congress successfully get rid of pornography on the internet (the Communications Decency Act), halt unauthorized immigration once and for all (the Illegal Immigration Reform and Immigrant Responsibility Act), and prohibit same-sex marriage forever (the Defense of Marriage Act), Congress passed the Private Securities Litigation Reform Act (PSLRA) with the intent of curbing securities fraud litigation — and you can probably guess just how effective it was.

In reality, the PSLRA codified a number of Supreme Court decisions, added some pleading and standing requirements, created a safe harbor for "forward-looking statements", established exclusive federal court venue and a two-year statute of limitations, and then left the rest of the judicially-crafted and SEC-guided system intact.

[1] "Security" has a broad definition that includes shares of corporations, corporate bonds, certain kinds of loans, partnership interests, and other types of investments. For the purpose of this chapter, we focus on shares of corporations.

[2] Including, insider trading (Chapter 16), which is a particular kind of criminal securities fraud.

[3] Loss is calculated as the difference between the price of the shares that were inflated or deflated as a result of the misstatements and the "actual" price that the shares were worth. In very large corporations, even a small loss for an individual shareholder can be enormous when added up over the entire shareholder base.

[4] *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975)).

The Supreme Court has since continued on its merry way, tweaking various parts of the whole securities fraud experience here and there, but generally avoiding big changes to existing doctrine — a shining example of the sort of judicial modesty, bipartisan comity, and care for precedent that we've come to expect and appreciate from the Roberts Court.

Why, you might ask, has a court known for its devotion to a cribbed understanding of textualism, hostility towards the administrative state, and willingness to interpret acts of Congress in the most ungenerous reading possible continued to uphold a system based entirely on emanations and penumbras from sparse legislative instruction and aggressive agency rulemaking? Well, smarty pants, how about *you* try telling billions and billions of dollars of investors' money that securities fraud is no longer a thing and that it's now perfectly legal for management to lie to shareholders? See how *that* goes, huh? Some things are bigger than the Supreme Court.

A Tiresome Policy Debate

Despite the fact that nobody can seem to get rid of them, class actions securities fraud cases have long been controversial, for three general reasons. First, there is a widespread perception that many such suits are meritless — that they are brought by opportunistic attorneys whenever a corporation's share price drops and attorneys simply work backwards to discover any potential misstatements made by management, regardless of whether they had anything to do with the drop in stock price. This criticism essentially holds that securities fraud suits are a form of "investment insurance" whereby plaintiffs upset about the underperformance of the corporation attempt to make management atone for their losses by claiming that they have been defrauded.

The second reason, which is often sugarcoated by the first, is the typical reactionary aversion to plaintiffs' lawyers as scummy parasites on our hardworking Randian ubermensches,[1] the narrative of which is propagandized by business interests, parroted by corporate lickspittles, and absorbed by the sort of drearily familiar dullard who thinks that "personal responsibility" is some sort of talisman to be waved in the face of systemic oppression and who has sincerely used the term "victimhood mentality" in a sentence. Each level of that intellectual human centipede has very strong "Duke basketball fan" energy, and for our mental and emotional health we will move along quickly.

[1] You know, rich dudes.

The final reason, and the one that has the distinct advantage of being based in fact rather than vibes, is that recovery in these actions is very often circular. As we have discussed previously, corporations indemnify their directors and officers for losses accrued when they are acting in their capacity as directors,[1] and both corporations and their management are insured for money damages in suits brought against them. As such, any money paid out to wronged shareholders in a securities fraud case comes out of the pockets of the corporation (which means the corporation is less valuable to its current and future shareholders) or out of the pockets of its insurers (which results in higher insurance premiums for the corporation), and not out of the pockets of the actual wrongdoers.

[1] Absent evidence of criminality or a final judgment of fraud or bad faith, this covers money paid in the settlement of securities fraud cases.

The common response is that securities fraud claims (even meritless ones) serve as a powerful deterrent for misstatements and provide a strong incentive for full and honest disclosure by corporations and their management — both of which were fundamentally the point of the Securities Exchange Act in the first place. In this light, claims that greedy plaintiffs' lawyers are engaging in fishing expeditions can be seen as tacit admissions that one can often find fraud in *any* corporation if you just look hard enough — which works to support, rather than undermine, the need to incentive honesty. Additionally, these suits are supremely annoying for directors and officers, and are considered a sign of poor management and a need for changes in corporate governance. As such — and even if it might not be particularly efficient or ultimately just — securities fraud liability exists alongside managerial fiduciary duties as another legal constraint on malevolent corporate managers.

Plus, lawyers on both sides make BANK.

Rules and Procedures For Bringing A Claim

Concerns about frivolous suits brought only to force a quick settlement ("nuisance" suit or "strike" suits) have led both courts and Congress to limit who can bring claims under Rule 10b-5. First, only actual purchasers and seller may bring claims — not people who would have bought but for the misstatement, or people who would have sold but for the misstatement — for fraud under 10b-5. This judge-made rule — reading the "purchase and sale" language in the statute as a hard limit on standing[2] — was codified in the PSLRA, and works to provide a finite limit to the number of potential plaintiffs (particularly in cases where the misstatements depressed the price of the security). Plaintiffs must also meet the adequacy requirement that we've previously discussed in the context of derivative suits — under the PSLRA, the plaintiff with the most money at stake is considered the most capable, and is generally appointed lead plaintiff.

[2] In other cases, however, the Court has read the "in connection with" language broadly to include frauds such as embezzlement by brokers.

Second, only "primary violators" — the party that made the statement — can be defendants in a private securities fraud action; under the PSLRA, only the SEC is authorized to go after "secondary violators" for aiding and abetting securities fraud. Under 10b-5(a), however, plaintiffs may sue multiple defendants under "scheme liability" if they can show that the defendants engaged in a conspiracy to mislead investors. One important thing that is not always obvious to students: defendants in a securities fraud case can be involved with either publicly-traded or privately-held corporations; 10b-5 applies to the purchase or sale of securities of any kind of corporation. Most 10b-5 actions area against publicly-traded corporations, however, as management of those firms tend to make more public statements,[1] cases against them bring larger verdicts/settlements, and the standards for showing reliance by shareholder plaintiffs are more relaxed (as we discuss below).

[1] This is in large part due to the requirements for mandatory disclosure that come with being publicly-traded.

Finally, the Securities Litigation Uniform Standards Act[2] specified that all securities fraud class action suits must be brought in federal court. These suits must be brought within two years of discovery of the facts of the fraudulent act (that is, that the statement made was untrue) or within five years of the fraudulent act itself (the untrue statement).

[2] An underwhelming *Hobbs & Shaw*-style spin-off of the more popular PSLRA franchise.

Another procedural and jurisdictional question that came before the Supreme Court prior to the PSLRA was whether claims that were fundamentally asserting violations of fiduciary duties under state law could be styled as securities fraud claims. After all, when the sale of the company is involved there is necessarily a purchase or sale of corporate securities, and a violation of duty could be seen as an artifice to defraud. However, expanding 10b-5 claims to reach unfair corporate practices would necessarily involve federal courts adjudicating state law breach of duty claims using the procedural and substantive standards of 10b-5 rather than the well-developed state law fiduciary duties. Should unfair practices be construed as fraud under Rule 10b-5? Take a look, it's in a book, a Reading Rainbow:

Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977)

White, J.

The issue in this case involves the reach and coverage of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder in the context of a Delaware short-form merger transaction used by the majority stockholder of a corporation to eliminate the minority interest.

In 1936, petitioner Santa Fe Industries, Inc. (Santa Fe), acquired control of 60% of the stock of Kirby Lumber Corp. (Kirby), a Delaware corporation. Through a series of purchases over the succeeding years, Santa Fe increased its control of Kirby's stock to 95%; the purchase prices during the period 1968-1973 ranged from $65 to $92.50 per share. In 1974, wishing to acquire 100% ownership of Kirby, Santa Fe availed itself of § 253 of the Delaware Corporation Law, known as the "short-form merger" statute.[1] Section 253 permits a parent corporation owning at least 90% of the stock of a subsidiary to merge with that subsidiary, upon approval by the parent's board of directors, and to make payment in cash for the shares of the minority stockholders. The statute does not require the consent of, or advance notice to, the minority stockholders. However, notice of the merger must be given within 10 days after its effective date, and any stockholder who is dissatisfied with the terms of the merger may petition the Delaware Court of Chancery for a decree ordering the surviving corporation to pay him the fair value of his shares, as determined by a court-appointed appraiser subject to review by the court.[2]

[1] We will discuss short form mergers in Chapter 15.

[2] We will discuss appraisal rights in Chapter 13.

Santa Fe obtained independent appraisals of the physical assets of Kirby — land, timber, buildings, and machinery — and of Kirby's oil, gas, and mineral interests. These appraisals, together with other financial information, were submitted to Morgan Stanley Co., an investment banking firm retained to appraise the fair market value of Kirby stock. Kirby's physical assets were appraised at $320 million (amounting to $640 for each of the 500,000 shares); Kirby's stock was valued by Morgan Stanley at $125 per share. Under the terms of the merger, minority stockholders were offered $150 per share.[3]

[3] Ignore for now the short-form merger statute and the appraisal rights — both of which we'll cover in later chapters — and just focus on how pissed these shareholders must have been with this low-ball price that they effectively couldn't refuse.

The provisions of the short-form merger statute were fully complied with. The minority stockholders of Kirby were notified the day after the merger became effective and were advised of their right to obtain an appraisal in Delaware court if dissatisfied with the offer of $150 per share. They also received an information statement containing, in addition to the relevant financial data about Kirby, the appraisals of the value of Kirby's assets and the Morgan Stanley appraisal concluding that the fair market value of the stock was $125 per share.

Respondents, minority stockholders of Kirby, objected to the terms of the merger, but did not pursue their appraisal remedy in the Delaware Court of Chancery. Instead, they brought this action in federal court on behalf of the corporation and other minority stockholders, seeking to set aside the merger or to recover what they claimed to be the fair value of their shares. The amended complaint asserted that, based on the fair market value of Kirby's physical assets as revealed by the appraisal included in the information statement sent to minority shareholders, Kirby's stock was worth at least $772 per share. The complaint alleged further that the merger took place without prior notice to minority stockholders;

that the purpose of the merger was to appropriate the difference between the "conceded pro rata value of the physical assets," and the offer of $150 per share — to "freez[e] out the minority stockholders at a wholly inadequate price," id., at 100a; and that Santa Fe, knowing the appraised value of the physical assets, obtained a "fraudulent appraisal" of the stock from Morgan Stanley and offered $25 above that appraisal "in order to lull the minority stockholders into erroneously believing that [Santa Fe was] generous." This course of conduct was alleged to be a violation of Rule 10b-5 because defendants employed a "device, scheme, or artifice to defraud" and engaged in an "act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

The District Court dismissed the complaint for failure to state a claim upon which relief could be granted. As the District Court understood the complaint, respondents' case rested on two distinct grounds. First, federal law was assertedly violated because the merger was for the sole purpose of eliminating the minority from the company, therefore lacking any justifiable business purpose, and because the merger was undertaken without prior notice to the minority shareholders. Second, the low valuation placed on the shares in the cash-exchange offer was itself said to be a fraud actionable under Rule 10b-5. [T]he District Court reasoned that Delaware law required neither a business purpose for a short-form merger nor prior notice to the minority shareholders who the statute contemplated would be removed from the company, and that Rule 10b-5 did not override these provisions of state corporate law by independently placing a duty on the majority not to merge without prior notice and without a justifiable business purpose.

A divided Court of Appeals for the Second Circuit reversed. The Court of Appeals' view was that, although the Rule plainly reached material misrepresentations and nondisclosures in connection with the purchase or sale of securities, neither misrepresentation nor nondisclosure was a necessary element of a Rule 10b-5 action; the Rule reached "breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure."

We reverse.

[T]he case comes to us on the premise that the complaint failed to allege a material misrepresentation or material failure to disclose. The finding of the District Court, undisturbed by the Court of Appeals, was that there was no "omission" or "misstatement" in the information statement accompanying the notice of merger. On the basis of the information provided, minority shareholders could either accept the price offered or reject it and seek an appraisal in the Delaware Court of Chancery. Their choice was fairly presented, and they were furnished with all relevant information on which to base their decision.

The language of the statute is, we think, "sufficiently clear in its context" to be dispositive here; but even if it were not, there are additional considerations that weigh heavily against permitting a cause of action under Rule 10b-5 for the breach of corporate fiduciary duty alleged in this complaint. As we noted earlier, the Court repeatedly has described the "fundamental purpose" of the Act as implementing a "philosophy of full disclosure"; once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute.

The reasoning behind a holding that the complaint in this case alleged fraud under Rule 10b-5 could not be easily contained. It is difficult to imagine how a court could distinguish, for purposes of Rule 10b-5 fraud, between a majority stockholder's use of a short-form merger to eliminate the minority at an unfair price and the use of some other device, such as a long-form merger, tender offer, or liquidation, to achieve the same result; or indeed how a court could distinguish the alleged abuses in these going private transactions from other types of fiduciary self-dealing involving transactions in securities. The result would be to bring within the Rule a wide variety of corporate conduct traditionally left to state regulation. Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden. "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."

The judgment of the Court of Appeals is reversed, and the case is remanded for further proceedings consistent with this opinion.

SOME DISCUSSION QUESTIONS:

1. If there is a deliberate misrepresentation to shareholders and a violation of corporate fiduciary duties, could shareholders bring separate claims against management?

2. Is the Court just ignoring any situation where the breach of a fiduciary duty is *per se* fraudulent? Or are they distinguishing ordinary fraud from securities fraud on some other grounds?

3. If fiduciary duty violations — particularly those involving fraud or bad faith — were to come under the ambit of Rule 10b-5, what would be the problem, exactly?

The Elements Of Securities Fraud

Through a combination of regulatory, judicial, and congressional action, securities fraud claims have come to have four key elements:[1]

1. A Materially False or Misleading Statement ("Material Misrepresentation")
2. The Statement Was Made with an Intent to Deceive ("Scienter")
3. The Plaintiff Relies on the Statement ("Reliance")
4. The Plaintiff Suffers Losses Caused By The Misrepresentation ("Loss Causation")

[1] Some courts/scholars list five elements by separating "material" and "misstatement". Some list six elements by breaking out the fourth category into "economic loss" and "loss causation". We, however, are smart enough to understand a compound proposition, so we're going with four.

In this section we will examine each of these elements in turn.

Material Misstatement

It is not enough that a statement be false or misleading — it must be materially so. This requirement exists to functionally limit the kind of misstatements that can be the subject of litigation to those important enough to sway investment decisions by shareholders. False or misleading statements that are irrelevant or (to use a term from litigation over false advertising) merely "puffery" are not actionable. The following case lays out the standard for determining materiality, and then wrestles with the difficult question of when information about a contingent event — an event that may or may not actually come to pass — becomes material (and therefore lies about it becomes actionable).

Basic Inc. v. Levinson, 485 U.S. 224 (1988)

Blackmun, J.

This case requires us to apply the materiality requirement of § 10(b) of the Securities Exchange Act of 1934 (1934 Act), and the Securities and Exchange Commission's Rule 10b-5, in the context of preliminary corporate merger discussions.

Prior to December 20, 1978, Basic Incorporated was a publicly traded company primarily engaged in the business of manufacturing chemical refractories for the steel industry. As early as 1965 or 1966, Combustion Engineering, Inc., a company producing mostly alumina-based refractories, expressed some interest in acquiring Basic, but was deterred from pursuing this inclination seriously because of antitrust concerns it then entertained. In 1976, however, regulatory action opened the way to a renewal of Combustion's interest. The "Strategic Plan," dated October 25, 1976, for Combustion's Industrial Products Group included the objective: "Acquire Basic Inc. $30 million."

Beginning in September 1976, Combustion representatives had meetings and telephone conversations with Basic officers and directors, including petitioners here, concerning the possibility of a merger. During 1977 and 1978, Basic made three public statements denying that it was engaged in merger negotiations.[1] On December 18, 1978, Basic asked the New York Stock Exchange to suspend trading in its shares and issued a release stating that it had been "approached" by another company concerning a merger. On December 19, Basic's board endorsed Combustion's offer of $46 per share for its common stock, and on the following day publicly announced its approval of Combustion's tender offer for all outstanding shares.

Respondents are former Basic shareholders who sold their stock after Basic's first public statement of October 21, 1977, and before the suspension of trading in December 1978. Respondents brought a class action against Basic and its directors, asserting that the defendants issued three false or misleading public statements and thereby were in violation of § 10(b) of the 1934 Act and of Rule 10b-5. Respondents alleged that they were injured by selling Basic shares at artificially depressed prices in a market affected by petitioners' misleading statements and in reliance thereon.

The District Court adopted a presumption of reliance by members of the plaintiff class upon petitioners' public statements that enabled the court to conclude that common questions of fact or law predominated over particular questions pertaining to individual plaintiffs. It held that, as a matter of law, any misstatements were immaterial: there were no negotiations ongoing at the time of the first statement, and although negotiations were taking place when the second and third statements were issued, those negotiations were not "destined, with reasonable certainty, to become a merger agreement in principle."

The United States Court of Appeals for the Sixth Circuit affirmed the class certification, but reversed the District Court's summary judgment, and remanded the case. The court reasoned that while petitioners were under no general duty to disclose their discussions with Combustion, any statement the company voluntarily released could not be "so incomplete as to mislead." In the Court of Appeals' view, Basic's statements that no negotiations were taking place, and that it knew of no corporate developments to account for the heavy trading activity, were misleading. With respect to materiality, the court rejected the argument that preliminary merger discussions are immaterial as a matter of law, and held that "once

[1] On October 21, 1977, after heavy trading and a new high in Basic stock, the following news item appeared in the Cleveland Plain Dealer:

"[Basic] President Max Muller said the company knew no reason for the stock's activity and that no negotiations were under way with any company for a merger. He said Flintkote recently denied Wall Street rumors that it would make a tender offer of $25 a share for control of the Cleveland-based maker of refractories for the steel industry."

On September 25, 1978, in reply to an inquiry from the New York Stock Exchange, Basic issued a release concerning increased activity in its stock and stated that "management is unaware of any present or pending company development that would result in the abnormally heavy trading activity and price fluctuation in company shares that have been experienced in the past few days."

On November 6, 1978, Basic issued to its shareholders a "Nine Months Report 1978." This Report stated:

"With regard to the stock market activity in the Company's shares we remain unaware of any present or pending developments which would account for the high volume of trading and price fluctuations in recent months."

a statement is made denying the existence of any discussions, even discussions that might not have been material in absence of the denial are material because they make the statement made untrue."

We granted certiorari to resolve the split among the Courts of Appeals as to the standard of materiality applicable to preliminary merger discussions, and to determine whether the courts below properly applied a presumption of reliance in certifying the class, rather than requiring each class member to show direct reliance on Basic's statements.[1]

[1] We'll deal with reliance in a later section.

The 1934 Act was designed to protect investors against manipulation of stock prices. Underlying the adoption of extensive disclosure requirements was a legislative philosophy: "There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy." This Court "repeatedly has described the 'fundamental purpose' of the Act as implementing a 'philosophy of full disclosure."'

Pursuant to its authority under § 10(b) of the 1934 Act, 15 U.S.C. § 78j, the Securities and Exchange Commission promulgated Rule 10b-5. Judicial interpretation and application, legislative acquiescence,[2] and the passage of time have removed any doubt that a private cause of action exists for a violation of § 10(b) and Rule 10b-5, and constitutes an essential tool for enforcement of the 1934 Act's requirements.

[2] Is this a thing?

The Court previously has addressed various positive and common-law requirements for a violation of § 10(b) or of Rule 10b-5. The Court also explicitly has defined a standard of materiality under the securities laws, see *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), concluding in the proxy-solicitation context that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." Acknowledging that certain information concerning corporate developments could well be of "dubious significance," the Court was careful not to set too low a standard of materiality; it was concerned that a minimal standard might bring an overabundance of information within its reach, and lead management "simply to bury the shareholders in an avalanche of trivial information — a result that is hardly conducive to informed decisionmaking." It further explained that to fulfill the materiality requirement "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." We now expressly adopt the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context.

The application of this materiality standard to preliminary merger discussions is not self-evident. Where the impact of the corporate development on the target's fortune is certain and clear, the *TSC Industries* materiality definition admits straightforward application. Where, on the other hand, the event is contingent or speculative in nature, it is difficult to ascertain whether the "reasonable investor" would have considered the omitted information significant at the time. Merger negotiations, because of the ever-present possibility that the contemplated transaction will not be effectuated, fall into the latter category.

A

Petitioners urge upon us a Third Circuit test for resolving this difficulty. Under this approach, preliminary merger discussions do not become material until "agreement-in-principle" as to the price and structure of the transaction has been reached between the would-be merger partners. By definition, then, information concerning any negotiations not yet at the agreement-in-principle stage could be withheld or even misrepresented without a violation of Rule 10b-5.

Three rationales have been offered in support of the "agreement-in-principle" test. The first derives from the concern expressed in *TSC Industries* that an investor not be overwhelmed by excessively detailed and trivial information, and focuses on the substantial risk that preliminary merger discussions may collapse: because such discussions are inherently tentative, disclosure of their existence itself could mislead investors and foster false optimism. The other two justifications for the agreement-in-principle standard are based on management concerns: because the requirement of "agreement-in-principle" limits the scope of disclosure obligations, it helps preserve the confidentiality of merger discussions where earlier disclosure might prejudice the negotiations; and the test also provides a usable, bright-line rule for determining when disclosure must be made.

None of these policy-based rationales, however, purports to explain why drawing the line at agreement-in-principle reflects the significance of the information upon the investor's decision. The first rationale, and the only one connected to the concerns expressed in *TSC Industries*, stands soundly rejected. "It assumes that investors are nitwits, unable to appreciate — even when told — that mergers are risky propositions up until the closing." Disclosure, and not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress. We have recognized time and again, a "fundamental purpose" of the various Securities Acts, "was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." The role of the materiality requirement is not to "attribute to investors a child-like simplicity, and inability to grasp the probabilistic significance of negotiations," , but to filter out essentially useless information that a reasonable investor would not consider significant.

The second rationale, the importance of secrecy during the early stages of merger discussions, also seems irrelevant to an assessment whether their existence is significant to the trading decision of a reasonable investor. To avoid a “bidding war" over its target, an acquiring firm often will insist that negotiations remain confidential, and at least one Court of Appeals has stated that “silence pending settlement of the price and structure of a deal is beneficial to most investors, most of the time." We need not ascertain, however, whether secrecy necessarily maximizes shareholder wealth — although we note that the proposition is at least disputed as a matter of theory and empirical research — for this case does not concern the timing of a disclosure; it concerns only its accuracy and completeness. We face here the narrow question whether information concerning the existence and status of preliminary merger discussions is significant to the reasonable investor's trading decision. The “secrecy" rationale is simply inapposite to the definition of materiality.

The final justification offered in support of the agreement-in-principle test seems to be directed solely at the comfort of corporate managers. A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the Securities Acts and Congress' policy decisions. Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive. In *TSC Industries* this Court explained: "The determination [of materiality] requires delicate assessments of the inferences a ‘reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him." After much study, the Advisory Committee on Corporate Disclosure cautioned the SEC against administratively confining materiality to a rigid formula. Courts also would do well to heed this advice.

We therefore find no valid justification for artificially excluding from the definition of materiality information concerning merger discussions, which would otherwise be considered significant to the trading decision of a reasonable investor, merely because agreement-in-principle as to price and structure has not yet been reached by the parties or their representatives.

B

The Sixth Circuit explicitly rejected the agreement-in-principle test, as we do today, but in its place adopted a rule that, if taken literally, would be equally insensitive, in our view, to the distinction between materiality and the other elements of an action under Rule 10b-5:

> "When a company whose stock is publicly traded makes a statement, as Basic did, that 'no negotiations' are underway, and that the corporation knows of 'no reason for the stock's activity,' and that 'management is unaware of any present or pending corporate development that would result in the abnormally heavy trading activity,' information concerning ongoing acquisition discussions becomes material by virtue of the statement denying their existence."

This approach, however, fails to recognize that, in order to prevail on a Rule 10b-5 claim, a plaintiff must show that the statements were misleading as to a material fact. It is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant.

C

Even before this Court's decision in *TSC Industries*, the Second Circuit had explained the role of the materiality requirement of Rule 10b-5, with respect to contingent or speculative information or events, in a manner that gave that term meaning that is independent of the other provisions of the Rule. Under such circumstances, materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[1] Interestingly, neither the Third Circuit decision adopting the agreement-in-principle test nor petitioners here take issue with this general standard. Rather, they suggest that with respect to preliminary merger discussions, there are good reasons to draw a line at agreement on price and structure.

[1] Another way to think about this is what was the expected value of the event, given the likelihood of the event occurring and the impact on price if it did. Just as $EV_X = \sum P(X_i) * X_i$, $Materiality_{Merger} = P(Merger) * Magnitude_{Merger}$.

In a subsequent decision, the late Judge Friendly, writing for a Second Circuit panel, applied the probability/magnitude approach in the specific context of preliminary merger negotiations. After acknowledging that materiality is something to be determined on the basis of the particular facts of each case, he stated:

> "Since a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions — and this even though the mortality rate of mergers in such formative stages is doubtless high."

We agree with that analysis.

Whether merger discussions in any particular case are material therefore depends on the facts. Generally, in order to assess the probability that the event will occur, a factfinder will need to look to indicia of interest in the transaction at the highest corporate levels. Without attempting to catalog all such possible factors, we note by way of example that board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries may serve as indicia of interest. To assess the magnitude of the transaction to the issuer of the securities allegedly manipulated, a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market value. No particular event or factor short of closing the transaction need be either necessary or sufficient by itself to render merger discussions material.[1]

[1] It has been suggested that given current market practices, a “no comment" statement is tantamount to an admission that merger discussions are underway. That may well hold true to the extent that issuers adopt a policy of truthfully denying merger rumors when no discussions are underway, and of issuing “no comment" statements when they are in the midst of negotiations. There are, of course, other statement policies firms could adopt; we need not now advise issuers as to what kind of practice to follow, within the range permitted by law. Perhaps more importantly, we think that creating an exception to a regulatory scheme founded on a prodisclosure legislative philosophy, because complying with the regulation might be “bad for business," is a role for Congress, not this Court.

As we clarify today, materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information. The fact-specific inquiry we endorse here is consistent with the approach a number of courts have taken in assessing the materiality of merger negotiations. Because the standard of materiality we have adopted differs from that used by both courts below, we remand the case for reconsideration of the question whether a grant of summary judgment is appropriate on this record.

Some discussion questions:

1. Why would the Third Circuit’s test have been appealing? What about the Sixth Circuit’s test? Why did the Supreme Court reject both of them?

2. What is a reasonable investor? Is it a specific investor, a specific kind of investor, or a particularly skillful or sophisticated investor? Do plaintiffs need to be one?

3. The Supreme Court finds that a corporate merger is pretty much always material to investors (duh); however, under the current law there is no duty to disclose merger discussions to a corporation’s shareholders. Why not? Should there be, given that it is so important?

4. What would you have told Basic’s President to say — or not say?

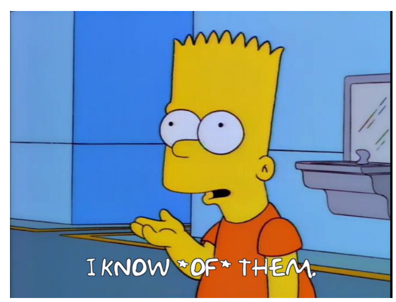
The canonical kind of misstatement is about a knowable, provable fact. I say that it is sunny when you can see through the window that it is raining, etc. The suit in *Basic* concerned another sort of misstatement: a falsity regarding an event that has not yet come to transpire. What about other types of false or misleading statements? To various degrees, each of the following kinds of statements have found to be actionable under certain circumstances:

- **Opinions**: If a corporate manager couches their statement as one of opinion rather than fact, you might think they could escape liability because, that's just like, their opinion, *man.* However, it is absolutely possible to lie about one's actual opinions, as anyone who has ever seen one of their friends experiment with bangs well knows.[1] If you can show that the speaker is lying about their opinion — either through contemporaneous communications from the speaker that contradict their stated opinion or through the existence of evidence that shows that there is no way the speaker could actually hold that opinion — that lie can be actionable.

[1] I am not categorically against bangs, mind you — people with the right face shape and the appropriate Zooey-Deschenal-assed vibe can certainly pull them off — but honestly nine times out of ten they're a cry for help.

- **Omissions**: Omissions can be misstatements under 10b-5 if the speaker had a duty to disclose material information (either via regulation or contract or whatever) and failed to do so. In situations like the one in *Basic*, where there is no affirmative duty to disclose the relevant information, silence is perfectly acceptable; in situations where there is an obligation to disclose, however, then disclosure must be made and it must be truthful.

- **Half-truths**: Disclosing less than the full truth can be a material misstatement if the selective disclosure creates a misleading impression for the listener, and would require the disclosure of additional facts to make the statement true.



- **Previously Correct Statements**: In some (but not all) circuits, a statement that was correct at the time it was made, but becomes incorrect and yet is still available to the public (in a mandatory disclosure or an annual report, for example) must be updated so as not to mislead investors. In all circuits, however, a statement that was *thought* to be correct at the time but turned out to be erroneous must be corrected as soon as is practicable.

Scienter

In 1976, more or less out of nowhere, the Supreme Court in *Ernst & Ernst v. Hochfelder*[2] required plaintiffs in private rights of action under 10b-5 to prove an "intent to deceive, manipulate, or defraud on the defendant's part", introducing a mental state requirement into securities fraud litigation. This was later expanded beyond **intentional** conduct to include **knowing** conduct — and in a few cases, **reckless** conduct as well. In any event, the consequence was that a defendant cannot merely negligently violate 10b-5, and plaintiffs must prove that defendants acted with the requisite scienter.

[2] 425 U.S. 1985 (1976)

As part of the PSLRA, this judge-made scienter requirement was codified into the Securities Exchange Act, along with a requirement that for every allegedly false or misleading statement plaintiffs must plead "with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." The next case examines what facts can be marshaled to meet this standard, and how courts use the objective (observable facts) to determine the subjective (mental state) in securities fraud cases.

Tellabs v. Makor Issues & Rights, 551 U.S. 308 (2007)

Ginsburg, J.

This Court has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission (SEC). Private securities fraud actions, however, if not adequately contained, can be employed abusively to impose substantial costs on companies and individuals whose conduct conforms to the law.[1] As a check against abusive litigation by private parties, Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA).

[1] Notorious R.B.G. in the house! Uncritically repeating propaganda from her homies at the Chamber of Commerce! Girlboss!

Exacting pleading requirements are among the control measures Congress included in the PSLRA. The PSLRA requires plaintiffs to state with particularity both the facts constituting the alleged violation, and the facts evidencing scienter, i.e., the defendant's intention "to deceive, manipulate, or defraud." This case concerns the latter requirement. [P]laintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."

Petitioner Tellabs, Inc., manufactures specialized equipment used in fiber optic networks. During the time period relevant to this case, petitioner Richard Notebaert was Tellabs' chief executive officer and president. Respondents (Shareholders) are persons who purchased Tellabs stock between December 11, 2000, and June 19, 2001. They accuse Tellabs and Notebaert (as well as several other Tellabs executives) of engaging in a scheme to deceive the investing public about the true value of Tellabs' stock.

Beginning on December 11, 2000, the Shareholders allege, Notebaert (and by imputation Tellabs) "falsely reassured public investors, in a series of statements ... that Tellabs was continuing to enjoy strong demand for its products and earning record revenues," when, in fact, Notebaert knew the opposite was true. From December 2000 until the spring of 2001, the Shareholders claim, Notebaert knowingly misled the public in four ways. First, he made statements indicating that demand for Tellabs' flagship networking device, the TITAN 5500, was continuing to grow, when, in fact, demand for that product was waning. Second, Notebaert made statements indicating that the TITAN 6500, Tellabs' next-generation networking device, was available for delivery, and that demand for that product was strong and growing, when in truth the product was not ready for delivery and demand was weak. Third, he falsely represented Tellabs' financial results for the fourth quarter of 2000 (and, in connection with those results, condoned the practice of "channel stuffing," under which Tellabs flooded its customers with unwanted products). Fourth, Notebaert made a series of overstated revenue projections, when demand for the TITAN 5500 was drying up and production of the TITAN 6500 was behind schedule. Based on Notebaert's sunny assessments, the Shareholders contend, market analysts recommended that investors buy Tellabs' stock.

The first public glimmer that business was not so healthy came in March 2001 when Tellabs modestly reduced its first quarter sales projections. In the next months, Tellabs made progressively more cautious statements about its projected sales. On June 19, 2001, the last day of the class period, Tellabs disclosed that demand for the TITAN 5500 had significantly dropped. Simultaneously, the company substantially lowered its revenue projections for the second quarter of 2001. The next day, the price of Tellabs stock, which had reached a high of $67 during the period, plunged to a low of $15.87.[1]

[1] Hot damn!

On December 3, 2002, the Shareholders filed a class action in the District Court for the Northern District of Illinois. Tellabs moved to dismiss the complaint on the ground that the Shareholders had failed to plead their case with the particularity the PSLRA requires. The District Court agreed, and therefore dismissed the complaint without prejudice. The Shareholders then amended their complaint, adding references to 27 confidential sources and making further, more specific, allegations concerning Notebaert's mental state. The District Court again dismissed, this time with prejudice. The Shareholders had sufficiently pleaded that Notebaert's statements were misleading, the court determined, but they had insufficiently alleged that he acted with scienter.

The Court of Appeals for the Seventh Circuit reversed in relevant part. [T]he Seventh Circuit concluded that the Shareholders had sufficiently alleged that Notebaert acted with the requisite state of mind. The Court of Appeals recognized that the PSLRA "unequivocally raise[d] the bar for pleading scienter" by requiring plaintiffs to "plea[d] sufficient facts to create a strong inference of scienter." In evaluating whether that pleading standard is met, the Seventh Circuit said, "courts [should] examine all of the allegations in the complaint and then ... decide whether collectively they establish such an inference." "[W]e will allow the complaint to survive," the court next and critically stated, "if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent. If a reasonable person could not draw such an inference from the alleged facts, the defendants are entitled to dismissal."

In an ordinary civil action, the Federal Rules of Civil Procedure require only "a short and plain statement of the claim showing that the pleader is entitled to relief." Fed. Rule Civ. Proc. 8(a)(2). Although the rule encourages brevity, the complaint must say enough to give the defendant "fair notice of what the plaintiff's claim is and the grounds upon which it rests."

Setting a uniform pleading standard for § 10(b) actions was among Congress' objectives when it enacted the PSLRA. Designed to curb perceived abuses of the § 10(b) private action — "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests and manipulation by class action lawyers" — the PSLRA installed both substantive and procedural controls. Notably, Congress prescribed new procedures for the appointment of lead plaintiffs and lead counsel. This innovation aimed to increase the likelihood that institutional investors — parties more likely to balance the interests of the class with the long-term interests of the company — would serve as lead plaintiffs.[1] And in § 21D(b) of the PSLRA, Congress "impose[d] heightened pleading requirements in actions brought pursuant to § 10(b) and Rule 10b–5."

[1] Indeed, this actually came true. Institutional investors — primarily but not exclusively state and union pension funds — are the lead plaintiffs in many private securities fraud class actions cases.

Under the PSLRA's heightened pleading instructions, any private securities complaint alleging that the defendant made a false or misleading statement must: (1) "specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading," and (2) "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." In the instant case, the District Court and the Seventh Circuit agreed that the Shareholders met the first of the two requirements, [b]ut those courts disagreed on whether the Shareholders "state[d] with particularity facts giving rise to a strong inference that [Notebaert] acted with [scienter]."

Our task is to prescribe a workable construction of the "strong inference" standard, a reading geared to the PSLRA's twin goals: to curb frivolous, lawyer-driven litigation, while preserving investors' ability to recover on meritorious claims.

We establish the following prescriptions: First, faced with a Rule 12(b)(6) motion to dismiss a § 10(b) action, courts must, as with any motion to dismiss for failure to plead a claim on which relief can be granted, accept all factual allegations in the complaint as true. On this point, the parties agree.

Second, courts must consider the complaint in its entirety, as well as other sources courts ordinarily examine when ruling on Rule 12(b)(6) motions to dismiss, in particular, documents incorporated into the complaint by reference, and matters of which a court may take judicial notice.

The inquiry is whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard.[1]

[1] Totality of the circumstances rides again!

Third, in determining whether the pleaded facts give rise to a "strong" inference of scienter, the court must take into account plausible opposing inferences. The Seventh Circuit expressly declined to engage in such a comparative inquiry. A complaint could survive, that court said, as long as it "alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent"; in other words, only "[i]f a reasonable person could not draw such an inference from the alleged facts" would the defendant prevail on a motion to dismiss. Congress did not merely require plaintiffs to "provide a factual basis for [their] scienter allegations," to allege facts from which an inference of scienter rationally could be drawn. Instead, Congress required plaintiffs to plead with particularity facts that give rise to a "strong" inference.[2]

[2] I have omitted here a panoply of citations the Court gives with regard to what the term "strong" means (including the undergraduate-essay-written-the-night-before-its-due trick of citing the dictionary). We don't need to go down that road, though, as we all know what "strong" means. It means: DO YOU EVEN LIFT, BRO?

The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion, as compared to others, follows from the underlying facts? To determine whether the plaintiff has alleged facts that give rise to the requisite "strong inference" of scienter, a court must consider plausible, nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff. The inference that the defendant acted with scienter need not be irrefutable, i.e., of the "smoking-gun" genre, or even the "most plausible of competing inferences." Yet the inference of scienter must be more than merely "reasonable" or "permissible" — it must be cogent and compelling,[3] thus strong in light of other explanations. A complaint will survive, we hold, only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.

[3] "Great story. Compelling and rich."

Tellabs contends that when competing inferences are considered, Notebaert's evident lack of pecuniary motive will be dispositive. The Shareholders, Tellabs stresses, did not allege that Notebaert sold any shares during the class period. While it is true that motive can be a relevant consideration, and personal financial gain may weigh heavily in favor of a scienter inference, we agree with the Seventh Circuit that the absence of a motive allegation is not fatal. [A]llegations must be considered collectively; the significance that can be ascribed to an allegation of motive, or lack thereof, depends on the entirety of the complaint.

Tellabs also maintains that several of the Shareholders' allegations are too vague or ambiguous to contribute to a strong inference of scienter. For example, the Shareholders alleged that Tellabs flooded its customers with unwanted products, a practice known as "channel stuffing." But they failed, Tellabs argues, to specify whether the channel stuffing allegedly known to Notebaert was the illegitimate kind (e.g., writing orders for products customers had not requested) or the legitimate kind (e.g., offering customers discounts as an incentive to buy). We agree that omissions and ambiguities count against inferring scienter, for plaintiffs must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."We reiterate, however, that the court's job is not to scrutinize each allegation in isolation but to assess all the allegations holistically. In sum, the reviewing court must ask: When the allegations are accepted as true and taken collectively, would a reasonable person deem the inference of scienter at least as strong as any opposing inference?

In the instant case, the case will fall within the jury's authority to assess the credibility of witnesses, resolve any genuine issues of fact, and make the ultimate determination whether Notebaert and, by imputation, Tellabs acted with scienter. We emphasize, as well, that under our construction of the "strong inference" standard, a plaintiff is not forced to plead more than she would be required to prove at trial. A plaintiff alleging fraud in a § 10(b) action, we hold today, must plead facts rendering an inference of scienter at least as likely as any plausible opposing inference. At trial, she must then prove her case by a "preponderance of the evidence." Stated otherwise, she must demonstrate that it is more likely than not that the defendant acted with scienter.

Neither the District Court nor the Court of Appeals had the opportunity to consider the matter in light of the prescriptions we announce today. We therefore vacate the Seventh Circuit's judgment so that the case may be reexamined in accord with our construction. The judgment of the Court of Appeals is vacated, and the case is remanded for further proceedings consistent with this opinion.

Scalia, J., concurring in the judgment

I fail to see how an inference that is merely "at least as compelling as any opposing inference" can conceivably be called what the statute here at issue requires: a "strong inference." If a jade falcon were stolen from a room to which only A and B had access, could it possibly be said there was a "strong inference" that B was the thief? I think not, and I therefore think that the Court's test must fail. In my view, the test should be whether the inference of scienter (if any) is *more plausible* than the inference of innocence.

Some discussion questions:

1. The defendants claimed that the fact that they didn't sell their shares for a profit negates an inference of scienter. Is that a good argument? Why or why not?

2. What objective facts are sufficient to prove (at least at the pleading stage) a "strong inference" of scienter?

3. Scalia's concurrence can basically be summed up as: $\geq \neq >$. Is this a really important point? Do we think there are a lot of cases where the inferences are *exactly* balanced?

Reliance

In any other context, plaintiffs claiming fraud would have to show that they relied on the misstatements made by the counterparty when entering into the transaction. This can be pretty straightforward in a one-on-one transaction,[1] but much harder to demonstrate for every single plaintiff in a massive class action lawsuit. Did every plaintiff hear the misstatement at the time it was made and decide to buy? Did they read about it in the press afterward and buy? Did the misstatement influence the decision of an investment advisor to recommend that the plaintiff buy the stock? Did the plaintiff buy after seeing the stock zooming upwards and shout "To the moon! #YOLO! Diamond hands!" while alone in the home office they'd set up in the single bedroom of their sparsely-decorated suburban sad-bachelor condo, the carpets dirty with crumbs from reheated chicken tenders, laundry in the corner, mattress on the floor?

[1] E.g., "The previous owners of the house told me that it was **not** built upon a haunted Indian burial ground, and that convinced me that it was safe to buy. Now the walls are weeping blood, my family is possessed by demons, and my homeowners policy doesn't cover any of it."

The first case to establish a rebuttable presumption regarding plaintiff reliance was *Basic v. Levinson*, portions of which we read earlier, and the following case articulates the rule *Basic* created ("fraud-on-the-market") and explains why it remains viable (and controversial).

Halliburton Co. v. Erica P. John Fund, Inc., 573 U.S. 258 (2014)

Roberts, C.J.

Investors can recover damages in a private securities fraud action only if they prove that they relied on the defendant's misrepresentation in deciding to buy or sell a company's stock. In *Basic Inc. v. Levinson*, we held that investors could satisfy this reliance requirement by invoking a presumption that the price of stock traded in an efficient market reflects all public, material information — including material misstatements. In such a case, we concluded, anyone who buys or sells the stock at the market price may be considered to have relied on those misstatements.

We also held, however, that a defendant could rebut this presumption in a number of ways, including by showing that the alleged misrepresentation did not actually affect the stock's price — that is, that the misrepresentation had no "price impact." The questions presented are whether we should overrule or modify *Basic*'s presumption of reliance and, if not, whether defendants should nonetheless be afforded an opportunity in securities class action cases to rebut the presumption at the class certification stage, by showing a lack of price impact.

Respondent Erica P. John Fund, Inc. (EPJ Fund), is the lead plaintiff in a putative class action against Halliburton and one of its executives (collectively Halliburton) alleging violations of section 10(b) of the Securities Exchange Act of 1934, and SEC Rule 10b–5. According to EPJ Fund, between June 3, 1999, and December 7, 2001, Halliburton made a series of misrepresentations regarding its potential liability in asbestos litigation, its expected revenue from certain construction contracts, and the anticipated benefits of its merger with another company[1] — all in an attempt to inflate the price of its stock. Halliburton subsequently made a number of corrective disclosures, which, EPJ Fund contends, caused the company's stock price to drop and investors to lose money.

Halliburton urges us to overrule *Basic*'s presumption of reliance and to instead require every securities fraud plaintiff to prove that he actually relied on the defendant's misrepresentation in deciding to buy or sell a company's stock. Before overturning a long-settled precedent, however, we require "special justification," not just an argument that the precedent was wrongly decided.[2] Halliburton has failed to make that showing.

The reliance element "ensures that there is a proper connection between a defendant's misrepresentation and a plaintiff's injury." The traditional (and most direct) way a plaintiff can demonstrate reliance is by showing that he was aware of a company's statement and engaged in a relevant transaction — e.g., purchasing common stock—based on that specific misrepresentation. In *Basic*, however, we recognized that requiring such direct proof of reliance "would place an unnecessarily unrealistic evidentiary burden on the Rule 10b–5 plaintiff who has traded on an impersonal market." That is because, even assuming an investor could prove that he was aware of the misrepresentation, he would still have to "show a speculative state of facts, i.e., how he would have acted ... if the misrepresentation had not been made." We also noted that "[r]equiring proof of individualized reliance" from every securities fraud plaintiff "effectively would prevent [plaintiffs] from proceeding with a class action" in Rule 10b–5 suits.[3]

To address these concerns, *Basic* held that securities fraud plaintiffs can in certain circumstances satisfy the reliance element of a Rule 10b–5 action by invoking a rebuttable presumption of reliance, rather than proving direct reliance on a misrepresentation. The Court based that presumption on what is known as the "fraud-on-the-market" theory, which holds that "the market price of shares traded on well-developed markets reflects

[1] This was Halliburton's 1998 acquisition of Dresser Industries, the second-largest oil-field-services company in Texas, in a transaction pursued by former Halliburton CEO Dick Cheney. The acquisition of Dresser, a company that turned out to have a shockingly massive amount of asbestos-related liability and which ultimately cost Halliburton many millions of dollars, was negotiated by Cheney while on a quail hunt with Dresser's CEO. This was somehow not the worst quail hunt of Dick Cheney's life, as on a different quail hunt in 2006 while serving as Vice President of the United States, Cheney shot a 78-year-old man point blank in the face. He also periodically went duck hunting with extremely dead former Supreme Court justice Antonin Scalia, which you'd think would present something of a conflict of interest in cases like this one, but Scalia's answer to that was "nuh uh" and that was that. Anyway, dude just loved shooting birds and making catastrophically bad decisions that other people had to deal with.

[2] OH IS THIS THE RULE FOR OVERTURNING LONG-SETTLED PRECEDENTS? BECAUSE ...

[3] We're against fraud, aren't we?

all publicly available information, and, hence, any material misrepresentations." The Court also noted that, rather than scrutinize every piece of public information about a company for himself, the typical "investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price" — the belief that it reflects all public, material information. As a result, whenever the investor buys or sells stock at the market price, his "reliance on any public material misrepresentations ... may be presumed for purposes of a Rule 10b–5 action."[1]

[1] Now hold up here. If an investor believes that the stock price accurately reflects the value of the corporation given all information, why would he or she — and note that the court goes with "he" throughout this opinion, despite it being a universal truth that women be shoppin' — buy the security in the first place? How can you square a belief in efficient markets with empirical evidence that investors take long or short positions in corporations even though all available information is public?

Based on this theory, a plaintiff must make the following showings to demonstrate that the presumption of reliance applies in a given case: (1) that the alleged misrepresentations were publicly known, (2) that they were material, (3) that the stock traded in an efficient market, and (4) that the plaintiff traded the stock between the time the misrepresentations were made and when the truth was revealed.

At the same time, *Basic* emphasized that the presumption of reliance was rebuttable rather than conclusive. Specifically , "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance." So for example, if a defendant could show that the alleged misrepresentation did not, for whatever reason, actually affect the market price, or that a plaintiff would have bought or sold the stock even had he been aware that the stock's price was tainted by fraud, then the presumption of reliance would not apply. In either of those cases, a plaintiff would have to prove that he directly relied on the defendant's misrepresentation in buying or selling the stock.

Halliburton contends that securities fraud plaintiffs should always have to prove direct reliance and that the *Basic* Court erred in allowing them to invoke a presumption of reliance instead. According to Halliburton, the *Basic* presumption contravenes congressional intent and has been undermined by subsequent developments in economic theory. Neither argument, however, so discredits *Basic* as to constitute "special justification" for overruling the decision.

Halliburton first argues that the *Basic* presumption is inconsistent with Congress's intent in passing the 1934 Exchange Act. We need not settle this dispute. In *Basic*, the dissenting Justices made the same argument that Halliburton presses here. The *Basic* majority did not find that argument persuasive then, and Halliburton has given us no new reason to endorse it now.

Halliburton's primary argument for overruling *Basic* is that the decision rested on two premises that can no longer withstand scrutiny. The first premise concerns what is known as the "efficient capital markets hypothesis." *Basic* stated that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." From that statement, Halliburton concludes that the *Basic* Court espoused "a robust view of market efficiency" that is no longer tenable, for "overwhelming empirical evidence now suggests that capital markets are not fundamentally efficient." To support this contention, Halliburton cites studies purporting to show that "public information is often not incorporated immediately (much less rationally) into market prices."[1]

[1] A small army of law professors filed an amicus brief supporting this position.

Halliburton's criticisms fail to take *Basic* on its own terms. Halliburton focuses on the debate among economists about the degree to which the market price of a company's stock reflects public information about the company — and thus the degree to which an investor can earn an abnormal, above-market return by trading on such information. That debate is not new. Indeed, the *Basic* Court acknowledged it and declined to enter the fray, declaring that "[w]e need not determine by adjudication what economists and social scientists have debated through the use of sophisticated statistical analysis and the application of economic theory." To recognize the presumption of reliance, the Court explained, was not "conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price." The Court instead based the presumption on the fairly modest premise that "market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices." *Basic*'s presumption of reliance thus does not rest on a "binary" view of market efficiency. Indeed, in making the presumption rebuttable, *Basic* recognized that market efficiency is a matter of degree and accordingly made it a matter of proof.

The academic debates discussed by Halliburton have not refuted the modest premise underlying the presumption of reliance. Even the foremost critics of the efficient-capital-markets hypothesis acknowledge that public information generally affects stock prices. Debates about the precise degree to which stock prices accurately reflect public information are thus largely beside the point. "That the ... price [of a stock] may be inaccurate does not detract from the fact that false statements affect it, and cause loss," which is "all that *Basic* requires." Halliburton has not identified the kind of fundamental shift in economic theory that could justify overruling a precedent on the ground that it misunderstood, or has since been overtaken by, economic realities.

* * *

Even if plaintiffs need not directly prove price impact to invoke the Basic presumption, Halliburton contends that defendants should at least be allowed to defeat the presumption at the class certification stage through evidence that the misrepresentation did not in fact affect the stock price. We agree.

There is no dispute that defendants may introduce such evidence at the merits stage to rebut the *Basic* presumption. *Basic* itself "made clear that the presumption was just that, and could be rebutted by appropriate evidence," including evidence that the asserted misrepresentation (or its correction) did not affect the market price of the defendant's stock. Nor is there any dispute that defendants may introduce price impact evidence at the class certification stage, so long as it is for the purpose of countering a plaintiff's showing of market efficiency, rather than directly rebutting the presumption.

As we explained in *Basic*, "[a]ny showing that severs the link between the alleged misrepresentation and ... the price received (or paid) by the plaintiff ... will be sufficient to rebut the presumption of reliance" because "the basis for finding that the fraud had been transmitted through market price would be gone." And without the presumption of reliance, a Rule 10b–5 suit cannot proceed as a class action: Each plaintiff would have to prove reliance individually, so common issues would not "predominate" over individual ones. Price impact is thus an essential precondition for any Rule 10b–5 class action. While *Basic* allows plaintiffs to establish that precondition indirectly, it does not require courts to ignore a defendant's direct, more salient evidence showing that the alleged misrepresentation did not actually affect the stock's market price and, consequently, that the *Basic* presumption does not apply.

* * *

More than 25 years ago, we held that plaintiffs could satisfy the reliance element of the Rule 10b–5 cause of action by invoking a presumption that a public, material misrepresentation will distort the price of stock traded in an efficient market, and that anyone who purchases the stock at the market price may be considered to have done so in reliance on the misrepresentation. We adhere to that decision and decline to modify the prerequisites for invoking the presumption of reliance.

Thomas, J., dissenting

The implied Rule 10b–5 private cause of action is "a relic of the heady days in which this Court assumed common-law powers to create causes of action." We have since ended that practice because the authority to fashion private remedies to enforce federal law belongs to Congress alone. Absent statutory authorization for a cause of action, "courts may not create one, no matter how desirable that might be as a policy matter."

Basic presented the question of how investors must prove the reliance element of the implied Rule 10b–5 cause of action — the requirement that the plaintiff buy or sell stock in reliance on the defendant's misstatement — when they transact on modern, impersonal securities exchanges. Were the Rule 10b–5 action statutory, the Court could have resolved this question by interpreting the statutory language. Without a statute to interpret for guidance, however, the Court began instead with a particular policy "problem": for investors in impersonal markets, the traditional reliance requirement was hard to prove and impossible to prove as common among plaintiffs bringing 10b–5 class-action suits. With the task thus framed as "resol[ving]" that "problem" rather than interpreting statutory text,[1] the Court turned to nascent economic theory and naked intuitions about investment behavior in its efforts to fashion a new, easier way to meet the reliance requirement. The result was an evidentiary presumption, based on a "fraud on the market" theory, that paved the way for class actions under Rule 10b–5.

[1] Even in this banger of a dissent, Thomas goes out of his way to show contempt for the relatively anodyne idea that the law should try to resolve problems — or, in his framing, "resolve" "problems". The dude remains extremely on-brand.

Today we are asked to determine whether *Basic* was correctly decided. The Court suggests that it was, and that stare decisis demands that we preserve it. I disagree. Logic, economic realities, and our subsequent jurisprudence have undermined the foundations of the *Basic* presumption, and stare decisis cannot prop up the façade that remains. *Basic* should be overruled.

Basic based the presumption of reliance on two factual assumptions. The first assumption was that, in a "well-developed market," public statements are generally "reflected" in the market price of securities. The second was that investors in such markets transact "in reliance on the integrity of that price." In other words, the Court created a presumption that a plaintiff had met the two-part, fraud-on-the-market version of the reliance requirement because, in the Court's view, "common sense and probability" suggested that each of those parts would be met.

In reality, both of the Court's key assumptions are highly contestable and do not provide the necessary support for *Basic*'s presumption of reliance. The first assumption—that public statements are "reflected" in the market price—was grounded in an economic theory that has garnered substantial criticism since *Basic*. The second assumption — that investors categorically rely on the integrity of the market price — is simply wrong.

The Court's first assumption was that "most publicly available information" — including public misstatements — "is reflected in [the] market price" of a security. The Court grounded that assumption in "empirical studies" testing a then-nascent economic theory known as the efficient capital markets hypothesis. Specifically, the Court relied upon the "semi-strong" version of that theory, which posits that the average investor cannot earn above-market returns (i.e., "beat the market") in an efficient market by trading on the basis of publicly available information. This view of market efficiency has since lost its luster. As it turns out, even "well-developed" markets (like the New York Stock Exchange) do not uniformly incorporate information into market prices with high speed. Further, and more importantly, "overwhelming empirical evidence" now suggests that even when markets do incorporate public information, they often fail to do so accurately. In sum, economists now understand that the price impact *Basic* assumed would happen reflexively is actually far from certain even in "well-developed" markets. Thus, *Basic*'s claim that "common sense and probability" support a presumption of reliance rests on shaky footing.

The *Basic* Court also grounded the presumption of reliance in a second assumption: that "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price." The Court's rather superficial analysis does not withstand scrutiny. It cannot be seriously disputed that a great many investors do not buy or sell stock based on a belief that the stock's price accurately reflects its value. Many investors in fact trade for the opposite reason — that is, because they think the market has under — or overvalued the stock, and they believe they can profit from that mispricing. Indeed, securities transactions often take place because the transacting parties disagree on the security's value.

Other investors trade for reasons entirely unrelated to price — for instance, to address changing liquidity needs, tax concerns, or portfolio balancing requirements. These investment decisions — made with indifference to price and thus without regard for price "integrity" — are at odds with *Basic* 's understanding of what motivates investment decisions. In short, *Basic*'s assumption that all investors rely in common on "price integrity" is simply wrong.

Basic's presumption of reliance also conflicts with our more recent cases clarifying Rule 23's class-certification requirements. To prevail on a motion for class certification, a party must demonstrate through "evidentiary proof" that "questions of law or fact common to class members predominate over any questions affecting only individual members." *Basic* permits plaintiffs to bypass that requirement of evidentiary proof. Plaintiffs who invoke the presumption of reliance are deemed to have shown predominance as a matter of law, even though the resulting rebuttable presumption leaves individualized questions of reliance in the case and predominance still unproved. Needless to say, that exemption was beyond the *Basic* Court's power to grant.[1]

[1] This is a good point — why are securities fraud class actions different than the other kinds of class actions that the Supreme Court has spent the last two decades reining in? Do we think it might have anything to do with who the plaintiffs are?

Principles of stare decisis do not compel us to save *Basic*'s muddled logic and armchair economics. We have not hesitated to overrule decisions when they are "unworkable or are badly reasoned" when "the theoretical underpinnings of those decisions are called into serious question" when the decisions have become "irreconcilable" with intervening developments in "competing legal doctrines or policies," or when they are otherwise "a positive detriment to coherence and consistency in the law". Just one of these circumstances can justify our correction of bad precedent; *Basic* checks all the boxes.

Basic's presumption of reliance remains our mistake to correct. Since *Basic*, Congress has enacted two major securities laws: the Private Securities Litigation Reform Act of 1995 (PSLRA) and the Securities Litigation Uniform Standards Act of 1998 (SLUSA). Neither of these Acts touched the reliance element of the implied Rule 10b–5 private cause of action or the *Basic* presumption. Contrary to respondent's argument (the majority wisely skips this next line of defense), we cannot draw from Congress' silence on this matter an inference that Congress approved of *Basic*. To begin with, it is inappropriate to give weight to "Congress' unenacted opinion" when construing judge-made doctrines, because doing so allows the Court to create law and then "effectively codif[y]" it "based only on Congress' failure to address it."[1]

[1] In this paragraph, Thomas cites exclusively to his own previous dissents, using the ol' "Clarence Thomas' Sock-Puppet Colloquy" maneuver.

That is especially true here, because Congress passed a law to tell us not to draw any inference from its inaction. The PSLRA expressly states that "[n]othing in this Act ... shall be deemed to create or ratify any implied private right of action." If the Act did not ratify even the Rule 10b–5 private cause of action, it cannot be read to ratify sub silentio the presumption of reliance this Court affixed to that action. Further, the PSLRA and SLUSA operate to curtail abuses of various private causes of action under our securities laws — hardly an indication that Congress approved of *Basic*'s expansion of the 10b–5 private cause of action.[2] Congress' failure to overturn *Basic* does not permit us to "place on the shoulders of Congress the burden of the Court's own error."

[2] Real, real, *real* shaky logic here.

* * *

Basic took an implied cause of action and grafted on a policy-driven presumption of reliance based on nascent economic theory and personal intuitions about investment behavior. The result was an unrecognizably broad cause of action ready made for class certification. Time and experience have pointed up the error of that decision, making it all too clear that the Court's attempt to revise securities law to fit the alleged "new realities of financial markets" should have been left to Congress.

Some discussion questions:

1. What is the basis for believing that a misstatement anywhere creates a "fraud on the market" everywhere?

2. Wait, what exactly is the "true" value of a share, if not the market price at any given time?

3. Do markets really have these sort of dramatic reactions to new information?

4. When Congress is silent, what is it saying?

5. As between John Roberts and Clarence Thomas, who do you think has a stronger educational background in finance? Who has more experience as a lawyer in capital markets? Who has better training in engaging in a statistical analysis of the variables that influence behavior of participants in the stock market? The answer here is: you, dear reader. You.

Loss Causation

The final element is that the misstatement caused the price to be distorted, and when the truth was revealed the plaintiff suffered economic harm. The canonical example of this is when the revelation of some corporate falsehood — accounting fraud, lies about the corporation's business, pretending that the CEO's dog was a wolf[1] — causes a corporation's stock price to tank. The damages that a plaintiff can seek are calculated by taking the difference between the inflated price at which they bought and the "true" share price after the revelation of the fraud.

[1] Elizabeth Holmes — founder of Theranos and Lady of Lothlorien wannabe — did this.

The plaintiff bears the burden of proof for loss causation, and it can be somewhat difficult to prove depending on the timing of the revelation of the fraud. If the share price drops on the day the misstatement is revealed, but it happened to be a bad day for the markets and every corporation's share price dropped (because of a massive bankruptcy, or a terrorist attack, or the first day people realized that a global pandemic might be bad for business), how do you determine what proportion of that drop is due to the revelation of the fraud? The answer is: get a bunch of nerds (statisticians, economists, anyone but lawyers) to gin up statistical analysis (usually an event study) to prove that at least some percentage of the loss was due to the revelation.

If loss causation is a necessary element for securities fraud, what happens if a manager makes a clearly false statement regarding a clearly material issue with the clear intent of broadcasting a falsehood to an investing public that relies on this kind of information — but the stock price doesn't drop? Ask Elon Musk and Tesla, who have thus far defeated several shareholder litigations regarding material misstatements made by Musk about Telsa (most famously, the claim that he was "taking Tesla private" at $420 a share[2]) on the grounds that Tesla's share price was unaffected by the revelation that the statements were false or misleading. Note here that the SEC does not

[2] Get it? GET IT? Do YoU gEt iT???

have a loss causation requirement for actions that they bring under Rule 10b-5; the feds can still get you even if private plaintiffs can't.

EVERY ONE OF THE FOUR ELEMENTS of securities fraud — Material Misstatement (Paul), Scienter (George), Reliance (Ringo), and Loss Causation (John) — are critical, though which element is most salient for any particular claim is dictated by the specific facts of the case. Plaintiffs will fight to make the case about the elements where the facts are strongest; Defendants will fight to orient the litigation around the elements where the evidence is weakest. Meanwhile, federal courts — including the Supreme Court, no shrinking daisy when it comes to assessing normative claims about fundamental human rights and the continuing viability of America as a democratic state — apply a procedurally strict but substantively light touch in mediating these disputes, preferring to let the strength of the facts and the evidence determine the viability of claims brought by investors against managers. This stands as yet more evidence that corporate law is real law — even a thoroughly and brazenly lawless body like the Supreme Court of the United States is scared to touch it.

11. *Abuse of the Corporate Form*

All the litigation in corporate law that we have seen to this point has arisen from fights between shareholders and managers in those corporations — asserting rights, demanding discretion, alleging breaches of duty, and bringing claims of fraud. Third parties,[1] if they're even mentioned, have generally been minor characters in the drama — the butlers and beat cops that exist to move the plot of the murder mystery along but aren't the protagonists or antagonists of the play. That changes now.

[1] I use the term "third party" here to refer to individuals or entities who have no investment or management position in the corporation. While they can have a contractual relationship with the corporation, they are not subject to the fiduciary duties of management, or enjoy the rights of shareholders, or have standing to bring the sorts of corporate law claims that we have discussed so far.

This chapter addresses the factual situations and legal criteria for third parties to bring tort or contract claims against shareholders of corporations instead of the corporation themselves. Called "piercing the corporate veil", this is a way for third parties to disregard the corporate form — and the all-so-important limited liability that it provides for its investors — and recover from the shareholders themselves. It is not done lightly, however — or commonly — and requires more than simply injury to a third party by a corporation. It requires plaintiffs to show an **abuse of the corporate form** by one or more shareholders in a way that would make giving those shareholders the benefit of limited liability unfair and inappropriate.

In the following pages, we will look at the tests that different courts and different states have applied to determine the threshold for disregarding the corporate form, tort and contract cases that involve piercing the corporate veil, and how corporate parents can be held liable when they do business through corporate subsidiaries under this doctrine.

Why Veil-Pierce?

But first, a simple question: why would a plaintiff go after the shareholders rather than the corporation? After all, for as rich as Apple CEO Tim Cook is,[2] Apple is far, far richer.[3] The loose change that you could find in the couches at Apple's Cupertino headquarters is

[2] Personal net worth: $1.8BN.

[3] Current Apple market cap:$2.3TN.

enough to buy and sell Tim Cook a hundred times over,[1] so if you had the choice to bring the same claims against one or other, you'd pick Apple every time. The answer to the question is that the same kind of abusive and fraudulent behavior that justifies piercing the corporate veil works to change the calculus in assessing which potential defendant offers the best chance of recovery.

[1] Current Apple cash-on-hand: $200BN

Why go after a shareholder instead of a corporation when you have claims against the corporation?

- The shareholder (whether an individual or a parent corporation) has moved all the money out of the corporation against whom the plaintiff has a claim, leaving the corporation unable to satisfy a judgment.
- The corporation has the resources to pay, but the shareholder's behaviour has opened the door to rope them into the litigation and bring new claims against them (conspiracy, tortious interference, etc.) in addition to the claims against the corporation.
- The shareholder can provide recovery that is unavailable to the corporation (disgorgement of profits, equitable relief) in satisfying the plaintiffs claims.

These are all variations on a theme, however, and that theme is: **find the deep pockets**.

i've got our man

Why go after a corporation instead of a shareholder when you have claims against the shareholder?

- If a shareholder doesn't have the personal assets to pay a judgment against them, but the corporation which they control does have the assets, the plaintiff can seek to hold the corporation liable for the obligations of the shareholder in a maneuver called "reverse veil-piercing".

  Courts use the exact same test for reverse veil-piercing that they use for veil-piercing. If the test is satisfied, the distinction between shareholder and corporation collapses and the plaintiff can seek recovery from both.

  Reverse veil-piercing is fairly uncommon. Courts are reluctant to reverse veil-pierce in situations where the corporation has other shareholders, as reverse piercing would diminish the value of their investment in the corporation as a result of behavior they did not engage in and were functionally powerless to stop. As such, reverse piercing is more likely to happen when the corporation is controlled by a single shareholder.

Both of these approaches make more sense if you think of them as "disregarding the corporate form" instead of the business with veils and piercings and whatnot, because at the end of the day the result is that the pile of money that was supposed to be the corporation's and the pile of money that was supposed to be the shareholders' are treated for equitable reasons as the same pile of money.

The Test For Veil-Piercing

Different states have different tests for piercing the corporate veil, use different terms, and often give differing levels of importance to various factors in their analysis. Realistically, cases involving veil-piercing are fact- and equity-driven, as courts are generally reluctant to chuck the protections of limited liability without a very good reason. That being said, the two most common tests are the "alter ego" test and the "instrumentality" test. Under "alter ego", plaintiffs need to show:

1 The corporation is not only influenced by the owners, but also there is such unity of ownership and interest that the separate personalities of the corporation and its owner cease to exist; and

2 The facts are such that an adherence to normal attributes ... would sanction a fraud or promote injustice.

Under "instrumentality", plaintiffs need to show:

1 The corporation was a mere instrumentality of the shareholder;

2 The shareholder exercised control over the corporation in such a way as to defraud or harm the plaintiff; and

3 The refusal to disregard the corporate entity would create an unjust loss.

Do you see a real hard and fast difference between those two tests? Yeah, neither do I. In reality, at their base all the tests require some showing that (1) due to the shareholder's actions there was no clear distinction between the corporation and the shareholder,[1] and that (2) this sleight-of-hand was used to facilitate fraud or wrongdoing (beyond just the corporation's inability to pay the damages owed the plaintiff).

[1] The "alter ego" relationship, or the "unity of interest", or a mere "instrumentality" or "domination and control" ...

Delaware uses the alter ego test. For the first prong, it requires:

> "[A]n examination of factors which reveal how the corporation operates and the particular defendant's relationship to that operation. These factors include whether the corporation was adequately capitalized for the corporate undertaking; whether the corporation was solvent; whether dividends were paid, corporate records kept, officers and directors functioned properly, and other corporate formalities were observed; whether the dominant shareholder siphoned corporate funds; and whether, in general, the corporation simply functioned as a facade for the dominant shareholder."[2]

[2] Mason v. Network of Wilmington, Inc., C.A. No. 19434-NC, (Del. Ch. Jul. 1, 2005)

For the second prong:

> "Piercing the corporate veil under the alter ego theory requires that the corporate structure cause fraud or similar injustice. Effectively, the corporation must be a sham and exist for no other purpose than as a vehicle for fraud."[1]

[1] Wallace v. Wood, 752 A.2d 1175 (Del. Ch. 1999)

The Kentucky Supreme Court has said what we're all thinking — that the tests are identical — and boils the analysis down to the two elements that we previously identified:

> "A Kentucky trial court may proceed under the traditional alter ego formulation or the instrumentality theory because the tests are essentially interchangeable. Each resolves to two dispositive elements: (1) domination of the corporation resulting in a loss of corporate separateness, and (2) circumstances under which continued recognition of the corporation would sanction fraud or promote injustice."[2]

[2] *Inter-Tel Technologies, Inc. v. Linn Station Properties, LLC*, 360 S.W.3d 152 (Ky. 2012)

The Factors For Veil-Piercing Analysis

There are a number of factors that courts consider when making a determination as to whether the corporation in question is a mere extension of the shareholder and not a separate entity. The first prong of Delaware's test lists capitalization,[3] payments of dividends, maintenance of records, observation of records, and whether the shareholder siphoned money out of the corporation as factors — but none of these factors are dispositive and that is by no means an exclusive list of things that courts examine.

[3] Whether the corporation had sufficient money to pay its bills, run its operations, satisfy its liabilities, etc.

Far and away, the most important factors that courts consider are:

- Whether there has been a misrepresentation by the shareholder/corporation (e.g., lying about who controls the corporation, using the corporation to enter into contracts with no intention of performing).
- Whether there has been commingling of corporate and shareholder assets (using personal assets to pay corporate debts or vice versa, basically treating the corporation as your personal piggy bank).
- The failure to treat the corporation as a separate entity (primarily when it comes to its business dealings but also when it comes to observing corporate formalities and corporate governance).

There are lots of different ways to articulate these core factors. California courts, bless their hearts, have managed to identify 23 (!) potential indicators that a corporation could be a sham.[4]

[4] From *Arnold v. Browne*, 27 Cal. App. 3d 386 (Cal. Ct. App. 1972).

Factors for veil-piercing:

1. Commingling of funds and assets.
2. Failure to segregate funds.
3. Diversion of funds or assets.
4. Treatment by shareholder of corporate assets as own.
5. Failure to maintain minutes.
6. Identical equitable ownership in two entities.
7. Officers and Directors of one entity same as controlled corporation.
8. Use of the same office or business location.
9. Employment of same employees.
10. Total absence of corporate assets.
11. Under-capitalization.
12. Use of Corporation as mere shell.
13. Instrumentality or conduit for single venture of another corporation.
14. Concealment or misrepresentation of the responsible ownership, management and financial interests.
15. Concealment or misrepresentation of personal business activities.
16. Disregard of legal formalities.
17. Failure to maintain arm's length relationships among related equities.
18. The use of the corporate identity to procure labor, services or merchandise for another entity.
19. The Diversion of assets from a corporation by or to a stockholder or other person or entity to the detriment of creditors.
20. The manipulation of corporate assets and liabilities in entities so as to concentrate the assets in one and the liabilities in another.
21. The contracting with another with the intent to avoid performance by use of the corporation entity as a shield against personal liability.
22. The use of the corporation as subterfuge for illegal transactions.
23. The formation and use of a corporation to transfer to it the existing liability.

Several things stand out about this list. First, a number of the items on this list are redundant (commingling and failure to segregate funds are the same thing). Second, many items on this list are not by themselves problematic (identical ownership in two entities, use of the same office). Third, a number of the items on this list are redundant (diversion of funds or assets is functionally the same as diversion of assets to the detriment of creditors). Fourth, the items on this list vary wildly in terms of actual severity (failure to maintain minutes is by no means grounds to lose limited liability, while the use of the corporation as a subterfuge for illegal transactions is extremely grounds to lose limited liability). Finally, a number of items on this list are redundant (total absence of corporate assets is the same as using the corporation as a mere shell).

To make a little more sense of why some factors are always bad (misrepresentation, commingling assets, being dodgy with the separate corporate identity) while some are only sometimes bad (sharing managers, operating related entities, being undercapitalized), it's worth teasing out the difference between correlation and causation.

Correlation, Causation, and Veil-Piercing

You might have heard the saying "correlation is not causation" — and this is true enough, though it obscures the important link between those two concepts.[1] In reality, there are a limited number of explanations for an observed correlation, and a causal relationship is one of them. Specifically, if there is an observed correlation between any two variables, it exists because of:

1. **Causation**. A causes B. Smoking cigarettes can be said to cause lung cancer, in that it directly increases the probability of the outcome.

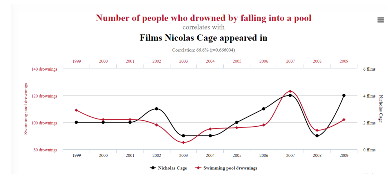
2. **Reverse Causation**. B causes A. There is a correlation between football teams running the ball and those teams winning; it used to be thought that running the ball more led to winning, but in reality winning (that is to say: leading in the game) leads to running the ball more. That's reverse causation.

3. **Confounding**. Also called omitted variable bias, this is when a common cause C influences both A and B, but if C is omitted from the analysis, that common cause creates a correlation between A and B. Did you know that the murder rate is highly correlated with sales of flip flops? It's not because people get so angry at how terrible flip flops look and go on a murderous rampage; it's because there is a common cause (summer) for both of those phenomena.

4. **"Berkson's Bias"**. A delightful form of selection bias where the inclusion — rather than the omission — of a variable induces correlation. In this, the inclusion of a common effect induces a correlation between two otherwise unrelated variables. For example,

[1] In this section, I use the broader understanding of the word "causation", which reflects a relationship in which one action or state of being contributes to a particular outcome, and is thus a causal factor for that outcome (but not necessarily the only causal factor). This is distinct from legal concepts of causation like "but-for" or "proximate" cause, which seek to identify the most important cause.

among NFL wide receivers there is a correlation between height and speed — shorter receivers tend to be faster. However, this correlation is because both height and speed are predictors of being in the NFL in the first place — and if you aren't tall, you had better be fast; if you aren't fast, you had better be tall; if you're neither, you're not in the league — so the correlation is at least in part induced by the inclusion of that common effect.



5. **Randomness**. Spurious correlation can arise completely by chance. Tests of statistical significance are used to sift out random correlations, but if the data set is large enough some things will be highly correlated simply by chance. And in the same way that a thousand monkeys sitting at a thousand typewriters will eventually write the complete works of Shakespeare, in the era of "big data" finding random correlations between variables that are completely unrelated is inevitable.

For veil-piercing factors, the important ones here are *causation* and *confounding*. Is this factor important because it influences a finding of veil-piercing (causation) or is this factor important because it is influenced by another factor that also influences veil-piercing (confounding)? Take undercapitalization, which is commonly listed as an indicative factor, and which scholarly analysis has revealed is a very common finding in cases involving veil-piercing. Firms can be undercapitalized for lots of reasons are unrelated to fraudulent conduct — maybe they are in the unprofitable early stages of a start-up, maybe they just made a large long-term investment and are illiquid, or maybe they are just bad at business — so an important question is *why* the firm is undercapitalized. As it turns out, an even more common finding in veil-piercing cases is the commingling of assets between shareholder and corporation, which is much more indicative of fraud and, importantly, is a direct cause of undercapitalization.

Similarly, academic studies have found that veil-piercing is more common in corporations that are closely-held, and even more common when the corporation has just a single shareholder. Yet despite sometimes being listed as a factor in veil-piercing, being a closely-held corporation is not, by itself, problematic. The reason that corporations who are veil-pierced tend to be closely-held is simply that if one were to want to deceive a counterparty, a closely-held corporation is going to be the type of entity one would choose because it is easier to control and use for illegitimate purposes than a corporation with many shareholders. Again, there is a common cause — a deceptive actor — between this "factor" and the outcome that creates the correlation.

As such, it might be useful to understand some of these qualities as "indicators" of the kind of fraudulent and deceptive practices that lead to veil-piercing, as distinguished from the "factors" that cause courts to pierce the corporate veil. Meanwhile, the qualities that we've previously identified as being the most important — misrepresentations to third parties, commingling of assets, and the failure to run the corporation as a separate entity — are the true causal "factors" for disregarding the corporate form.

Veil-Piercing In Tort Claims

The first cases we'll examine are those in which a party has been injured by a corporation (or, more accurately, by their employee and they are liable via *respondeat superior*) and the tort claimant seeks recovery from the corporation. As with the cases we read regarding vicarious liability for employers, one question to keep in mind as you read these opinions is whether the plaintiff had any notice as to who or what they were dealing with when they were injured.

Radaszewski by Radaszewski v. Telecom Corp., 981 F.2d 305 (8th Cir. 1992)

Arnold, C.J.

This is an action for personal injuries filed on behalf of Konrad Radaszewski, who was seriously injured in an automobile accident on August 21, 1984. Radaszewski, who was on a motorcycle, was struck by a truck driven by an employee of Contrux, Inc. The question presented on this appeal is whether the District Court had jurisdiction over the person of Telecom Corporation, which is the corporate parent of Contrux. This question depends, in turn, on whether, under Missouri law, Radaszewski can "pierce the corporate veil," and hold Telecom liable for the conduct of its subsidiary, Contrux, and Contrux's driver.

In general, someone injured by the conduct of a corporation or one of its employees can look only to the assets of the employee or of the employer corporation for recovery. The shareholders of the corporation, including, if there is one, its parent corporation, are not responsible. This is a conscious decision made by the law of every state to encourage business in the corporate form. Obviously the decision has its costs. Some injuries are going to go unredressed because of the insolvency of the corporate defendant immediately involved, even when its shareholders have plenty of money. To the general rule, though, there are exceptions. There are instances in which an injured person may "pierce the corporate veil," that is, reach the assets of one or more of the shareholders of the corporation whose conduct has created liability. In the present case, the plaintiff seeks to hold Telecom Corporation liable for the conduct of an employee of its wholly owned subsidiary, Contrux, Inc.

Under Missouri law, a plaintiff in this position needs to show three things. To "pierce the corporate veil," one must show:

1. Control, not mere majority or complete stock control, but complete domination, not only of finances, but of policy and business practice in respect to the transaction attacked so that the corporate entity as to this transaction had at the time no separate mind, will or existence of its own;[1] and

2. Such control must have been used by the defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or dishonest and unjust act in contravention of plaintiff's legal rights; and

3. The aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of.[2]

[1] In the "pretending a corporation is a person" olympics, this sentence just got the gold.

[2] This is just the same two-part test we've discussed with a "proximate cause" test from tort law stapled onto it.

It is common ground among all parties that Telecom, as such, has had no contact with Missouri. If it is subject to jurisdiction over its person in Missouri courts, it is only because of the conduct of Contrux, its subsidiary. So the issue of jurisdiction over the person depends on whether the corporate veil of Contrux can be pierced to bring Telecom into the case. The parties have treated the matter as one of jurisdiction, and so will we, but in fact the underlying issue is the same: is Telecom liable for what Contrux did?

In order to pierce the corporate veil, a plaintiff must show, among other things, that the defendant's control of a subsidiary has been used by the defendant to commit fraud or wrong, to perpetrate the violation of a statutory or other positive legal duty, or dishonest and unjust act in contravention of plaintiff's legal rights. To satisfy this element, plaintiff cites no direct evidence of improper motivation or violation of law on Telecom's part. He argues, instead, that Contrux was undercapitalized.

Undercapitalizing a subsidiary, which we take to mean creating it and putting it in business without a reasonably sufficient supply of money, has become a sort of proxy under Missouri law for this element. The reason, we think, is not because undercapitalization, in and of itself, is unlawful (though it may be for some purposes), but rather because the creation of an undercapitalized subsidiary justifies an inference that the parent is either deliberately or recklessly creating a business that will not be able to pay its bills or satisfy judgments against it. In *Consolidated Sun Ray, Inc. v. Oppenstein*, 335 F.2d 801, 806-07 (8th Cir. 1964), we said:

> Making a corporation a supplemental part of an economic unit and operating it without sufficient funds to meet obligations to those who must deal with it would be circumstantial evidence tending to show either an improper purpose or reckless disregard of the rights of others.

Here, the District Court held, and we assume, that Contrux was undercapitalized in the accounting sense. Most of the money contributed to its operation by Telecom was in the form of loans, not equity, and, when Contrux first went into business, Telecom did not pay for all of the stock that was issued to it. This is a classic instance of watered stock, of putting a corporation into business without sufficient equity investment. Telecom in effect concedes that Contrux's balance sheet was anemic, and that, from the point of view of generally accepted accounting principles, Contrux was inadequately capitalized. Telecom says, however, that this doesn't matter, because Contrux had $11,000,000 worth of liability insurance available to pay judgments like the one that Radaszewski hopes to obtain. No one can say, therefore, the argument runs, that Telecom was improperly motivated in setting up Contrux, in the sense of either knowingly or recklessly establishing it without the ability to pay tort judgments.

In fact, Contrux did have $1,000,000 in basic liability coverage, plus $10,000,000 in excess coverage. This coverage was bound on March 1, 1984, about five and one-half months before the accident involving Radaszewski. Unhappily, Contrux's insurance carrier became insolvent two years after the accident and is now in receivership. But this insurance, Telecom points out, was sufficient to satisfy federal financial-responsibility requirements. It is undisputed that the amount of insurance maintained by Contrux exceeded federal requirements, and that Contrux, at all times during its operations, was considered financially responsible by the relevant federal agency, the Interstate Commerce Commission.

The District Court rejected this argument. Undercapitalization is undercapitalization, it reasoned, regardless of insurance. The Court said:

> The federal regulation does not speak to what constitutes a properly capitalized motor carrier company. Rather, the regulation speaks to what constitutes an appropriate level of financial responsibility.

This distinction escapes us. The whole purpose of asking whether a subsidiary is "properly capitalized," is precisely to determine its "financial responsibility." If the subsidiary is financially responsible, whether by means of insurance or otherwise, the policy behind the second part of the test is met. Insurance meets this policy just as well, perhaps even better, than a healthy balance sheet.

At the oral argument, counsel for Radaszewski described the insurance company in question as "fly-by-night." He pointed out, and this is in the record, that the insurance agency that placed the coverage, Dixie Insurance Agency, Inc., was, like Contrux, a wholly owned subsidiary of Telecom. (Apparently the $1,000,000 primary policy is still in force. It is only the $10,000,000 excess policy that is inoperative on account of the insolvency of the excess carrier, Integrity Insurance Co.)

lol at “integrity”

Plaintiff argues that if the case went to trial he could show that the excess carrier “was an insurance company with wobbly knees for years before its receivership.” He also says that the excess carrier was not strong enough even to receive a minimum rating in the Best Insurance Guide. Finally, plaintiff suggests that Contrux bought “its insurance from a financially unsound company which most certainly charged a significantly lower premium.”

Here, it is beyond dispute that Contrux had insurance, and that it was considered financially responsible under the applicable federal regulations. We see nothing sinister in the fact that the insurance was purchased through an agency wholly owned by Telecom. This is a common business practice. The assertion that a reduced premium was paid is wholly without support in the record. It is based on speculation only. There is no evidence that Telecom or Contrux knew that the insurance company was going to become insolvent, and no reason, indeed, that we can think of why anyone would want to buy insurance from a company that he thought would become insolvent.

The doctrine of limited liability is intended precisely to protect a parent corporation whose subsidiary goes broke. That is the whole purpose of the doctrine, and those who have the right to decide such questions, that is, legislatures, believe that the doctrine, on the whole, is socially reasonable and useful. We think that the doctrine would largely be destroyed if a parent corporation could be held liable simply on the basis of errors in business judgment. Something more than that should be shown. In our view, this record is devoid of facts to show that “something more.”

Heaney, S.J., dissenting

I respectfully dissent. The record is more than sufficient to support a prima facie showing that personal jurisdiction over Telecom exists.

Contrux is a wholly owned subsidiary of Telecom. It was organized as a nonunion subsidiary to take advantage of the lower wage and benefit package that such status would permit. It was initially capitalized for only $25,000, even though it was to operate as a nationwide motor carrier with equipment valued at $1,000,000 or more. Tractors and trailers were purchased for Contrux by Telecom. Telecom assumed ultimate responsibility for the payment of the purchase price. Moreover, Telecom periodically advanced money to Contrux for operating expenses or guaranteed payment for such expenses, taking as security for its advances a mortgage on all the tangible assets of Contrux. Contrux's debt to Telecom eventually totaled over $750,000, all of which was secured in 1985 by a mortgage on all of Contrux's assets, leaving little or nothing for unsecured or judgment creditors.

Contrux had a negative net worth and net operating losses each of the four years that it was actively in business. Most important business decisions involving Contrux were made by Telecom because Contrux had neither the working capital nor the unencumbered assets to permit it to make decisions on its own. In every respect on the basis of the record now before us, Contrux was nothing but a shell corporation established by Telecom to permit it to operate as a nonunion carrier without regard to the consequences that might occur to those who did business with Contrux or those who might be affected by its actions.

The majority asks why anyone would want to buy insurance from an insolvent company. An answer readily comes to mind. The purchase was a cheap way of complying with federal regulations and furthered the illusion to all concerned that Contrux was a viable company able to meet its responsibilities. The record does not show that the federal regulating agency determines whether an insurance company is capable of meeting the claims that may be valid against it. The regulation is apparently satisfied simply by filing proof of insurance.

As the matter now stands, the innocent victim may have to bear most of the costs of his disabling injuries without having the opportunity to prove that Contrux was intentionally undercapitalized. I believe this is wrong and inconsistent with Missouri law. I would thus remand for trial.

Some discussion questions:

1. Is there anything Radaszewski could have done to make sure he was pancaked by a truck operated by a corporation with adequate means to pay his tort claim?

2. The dissent mentions that insurance from an shady insurer might be cheaper to purchase, and that they could have known that Integrity was about to go insolvent. How might Telecom have known that Integrity was, well, lacking?

3. Do you think Radaszewski — or, let's be honest given the physics involved in this crash here, his estate — agrees that limited liability is socially reasonable and useful in this instance?

Walkovszky v. Carlton, 18 N.Y.2d 414 (N.Y. 1966)

Fuld, J.

This case involves what appears to be a rather common practice in the taxicab industry of vesting the ownership of a taxi fleet in many corporations, each owning only one or two cabs.

The complaint alleges that the plaintiff was severely injured four years ago in New York City when he was run down by a taxicab owned by the defendant Seon Cab Corporation and negligently operated at the time by the defendant Marchese. The individual defendant, Carlton, is claimed to be a stockholder of 10 corporations, including Seon, each of which has but two cabs registered in its name, and it is implied that only the minimum automobile liability insurance required by law (in the amount of $10,000) is carried on any one cab. Although seemingly independent of one another, these corporations are alleged to be "operated as a single entity, unit and enterprise" with regard to financing, supplies, repairs, employees and garaging, and all are named as defendants. The plaintiff asserts that he is also entitled to hold their stockholders personally liable for the damages sought because the multiple corporate structure constitutes an unlawful attempt "to defraud members of the general public" who might be injured by the cabs.

The defendant Carlton[1] has moved to dismiss the complaint on the ground that as to him it "fails to state a cause of action". The Appellate Division, by a divided vote, reversed, holding that a valid cause of action was sufficiently stated. The defendant Carlton appeals to us, from the nonfinal order, by leave of the Appellate Division on a certified question.

[1] The principal shareholder.

The law permits the incorporation of a business for the very purpose of enabling its proprietors to escape personal liability but, manifestly, the privilege is not without its limits. Broadly speaking, the courts will disregard the corporate form, or, to use accepted terminology, "pierce the corporate veil", whenever necessary to prevent fraud or to achieve equity. In determining whether liability should be extended to reach assets beyond those belonging to the corporation, we are guided by general rules of agency. In other words, whenever anyone uses control of the corporation to further his own rather than the corporation's business, he will be liable for the corporation's acts upon the principle of respondeat superior applicable even where the agent is a natural person.

In the case before us, the plaintiff has explicitly alleged that none of the corporations "had a separate existence of their own" and, as indicated above, all are named as defendants. However, it is one thing to assert that a corporation is a fragment of a larger corporate combine which actually conducts the business. It is quite another to claim that the corporation is a "dummy" for its individual stockholders who are in reality carrying on the business in their personal capacities for purely personal rather than corporate ends. Either circumstance would justify treating the corporation as an agent and piercing the corporate veil to reach the principal but a different result would follow in each case. In the first, only a larger corporate entity would be held financially responsible while, in the other, the stockholder would be personally liable. Either the stockholder is conducting the business in his individual capacity or he is not. If he is, he will be liable; if he is not, then, it does not matter — insofar as his personal liability is concerned — that the enterprise is actually being carried on by a larger "enterprise entity".[1]

[1] You can think of enterprise liability as a sort of horizontal veil-piercing, where corporations controlled by the same parent can share liability for the legal obligations of one another.

The individual defendant is charged with having "organized, managed, dominated and controlled" a fragmented corporate entity but there are no allegations that he was conducting business in his individual capacity. Had the taxicab fleet been owned by a single corporation, it would be readily apparent that the plaintiff would face formidable barriers in attempting to establish personal liability on the part of the corporation's stockholders. The fact that the fleet ownership has been deliberately split up among many corporations does not ease the plaintiff's burden in that respect. The corporate form may not be disregarded merely because the assets of the corporation, together with the mandatory insurance coverage of the vehicle which struck the plaintiff, are insufficient to assure him the recovery sought. If Carlton were to be held individually liable on those facts alone, the decision would apply equally to the thousands of cabs which are owned by their individual drivers who conduct their businesses through corporations organized pursuant to the Business Corporation Law and carry the minimum insurance required by the Vehicle and Traffic Law.[2] These taxi owner-operators are entitled to form such corporations, and we agree with the [lower] court that, if the insurance coverage required by statute "is inadequate for the protection of the public, the remedy lies not with the courts but with the Legislature."[3] It may very well be sound policy to require that certain corporations must take out liability insurance which will afford adequate compensation to their potential tort victims. However, the responsibility for imposing conditions on the privilege of incorporation has been committed by the Constitution to the Legislature and it may not be fairly implied, from any statute, that the Legislature intended, without the slightest discussion or debate, to require of taxi corporations that they carry automobile liability insurance over and above that mandated by the Vehicle and Traffic Law.

[2] I love arguments like these. "Are you suggesting that our beloved New York cab companies are operating unethically and should organize in a more responsible way? The gall!"

[3] Piercing the corporate veil is an entirely judge-made doctrine, just FYI.

This is not to say that it is impossible for the plaintiff to state a valid cause of action against the defendant Carlton. However, the simple fact is that the plaintiff has just not done so here. While the complaint alleges that the separate corporations were undercapitalized and that their assets have been intermingled, it is barren of any "sufficiently particular[ized] statements" that the defendant Carlton and his associates are actually doing business in their individual capacities, shuttling their personal funds in and out of the corporations "without regard to formality and to suit their immediate convenience." Such a "perversion of the privilege to do business in a corporate form" would justify imposing personal liability on the individual stockholders. Nothing of the sort has in fact been charged, and it cannot reasonably or logically be inferred from the happenstance that the business of Seon Cab Corporation may actually be carried on by a larger corporate entity composed of many corporations which, under general principles of agency, would be liable to each other's creditors in contract and in tort.

In point of fact, the principle relied upon in the complaint to sustain the imposition of personal liability is not agency but fraud. Such a cause of action cannot withstand analysis. If it is not fraudulent for the owner-operator of a single cab corporation to take out only the minimum required liability insurance, the enterprise does not become either illicit or fraudulent merely because it consists of many such corporations. The plaintiff's injuries are the same regardless of whether the cab which strikes him is owned by a single corporation or part of a fleet with ownership fragmented among many corporations.

In sum, then, the complaint falls short of adequately stating a cause of action against the defendant Carlton in his individual capacity. The order of the Appellate Division should be reversed.

Keating, J., dissenting

The defendant Carlton, the shareholder here sought to be held for the negligence of the driver of a taxicab, was a principal shareholder and organizer of the defendant corporation which owned the taxicab. The corporation was one of 10 organized by the defendant, each containing two cabs and each cab having the "minimum liability" insurance coverage mandated by the Vehicle and Traffic Law. The sole assets of these operating corporations are the vehicles themselves and they are apparently subject to mortgages.

From their inception these corporations were intentionally undercapitalized for the purpose of avoiding responsibility for acts which were bound to arise as a result of the operation of a large taxi fleet having cars out on the street 24 hours a day and engaged in public transportation. And during the course of the corporations' existence all income was continually drained out of the corporations for the same purpose.

The issue presented by this action is whether the policy of this State, which affords those desiring to engage in a business enterprise the privilege of limited liability through the use of the corporate device, is so strong that it will permit that privilege to continue no matter how much it is abused, no matter how irresponsibly the corporation is operated, no matter what the cost to the public. I do not believe that it is.

Under the circumstances of this case the shareholders should all be held individually liable to this plaintiff for the injuries he suffered. At least, the matter should not be disposed of on the pleadings by a dismissal of the complaint. "If a corporation is organized and carries on business without substantial capital in such a way that the corporation is likely to have no sufficient assets available to meet its debts, it is inequitable that shareholders should set up such a flimsy organization to escape personal liability. The attempt to do corporate business without providing any sufficient basis of financial responsibility to creditors is an abuse of the separate entity and will be ineffectual to exempt the shareholders from corporate debts. It is coming to be recognized as the policy of law that shareholders should in good faith put at the risk of the business unincumbered capital reasonably adequate for its prospective liabilities. If capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege."[1]

[1] The court is citing a corporate treatise from the 1940s here.

The defendant Carlton claims that, because the minimum amount of insurance required by the statute was obtained, the corporate veil cannot and should not be pierced despite the fact that the assets of the corporation which owned the cab were "trifling compared with the business to be done and the risks of loss" which were certain to be encountered. I do not agree.

The Legislature in requiring minimum liability insurance of $10,000, no doubt, intended to provide at least some small fund for recovery against those individuals and corporations who just did not have and were not able to raise or accumulate assets sufficient to satisfy the claims of those who were injured as a result of their negligence. It certainly could not have intended to shield those individuals who organized corporations, with the specific intent of avoiding responsibility to the public, where the operation of the corporate enterprise yielded profits sufficient to purchase additional insurance. Moreover, it is reasonable to assume that the Legislature believed that those individuals and corporations having substantial assets would take out insurance far in excess of the minimum in order to protect those assets from depletion. Given the costs of hospital care and treatment and the nature of injuries sustained in auto collisions, it would be unreasonable to assume that the Legislature believed that the minimum provided in the statute would in and of itself be sufficient to recompense innocent victims of motor vehicle accidents for the injury and financial loss inflicted upon them.

The defendant, however, argues that the failure of the Legislature to increase the minimum insurance requirements indicates legislative acquiescence in this scheme to avoid liability and responsibility to the public. In the absence of a clear legislative statement, approval of a scheme having such serious consequences is not to be so lightly inferred.

The defendant contends that a decision holding him personally liable would discourage people from engaging in corporate enterprise. What I would merely hold is that a participating shareholder of a corporation vested with a public interest, organized with capital insufficient to meet liabilities which are certain to arise in the ordinary course of the corporation's business, may be held personally responsible for such liabilities. Where corporate income is not sufficient to cover the cost of insurance premiums above the statutory minimum or where initially adequate finances dwindle under the pressure of competition, bad times or extraordinary and unexpected liability, obviously the shareholder will not be held liable. The only types of corporate enterprises that will be discouraged as a result of a decision allowing the individual shareholder to be sued will be those such as the one in question, designed solely to abuse the corporate privilege at the expense of the public interest.

For these reasons I would vote to affirm the order of the Appellate Division.

Some discussion questions:

1. Is this veil-piercing or reverse veil-piercing? Or both?

2. What does the number of businesses operating under similar corporate structures have to do with anything? Is that part of the test?

3. Why does the court look to the legislature to determine whether a plaintiff has met a test invented by the court?

4. How would you draw the line — as the dissent does — between a corporation that lacks sufficient funds for business reasons and a corporation that lacks sufficient funds for unjust reasons?

5. After the judgment, the plaintiff was able to amend the complaint to cite with more specificity the ways that Carlton ran the business in his personal capacity (including taking money out of the corporation and its siblings), and subsequently survived another motion to dismiss. When in doubt, add more facts to your pleading.

Veil-Piercing In Contract Claims

THE NEXT CASES WE'LL EXAMINE are those in which plaintiffs use veil-piercing claims to enforce their rights against a corporation's shareholders under their contracts with the corporation. Tort and contract are obviously very distinct areas of law,[1] yet whatever test for piercing the corporate veil a court applies in tort cases is exactly the same test that the court will use in contract cases. Why is that? Even if one looks beyond the different doctrines at hand, it is clear that the plaintiffs in tort and contract claims are different, particularly in their ability to investigate the defendant's business and their powers to protect themselves via contract. Moreover, courts do not completely ignore plaintiffs in their veil-piercing analysis — that's what the fraud prong is all about — so why ignore those differences and use the same test for both cases? I dunno, man, seems bad.

[1] Yes, yes, I suppose you could posit that duties under tort are like a contract we all make with one another — a *social contract*, if you will — but the point is that the law treats them as distinct.

Kinney Shoe Corp. v. Polan, 939 F.2d 209 (4th Cir. 1991)

Chapman, S.J.

Plaintiff-appellant Kinney Shoe Corporation ("Kinney") brought this action in the United States District Court for the Southern District of West Virginia against Lincoln M. Polan ("Polan") seeking to recover money owed on a sublease between Kinney and Industrial Realty Company ("Industrial"). Polan is the sole shareholder of Industrial. The district court found that Polan was not personally liable on the lease between Kinney and Industrial. Kinney appeals asserting that the corporate veil should be pierced, and we agree.

In 1984 Polan formed two corporations, Industrial and Polan Industries, Inc., for the purpose of re-establishing an industrial manufacturing business. The certificate of incorporation for Polan Industries, Inc. was issued by the West Virginia Secretary of State in November 1984. The following month the certificate of incorporation for Industrial was issued. Polan was the owner of both corporations. Although certificates of incorporation were issued, no organizational meetings were held, and no officers were elected.[2]

[2] Strike one!

In November 1984 Polan and Kinney began negotiating the sublease of a building in which Kinney held a leasehold interest. The term of the sublease from Kinney to Industrial commenced in December 1984, even though the written lease was not signed by the parties until April 5, 1985. On April 15, 1985, Industrial subleased part of the building to Polan Industries for fifty percent of the rental amount due Kinney. Polan signed both subleases on behalf of the respective companies.

Other than the sublease with Kinney, Industrial had no assets, no income and no bank account.[1] Industrial issued no stock certificates because nothing was ever paid in to this corporation.[2] Industrial's only income was from its sublease to Polan Industries, Inc. The first rental payment to Kinney was made out of Polan's personal funds,[3] and no further payments were made by Polan or by Polan Industries, Inc. to either Industrial or to Kinney.

[1] Strike two!

[2] Strike three!

[3] Strike four! (I don't watch a lot of baseball.)

Kinney filed suit against Industrial for unpaid rent and obtained a judgment in the amount of $166,400.00 on June 19, 1987. Kinney then filed this action against Polan individually to collect the amount owed by Industrial to Kinney. Since the amount to which Kinney is entitled is undisputed, the only issue is whether Kinney can pierce the corporate veil and hold Polan personally liable.

The district court held that Kinney had assumed the risk of Industrial's undercapitalization and was not entitled to pierce the corporate veil. Kinney appeals, and we reverse.

We have long recognized that a corporation is an entity, separate and distinct from its officers and stockholders, and the individual stockholders are not responsible for the debts of the corporation. This concept, however, is a fiction of the law and it is now well settled, as a general principle, that the fiction should be disregarded when it is urged with an intent not within its reason and purpose and in such a way that its retention would produce injustices or inequitable consequences.

Piercing the corporate veil is an equitable remedy, and the burden rests with the party asserting such claim. A totality of the circumstances test is used in determining whether to pierce the corporate veil, and each case must be decided on its own facts.

Kinney seeks to pierce the corporate veil of Industrial so as to hold Polan personally liable on the sublease debt. The Supreme Court of Appeals of West Virginia has set forth a two prong test to be used in determining whether to pierce a corporate veil in a breach of contract case. This test raises two issues: first, is the unity of interest and ownership such that the separate personalities of the corporation and the individual shareholder no longer exist; and second, would an equitable result occur if the acts are treated as those of the corporation alone. Numerous factors have been identified as relevant in making this determination.

In this case, Polan bought no stock, made no capital contribution, kept no minutes, and elected no officers for Industrial. In addition, Polan attempted to protect his assets by placing them in Polan Industries, Inc. and interposing Industrial between Polan Industries, Inc. and Kinney so as to prevent Kinney from going against the corporation with assets. Polan gave no explanation or justification for the existence of Industrial as the intermediary between Polan Industries, Inc. and Kinney. Polan was obviously trying to limit his liability and the liability of Polan Industries, Inc. by setting up a paper curtain constructed of nothing more than Industrial's certificate of incorporation. These facts present the classic scenario for an action to pierce the corporate veil so as to reach the responsible party and produce an equitable result. Accordingly, we hold that the district court correctly found that the two prong test had been satisfied.

[W]hen determining whether to pierce a corporate veil a third prong may apply in certain cases.

> When, under the circumstances, it would be reasonable for [a] particular type of a party entering into a contract with the corporation, for example, a bank or other lending institution, to conduct an investigation of the credit of the corporation prior to entering into the contract, such party will be charged with the knowledge that a reasonable credit investigation would disclose. If such an investigation would disclose that the corporation is grossly undercapitalized, based upon the nature and the magnitude of the corporate undertaking, such party will be deemed to have assumed the risk of the gross undercapitalization and will not be permitted to pierce the corporate veil.

The district court applied this third prong and concluded that Kinney "assumed the risk of Industrial's defaulting" and that "the application of the doctrine of 'piercing the corporate veil' ought not and does not [apply]." While we agree that the two prong test was satisfied, we hold that the district court's conclusion that Kinney had assumed the risk is clearly erroneous.

[W]e hold that, even if it applies to creditors such as Kinney, it does not prevent Kinney from piercing the corporate veil in this case. The third prong is permissive and not mandatory. This is not a factual situation that calls for the third prong, if we are to seek an equitable result. Polan set up Industrial to limit his liability and the liability of Polan Industries, Inc. in their dealings with Kinney. A stockholder's liability is limited to the amount he has invested in the corporation, but Polan invested nothing in Industrial. This corporation was no more than a shell — a transparent shell. When nothing is invested in the corporation, the corporation provides no protection to its owner; nothing in, nothing out, no protection. If Polan wishes the protection of a corporation to limit his liability, he must follow the simple formalities of maintaining the corporation. This he failed to do, and he may not relieve his circumstances by saying Kinney should have known better.

For the foregoing reasons, we hold that Polan is personally liable for the debt of Industrial, and the decision of the district court is reversed and this case is remanded with instructions to enter judgment for the plaintiff.

Some discussion questions:

1. The test the court applies in this case has a fun little "caveat emptor" wrinkle for particular kinds of businesses — mentioned in the opinion to be banks and lending institutions — that prevents them from attempting to pierce the corporate veil. What is the rationale for this?

2. Would it be permissible for a business to conduct its leasing and purchasing through one of its subsidiaries so the rest of its business is insulated from land-related issues? If so, what makes this case distinct from that scenario?

3. The court pretty conclusively establishes that Industrial Realty was a sham, but less so Polan Industries. Why was it not necessary to establish that Polan Industries was also a sham corporation?

Freeman v. Complex Computing Company, Inc., 119 F.3d 1044 (2d Cir. 1997)

Miner, C.J.

While pursuing graduate studies under a fellowship at Columbia University in the early 1990s, [Jason] Glazier co-developed computer software with potential commercial value and negotiated with Columbia to obtain a license for the software. Columbia apparently was unwilling to license software to a corporation of which Glazier was an officer, director, or shareholder. Nonetheless, Columbia was willing to license the software to a corporation that retained Glazier as an independent contractor. The licensed corporation then could sublicense the product to others for profit.

Glazier

Accordingly, in September of 1992, C3 was incorporated, with an acquaintance of Glazier's as the sole shareholder and initial director, and Seth Akabas (a partner of Glazier's counsel in this action) as the president, treasurer and assistant secretary.[1] In November of 1992, another corporation, Glazier, Inc., of which Glazier was the sole shareholder, entered into an agreement with C3 (the "consulting agreement"). Under the consulting agreement, Glazier, Inc. was retained as an independent contractor (titled as C3's "Scientific Advisor") to develop and market Glazier's software, which was licensed from Columbia, and to provide support services to C3's clients. Glazier was designated the sole signatory on C3's bank account, and was given a written option to purchase all of C3's stock for $2,000.[2]

[1] Just name him the "official corporate stooge", this is taking forever.

[2] What a totally normal provision to put in a consulting agreement.

In September of 1993, C3 entered into an agreement with [Daniel] Freeman (the "C3-Freeman Agreement"), under which Freeman agreed to sell and license C3's computer software products for a five-year term. In exchange, C3 agreed to pay Freeman commissions on the revenue received by C3 over a ten-year period from the client-base developed by Freeman, including the revenue received from sales and licensing, maintenance and support services. The C3-Freeman Agreement included provisions relating to Freeman's compensation if C3 terminated the agreement prior to its expiration, or if C3 made a sale that did not result in revenues because of a future merger, consolidation, or stock acquisition. The agreement included an arbitration clause, as well as a provision that the entire agreement would be binding upon the heirs, legal representatives, successors and assigns of the parties.

Freeman

Schedule 1 of the C3-Freeman Agreement listed the customers from whom Freeman would receive commissions. Although C3's president signed the C3-Freeman Agreement, Glazier personally signed the periodic amendments to Schedule 1.[1] On March 24, 1994, Glazier signed an amended Schedule 1 that listed as customers, among numerous others, Thomson Financial, Banker's Trust and Chemical Bank. The amendment provided that "[t]o date, Dan Freeman has performed — and will continue to perform — material marketing services" as regards these customers.

[1] Strike Five! Wait, new case. Uhhh ... Touchdown!

On August 22, 1994, C3 and Thomson Investment Software, a unit or affiliate of Thomson, entered into a licensing agreement that granted Thomson exclusive worldwide sales and marketing rights of C3's products. Freeman contends that the licensing agreement resulted from efforts made by him over approximately nine months to bring the transaction to fruition.

In October of 1994, C3 gave Freeman the requisite 60-days notice of the termination of its agreement with him. The letter of termination, signed by Glazier,[2] explained that C3's exercise of its option to terminate Freeman's employment was "an action to combat the overly generous termination clause we committed to, and to force a renegotiation of your sales contract."[3]

[2] Free throw!

[3] You're not supposed to ... say ... that? You're not supposed to say that at all?!?

Glazier was hired in January of 1995 as Thomson Investment Software's Vice President and Director of Research and Development at a starting salary of $150,000 plus additional payments of "incentive compensation" based in part upon the revenues received by Thomson in connection with the sale or license of products developed by Glazier. On the same day, Thomson and C3 entered into an assets purchase agreement (the "Thomson Agreement" or "assets purchase agreement"). As part of the transaction, Thomson assumed C3's intellectual products, trademarks and tradenames. The Thomson Agreement set forth a list of C3 agreements assumed by Thomson, but expressly excluded the C3-Freeman Agreement. Thomson paid a total of $750,000, from which Glazier was paid $450,000 as a "signing bonus" in connection with his new employment contract; and C3 was paid $300,000, $100,000 of which was held by Thomson in an escrow account to indemnify Thomson for legal expenses in defending itself against claims arising from the assets purchase agreement, as well as for other expenses.

In May of 1995, Freeman commenced the action giving rise to this appeal. Named as defendants were C3, Thomson, and Glazier. Freeman asserted claims against C3 and, on successor liability theories, Thomson, for breach of contract. He sought relief from Glazier and Thomson for inducement of C3's alleged breach of contract and on a fraudulent conveyance theory. He estimated that he currently was due more than $100,000, and that the moneys due him in the future under the agreement would be in excess of $5 million.

Defendants contended that Freeman was obliged to arbitrate his claims against C3 in accordance with the terms of the C3-Freeman Agreement, and that the claims against Thomson and Glazier should not proceed until the arbitration was concluded. Freeman then moved to compel all three defendants to arbitrate, asserting that Glazier and Thomson were obliged to arbitrate on the theory that they were alter egos of, or successors in interest to, C3.

In a memorandum opinion dated June 28, 1996, the district court found that both C3 and Glazier should be compelled to arbitrate their disputes with Freeman in accordance with the C3-Freeman Agreement. The district court found that Glazier was subject to the arbitration clause of the C3-Freeman Agreement because he "did not merely dominate and control C3 — to all intents and purposes, he was C3" and because he held the "sole economic interest of any significance" in the corporation.

Neither party disputes that New York law applies to these issues. We review de novo the district court's legal conclusions.

A. Glazier's Equitable Ownership of C3

Glazier contends that he should not be held personally liable under a veil-piercing theory because he is not a shareholder, officer, director, or employee of C3. We reject this argument.

New York courts have recognized for veil-piercing purposes the doctrine of equitable ownership, under which an individual who exercises sufficient control over the corporation may be deemed an "equitable owner", notwithstanding the fact that the individual is not a shareholder of the corporation.

Because Glazier "exercised considerable authority over the corporation ... to the point of completely disregarding the corporate form and acting as though its assets were his alone to manage and distribute," he is appropriately viewed as C3's equitable owner for veil-piercing purposes. If there were board meetings, no minutes were kept from August

1994 through May 1995. Glazier agreed to personally indemnify C3's sole shareholder and director against any liability arising from the performance of his duties as C3's director. The president of C3 never attended a meeting of the Board of Directors. No shareholder received dividends or other distributions, despite the corporate income of $563,257 in 1994 and $200,000 from the assets sale to Thomson.

Glazier used C3 to sell his intellectual product and powers, including the software that he had co-developed at Columbia and which Columbia licensed to C3. Through payments from C3 to Glazier, Inc., he received the vast majority of the resulting revenues. Both Glazier, Inc. and C3 were located at Glazier's apartment, and Glazier was the sole signatory on C3's bank account. Glazier, Inc.'s consulting agreement with C3 expressly provided that it was terminable if Glazier himself was unable to perform or supervise the performance of Glazier, Inc.'s obligations to C3, which were described as "marketing C3's software products, developing new software products, enhancing C3's existing software products, and providing support services to C3's clients." These obligations essentially described C3's entire business.

Glazier himself gave Thomson a resume stating that from 1992 to the present, Glazier was the principal, owner and manager of C3, and that Glazier, Inc. was the predecessor to C3.[1] C3 paid over $8000 to the law firm that represented Glazier personally in his negotiations with Thomson. These negotiations resulted in Thomson employing Glazier and paying him a $450,000 signing bonus. C3 then paid Glazier, through Glazier, Inc., an additional $210,000 out of the proceeds of the assets and other funds that were in the C3 bank account following the assets purchase. After payment of taxes and other expenses, this left only $10,000 in C3's account. Freeman contends that this balance renders C3 unable to fulfill its alleged obligations to him. Additionally, Glazier had an option to purchase all the shares of C3 from its sole shareholder for $2000. Thus, at his discretion, he could have become the sole shareholder for a small payment.

[1] You really can't get more "equitable owner" than this, honestly.

The district court found that "to regard Glazier as anything but the sole stockholder and controlling person of C3 would be to exalt form over substance." Under the unique facts of the instant case, viewed in their totality, we agree that it is appropriate to treat Glazier as an "equitable owner" for veil-piercing purposes.

B. Piercing the C3 Veil

The presumption of corporate independence and limited shareholder liability serves to encourage business development. Nevertheless, that presumption will be set aside, and courts will pierce the corporate veil under certain limited circumstances. Specifically, under New York law, a plaintiff must prove that "(1) the owner has exercised such control that the corporation has become a mere instrumentality of the owner, which is the real actor; (2) such control has been used to commit a fraud or other wrong; and (3) the fraud or wrong results in an unjust loss or injury to plaintiff."

In determining whether "complete control" exists, we have considered such factors as: (1) disregard of corporate formalities; (2) inadequate capitalization; (3) intermingling of funds; (4) overlap in ownership, officers, directors, and personnel; (5) common office space, address and telephone numbers of corporate entities; (6) the degree of discretion shown by the allegedly dominated corporation; (7) whether the dealings between the entities are at arms length; (8) whether the corporations are treated as independent profit centers; (9) payment or guarantee of the corporation's debts by the dominating entity, and (10) intermingling of property between the entities. No one factor is decisive. In this case, there is little question that Glazier exercised "complete control" over C3.

As discussed in the context of equitable ownership, the record is replete with examples of Glazier's control over C3. Therefore, the district court's finding of control was not erroneous. However, the district court erred in the decision to pierce C3's corporate veil solely on the basis of a finding of domination and control. "While complete domination of the corporation is the key to piercing the corporate veil, such domination, standing alone, is not enough; some showing of a wrongful or unjust act toward plaintiff is required." Thus, while we accept the district court's factual finding that Glazier controlled C3, we remand to the district court the issue of whether Glazier used his control over C3 to commit a fraud or other wrong that resulted in unjust loss or injury to Freeman. Though there is substantial evidence of such wrongdoing, a finding on this issue must be made in the first instance by the district court before veil-piercing occurs.

Godbold, S.J., concurring in part, dissenting in part

I concur in affirming the district court's holding that Glazier was in total control of C3. I see no need, however, to remand the case to the district court for it to determine whether "Glazier used his control over C3 to commit a fraud or other wrong that resulted in an unjust loss or injury to Freeman." The record before us discloses fraud or other wrong by Glazier, through C3, resulting in an unjust loss or injury to Freeman. Consequently C3's corporate veil is to be pierced, and, without more, arbitration should proceed against Glazier as well as C3.

In some "corporate veil" cases one must search the record for evidence shedding light on whether an individual's control of the corporation has been used to commit a fraud or wrong resulting in unjust loss or injury.

Not in this case. Here it all hangs out.

C3 is Glazier's creature, subject to his "complete control". C3 agreed with Freeman for him to sell and license C3's software products for five years and to receive commissions for ten years on revenue received from Freeman's clients. Plus, if C3 merged or consolidated, Freeman was to receive an additional payment of 10% percent of the total consideration conveyed. The agreement contained a termination clause. C3 could terminate on sixty days notice, but Freeman was entitled to receive all compensation for services previously rendered as well as the commissions that accrued over a ten year period (presumably to include 10% percent of the consideration for a buy out or merger).

It remained for C3 to get rid of Freeman. It did so by a purported termination of the C3-Freeman agreement. C3 recited that it was exercising its option to terminate as "an action to combat the overly generous termination clause we committed to, and to force a renegotiation of your sales contract." In short, Freeman was not to receive the benefits guaranteed him by the termination clause; the termination was to force him to give up the "overly generous" termination benefits he was entitled to receive. The asserted termination was not to implement the provision for termination but in derogation of it.

By this Tinker-to-Evans-to-Chance play:[1]

[1] "Like one of Mordecai 'Three Finger' Brown's patented screwballs ...".

- C3's business has gone to Thomson.
- Thomson has handsomely rewarded Glazier.
- Thomson, in acquiring C3, has not assumed responsibility for the Freeman agreement.
- Glazier is enjoying the generous fruits of the C3-Thomson deal while C3 has been reduced to a shell.
- Freeman has been stripped of his benefits, paid nothing, and hung out to dry, on the asserted ground that benefits (past and future) agreed to be paid to him by C3 were too generous.

This is fraud by Glazier — a fully revealed rip off.[2] But if one shrinks from the word "fraud" it is at least a "wrongful injury." We should not hesitate to say so at the appellate level, for the record is clear.

[2] A swindle! A fast one! The old one-two-buckle-my-shoe!

SOME DISCUSSION QUESTIONS:

1. Was Glazier Inc. a sham? Did it get pierced?
2. Could C3's nominal shareholder be liable under the corporate veil-piercing doctrine?

3. When this sucker got sent back down to the district court, do you think they had any trouble showing that fraud had been committed?

You might think it coincidental that both tort claimants in this book lost but both contract claimants in this book won, but studies have shown that piercing the corporate veil does succeed more often in contract disputes than in tort claims. This disparity is somewhat strange, given the fact that tort claimants should have stronger claims of injustice than contract claimants, as the latter had the ability to do due diligence before they put their name on the dotted line and got into business with the defendant. However, there are several possible reasons for the differing outcomes:

- It could be an effect of how often veil-piercing is plead in tort cases versus contract cases, and also the relative strength of cases in which they are brought.[1]
- Somewhat counterintuitively, the negotiation process can work in favor of contract claimants. Misrepresentation is a powerful factor in choosing to veil-pierce, and the negotiation of a contract offers opportunities for malefactors to make those misrepresentations.
- Similarly, it may be easier to prove the "fraud" prong of the test in contract cases, as in those it can be shown that the defendant had a specific fraud in mind, as opposed to the more general fraud of operating a deliberately undercapitalized corporation.

[1] That is to say: selection bias.

Or maybe courts are just more annoyed with businesses abusing the corporate form in their dealings with other businesses than they are sympathetic to random people injured by those businesses? But that would imply that the law is a tool of *capital* rather than *justice*, and that simply can't be right. Moving along!

Corporate Conglomerates and Veil-Piercing

THE FINAL CASES WE'LL EXAMINE explore veil-piercing issues (in tort and and in contract) within corporate groups.[2] We have already seen attempted veil-piercing of a corporation through its subsidiary (in *Radaszewski*) and attempted veil-piercing of a corporate group (one of the two veil-piercing claims in *Walkovsky*), but it worth examining how the ways that a corporation's practices vis-a-vis their subsidiaries may open themselves up to liability through piercing of the corporate veil.

[2] I will note briefly here that you will occasionally see cases where an individual shareholder conducts business through a chain of sham corporations — one sham corporation is a subsidiary of another sham corporation, which itself is the "alter ego" of a single shareholder. While those technically involve veil-piercing in the parent-subsidiary relationship (because courts will pierce multiple entities to get to the actual party in charge), this section will deal with corporations operating legitimate businesses through corporate subsidiaries.

Gardemal v. Westin Hotel Company, 186 F.3d 588 (5th Cir. 1999)

DeMoss, C.J.

Lisa Cerza Gardemal sued Westin Hotel Company ("Westin") and Westin Mexico, S.A. de C.V. ("Westin Mexico"), under Texas law, alleging that the defendants were liable for the drowning death of her husband in Cabo San Lucas, Mexico. The district court dismissed the suit in accordance with the magistrate judge's recommendation that the court grant Westin's motion for summary judgment, and Westin Mexico's motion to dismiss for lack of personal jurisdiction. We affirm the district court's rulings.

In June 1995, Gardemal and her husband John W. Gardemal, a physician, traveled to Cabo San Lucas, Baja California Sur, Mexico, to attend a medical seminar held at the Westin Regina Resort Los Cabos ("Westin Regina"). The Westin Regina is owned by Desarollos Turisticos Integrales Cabo San Lucas, S.A. de C.V. ("DTI"), and managed by Westin Mexico. Westin Mexico is a subsidiary of Westin, and is incorporated in Mexico. During their stay at the hotel, the Gardemals decided to go snorkeling with a group of guests. According to Gardemal, the concierge at the Westin Regina directed the group to "Lovers Beach" which, unbeknownst to the group, was notorious for its rough surf and strong undercurrents. While climbing the beach's rocky shore, five men in the group were swept into the Pacific Ocean by a rogue wave and thrown against the rocks. Two of the men, including John Gardemal, drowned.[1]

[1] I find this plaintiff extremely sympathetic for many reasons, not least of which is because this is definitely a way I would die.

Gardemal, as administrator of her husband's estate, brought wrongful death and survival actions under Texas law against Westin and Westin Mexico, alleging that her husband drowned because Westin Regina's concierge negligently directed the group to Lovers Beach and failed to warn her husband of its dangerous condition. Westin then moved for summary judgment, alleging that although it is the parent company of Westin Mexico, it is a separate corporate entity and thus could not be held liable for acts committed by its subsidiary. The magistrate judge agreed with Westin, and recommended that Westin be dismissed from the action. After Westin filed its motion for summary judgment, Westin Mexico also moved to dismiss the suit. Finding that there was neither general nor specific jurisdiction over Westin Mexico, the magistrate judge concluded that personal jurisdiction was in fact lacking and recommended that Westin Mexico be dismissed.

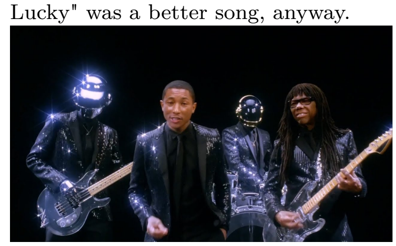
Gardemal now appeals, alleging that the district court erred in granting Westin's motion for summary judgment, and Westin Mexico's motion to dismiss. We affirm.

In this action Gardemal seeks to hold Westin liable for the acts of Westin Mexico by invoking two separate, but related, state-law doctrines.

Gardemal first argues that liability may be imputed to Westin because Westin Mexico functioned as the alter ego of Westin. Gardemal next contends that Westin may be held liable on the theory that Westin Mexico operated a single business enterprise.

Under Texas law the alter ego doctrine allows the imposition of liability on a corporation for the acts of another corporation when the subject corporation is organized or operated as a mere tool or business conduit. It applies "when there is such unity between the parent corporation and its subsidiary that the separateness of the two corporations has ceased and holding only the subsidiary corporation liable would result in injustice." Alter ego is demonstrated "by evidence showing a blending of identities, or a blurring of lines of distinction, both formal and substantive, between two corporations.[1] An important consideration is whether a corporation is underfunded or undercapitalized, which is an indication that the company is a mere conduit or business tool.

[1] I was gonna reference the song, but that guy's been canceled, right? Probably for the best — "Get Lucky" was a better song, anyway.



On appeal Gardemal points to several factors which, in her opinion, show that Westin is operating as the alter ego of Westin Mexico. She claims, for example, that Westin owns most of Westin Mexico's stock; that the two companies share common corporate officers; that Westin maintains quality control at Westin Mexico by requiring Westin Mexico to use certain operations manuals; that Westin oversees advertising and marketing operations at Westin Mexico through two separate contracts; and that Westin Mexico is grossly undercapitalized. Gardemal places particular emphasis on the last purported factor, that Westin Mexico is undercapitalized. We are not convinced.

The record, even when viewed in a light most favorable to Gardemal, reveals nothing more than a typical corporate relationship between a parent and subsidiary. It is true, as Gardemal points out, that Westin and Westin Mexico are closely tied through stock ownership, shared officers, financing arrangements, and the like. But this alone does not establish an alter-ego relationship.

The control necessary is not mere majority or complete stock control but such domination of finances, policies and practices that the controlled corporation has, so to speak, no separate mind, will or existence of its own and is but a business conduit for its principal. Thus, "one-hundred percent ownership and identity of directors and officers are, even together, an insufficient basis for applying the alter ego theory to pierce the corporate veil."

In this case, there is insufficient record evidence that Westin dominates Westin Mexico to the extent that Westin Mexico has, for practical purposes, surrendered its corporate identity. In fact, the evidence suggests just the opposite, that Westin Mexico functions as an autonomous business entity. There is evidence, for example, that Westin Mexico banks in Mexico and deposits all of the revenue from its six hotels into that account. The facts also show that while Westin is incorporated in Delaware, Westin Mexico is incorporated in Mexico and faithfully adheres to the required corporate formalities. Finally, Westin Mexico has its own staff, its own assets, and even maintains its own insurance policies.[1]

[1] This honestly reads like the judge is proud of Westin Mexico. "My little subsidiary is all grown-up!"

In this case, there is insufficient evidence that Westin Mexico is undercapitalized or uninsured. Moreover, there is no indication that Gardemal could not recover by suing Westin Mexico directly. As a result, equity does not demand that we merge and disregard the corporate identities of Westin and Westin Mexico. We reject Gardemal's attempt to impute liability on Westin based on the alter-ego doctrine.

Likewise, we reject Gardemal's attempt to impute liability to Westin based on the single business enterprise doctrine. Under that doctrine, when corporations are not operated as separate entities, but integrate their resources to achieve a common business purpose, each constituent corporation may be held liable for the debts incurred in pursuit of that business purpose. Like the alter-ego doctrine, the single business enterprise doctrine is an equitable remedy which applies when the corporate form is "used as part of an unfair device to achieve an inequitable result."

On appeal, Gardemal attempts to prove a single business enterprise by calling our attention to the fact that Westin Mexico uses the trademark "Westin Hotels and Resorts." She also emphasizes that Westin Regina uses Westin's operations manuals. Gardemal also observes that Westin allows Westin Mexico to use its reservation system. Again, these facts merely demonstrate what we would describe as a typical, working relationship between a parent and subsidiary. Gardemal has pointed to no evidence in the record demonstrating that the operations of the two corporations were so integrated as to result in a blending of the two corporate identities. Moreover, Gardemal has come forward with no evidence that she has suffered some harm, or injustice, because Westin and Westin Mexico maintain separate corporate identities.

Reviewing the record in the light most favorable to Gardemal, we conclude that there is insufficient evidence that Westin Mexico was Westin's alter ego. Similarly, there is insufficient evidence that the resources of Westin and Westin Mexico are so integrated as to constitute a single business enterprise. Accordingly, we affirm the district court's grant of Westin's motion for summary judgment on that issue. We turn next to whether the district court erred in granting Westin Mexico's motion to dismiss for lack of personal jurisdiction.

On appeal Gardemal contends that the district court has specific jurisdiction over Westin Mexico because her husband decided to attend the seminar after reading a brochure about the Westin Regina resort. We disagree. As noted by the district court, the record reflects that the medical seminar at Cabo San Lucas was arranged and promoted by Smith Nephew Richards, Inc., a supplier of orthopedic hardware. The facts also show that the Gardemals obtained the brochure from Smith Nephew Richards, Inc. with the registration materials for the seminar. There is no specific evidence that Westin Mexico, or the Westin Regina, were involved in promoting the seminar or soliciting the Gardemals. Accordingly, there is simply no basis for the exercise of specific jurisdiction over Westin Mexico.

We conclude that the district court did not err in finding that personal jurisdiction is lacking over Westin Mexico. We affirm the district court's grant of Westin Mexico's motion to dismiss.

SOME DISCUSSION QUESTIONS:

1. Why do you think plaintiffs wanted to go after Westin rather than Westin's Mexican subsidiary? Was it just the personal jurisdiction issue?
2. Internal to the corporations, they shared overlapping management, personnel, and policies. External to the corporations, they used the same logos, advertisements, and booking websites. Which of these mattered more to the determination?
3. Is this court analyzing this under the same tests involving individual shareholders (like in *Walkovsky*) or is there a different analysis?

OTR Associates v. IBC Services, Inc., 353 N.J. Super. 48 (App. Div. 2002)

Pressler, J.

The single dispositive issue raised by this appeal is whether the trial court, based on its findings of fact following a bench trial, was justified, as a matter of law, in piercing the corporate veil and thus holding a parent corporation liable for the debt incurred by its wholly owned subsidiary. We are satisfied that the facts, both undisputed and as found, present a textbook illustration of circumstances mandating corporate-veil piercing.[1]

[1] Not a typo, the court seems to think it's "corporate-veil piercing". Weird.

Plaintiff OTR Associates, a limited partnership, owns a shopping mall in Edison, New Jersey, in which it leased space in 1985 for use by a Blimpie franchisee, Samyrna, Inc., a corporation owned by Sam Iskander and his wife. The franchise agreement, styled as a licensing agreement, had been entered into in 1984 between Samyrna and the parent company, then known as International Blimpie Corporation, whose name was changed in 1985 to Astor Restaurant Group, Inc., and again in 1991 or

1992 to Blimpie International, Inc. Thus the three names denote the same corporation at different stages of its existence, and we refer to it hereafter as Blimpie. Blimpie was the sole owner of a subsidiary named IBC Services, Inc. (IBC), created for the single purpose of holding the lease on premises occupied by a Blimpie franchisee. Accordingly, it was IBC that entered into the lease with OTR in July 1985 and, on the same day and apparently with OTR's consent, subleased the space to the franchisee. The history of the tenancy was marked by regular and increasingly substantial rent arrearages, and it was terminated by a dispossess judgment and warrant for removal in 1996. In 1998 OTR commenced this action for unpaid rent, then in the amount of close to $150,000, against Blimpie under both its present name and its former name, International Blimpie Corporation. It also joined as defendants the leasing subsidiary, IBC, as well as Garden State Blimpie, Inc., another wholly-owned leaseholding subsidiary of Blimpie to whom IBC had assigned the lease in 1991 without notice to the landlord in violation of the terms of the lease requiring such notice. The action was tried in December 2000, and judgment was entered in favor of OTR against Blimpie as well as the two judgment-proof subsidiaries in the full amount of the rent arrearages plus interest thereon, then some $208,000. Blimpie appeals, and we affirm.

We consider the facts in the context of the well-settled principles respecting corporate-veil piercing. Nearly three-quarters of a century ago, the Court of Errors and Appeals, made clear that while "ownership alone of capital stock in one corporation by another, does not create any relationship that by reason of which the stockholding company would be liable for torts of the other," nevertheless "[w]here a corporation holds stock of another, not for the purpose of participating in the affairs of the other corporation, in the normal and usual manner, but for the purpose of control, so that the subsidiary company may be used as a mere agency or instrumentality for the stockholding company, such company will be liable for injuries due to the negligence of the subsidiary." The conceptual basis of the rule, which is equally applicable to contractual obligations, is simply that "[i]t is where the corporate form is used as a shield behind which injustice is sought to be done by those who have control of it that equity penetrates the [corporate] veil."

Thus, the basic finding that must be made to enable the court to pierce the corporate veil is "that the parent so dominated the subsidiary that it had no separate existence but was merely a conduit for the parent." But beyond domination, the court must also find that the "parent has abused the privilege of incorporation by using the subsidiary to perpetrate a fraud or injustice, or otherwise to circumvent the law." And the hallmarks of that abuse are typically the engagement of the subsidiary in no independent business of its own but exclusively the performance of a service for the parent and, even more importantly, the undercapitalization of the subsidiary rendering it judgment-proof.[1]

Blimpie concedes that it formed IBC for the sole purpose of holding the lease on the premises of a Blimpie franchisee. It is also clear that IBC had virtually no assets other than the lease itself, which, in the circumstances, was not an asset at all but only a liability since IBC had no independent right to alienate its interest therein but was subject to Blimpie's exclusive control. It had no business premises of its own, sharing the New York address of Blimpie. It had no income other than the rent payments by the franchisee, which appear to have been made directly to OTR. It does not appear that it had its own employees or office staff. We further note that Blimpie not only retained the right to approve the premises to be occupied by the franchisee and leased by IBC, but itself, in its Georgia headquarters, managed all the leases held by its subsidiaries on franchisee premises. As explained by Charles G. Leaness, presently Executive Vice-President of Blimpie and formerly corporate counsel as well as vice-president and secretary of IBC, in 1996, the year of IBC's eviction for non-payment of rent, he was Blimpie's Corporate Counsel Compliance Officer. Blimpie, he testified, is exclusively a franchising corporation with "hundreds and hundreds" of leases held by its wholly-owned leasehold companies,[2] which are, however, overseen by Blimpie's administrative assistants, that is "people in our organization that ... do this as their everyday job." Leaness also made clear that the leasing companies, whose function he explained as assisting franchisees in negotiating leases, "don't make a profit. There's no profit made in a leasehold."

Domination and control by Blimpie of IBC is patent and was not, nor could have been, reasonably disputed. The question then is whether Blimpie abused the privilege of incorporation by using IBC to commit a fraud or injustice or other improper purpose. We agree with the trial judge that the evidence overwhelmingly requires an affirmative answer. The leit motif of the testimony of plaintiff's partners who were involved in the dealings with IBC was that they believed that they were dealing with Blimpie, the national and financially responsible franchising company, and never discovered the fact of separate corporate entities until after the eviction. While it is true that IBC never apparently expressly claimed to be Blimpie, it not only failed to explain its relationship to Blimpie as a purported independent company but it affirmatively, intentionally, and calculatedly led OTR to believe it was Blimpie. Illustratively, when OTR was pre-leasing space in the mall, the first approach to it was the appearance at its on-site office of two men in Blimpie uniforms who announced that they wanted to open a Blimpie sandwich shop. One of the men was the franchisee, Iskander.[3] The other was never identified but presumably was someone with a connection to Blimpie. It is also true

[1] Think of undercapitalization as accelerant, like gasoline with fire. Harmless on its own, but it makes an existing problem so much worse.

[2] So much stale bread. So much wet meat.

[3] King of Gondor-ass name.

that the named tenant in the lease was IBC Services, Inc., but the tenant was actually identified in the first paragraph of the lease as "IBC Services, Inc. having an address at c/o International Blimpie Corporation, 1414 Avenue of the Americas, New York, New York." It hardly required a cryptographer to draw the entirely reasonable inference that IBC stood for International Blimpie Corporation, Blimpie's corporate name when the lease was executed. The suggestion, unmistakably, was that IBC was either the corporate name or a trading-as name and that International Blimpie Corporation was the other of these two possibilities.

Beyond the circumstances surrounding the commencement of the tenancy relationship, the correspondence through the years between plaintiff and the entity it believed to be its tenant confirmed plaintiff's belief that Blimpie was its tenant. Blimpie's letters to OTR were on stationary headed only by the Blimpie logo. There is nothing in any of that correspondence that would have suggested the existence of an independent company standing between the franchisor and the franchisee, and, indeed, the correspondence received by OTR from its lessee typically referred to the sub-tenant, Samyrna, as "our franchisee."

We agree with the trial judge that the inference is ineluctable and virtually conceded by Blimpie that IBC was created as a judgment-proof corporation for the sole purpose of insulating Blimpie from any liability on the lease in the event of the franchisee's default, a purpose found by the trial judge to have been deliberately concealed by Blimpie by its conduct in creating the impression from the outset of the tenancy relationship and throughout its duration that it and IBC were one and the same. We reject Blimpie's contention of the irrelevancy of its conduct after execution of the lease that tended to confirm to plaintiff that it was the actual tenant. As we have noted, the franchisee was habitually late and in arrears in its rent payments. We think it clear that if OTR had any suspicion that its tenant was a judgment-proof corporation, it would not have forborne over the years as the arrearages continued to accumulate but would have taken steps to regain possession long before the tenant's obligations reached $150,000.

As we understand Blimpie's defense and its argument on this appeal, it asserts that it is entitled to the benefit of the separate corporate identities merely because IBC observed all the corporate proprieties — it had its own officers and directors albeit interlocking with Blimpie's, it filed annual reports, kept minutes, held meetings, and had a bank account. But that argument begs the question. The separate corporate shell created by Blimpie to avoid liability may have been mechanistically impeccable, but in every functional and operational sense, the subsidiary had no separate identity. It was moreover not intended to shield the parent from responsibility for its subsidiary's obligations but rather to shield the parent from its own obligations. And that is an evasion and an improper purpose, fraudulently conceived and executed. The corporate veil was properly pierced.

SOME DISCUSSION QUESTIONS:

1. Why the different outcomes in these two cases? Was there any allegation that in either case corporate formalities were not followed? (What does this tell you about the comparative importance of corporate formalities?)

2. Is this court analyzing this under the same tests involving individual shareholders (in *Freeman* or *Kinney*) or is there a different analysis?

3. The law firm Gibson Dunn has offered up some helpful tips for avoiding veil-piercing in corporate parent-subsidiary relationships.[1] Which of these tips would have been helpful in the *OTR* case?

[1] From Robert A. Klyman, Lori Zyskowski, John M. Pollack, and Sabina Jacobs Margot, "Strategies Regarding Corporate Veil Piercing and Alter Ego Doctrine", July 31, 2018:

(1) Adequately capitalize each subsidiary
(2) Keep subsidiaries solvent
(3) Adequately separate management
(4) Avoid excessive parental control
(5) Comply with corporate formalities
(6) Consolidate each business's assets in separate subsidiaries
(7) Conduct subsidiary business in its own name
(8) Separate offices
(9) Separate bank accounts
(10) Separate books and records
(11) Maintain financial integrity
(12) Separate employees
(13) Document intercompany transactions
(14) Intercompany transactions should be fair
(15) Be mindful about directors and officers

A Note On "Veil-Peeking"

For example, in Dole Food Co. v. Patrickson, 538 U.S. 468 (2003), A foreign state must itself own a majority of a corporation's shares if the corporation is to be deemed an instrumentality of the state under the Foreign Sovereign Immunities Act (and thus subject to removal).

12. *The Limited Liability Company*

The story of the limited liability company, the final type of business entity we consider in this casebook, begins in Wyoming, for some reason. In 1977, Wyoming — perhaps in a bid to become the Delaware of the West[1] — passed the first enabling statute for limited liability companies (LLCs), a new non-corporate, non-partnership business entity dreamed up by a group of tax and business lawyers looking for an alternative to general and limited partnerships.[2] The idea behind the LLC was to create an entity with limited liability for all its members (like a corporation), the option of pass-through taxation (like a partnership), with the possibility of having just a single investor (unlike a partnership), and with few statutory formalities (unlike a corporation). Once the pass-through taxation piece of it was formally approved by the IRS in 1988, LLCs took off and by 1996 every single state had passed a statute enabling the formation of LLCs for business purposes.

[1] How depressing is that concept?

[2] The limited liability partnership had yet to come into being.

Fitting for an entity birthed by a group of corporate lawyers[3] — as opposed to the British crown (corporations) or a bunch of Italian merchants (general and limited partnerships) — LLCs are creatures of contract, with governance issues left to be determined by the parties involved. In an LLC, the central document is called an **Operating Agreement**, investors are called **members**, and managers are called — get this — **managers**.[4] Beyond a few key restrictions, which we'll discuss momentarily, the rights, duties, powers, obligations, and expectations of investors and managers in an LLC are governed entirely by the agreement.

[3] Ew.

[4] The actual investment interests can be called whatever the parties want: shares, units, percentages; go nuts with this part, is what I'm saying.

This combination of contractual flexibility, pass-through taxation, and loose requirements for management has proved to be extremely popular, especially for small businesses (though large businesses use them, too, often as subsidiaries of traditional corporations). This popularity, in turn, has created an interesting sort of natural experiment for legal debates about what exactly a corporation is. Is a corporation a fundamentally *social* phenomenon, an entity created by the state for the general benefit of the public that can and should be responsive to the needs of the public — or at least be regulated with the greater good of society in mind?[1] Or is a corporation merely a nexus of contracts, the product of bargaining between private individuals representing their own personal interests, beholden only to those with whom it contracts, which for reasons of efficiency and the principles of freedom can and should be left unregulated by the state, hands off, go away, *mine,* ***mine, MINE***?[2]

[1] Sometimes called "team production" or "concession" theory, it is most closely associated with the late law professor Lynn Stout and Senator Elizabeth Warren.

[2] Called the "contractarian" theory, this is a distinctly law-and-economics phenomenon, and its development can be traced back to the patron saint of invisible-hand, assume-a-can-opener-type market fundamentalists everywhere, Milton Friedman.

The LLC is essentially a dream come true for adherents to the latter view, and (at least in your humble author's view) a tacit acknowledgement that the corporation was and is way more than just a bundle of contracts, because LLCs can and do operate in ways distinct from the other kinds of business entities in ways both anticipated and not. Untethered from corporate law principles, judicial oversight, and statutory rules shaping their foundational documents, LLCs offer businesses a remarkable amount of freedom in how they are governed, but also a variety of new and interesting ways to totally melt down. LLCs, in short, can get *wild*.

In this chapter, we take a look at the properties of LLCs (with an eye towards how they are like and unlike partnerships and corporations), their formation (and the central importance of the operating agreement), the existence (or not) of fiduciary duties in an LLC, and then take a look at some conflicts and issues that can arise when running a business through an LLC.

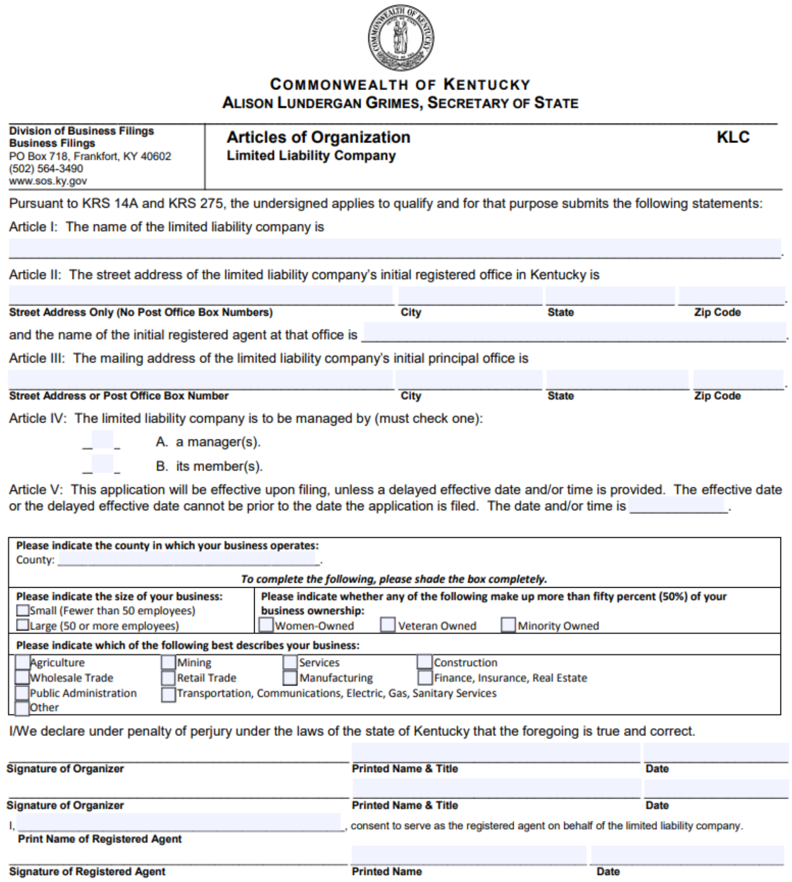
The Basics of Limited Liability Companies

An LLC is formed by filing the articles of organization[3] with the state. The articles of organization are extremely bare-bones — even more so than a corporation's articles of incorporation — and serve to put both the state and counterparties on notice that the LLC exists, and to provide some basic information.

[3] a.k.a. "certificate of organization" in some states.

The articles of organization are generally required to have the name of the LLC (which must contain the acronym "LLC"), the address of the principal office, the name and address of the registered agent, and a designation about whether the LLC will be member-managed or manager-managed.[4] Some states require LLCs to list a purpose (just fill in "any lawful activity"), designate whether the LLC is perpetual or for a specific term, and/or provide information about the initial members — though those kinds of questions are not universal. A typical state LLC filing form looks like this:

[4] We will cover this distinction in a second, but basically an LLC's management structure can be like a partnership (member-managed) or like a corporation (manager-managed).



COMMONWEALTH OF KENTUCKY
ALISON LUNDERGAN GRIMES, SECRETARY OF STATE

Division of Business Filings
Business Filings
PO Box 718, Frankfort, KY 40602
(502) 564-3490
www.sos.ky.gov

Articles of Organization
Limited Liability Company
KLC

Pursuant to KRS 14A and KRS 275, the undersigned applies to qualify and for that purpose submits the following statements:

Article I: The name of the limited liability company is ______________________.

Article II: The street address of the limited liability company's initial registered office in Kentucky is

______ Street Address Only (No Post Office Box Numbers) ______ City ______ State ______ Zip Code.

and the name of the initial registered agent at that office is ______________________.

Article III: The mailing address of the limited liability company's initial principal office is

______ Street Address or Post Office Box Number ______ City ______ State ______ Zip Code.

Article IV: The limited liability company is to be managed by (must check one):

___ A. a manager(s).

___ B. its member(s).

Article V: This application will be effective upon filing, unless a delayed effective date and/or time is provided. The effective date or the delayed effective date cannot be prior to the date the application is filed. The date and/or time is ____________.

Please indicate the county in which your business operates:
County: ______________________.

To complete the following, please shade the box completely.

Please indicate the size of your business:
☐ Small (Fewer than 50 employees)
☐ Large (50 or more employees)

Please indicate whether any of the following make up more than fifty percent (50%) of your business ownership:
☐ Women-Owned ☐ Veteran Owned ☐ Minority Owned

Please indicate which of the following best describes your business:
☐ Agriculture ☐ Mining ☐ Services ☐ Construction
☐ Wholesale Trade ☐ Retail Trade ☐ Manufacturing ☐ Finance, Insurance, Real Estate
☐ Public Administration ☐ Transportation, Communications, Electric, Gas, Sanitary Services
☐ Other

I/We declare under penalty of perjury under the laws of the state of Kentucky that the foregoing is true and correct.

Signature of Organizer ______ Printed Name & Title ______ Date ______

Signature of Organizer ______ Printed Name & Title ______ Date ______

I, ______________________, consent to serve as the registered agent on behalf of the limited liability company.
Print Name of Registered Agent

Signature of Registered Agent ______ Printed Name ______ Date ______

This is about as elaborate as these forms get.

SIMULTANEOUS WITH THE FILING OF THE ARTICLES OF ORGANIZATION, the founders of an LLC will create and enter into an operating agreement (the rough equivalent of a partnership agreement for a partnership), which does not have to be filed with the state. The operating agreement sets forth the terms that govern the finances, obligations, rights, and duties of the LLC's managers and members. Because LLCs are treated as almost entirely creations of contract, the terms of the operating agreement control every aspect of LLC governance, without regard to concerns of equity or fairness. What the operating agreement says, goes.

Under many state LLC statutes (including Delaware's), however, an LLC operating agreement is not strictly required,[1] and courts may infer the terms of an LLC from the conduct of the members. This is — to put it mildly — absolutely insane and the recipe for complete disaster (indeed, we'll read a case in which this is an issue). Get it in writing. Every. Time.

[1] Under the Kentucky LLC statute, an operating agreement is also optional.

Properties of an LLC

While there are minor differences between the various state LLC statutes — primarily having to do with variations that we'll discuss later in the chapter — the basics of an LLC are the same in all jurisdictions. An LLC has:

- MANAGEMENT. An LLC can either be member-managed (like a partnership) or manager-managed (like a limited partnership or corporation). If member-managed, each member has by default an equal right to management — but no member is an agent of the LLC simply by virtue of being a member[1] — though management rights may be altered in the operating agreement. If manager-managed, then the members have no management rights (like limited partners). Managers are appointed and/or elected and/or removed according to the terms of the operating agreement.

- MEMBERS. Investment in LLCs comes through the purchase of membership interests in the LLC, which can be expressed as discrete units or as a percentage. There is no limitation on the number of interests that can be sold, absent language in the operating agreement to the contrary. There are no pre-emptive rights that attach to membership interests, absent language in the operating agreement to the contrary. An LLC can have a single member or multiple members.

- STRICT SEPARATION of the LLC's members/managers and the LLC itself.

- LIMITED LIABILITY for all of the LLC's members.

- PERPETUAL EXISTENCE AS THE DEFAULT RULE, but an LLC may instead choose to exist for a particular duration of time and then expire, like the mythical phoenix or (more mundanely) a limited partnership. An LLC may be dissolved voluntarily according to the terms of the operating agreement or by judicial decree.

- CHOICE OF PASS-THROUGH OR ENTITY-LEVEL TAXATION. Most LLCs check the box for pass-through (aka partnership) taxation, so that for tax purposes the LLC is disregarded and the members' distributions are taxed as ordinary income. One mildly annoying bit about a pass-through designation is that LLC members

[1] This neatly sidesteps the Three Musketeers problem that is inherent to partnerships.

can be taxed on an LLC's profits even if they aren't distributed to the members.[1] Another mildly annoying bit about a pass-through designation is that members are forbidden from earning wages under this structure and instead are paid distributions from the LLC's assets (like partners in a partnership).[2]

- NON-TRANSFERABLE INTERESTS. The default rule for LLCs is that, absent language in the operating agreement to the contrary, a member may only transfer the economic interest in the LLC to a third party and not any voting or management rights. Many operating agreements, however, specify the conditions for a member to transfer their interest (usually involving consent of management). Member withdrawal does not dissolve an LLC, absent — say it with me now! — language in the operating agreement to the contrary.

- VOTING RIGHTS ARE WHAT YOU SAY THEY ARE in the operating agreement.[3] Certain members may have super-voting interests, or non-voting interests, or the ability to vote on only certain fundamental matters — but all of these are determined by the operating agreement and not by statute or common law.

- FIDUCIARY DUTIES ARE WHAT YOU SAY THEY ARE in the operating agreement. The default rule is that the duty of care and duty of loyalty apply to the managers of the LLC (that is, to members in a member-managed LLC and to managers in a manager-managed LLC), but the operating agreement can change or remove the fiduciary duties of management. I'm going to say that again, because it is extremely important: in an LLC, the fiduciary duties of management can be defined, modified, or eliminated entirely in the operating agreement.[4]

Looking at that list, you might have noticed that pretty much every one of those properties makes reference to the operating agreement, and that is because a key feature/flaw of LLCs is that almost everything that is established by statute or by common law in corporations is up for negotiation in an LLC's operating agreement. Seems like the operating agreement is pretty important, no? Let's take a look at just how important.

[1] Many LLC operating agreements have a provision that addresses this problem by agreeing to make payments to satisfy their members' tax obligations if this becomes an issue. These are often called "top-up" provisions.

[2] The LLC may make "guaranteed payments" or "advances on draws" to its members in lieu of wages.

[3] No shareholder democracy here!

[4] Note that some state statutes may limit this; for example, Kentucky disallows the elimination of the duty of care in the context of the dissolution of the LLC.

The Operating Agreement

The operating agreement can and should set the terms for, among other things:

- Selection and removal of managers
- Management structure[1]
- Duties of management
- Powers of management
- Meetings[2]
- Restrictions on certain kinds of investment
- The purpose of the business
- Voting rights[3]
- Information rights
- *MTV*'s Dan Cortese
- Distribution of profits and losses
- Capital contributions
- Indemnification
- Admission of new members
- Member withdrawal and "buy-sell" rules[4]
- Rights to bring a suit for or against the LLC
- The applicable state law and jurisdiction
- Dissolution

[1] A single manager? A board? A giant spinning wheel?

[2] How to have them, whether to have them, etc.

[3] Including member voting on fundamental transactions.

[4] Rights that members have to sell their interest back to the LLC under certain conditions, to buy into a future business combination that the LLC enters into, to transfer interest to a third party, etc.

Not only is the operating agreement the first and last word when it comes to the governance of the LLC, there are very few restrictions on what exactly one can put in an operating agreement — even to the detriment of the LLC or its members. Only things that are explicitly prohibited by statute (and there aren't many of those) are disallowed in an LLC agreement.

An LLC is often called a hybrid entity, because it blends properties of partnerships and corporations — but it is more accurately understood as a choose-your-own-adventure entity, giving founders, investors, and managers the flexibility in contract to choose how their LLC will operate and will be governed. And, like a choose-your-own-adventure novel, making a single bad call can absolutely wreck your shit.

The following case illustrates the deference that courts will give to the provisions of the operating agreement — and how much this differs from traditional corporate law principles.

Elf Atochem North America, Inc. v. Jaffari, 727 A.2d 286 (Del. 1999)

Veasey, C.J.

This is a case of first impression before this Court involving the Delaware Limited Liability Company Act (the "[LLC] Act"). The limited liability company ("LLC") is a relatively new entity that has emerged in recent years as an attractive vehicle to facilitate business relationships and transactions. The wording and architecture of the [LLC] Act is somewhat complicated, but it is designed to achieve what is seemingly a simple concept — to permit persons or entities ("members") to join together in an environment of private ordering to form and operate the enterprise under an LLC agreement with tax benefits akin to a partnership and limited liability akin to the corporate form.

This is a purported derivative suit brought on behalf of a Delaware LLC calling into question whether: (1) the LLC, which did not itself execute the LLC agreement in this case ("the Agreement") defining its governance and operation, is nevertheless bound by the Agreement; and (2) contractual provisions directing that all disputes be resolved exclusively by arbitration or court proceedings in California are valid under the [LLC] Act. Resolution of these issues requires us to examine the applicability and scope of certain provisions of the [LLC] Act in light of the Agreement.

We hold that: (1) the Agreement is binding on the LLC as well as the members; and (2) since the [LLC] Act does not prohibit the members of an LLC from vesting exclusive subject matter jurisdiction in arbitration proceedings (or court enforcement of arbitration) in California to resolve disputes, the contractual forum selection provisions must govern.

Accordingly, we affirm the judgment of the Court of Chancery dismissing the action brought in that court on the ground that the Agreement validly predetermined the fora in which disputes would be resolved, thus stripping the Court of Chancery of subject matter jurisdiction.

Facts

Plaintiff below-appellant Elf Atochem North America, Inc., a Pennsylvania Corporation ("Elf"), manufactures and distributes solvent-based maskants to the aerospace and aviation industries throughout the world. Defendant below-appellee Cyrus A. Jaffari is the president of Malek, Inc., a California Corporation. Jaffari had developed an innovative, environmentally-friendly alternative to the solvent-based maskants that presently dominate the market.

For decades, the aerospace and aviation industries have used solvent-based maskants in the chemical milling process. Recently, however, the Environmental Protection Agency ("EPA") classified solvent-based maskants as hazardous chemicals and air contaminants. To avoid conflict with EPA regulations, Elf considered developing or distributing a maskant less harmful to the environment.

In the mid-nineties, Elf approached Jaffari and proposed investing in his product and assisting in its marketing. Jaffari found the proposal attractive since his company, Malek, Inc., possessed limited resources and little international sales expertise. Elf and Jaffari agreed to undertake a joint venture that was to be carried out using a limited liability company as the vehicle.

On October 29, 1996, Malek, Inc. caused to be filed a Certificate of Formation with the Delaware Secretary of State, thus forming Malek LLC, a Delaware limited liability company under the Act. The certificate of formation is a relatively brief and formal document that is the first statutory step in creating the LLC as a separate legal entity. The certificate does not contain a comprehensive agreement among the parties, and the statute contemplates that the certificate of formation is to be complemented by the terms of the Agreement.

Next, Elf, Jaffari and Malek, Inc. entered into a series of agreements providing for the governance and operation of the joint venture. Of particular importance to this litigation, Elf, Malek, Inc., and Jaffari entered into the Agreement, a comprehensive and integrated document of 38 single-spaced pages setting forth detailed provisions for the governance of Malek LLC, which is not itself a signatory to the Agreement. Elf and Malek LLC entered into an Exclusive Distributorship Agreement in which Elf would be the exclusive, worldwide distributor for Malek LLC. The Agreement provides that Jaffari will be the manager of Malek LLC. Jaffari and Malek LLC entered into an employment agreement providing for Jaffari's employment as chief executive officer of Malek LLC.

The Agreement is the operative document for purposes of this Opinion, however. Under the Agreement, Elf contributed $1 million in exchange for a 30 percent interest in Malek LLC. Malek, Inc. contributed its rights to the water-based maskant in exchange for a 70 percent interest in Malek LLC.

The Agreement contains an arbitration clause covering all disputes. The clause, Section 13.8, provides that "any controversy or dispute arising out of this Agreement, the interpretation of any of the provisions hereof, or the action or inaction of any Member or Manager hereunder shall be submitted to arbitration in San Francisco, California." Section 13.8 further provides: "No action ... based upon any claim arising out of or related to this Agreement shall be instituted in any court by any Member except (a) an action to compel arbitration ... or (b) an action to enforce an award obtained in an arbitration proceeding." The Agreement also contains a forum selection clause, Section 13.7, providing that all members consent to: "exclusive jurisdiction of the state and federal courts sitting in California in any action on a claim arising out of, under or in connection with this Agreement or the transactions contemplated by this Agreement, provided such claim is not required to be arbitrated pursuant to Section 13.8"; and personal jurisdiction in California. The [Distributorship] Agreement contains no forum selection or arbitration clause.

Elf's Suit in the Court of Chancery

On April 27, 1998, Elf sued Jaffari and Malek LLC, individually and derivatively on behalf of Malek LLC, in the Delaware Court of Chancery, seeking equitable remedies. Among other claims, Elf alleged that Jaffari breached his fiduciary duty to Malek LLC, pushed Malek LLC to the brink of insolvency by withdrawing funds for personal use, interfered with business opportunities, failed to make disclosures to Elf, and threatened to make poor quality maskant and to violate environmental regulations. Elf also alleged breach of contract, tortious interference with prospective business relations, and (solely as to Jaffari) fraud.[1]

[1] Sure you couldn't have wedged any more claims in there, buddy?

The Court of Chancery granted defendants' motion to dismiss based on lack of subject matter jurisdiction. The court held that Elf's claims arose under the Agreement, or the transactions contemplated by the agreement, and were directly related to Jaffari's actions as manager of Malek LLC. Therefore, the court found that the Agreement governed the question of jurisdiction and that only a court of law or arbitrator in California is empowered to decide these claims. Elf now appeals the order of the Court of Chancery dismissing the complaint.

Contentions of the Parties

Elf claims that the Court of Chancery erred in holding that the arbitration and forum selection clauses in the Agreement governed, and thus deprived that court of jurisdiction to adjudicate all of Elf's claims, including its derivative claims made on behalf of Malek LLC. Elf contends that, since Malek LLC is not a party to the Agreement, it is not bound by the forum selection provisions. Elf also argues that the court erred in failing to classify its claim as derivative on behalf of Malek LLC against Jaffari as manager. Therefore, Elf claims that the Court of Chancery should have adjudicated the dispute. Finally, Elf argues that the dispute resolution clauses of the Agreement are invalid under Section 109(d) of the [LLC] Act, which, it alleges, prohibits the parties from vesting exclusive jurisdiction in a forum outside of Delaware.

Defendants claim that Elf contracted with Malek, Inc. and Jaffari that all disputes that arise out of, under, or in connection with the Agreement must be resolved exclusively in California by arbitration or court proceedings. Defendants allege that the characterization of Elf's claim as direct or derivative is irrelevant, as the Agreement provides that the members would not institute "any" action at law or equity except one to compel arbitration, and that any such action must be brought in California. Defendants also argue that, in reality, Elf's claims are direct, not derivative, claims against its fellow LLC members, Malek, Inc. and Jaffari.

General Summary of Background of the Act

The phenomenon of business arrangements using "alternative entities" has been developing rapidly over the past several years. Long gone are the days when business planners were confined to corporate or partnership structures.

The Delaware [LLC] Act was adopted in October 1992. The LLC is an attractive form of business entity because it combines corporate-type limited liability with partnership-type flexibility and tax advantages. The Act can be characterized as a "flexible statute" because it generally permits members to engage in private ordering with substantial freedom of contract to govern their relationship, provided they do not contravene any mandatory provisions of the [LLC] Act. Indeed, the LLC has been characterized as the "best of both worlds."[1]

[1] Oh, for sure.

The Delaware Act has been modeled on the popular Delaware LP Act. In fact, its architecture and much of its wording is almost identical to that of the Delaware LP Act. Under the [LLC] Act, a member of an LLC is treated much like a limited partner under the LP Act. The policy of freedom of contract underlies both the [LLC] Act and the LP Act.

Although business planners may find comfort in working with the [LLC] Act in structuring transactions and relationships, it is a somewhat awkward document for this Court to construe and apply in this case. To understand the overall structure and thrust of the [LLC] Act, one must wade through provisions that are prolix, sometimes oddly organized, and do not always flow evenly. Be that as it may as a problem in mastering the [LLC] Act as a whole, one returns to the narrow and discrete issues presented in this case.

Freedom of Contract

Section 18-1101(b) of the [LLC] Act provides that "[i]t is the policy of [the LLC Act] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."

In general, the commentators observe that only where the agreement is inconsistent with mandatory statutory provisions will the members' agreement be invalidated. Such statutory provisions are likely to be those intended to protect third parties, not necessarily the contracting members. As a framework for decision, we apply that principle to the issues before us, without expressing any views more broadly.

The Arbitration and Forum Selection Clauses in the Agreement are a Bar to Jurisdiction in the Court of Chancery

In vesting the Court of Chancery with jurisdiction, the [LLC] Act accomplished at least three purposes: (1) it assured that the Court of Chancery has jurisdiction it might not otherwise have because it is a court of limited jurisdiction that requires traditional equitable relief or specific legislation to act; (2) it established the Court of Chancery as the default forum in the event the members did not provide another choice of forum or dispute resolution mechanism; and (3) it tends to center interpretive litigation in Delaware courts with the expectation of uniformity. Nevertheless, the arbitration provision of the Agreement in this case fosters the Delaware policy favoring alternate dispute resolution mechanisms, including arbitration. Such mechanisms are an important goal of Delaware legislation, court rules, and jurisprudence.

Malek LLC's Failure to Sign the Agreement Does Not Affect the Members' Agreement Governing Dispute Resolution

Elf argues that because Malek LLC, on whose behalf Elf allegedly brings these claims, is not a party to the Agreement, the derivative claims it brought on behalf of Malek LLC are not governed by the arbitration and forum selection clauses of the Agreement.

We are not persuaded by this argument. Section 18-101(7) defines the limited liability company agreement as "any agreement, written or oral, of the member or members as to the affairs of a limited liability company and the conduct of its business." Here, Malek, Inc. and Elf, the members of Malek LLC, executed the Agreement to carry out the affairs and business of Malek LLC and to provide for arbitration and forum selection.

Notwithstanding Malek LLC's failure to sign the Agreement, Elf's claims are subject to the arbitration and forum selection clauses of the Agreement. The [LLC] Act is a statute designed to permit members maximum flexibility in entering into an agreement to govern their relationship. It is the members who are the real parties in interest. The LLC is simply their joint business vehicle. This is the contemplation of the statute in prescribing the outlines of a limited liability company agreement.

Classification by Elf of its Claims as Derivative is Irrelevant

Elf argues that the Court of Chancery erred in failing to classify its claims against Malek LLC as derivative. Elf contends that, had the court properly characterized its claims as derivative instead of direct, the arbitration and forum selection clauses would not have applied to bar adjudication in Delaware.

In the corporate context, "the derivative form of action permits an individual shareholder to bring 'suit to enforce a corporate cause of action against officers, directors and third parties.' " The derivative suit is a corporate concept grafted onto the limited liability company form. The [LLC] Act expressly allows for a derivative suit, providing that "a member ... may bring an action in the Court of Chancery in the right of a limited liability company to recover a judgment in its favor if managers or members with authority to do so have refused to bring the action or if an effort to cause those managers or members to bring the action is not likely to succeed." Notwithstanding the Agreement to the contrary, Elf argues that [this] permits the assertion of derivative claims of Malek LLC against Malek LLC's manager, Jaffari.

Although Elf correctly points out that Delaware law allows for derivative suits against management of an LLC, Elf contracted away its right to bring such an action in Delaware and agreed instead to dispute resolution in California. That is, Section 13.8 of the Agreement specifically provides that the parties (i.e., Elf) agree to institute "[n]o action at law or in equity based upon any claim arising out of or related to this Agreement" except an action to compel arbitration or to enforce an arbitration award. Furthermore, under Section 13.7 of the Agreement, each member (i.e., Elf)[1] "consent[ed] to the exclusive jurisdiction of the state and federal courts sitting in California in any action on a claim arising out of, under or in connection with this Agreement or the transactions contemplated by this Agreement."

[1] The court is just slowly walking Elf through every step of where they screwed up here.

Sections 13.7 and 13.8 of the Agreement do not distinguish between direct and derivative claims. They simply state that the members may not initiate any claims outside of California. Elf initiated this action in the Court of Chancery in contravention of its own contractual agreement. As a result, the Court of Chancery correctly held that all claims, whether derivative or direct, arose under, out of or in connection with the Agreement, and thus are covered by the arbitration and forum selection clauses.

We agree with the Court of Chancery's decision that:

> [P]laintiffs's claims arise under the LLC Agreement or the transactions contemplated by the Agreement, and are directly related to Jaffari's "action or inaction" in connection with his role as the manager of Malek. Plainly, all of plaintiff's claims revolve around Jaffari's conduct (or misconduct) as Malek's manager. Virtually all the remedies that plaintiff seeks bear directly on Jaffari's duties and obligations under the LLC Agreement.

The Court of Chancery was correct in holding that Elf's claims bear directly on Jaffari's duties and obligations under the Agreement. Thus, we decline to disturb its holding.

Our conclusion is bolstered by the fact that Delaware recognizes a strong public policy in favor of arbitration. Normally, doubts on the issue of whether a particular issue is arbitrable will be resolved in favor of arbitration. In the case at bar, we do not believe there is any doubt of the parties' intention to agree to arbitrate all disputed matters in California. If we were to hold otherwise, arbitration clauses in existing LLC agreements could be rendered meaningless.

Had the General Assembly intended to prohibit the parties from vesting exclusive jurisdiction in arbitration or court proceedings in another state, it could have proscribed such an option. The Court of Chancery did not err in declining to strike down the validity of Section 13.7 or Section 13.8 of the Agreement. We affirm the judgment of the Court of Chancery dismissing Elf Atochem's amended complaint for lack of subject matter jurisdiction.

SOME DISCUSSION QUESTIONS:

1. Is it necessary for an LLC to sign its own operating agreement? How would that even work?

2. Could the operating agreement have fully exculpated Jaffari from claims against him? From claims against Malek LLC?

3. Did equitable concerns come into play at all?

4. Would this have been handled differently if Malek LLC was a corporation instead? How?

Fiduciary Duties

When it comes to fiduciary duties, LLCs are unique among business entities, as the classic fiduciary duties of management — loyalty and care — can be modified or bargained away entirely in the LLC operating agreement. The Delaware statute provides typical language enabling this modification:

> "To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be **expanded or restricted or eliminated** by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing."[1]

[1] 6 Del. C. § 18-1101(c) (emphasis added).

The only duty that cannot be eliminated in the operating agreement is the *contractual* duty of good faith and fair dealing, which relates not to the conduct of management, but to the interpretation of the operating agreement. Also, if the operating agreement is silent on fiduciary duties, then by default those duties exist and have not been modified or eliminated.[2]

[2] "In any case not provided for in this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern." 6 Del. C. § 18-1104.

How might the elimination of fiduciary duties operate in the real world? Let's take a look at a case that combines the fiduciary duty of loyalty, a cautionary tale about careful contractual drafting, and the great sport of ... what's this? Hockey? *Hockey*? That can't be right. Are we doing Canadian corporate law now, eh?

McConnell v. Hunt Sports Enterprises, 132 Ohio App.3d 657 (Ohio Ct. App. 1999)

Tyack, J.

On June 17, 1997, John H. McConnell and Wolfe Enterprises, Inc. filed a complaint for declaratory judgment in the Franklin County Court of Common Pleas against Hunt Sports Enterprises, Hunt Sports Enterprises, L.L.C., Hunt Sports Group, L.L.C. (hereinafter collectively referred to as "Hunt Sports Group") and Columbus Hockey Limited [LLC] ("CHL"). A brief background of the events leading up to the formation of CHL and the subsequent discord among certain of its members follows.

In 1996, the National Hockey League ("NHL") determined it would be accepting applications for new hockey franchises. In April 1996, Gregory S. Lashutka, the mayor of Columbus, received a phone call from an NHL representative inquiring as to Columbus's interest in a hockey team. As a result, Mayor Lashutka asked certain community leaders who had been involved in exploring professional sports in Columbus to pursue the possibility of applying for an NHL hockey franchise. Two of these persons were Ronald A. Pizzuti and Mr. McConnell.

Mr. Pizzuti began efforts to recruit investors in a possible franchise. Mr. Pizzuti approached Lamar Hunt, principal of Hunt Sports Group, as to Mr. Hunt's interest in investing in such a franchise for Columbus. Mr. Hunt was already the operating member of the Columbus Crew, a professional soccer team whose investors included Hunt Sports Group, Pizzuti, Mr. McConnell, and Wolfe Enterprises, Inc. Mr. Hunt expressed an interest in participating in a possible franchise. The deadline for applying for an NHL expansion franchise was November 1, 1996.

On October 31, 1996, CHL was formed when its articles of organization were filed with the secretary of state. The members of CHL were Mr. McConnell, Wolfe Enterprises, Inc., Hunt Sports Group, Pizzuti Sports Limited, and Buckeye Hockey, L.L.C. Each member made an initial capital contribution of $25,000. CHL was subject to an operating agreement that set forth the terms between the members. Pursuant to section 2.1 of CHL's operating agreement, the general character of the business of CHL was to invest in and operate a franchise in the NHL.

On or about November 1, 1996, an application was filed with the NHL on behalf of the city of Columbus. In the application, the ownership group was identified as CHL, and the individuals in such group were listed as Pizzuti Sports Limited, Mr. McConnell, Wolfe Enterprises, Inc. and Hunt Sports Group. A $100,000 check from CHL was included as the application fee. Also included within the application package was Columbus's plan for an arena to house the hockey games. There was no facility at the time, and the proposal was to build a facility that would be financed, in large part, by a three-year countywide one-half percent sales tax. The sales tax issue would be on the May 1997 ballot.

On May 6, 1997, the sales tax issue failed. The day after, Mayor Lashutka met with Mr. Hunt, and other opportunities were discussed. The mayor also spoke with Gary Bettman,[1] commissioner of the NHL, and they discussed whether or not an alternate plan for an arena was possible. Also on May 7, 1997, Dimon McPherson, chairman and chief executive officer of Nationwide Insurance Enterprise ("Nationwide"), met with Mr. Hunt, and they discussed the possibility of building the arena despite the failure of the sales tax issue. Mr. McPherson testified that he chose Mr. Hunt because: "[w]ell, he was the visible, obvious, only person that was involved in trying to bring NHL hockey to Columbus. There was really no on else to turn to." Mr. Hunt was interested, and Nationwide began working on an arena plan. On or about May 9, 1997, the mayor spoke with Mr. Bettman and let him know that alternate plans would be

[1] Boooooooooo.

pursued, and Mr. Bettman gave Columbus until June 4, 1997 to come up with a plan.

By May 28, 1997, Nationwide had come up with a plan to finance an arena privately and on such date, Nationwide representatives met with representatives of Hunt Sports Group. Hunt Sports Group did not accept Nationwide's lease proposal. On May 30, 1997, Mr. McPherson called Mr. McConnell and requested that they meet and discuss "where we were on the arena." Mr. McPherson "could see that the situation now was slipping away, and [he] just didn't want that to happen," so he went to see Mr. McConnell for advice and counsel. Mr. McConnell testified that the conversation was "totally out of the blue. [Mr. McPherson] said that Nationwide was going to finance and build an arena, and that he had offered the Hunt group the opportunity to pick up the lease and bring a franchise in. That was news to me. It was out of the blue." Mr. McPherson told Mr. McConnell about appellant's rejection of the lease proposal and discussed the NHL's June 4 deadline. Mr. McConnell stated that if Mr. Hunt would not step up and lease the arena and, therefore, get the franchise, Mr. McConnell would.

On June 4, 1997, the NHL franchise expansion committee met. Mr. Bettman informed the committee that Nationwide would build an arena, and Mr. McConnell was prepared to go forward with the franchise even if he had to do it himself. The committee was told that Hunt Sports Group's involvement was an open issue, but Mr. McConnell as an owner was more than adequate. The expansion committee recommended Columbus to the NHL board of governors as one of four cities to be granted a franchise.

On June 5, 1997, the NHL sent Mr. Hunt a letter requesting that he let them know by Monday, June 9, 1997 whether or not he was going forward with his franchise application. In a June 6, 1997 letter to the NHL, Mr. Hunt responded that CHL intended to pursue the franchise application. Mr. Hunt informed the NHL that he had arranged a meeting with the members of CHL to be held on June 9, 1997. Hunt indicated that the application was contingent upon entering into an appropriate lease of a hockey facility.

On June 9, 1997, a meeting [of CHL's members] took place at the office of Mr. Pizzuti. Mr. Hunt indicated the lease was unacceptable. Mr. Pizzuti and Mr. Wolfe agreed to participate along with Mr. McConnell. The [NHL's] term sheet contained a signature line for "Columbus Hockey Limited" as the franchise owner. [After omitting the name] "Columbus Hockey Limited" from under the signature line, Mr. McConnell signed the term sheet as the owner of the franchise.

On June 17, 1997, the NHL expansion committee recommended to the NHL board of governors that Columbus be awarded a franchise with Mr. McConnell's group as owner of the franchise. On this same date, the complaint in the case at bar was filed. On or about June 25, 1997, the NHL board of governors awarded Columbus a franchise with Mr. McConnell's group as owner. Hunt Sports Group [has] no ownership interest in the hockey franchise.

In their complaint, Mr. McConnell and Wolfe Enterprises, Inc. requested a declaration that section 3.3 of the CHL operating agreement allowed members of CHL to compete with CHL. Specifically, Mr. McConnell and Wolfe Enterprises, Inc. sought a declaration that under the operating agreement, they were permitted to obtain the franchise.

On June 23, 1997, Hunt Sports Group filed an answer and counterclaim on its behalf and on behalf on CHL. The counterclaim was asserted against Mr. McConnell and alleged breach of contract, breach of fiduciary duty and interference with prospective business relationships.

[The trial court granted summary judgment for McConnell, dismissed Hunt's claims, and awarded McConnell attorney's fees.]

The construction of written contracts is a matter of law. The purpose of contract construction is to discover and effectuate the intent of the parties, and the intent of the parties is presumed to reside in the language they chose to use in the agreement. If a contract is clear and unambiguous, there is no issue of fact to be determined, and the court cannot create a new contract by finding an intent not expressed in the clear language employed by the parties. Only where the language of a contract is unclear or ambiguous or when the circumstances surrounding the agreement invest the language of the contract with a special meaning, will extrinsic evidence be considered in an effort to give effect to the parties' intentions.

The test for determining whether a term is ambiguous is that common words in a written contract will be given their ordinary meaning unless manifest absurdity results or unless some other meaning is clearly evidenced from the face or overall content of the contract. A writing will be read as a whole, and the intent of each part will be gathered from a consideration of the whole. For the reasons that follow, we conclude that section 3.3 is plain and unambiguous and allowed members of CHL to compete against CHL for an NHL franchise.

Section 3.3 of the operating agreement states:

> "Members May Compete. Members shall not in any way be prohibited from or restricted in engaging or owning an interest in any other business venture of any nature, including any venture which might be competitive with the business of the Company."

Appellant emphasizes the word "other" in the above language and states, in essence, that it means any business venture that is different from the business of the company. Appellant points out that under section 2.1 of the operating agreement, the general character of the business is "to invest in and operate a franchise in the National Hockey League." Hence, appellant contends that members may only engage in or own an interest in a venture that is not in the business of investing in and operating a franchise with the NHL.

Appellant's interpretation of section 3.3 goes beyond the plain language of the agreement and adds words or meanings not stated in the provision. Section 3.3, for example, does not state "[m]embers shall not be prohibited from or restricted in engaging or owning an interest in any other business venture that is different from the business of the company." Rather, section 3.3 states: "any other business venture of any nature." It then adds to this statement: "including any venture which might be competitive with the business of the Company." The words "any nature" could not be broader, and the inclusion of the words "* * * any venture which might be competitive with the business of the Company" makes it clear that members were not prohibited from engaging in a venture that was competitive with CHL's investing in and operating an NHL franchise. Contrary to appellant's contention, the word "other" simply means a business venture other than CHL. The word "other" does not limit the type of business venture in which members may engage.

Hence, section 3.3 did not prohibit appellees from engaging in activities that may have been competitive with CHL. Accordingly, summary judgment in favor of appellees was appropriate, and appellees were entitled to a declaration that section 3.3 of the operating agreement permitted appellees to request and obtain an NHL hockey franchise to the exclusion of CHL.

Here, the injury complained of by appellant was, essentially, appellees competing with CHL and obtaining the NHL franchise. The operating agreement constitutes the undertaking of the parties herein. In becoming members of CHL, appellant and appellees agreed to abide by the terms of the operating agreement, and such agreement specifically allowed competition with the company by its members. As such, the duties created pursuant to such undertaking did not include a duty not to compete. Therefore, there was no duty on the part of appellees to refrain from subjecting appellant to the injury complained of herein.

Given the above, we conclude as a matter of law that it was not a breach of fiduciary duty for appellees to ... obtain an NHL franchise to the exclusion of CHL. In so concluding, we are not stating that no act related to such obtainment could be considered a breach of fiduciary duty. In general terms, members of limited liability companies owe one another the duty of utmost trust and loyalty. However, such general duty in this case must be considered in the context of members' ability, pursuant to operating agreement, to compete with the company.

We now turn to the elements of tortious interference with a prospective business relationship. The tort of interference with a business relationship occurs when a person, without a privilege to do so, induces or otherwise purposely causes a third person not to enter into or continue a business relationship with another. The essential facts, construed most strongly in favor of appellant, have been set forth above. This evidence shows that appellees obtained the NHL franchise to the exclusion of CHL. This constituted direct competition with CHL. However, appellees were permitted under the operating agreement to compete with CHL and, as discussed above, this in and of itself cannot constitute a breach of fiduciary duty. Further, in so competing, appellees did not engage in any acts that would otherwise constitute wrongful behavior. Nationwide contacted Mr. McConnell only after appellant indicated the lease terms were unacceptable. Even then, Mr. McConnell stated he would accept the lease terms and obtain the franchise on his own only if appellant did not. There is no evidence that McConnell acted in any secretive manner in his actions leading up to the franchise award or that he used CHL assets for personal gain. In short, the evidence shows that appellees obtained the NHL franchise to the exclusion of CHL. Appellees did nothing beyond this that could constitute a breach of fiduciary duty.

Likewise, the evidence does not show that appellees tortiously interfered with appellant's prospective business relationships with Nationwide and the NHL. The evidence does not show that appellees induced or otherwise purposely caused Nationwide and the NHL to not enter into or continue a business relationship with appellant. Indeed, and as indicated above, the evidence shows Mr. McConnell stated he would lease the arena and obtain the franchise only if appellant did not. It was only after appellant rejected the lease proposal on several occasions that Mr. McConnell stepped in. Appellant had yet another opportunity on June 9, 1997 to participate in the Nationwide arena lease and the NHL franchise. Appellant again found the lease proposal unacceptable, and without a signed lease term sheet, there would have been no franchise from the NHL.[1] In short, it was appellant's actions that caused the termination of any relationship or potential relationship it had with Nationwide and the NHL.

[1] Do we think the judge is a hockey fan?

In granting appellees' motion for a directed verdict, the trial court found appellant violated the CHL operating agreement in failing to ask for and obtain the authorization of CHL members, other than appellees, prior to filing the answer and counterclaim in this action and the suit in New York and by instigating the action against the trial judge in the Supreme Court of Ohio. The trial court awarded appellees $1.00 in damages. Appellant contends that under the operating agreement, it could only be liable for willful misconduct. In addition, appellant contends it was the "operating member" of CHL and, therefore, had full authority to act on CHL's behalf.

First, there was no evidence at trial that appellant was the operating member of CHL. The operating agreement, which sets forth the entire agreement between the members of CHL, does not name any person or entity the operating or managing member of CHL. Instead, all members of CHL had an equal number of units in CHL, as reflected by the amount of their capital contributions shown on Schedule A of the operating agreement. Pursuant to section 4.1 of the operating agreement, no member was permitted to take any action on behalf of the company unless such action was approved by the specified number of members which was, at the very least, a majority of the units allocated.

This brings us to the question of whether appellant breached the operating agreement by failing to obtain the approval of the other CHL members prior to filing, in CHL's name, the answer and counterclaim in this suit.[1] Again, section 4.1(b) of the operating agreement requires at least majority approval prior to taking any action on behalf of CHL. Further, the approval of the members as to any action on behalf of CHL must have been evidenced by minutes of a meeting properly noticed and held or by an action in writing signed by the requisite number of members.

[1] The Hunt group also filed a number of other related suits in CHL's name.

There is no evidence appellant obtained the approval of CHL members prior to filing the actions listed above. Indeed, there is no evidence that appellant even asked permission of any member to file the actions, let alone held a meeting or requested approval in writing. The evidence does show that appellant, in the name of CHL, filed the answer and counterclaim in the present suit. This was contrary to section 4.1 and 4.2 of the operating agreement and constituted breach of such agreement.As

indicated above, appellant was a member of CHL at the time of its formation. As a member of CHL, appellant agreed to be bound by the terms of the operating agreement. Mr. Hunt read the operating agreement prior to signing it.[2] Such agreement required a majority vote prior to taking any action on behalf of CHL such as the filing of the actions at issue. Appellant nonetheless filed such actions without obtaining the required approval and, indeed, without even asking one member (other than itself) for such permission.

[2] Ouch.

Some discussion questions:

1. Who filed suit against who here? Why do you think they did that?
2. What is another plausible reading of the provision about "other business ventures"? Why did the court choose the reading it did?

3. I'm sorry, but *who* was actually in violation of the LLC agreement? Really? *Really?* Do we think there was any way that the drafters actually intended this reading of the agreement?

LLC Variations

As if LLCs weren't already variations on traditional business entities, LLCs themselves have a couple of variants: the Professional Limited Liability Company and the Series Limited Liability Company.

- **PLLCs** are LLCs formed for the purpose of conducting business as licensed professionals. Many states require these to be used by professional firms instead of LLCs (to resolve conflicts between the "anything goes" nature of LLC operating agreements and the state rules of professional practice) and are functionally similar to Professional Corporations or Limited Liability Partnerships.
- **Series LLCs** are single LLCs that create legally separate "series" within the LLC, whose assets and liabilities are partitioned off from one another. The name and management of the LLC remains the same, but the LLC has essentially created a bunch of subsidiaries within itself distinguished by their titles (Series A, Series B, etc.). Only a few states — notably including Delaware[1] — allow Series LLCs, and even within those jurisdictions they are useful only if the assets of one series are easily distinguishable from the assets of another series.[2] If you aren't in a state that allows them, and the assets and liabilities of your businesses are neatly divisible, just create subsidiary LLCs.

[1] Series LLCs are neither authorized nor recognized under Kentucky law.

[2] Something like real estate, where each property is distinct, would make sense. Or how about the taxicabs in *Wolkovsky v. Carlton*?

Conflicts in LLCs

THE DEFAULT RULE FOR SOLVING CONFLICTS IN LLCS IS: look to the operating agreement. In the following cases, however, the agreement is either insufficient to resolve the problem, does not deal with the rights of third parties to the LLC, or barely exists at all. When deference to the contractual bargaining of the parties gets us nowhere, how do courts resolve LLC conflicts — and what doctrinal tools do they use?

Deadlock

The following two opinions arise from the same case and examine the role of courts in dealing with deadlocks in LLCs. Remember: in corporations, there is statutory authority for a court to intervene in a deadlocked corporation and take a number of measures including appointing a board member or forcing the sale of the corporation. Not so much with LLCs, though. The first opinion examines the rights and claims that the deadlocked parties have under the LLC operating agreement and whether fiduciary duties apply to force action; the second opinion examines what power the court has to order a judicial dissolution of an LLC.

Fisk Ventures, LLC v. Segal, C.A. No. 3017-CC

Memorandum Opinion, Del. Ch. (May 7, 2008)

Chandler, Ch.

Genitrix, LLC, is a Delaware limited liability company formed to develop and market biomedical technology. Dr. Segal founded the Company in 1996 following his postdoctoral fellowship at the Whitehead Institute for Biomedical Research. Originally formed as a Maryland limited liability company, Genitrix was moved in 1997 to Delaware at the behest of Dr. H. Fisk Johnson, who invested heavily.

Equity in Genitrix is divided into three classes of membership. In exchange for the patent rights he obtained from the Whitehead Institute, Segal's capital account was credited with $500,000. This allowed him to retain approximately 55% of the Class A membership interest. The remainder of the Class A interest was apparently granted to other individuals not involved in this suit. In the initial round of investment, Johnson contributed $843,000 in return for a sizeable portion of the Class B membership interest. The remainder of the Class B interest is held by Fisk Ventures, LLC, and Stephen Rose. Finally, various other investors contributed over $1 million for membership interests in Class C. These Class C investors are apparently mostly passive; the power in the LLC is essentially divided by the LLC Agreement (the "Agreement") between the Class A and Class B members.

Under the Agreement, the Board of Member Representatives (the "Board") manages the business and affairs of the Company. As originally contemplated by the Agreement, the Board consisted of four members: two of whom were appointed by Johnson and two of whom were appointed by Segal. In early 2007, however, the balance of power seemingly shifted. Because the Company failed to meet certain benchmarks, the Board expanded to five seats and the Class B members were able to appoint a representative to the newly created seat. Nevertheless, because the Agreement requires the approval of 75% of the Board for most actions, the combined 60% stake of Fisk Ventures and Johnson is insufficient to control the Company. In other words, the LLC Agreement was drafted in such a way as to require the cooperation of the Class A and B members.

Dr. Andrew Segal, fresh out of residency training, worked for the Whitehead Institute for Biomedical Research in Cambridge, Massachusetts from 1994 to early 1996. While there, Segal researched and worked on projects relating to how the human immune system could be manipulated effectively to attack cancer and infectious diseases. In early 1996, Dr. Segal left the Whitehead Institute and obtained a license to certain patent rights related to his research.

With these patent rights in hand, Dr. Segal formed Genitrix. Intellectual property rights alone, however, could not fund the research, testing, and trials necessary to bring Dr. Segal's ideas to some sort of profitable fruition. Consequently, Segal sought and obtained capital for the Company. Originally, Segal served as both President and Chief Executive Officer, and the terms of his employment were governed by contract (the "Segal Employment Agreement"). Under the Segal Employment Agreement, any intellectual property rights developed by Dr. Segal during his tenure with Genitrix would be assigned to the Company.

Fisk Ventures is a Delaware limited liability company controlled by Dr. H. Fisk Johnson, who owns 99% of it. Fisk is a Class B member and is entitled to appoint one person to the Board. Fisk filed the initial petition in this action seeking dissolution of the Company.

Dr. Johnson is the controlling member of Fisk and is himself a Class B shareholder in the Company who is personally now entitled to appoint two members to the Board. Dr. Johnson insisted that Genitrix be formed under Delaware law before he would invest in the Company.

Stephen Rose and William Freund are Class B Members of the Company and are Class B Representatives on the Board who were appointed by Johnson. Johnson also employs both Rose and Freund in a number of capacities outside of Genitrix, and Segal alleges that they are therefore dependant on Johnson or his affiliates for their livelihood.[1]

[1] This would be problematic ... if we were dealing with a corporation.

From its inception, Genitrix found itself strapped for cash. Segal's allegations contain numerous references to the tight budget and reminders that he worked for the Company for little or no pay in order to ease Genitrix's financial pain. In the earliest part of this decade, the Company hobbled along on grants from the National Institutes of Health and a series of relatively small financing transactions. Between November 2000 and August 2002, Johnson contributed another $550,000 in convertible debt, much of which was subsequently converted to Class B equity, and other investors provided $100,000 in convertible debt that was subsequently converted to Class C equity.

This influx of financing was insufficient, however. In the summer of 2003, Segal communicated to the Board that the Company would require $2.6 million to allow for human trials of the technology. Johnson, who by that point had contributed about $1.4 million, stated that he was unwilling to be the sole financier of the Company. Nevertheless, Johnson and Fisk Ventures agreed to contribute another $2 million in convertible debt if the Company agreed to try to raise an additional $5 million from other investors over the following two years.

Over the course of negotiating the terms of the Fisk Ventures note, Segal proposed that the "Put Right" of the Class B investors be suspended to allow him to more easily woo other investors. Pursuant to Section 11.5 of the LLC Agreement, the Class B Members may, at any time, force the Company to purchase any or all of their Class B membership interests at a price determined by an independent appraisal. If the purchase price exceeds 50% of the Company's tangible assets, the Members who exercised the Put Right would receive notes secured by all of the assets of the Company. In other words, the Put — if exercised — would subrogate what would otherwise be senior claims of new investors. Though Segal believed this right would scare off potential investors, the Class B Members refused to suspend or relinquish their contractual rights, though they did communicate that they had no immediate or foreseeable intention of exercising the right.

Dr. Segal turned his attention to individual, high-net-worth investors. Early indications were positive, but, Segal alleges, several potential investors complained about the Class B Put Right, one of whom called it a "deal killer." Thus, Segal asked the Class B members to relinquish or suspend the Put Right. The Class B members refused.

The LLC Agreement contains a provision that allows the Class B members to replace Segal's Board representatives if the Company fails to adhere to certain covenants while Segal serves as CEO. Concerned that the Company was dangerously close to breaching those covenants and worried that he would lose his Board representation, Segal circulated to the Board in March 2006 a proposal to remove himself as CEO. Instead of discussing and approving this resolution, however, the Class B representatives, who represented over 50% of the Board, executed and circulated their own resolution, which replaced Segal with Chris Pugh, another employee of Genitrix,[1] as "interim" CEO. The Class B Board representatives arranged a telephonic meeting with the Company's employees to tell them Pugh was now in charge.

[1] There were only ever three employees at Genitrix.

In March 2006, the Company ran out of operating cash. Fisk Ventures provided another $125,000 capital contribution to pay the remaining employees and to cover some expenses, but larger problems loomed. The Board met in the third week of April to discuss its options.

Keeping with the common theme in this case, Dr. Segal and the Class B members had different ideas of what the Company should do. Dr. Segal proposed splitting Genitrix in two; the Class B members flatly rejected this proposal. The Class B members advocated a "buy down" proposal in which the Company would raise $3.5 million, in exchange for which the Class B members would find their interest in the Company reduced to 25% and would become largely passive investors. Although Dr. Segal initially expressed some interest in this proposal, he rejected it when he saw the actual terms set forth in writing by the Class B members about a month later.

In August 2006, Pugh left Genitrix to work for another firm, leaving the Company with just two employees (including Dr. Segal). That other employee left in May 2007. The Company has no office, no capital funds, no grant funds, and generates no revenue. The Board has not met since the fall of 2006 because the Class A representatives have refused to participate in any meetings.[1] In May 2007 and at the invitation of the Class B members, Dr. Segal proposed terms under which the Class B members might purchase his interest in the Company. The Class B members rejected those terms in June 2007 and subsequently Fisk Ventures initiated this suit, seeking dissolution of Genitrix.[2]

[1] Other than, things are great.

[2] Finally!

In answering the petition, Dr. Segal made counterclaims against Fisk Ventures and third-party claims against Johnson, Rose, and Freund. Specifically, Segal contends that the counterclaim/third-party defendants breached the LLC Agreement, breached the implied covenant of good faith and fair dealing implicit in the LLC Agreement, breached their fiduciary duties to the Company, and tortiously interfered with the Segal Employment Agreement. Segal passionately contends that the Class B defendants failed to comply with their duties to Segal and to the Company by standing in the way of proposed financing.

Breach of Contract

Dr. Segal's counterclaims and third-party claims contend—perhaps reasonably—that Genitrix suffered because the Class B members refused to accede to Segal's proposals with respect to research, financing, and other matters. It may very well be that Genitrix would be a thriving company today if only the Class B members had seen things Segal's way. However, it may very well be that Genitrix would also be a thriving company today if only Dr. Segal had gone along with what the Class B members wanted. Indeed, the LLC Agreement endows both the Class A and Class B members with certain rights and protections. In no way does it obligate one class to acquiesce to the wishes of the other simply because the other believes its approach is superior or in the best interests of the Company. To find otherwise—that is, to find that the Court must decide whose business judgment was more in keeping with the LLC's best interests—would cripple the policy underlying the LLC Act promoting freedom of contract.

Breach of the Implied Covenant of Good Faith and Fair Dealing

Every contract contains an implied covenant of good faith and fair dealing that "requires a 'party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits' of the bargain." Although occasionally described in broad terms, the implied covenant is not a panacea for the disgruntled litigant. In fact, it is clear that "a court cannot and should not use the implied covenant of good faith and fair dealing to fill a gap in a contract with an implied term unless it is clear from the contract that the parties would have agreed to that term had they thought to negotiate the matter." Only rarely invoked successfully, the implied covenant of good faith and fair dealing protects the spirit of what was actually bargained and negotiated for in the contract. Moreover, because the implied covenant is, by definition, implied, and because it protects the spirit of the agreement rather than the form, it cannot be invoked where the contract itself expressly covers the subject at issue.

Here, Segal argues that Fisk, Rose, and Freund breached the implied covenant of good faith and fair dealing by frustrating or blocking the financing opportunities proposed by Segal. However, neither the LLC Agreement nor any other contract endowed him with the right to unilaterally decide what fundraising or financing opportunities the Company should pursue, and his argument is "another in a long line of cases in which a plaintiff has tried, unsuccessfully, to argue that the implied covenant grants [him] a substantive right that [he] did not extract during negotiation." Moreover, the LLC Agreement does address the subject of financing, and it specifically requires the approval of 75% of the Board. Implicit in such a requirement is the right of the Class B Board representatives to disapprove of and therefore block Segal's proposals. Negotiating forcefully and within the bounds of rights granted by the LLC agreement does not translate to a breach of the implied covenant on the part of the Class B members.

Breach of Fiduciary Duties

[T]]he Genitrix LLC Agreement eliminates fiduciary duties to the maximum extent permitted by law by flatly stating that members have no duties other than those expressly articulated in the Agreement. Because the Agreement does not expressly articulate fiduciary obligations, they are eliminated. Second, even if Segal were correct that in the LLC Agreement there remained a fiduciary duty to not act in bad faith or with gross negligence, Segal has manifestly failed to allege facts sufficient to support a claim that anyone has breached such a hypothetical duty. As discussed above, the hollow invocation of "bad faith" does not magically render a deficient complaint dismissal-proof; this Court will not blindly accept conclusory allegations.

Conclusion

Anyone in Dr. Segal's position would be understandably frustrated by the demise of Genitrix, a company in which he has invested monetary, temporal, intellectual, and emotional resources. Nevertheless, such frustration cannot justify the post hoc refashioning of the bargain he struck with Johnson and the Class B investors in the LLC Agreement. Consequently, Segal's counterclaims/third-party claims are hereby dismissed.

Memorandum Opinion, Del. Ch. (Jan. 13, 2009)

Chandler, Ch.

This case presents the narrow question of whether it is "reasonably practicable," under 6 Del. C. § 18-802, for a Delaware limited liability company to continue to operate. When such a company has no office, no employees, no operating revenue, no prospects of equity or debt infusion, and when the company's Board has a long history of deadlock as a result of its governance structure, more than ample reason and sufficient evidence exists to order dissolution. Accordingly, I will grant petitioner's motion for judgment on the pleadings and order that dissolution of the limited liability company occur as contemplated in the company's charter.

The Court of Chancery may decree judicial dissolution of a Delaware limited liability company "whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement." Section 18-802 has the "obvious purpose of providing an avenue of relief when an LLC cannot continue to function in accordance with its chartering agreement."

In interpreting § 18-802, this Court has by analogy often looked to the dissolution statute for limited partnerships, 6 Del. C. § 17-802. In so doing, the Court has found that "the test of § 17-802 is whether it is 'reasonably practicable' to carry on the business of a limited partnership, and not whether it is impossible." To decide whether to dissolve a partnership pursuant to § 17-802, the courts have historically looked to the "business of the partnership and the general partner's ability to achieve that purpose in conformity with the partnership agreement."

Applying the same logic in the limited liability company context, there is no need to show that the purpose of the limited liability company has been "completely frustrated." The standard is whether it is reasonably practicable for Genitrix to continue to operate its business in conformity with its LLC Agreement.

The text of § 18-802 does not specify what a court must consider in evaluating the "reasonably practicable" standard, but several convincing factual circumstances have pervaded the case law: (1) the members' vote is deadlocked at the Board level; (2) the operating agreement gives no means of navigating around the deadlock; and (3) due to the financial condition of the company, there is effectively no business to operate.

More than sufficient undisputed evidence exists in this case to demonstrate the futility of Genitrix's deadlocked board, the LLC Agreement's failure to prescribe a solution to a potentially deadlocked board, and Genitrix's dire financial straits. For these reasons, and as explained further below, I conclude that it is not reasonably practicable to carry on the business operations of Genitrix in conformity with the LLC Agreement.

Although Genitrix's Board is charged to run the Company, the Board is unable to act and is hopelessly deadlocked. Fisk Ventures and Segal have a long history of disagreement and discord over a wide range of issues concerning the direction and operation of Genitrix. On one of the most important issues facing the Company, the raising and use of operating capital, the Board is unable to negotiate acceptable terms to all involved parties. Additionally, the Board has even been considerably deadlocked over whether to have Board meetings. The parties have a history of discord and disagreement on almost every issue facing the Company. There exists almost a five-year track record of perpetual deadlock. Indeed, concerning the current issue, dissolution, the Board is equally deadlocked.

Given the Board's history of discord and disagreement, I do not believe that these parties will ever be able to harmoniously resolve their differences. Consequently, I conclude that Genitrix's Board is deadlocked and unable to resolve any issue, including the current issue of dissolution, facing Genitrix.

In examining the four corners of Genitrix's LLC Agreement I conclude that no provision exists that would allow the Board to circumvent the deadlocked stalemate. The document was negotiated by sophisticated parties engaged in an arm's length negotiation. The product of that negotiation, the LLC Agreement, was carefully drafted in such a way that solved one problem but lead directly to the deadlock now gripping the Company. The provision requiring a 75% vote for Board action was agreed upon by the parties to specifically prohibit board domination by one party over another. The provision has certainly accomplished its intended purpose. Unfortunately, it has also led to a stalemate, and the LLC Agreement on its face provides no means of remedying the situation.

Segal argues that since Fisk Ventures owns a Put Right, provided for in § 11.5 of the LLC Agreement, which allows Fisk Ventures to exit its investment by forcing Genitrix to buy out Fisk Ventures for the fair value of its investment, the LLC Agreement contains a provision that will resolve the Board's deadlock. Segal points to Fisk Ventures' Put Right as a proper "exit mechanism" and as an alternative to judicial dissolution. Under § 11.5, the amount to be paid to the Class B investors is to be determined by an independent valuation. If the price exceeds 50% of the value of Genitrix's tangible assets, they will gain creditor status, giving their holder greater security and a higher priority than they currently have as purely equity members.

Segal ignores the fact, however, that the Put Right contemplated in the LLC Agreement grants its owner an option, to be freely exercised at the will and pleasure of its holder. Nowhere in § 11.5 or in the entire LLC Agreement does the Company have the right to force a buyout if it considers one of its members belligerent or uncooperative. Fisk Ventures holds the option, not Genitrix. Fisk Ventures negotiated for and obtained the Put Right as consideration for its original investment in Genitrix and it would be inequitable for this Court to force a party to exercise its option when that party deems it in its best interests not to do so. I am not permitted to second guess a party's business decision in choosing whether or not to exercise its previously negotiated option rights.

Ultimately, even if the financial progress of Genitrix is impeded by the deadlock in the boardroom, if that deadlock cannot be remedied through a legal mechanism set forth within the four corners of the operating agreement, dissolution becomes the only remedy available as a matter of law. The Court is in no position to redraft the LLC Agreement for these sophisticated and well-represented parties.

This case involves a long-lived corporate dispute that resulted in devastating deadlock to Genitrix's Board and the loss of significant value to all involved. Genitrix's Board is hopelessly deadlocked, and the LLC Agreement fails to anticipate that risk by prescribing a solution to the Board conflict. Further, Genitrix has no office, no operating revenue, and no prospects of equity or debt infusion. Because Genitrix's dire financial straits leave the Company with no reasonably practical means to operate its business, I conclude judicial dissolution in accordance with the LLC Agreement is the best and only option for these parties.[1] For the foregoing reasons, I grant the motion seeking judgment in favor of petitioner on the petition for dissolution.

[1] As of this writing, North Carolina, New York, Michigan, Colorado, Kentucky, South Dakota and Mississippi have all joined Delaware in looking to whether it's "feasible" for an LLC to operate under conditions of management gridlock in deciding whether to order dissolution.

SOME DISCUSSION QUESTIONS:

1. To which contract, precisely, did the Covenant of Good Faith and

Fair Dealing apply?

2. Were any of the parties necessarily acting in bad faith here?

3. As much as I harp on the annoying tendency of badly-run companies to have even numbers of people on their boards, this supermajority requirement is even worse. Does the court look to the formal structure of the LLC or the actions of the parties when determining whether it is "not reasonably practical" to continue?

Veil-Piercing

LLCs are not immune to bad actors abusing the protections of limited liability to engage in fraudulent conduct; indeed, a quick search of "LLC" on the social media platform of your choice will reveal that some people out there seem to think an LLC immunizes one from any legal consequences whatsoever. Given the flexibility of an LLC's form, however, how do courts determine when that form is being abused?

NetJets Aviation, Inc. v. LHC Communications, LLC, 537 F.3d 168 (2d Cir. 2008)

Kearse, C.J.

Plaintiffs NetJets Aviation, Inc., and NetJets Sales, Inc. (collectively "NetJets"), appeal from so much of a judgment of the United States District Court for the Southern District of New York, Deborah A. Batts, Judge, as summarily dismissed their claims against defendant LHC Communications, LLC ("LHC"), for breach of contract and their claims against defendant Laurence S. Zimmerman, as LHC's alter ego, for breach of contract and account stated.

NetJets is engaged in the business of leasing fractional interests in airplanes and providing related air-travel services. LHC is a Delaware limited liability company whose sole member-owner is Zimmerman. Most of the facts with respect to the relationship between NetJets and LHC are not in dispute.

On August 1, 1999, LHC entered into two contracts with NetJets. In the first (the "Lease Agreement"), NetJets leased to LHC a 12.5 percent interest in an airplane, for which LHC was to pay NetJets a fixed monthly rental fee. The lease term was five years, with LHC having a qualified right of early termination. The second contract (the "Management Agreement") required NetJets to manage LHC's interest in the leased airplane and to provide services such as maintenance and piloting with respect to that airplane, or substitute aircraft, at specified hourly rates. It required LHC to pay a monthly management fee, as well as fuel charges, taxes, and other fees associated with LHC's air travel. The Management Agreement allotted to LHC use of the airplane for an average of 100 hours per year for the five-year term of the lease, and it provided that if the leased airplane were unavailable at a time when LHC wished to use it, NetJets would provide substitute aircraft. NetJets regularly sent LHC invoices for the services provided under the Lease and Management Agreements.

In July 2000, LHC terminated its agreements with NetJets. LHC's chief financial officer ("CFO") James P. Whittier sent a letter, addressed to a NetJets vice president, stating, in pertinent part, that "[t]he present outstanding is $440,840.39 and we are requesting that you apply the deposit of $100,000 against the outstanding and contact this office to resolve the balance."

As requested, NetJets contacted LHC and applied the $100,000 deposit against LHC's debt; however, it did not receive payment of the remaining balance of $340,840.39. In 2001, LHC ceased operations.

NetJets commenced the present diversity action in 2002, asserting claims against LHC and Zimmerman for breach of contract, account stated, and unjust enrichment.

Following a period of discovery, NetJets moved for summary judgment against both defendants on the breach-of-contract and account-stated claims. NetJets contended that Zimmerman should be held liable for the debts of LHC as its alter ego based on evidence of, inter alia, (a) the frequent use of LHC air hours for personal travel by Zimmerman and his friends and family, (b) the frequent transfers of funds between LHC and Zimmerman's other companies, (c) Zimmerman's frequent withdrawal of funds from LHC for his own personal use, and (d) the fact that LHC is no longer in business and has no assets with which to pay its debt to NetJets, a condition that NetJets contends was caused by Zimmerman's withdrawals.

In a Memorandum and Order dated June 12, 2006, the district court granted NetJets's summary judgment motion in part, awarding it $340,840.39 against LHC on the account-stated claims. The district court also denied NetJets's motion for summary judgment on its contract and account-stated claims against Zimmerman. Although Zimmerman had not moved for summary judgment in his favor, the court sua sponte granted summary judgment dismissing all of NetJets's claims against him.

For the reasons that follow, we conclude that NetJets's breach-of-contract claims against LHC were erroneously dismissed and that NetJets is entitled to trial on its contract and account-stated claims against Zimmerman as LHC's alter ego.

Limitations on Limited Liability

A limited liability company (or "LLC"), formed by one or more entities and/or individuals as its "members," is an entity that, as a general matter, provides "tax benefits akin to a partnership and limited liability akin to the corporate form." The shareholders of a corporation and the members of an LLC generally are not liable for the debts of the entity, and a plaintiff seeking to persuade a Delaware court to disregard the corporate structure faces "a difficult task".

Nonetheless, in appropriate circumstances, the distinction between the entity and its owner "may be disregarded" to require an owner to answer for the entity's debts. In general, with respect to the limited liability of owners of a corporation, Delaware law permits a court to pierce the corporate veil "where there is fraud or where [the corporation] is in fact a mere instrumentality or alter ego of its owner."

To prevail under the alter-ego theory of piercing the veil, a plaintiff need not prove that there was actual fraud but must show a mingling of the operations of the entity and its owner plus an "overall element of injustice or unfairness."

Our Court has stated this as a two-pronged test focusing on (1) whether the entities in question operated as a single economic entity, and (2) whether there was an overall element of injustice or unfairness.

These principles are generally applicable as well where one of the entities in question is an LLC rather than a corporation. In the alter-ego analysis of an LLC, somewhat less emphasis is placed on whether the LLC observed internal formalities because fewer such formalities are legally required.

The Evidence that LHC and Zimmerman Operated as One

With respect to the question of whether LHC and Zimmerman operated as a single entity, the record contains, inter alia, financial records of LHC and deposition testimony from Zimmerman and LHC's CFO, Whittier. The evidence discussed below, taken in the light most favorable to NetJets, shows, inter alia, that LHC, of which Zimmerman is the sole member-owner, was started with a capitalization of no more than $20,100; that LHC proceeded to invest millions of dollars supplied by Zimmerman, including some $22 million in an internet technology company eventually called Bazillion, Inc. ("Bazillion");[1] and that Zimmerman put money into LHC as LHC needed it, and took money out of LHC as Zimmerman needed it.

[1] Oh, come on.

Whittier, who had known Zimmerman since 1980 and worked with him full time from 1996 until April 2002, was LHC's only officer other than

Zimmerman. In addition to LHC, Zimmerman directly or indirectly owned or controlled a number of companies, including Landover Telecom Corporation ("Landover Telecom"), Land-Tel N.V. ("LandTel"), IP II Partners, LP ("IP II"), Fox Lair Holdings Corporation ("Fox Lair"), and Kimlar Consulting Corporation ("Kimlar"). Whittier acted as CFO for each of those companies. During most of the period 1996 to April 2002, Whittier "got paid from either Mr. Zimmerman or one of his corporations."

Zimmerman formed LHC in 1998; for most of its operating life, it shared office space with some of Zimmerman's other companies; LHC employed no more than five-to-seven people at any given time; and some of its employees worked for both LHC and Zimmerman's other companies or for LHC and Zimmerman personally. Whittier ran much of LHC's day-to-day operations based on instructions, general or specific, received from Zimmerman.

Zimmerman formed LHC "to be used as an investment vehicle for Mr. Zimmerman for him to make investments." "With regards to investments, Mr. Zimmerman reviewed investments. If he decided to go forward after his review, he would make an investment through [LHC] to an investment corporation he wanted to invest in." Although Zimmerman sought Whittier's advice as to the best way of accomplishing something he had decided he wanted to do, the ultimate decisions were always made by Zimmerman. "There were no decisions, financial decisions, made with regard to LHC without Mr. Zimmerman's approval." Whittier's compensation was paid sometimes by LHC and sometimes by Zimmerman personally.

In connection with Zimmerman's personal business, LHC's records show numerous transfers of money by Zimmerman to LHC, as well as numerous transfers of money from LHC to Zimmerman. Some of the transfers by Zimmerman to LHC were for the purpose of having LHC make investments, principally in Bazillion. Whittier testified also that "[m]onies would go . . . out of LHC based on the need." For example, Zimmerman would take money out of LHC to "mak[e] an investment in another entity." In addition, at several brokerage firms, Zimmerman had personal accounts that were unrelated to LHC's operations; he had many margin calls in those accounts because he "utilized margin debt very aggressively," especially with respect to two stocks whose market prices dropped sharply in 2000 (one "from a high of above 90 down to the 60s" and the other "from a high of 93 down to 3"[1]). Zimmerman had LHC make payments to meet some of these margin calls in his personal accounts. On May 15 and 16, 2000, for example, LHC wired a total of $2 million to Salomon Smith Barney to meet margin calls or reduce the margin debt on Zimmerman's personal brokerage accounts. On August 22 and October 6, 2000, LHC sent Paine Webber, another firm at which

[1] Is that bad?

Zimmerman personally had "big brokerage accounts", checks totaling $2 million. Some of the money that LHC used to pay Zimmerman's margin calls was "loan money" that Zimmerman had put into LHC.

LHC also transferred money to Zimmerman, or to third persons on his behalf, in connection with his living expenses. For example, LHC made payments to Fox Lair[1] (consistently called "Fox Liar" in LHC's general ledger), a Zimmerman corporation that owned a $15 million New York apartment on Park Avenue, which was characterized by Zimmerman as "a corporate residence" but was used by no one other than Zimmerman and his family. Fox Lair needed money "to pay phone bills and cleaning people and things of that nature"; according to LHC's ledgers, from December 5, 2000, through July 2, 2001, Fox Lair received some $70,000 from LHC. In addition, LHC made periodic payments to the Screen Actors Guild (of which Zimmerman's wife was a member)[2] for health insurance for Zimmerman and his family; LHC purchased a Bentley automobile at a cost of approximately $350,000 for Zimmerman's personal use, placing title in his name; and LHC made a payment of $110,000, characterized in its general ledger as "Loan receivable" and in its check register as "Interest Expense," to a person who had no connection with LHC but who held a mortgage on a property owned by Zimmerman personally.

[1] Yeah, bro!

[2] Zimmerman's wife had a regular role in *Dallas* and guest-starred in an episode of *Quantum Leap* (pictured below, left) that also featured a young Carla Gugino, who played the mom in the *Spy Kids* movie franchise, created by Robert Rodriguez, who also directed *Desperado*, in which Tito Larriva, lead singer of the legendary L.A. punk band The Plugz, played a minor role and whose subsequent band, Cruzados, is seen playing the opening scene of — you guessed it — *Road House*.

In LHC's general ledger, each of the transfers of money between LHC and Zimmerman — in either direction — is labeled "Loan receivable." They were also so labeled regardless of whether Zimmerman's payment to LHC was to be used to make an investment or was to be used for operating expenses. Whittier, who had responsibility for LHC's financial records, testified that the ledger treated Zimmerman's payments to and withdrawals from LHC as loans and loan repayments in order to allow Zimmerman to make withdrawals as he needed money, without having to pay taxes on the moneys withdrawn.

In all, LHC's financial records for the period January 1, 2000, through June 18, 2002, show — in addition to some two dozen transactions between LHC and Zimmerman's other companies — approximately 60 transfers of money directly from Zimmerman to LHC and approximately 60 transfers of money out of LHC directly to Zimmerman. In sum, there is evidence that, inter alia, Zimmerman created LHC to be one of his personal investment vehicles; that he was the sole decisionmaker with respect to LHC's financial actions; that Zimmerman frequently put money into LHC as LHC needed it to meet operating expenses; that LHC used some of that money, as well as some moneys it received from selling shares of one of its assets, to pay more than $4.5 million to third persons for Zimmerman's personal expenses including margin calls, mortgage payments, apartment expenses, and automobiles; and that with no written agreements or documentation or procedures in place, Zimmerman directly, on the average of twice a month for 2 $\frac{1}{2}$ years, took money out of LHC at will in order to make other investments or to meet his other personal expenses. This evidence is ample to permit a reasonable factfinder to find that Zimmerman completely dominated LHC and that he essentially treated LHC's bank account as one of his pockets, into which he reached when he needed or desired funds for his personal use. Accordingly, we reject Zimmerman's contention that the district court should have granted summary judgment in his favor on the ground that he and LHC did not operate as a single economic entity.

The Evidence of Fraud, Illegality, or Injustice

NetJets adduced sufficient evidence of fraud, illegality, or unfairness to warrant a trial on its contract and account-stated claims against Zimmerman as LHC's alter ego. For example, in an effort to parry NetJets's contention that LHC was undercapitalized, Zimmerman submitted an affidavit from LHC's accountant stating that "it was not intended by Zimmerman to treat the monies paid into LHC as loans" and that all of Zimmerman's payments into LHC were in fact capital contributions. Yet, as discussed above, Whittier testified that Zimmerman instructed him that those payments were to be characterized as loans, in order to allow Zimmerman to take money out of LHC at will and to do so without tax consequences.

A factfinder could infer that Zimmerman's payments to LHC were deliberately mischaracterized as loans in order to mask the fact that Zimmerman was making withdrawals from LHC that were forbidden by law, and could thereby properly find fraud or an unfair siphoning of LHC's assets.

The record also includes other evidence from which a reasonable factfinder could find that Zimmerman operated LHC in his own self-interest in a manner that unfairly disregarded the rights of LHC's creditors. For example, it could find:

- that although LHC was apparently unable in 2000 to pay its $340,840.39 (net of LHC's deposit) debt to NetJets, in that year LHC bought, and gave Zimmerman title to, a Bentley automobile for $350,210.95;[1]
- that LHC's only paying client for its consulting services began paying LHC for those services in July 2000 (the month in which LHC terminated its agreements with NetJets), sending LHC a first payment of approximately $675,000 on July 9, and that on that day Zimmerman withdrew that amount and more from LHC;
- that from the point at which LHC terminated its relationship with NetJets in July 2000 until the end of 2001 — the year in which NetJets ceased operations — LHC's records of its transactions directly

[1] I'm starting to get the sense that this judge is a hater.

with Zimmerman indicate that Zimmerman withdrew from LHC approximately $750,000 more than he put in;[1]

[1] Pure profit, bro. Pure profit.

- and that, excluding moneys put into LHC solely for its investments in Bazillion, the total amount of money taken out of LHC by Zimmerman and his other companies appears to exceed the amount that he and those companies put into LHC by some $3 million.

From this record, a reasonable factfinder could properly find that there was an overall element of injustice in Zimmerman's operation of LHC. Summary judgment should not have been entered dismissing NetJets's breach-of-contract and account-stated claims against Zimmerman.

For the reasons stated above, the judgment of the district court is vacated insofar as it dismissed the breach-of-contract claims against LHC and the breach-of-contract and account-stated claims against Zimmerman; with respect to those claims, the case is remanded for further proceedings not inconsistent with this opinion.

Some discussion questions:

1. Why would the traditional factors for piercing the corporate veil perhaps be ill-suited to an LLC?
2. Was the counterparty here sophisticated enough to examine Zimmerman's whole deal and protect itself via contract?
3. Can you believe that LLCs have something of a reputation for being the entity of choice for fraudulent actors?

Dissolution

The LLC operating agreement can (and should) set the terms for the process of dissolution of the LLC — the criteria for dissolution, how the decision is made, who is charge during the liquidation, etc.[2] However, if an LLC's operating agreement does not prepare adequately for dissolution (or if its managers disregard that process), it can lead to unjust results and courts may have to step in.

[2] Note that if the members/managers simply want to switch entities, most states allow an LLC to either (a) convert to a corporation or (b) merge with and into a corporation.

New Horizons Supply Coop. v. Haack, Case No. 98-1865, (Wis. Ct. App. Jan. 28, 1999)

Deininger, J.

Allison Haack appeals a small claims judgment in the amount of $1,009.99 plus costs entered against her in favor of New Horizons Supply Cooperative. Haack contends the trial court erred in denying her defense that because the debt was incurred by Kickapoo Valley Freight

LLC, a limited liability company, she was not personally liable for the cooperative's claim.

On May 30, 1995, Haack signed a "Cardtrol Agreement" whereby the "Patron" agreed to be responsible for payment of all fuel purchased with the "Cardtrol Card" issued under the agreement by a predecessor to New Horizons. "Kickapoo Valley Freight, LLC" is shown as the "Patron" in the first paragraph of the form agreement, and it is signed by "Allison Haack," with no designation indicating whether her signature was given individually or in a representative capacity on behalf of Kickapoo Valley.[1]

[1] "Who cares?" — Haack, probably.

An employee of New Horizons testified at trial that in September 1997, when the Kickapoo Valley account was in arrears, she contacted ... Haack, who apparently took care of paying the bills for the company. When contacted, Haack told the New Horizons employee that she would start paying $100 per month on the account. When no payment was received in October, Haack was contacted again, and she then informed New Horizons that Kickapoo Valley had dissolved, "that she was . . . a partner, that Robert had moved out of state, and that she planned to assume responsibility and would again start to make a hundred dollars per month beginning in October." The employee also testified that during the October telephone conversation, Haack told her she had the assets of the business: a truck, which was secured by the bank; and some accounts receivable "that they were trying to collect." When contacted in November, Haack again promised a payment, but in December, Haack told the New Horizons employee "not to call her at work anymore."[2]

[2] "Fuck off." — Haack, probably.

When attempts to contact Haack at her home phone number proved unsuccessful, New Horizons commenced this action to collect the account balance, $1,009.99, from Haack. Haack testified that Kickapoo Valley had been organized as a limited liability company, but she did not introduce articles of organization or an operating agreement into evidence. Haack did offer as exhibits a Wisconsin Department of Revenue registration certificate, as well as some correspondence from the department, showing the enterprise identified as "Kickapoo Valley Freight LLC." Haack stated her defense to New Horizons' claim was that the account was in the business name, that she was not personally liable for debts of the limited liability company, and that she had not personally guaranteed the obligation.

According to Haack, her brother, Robert Koch, had suffered a nervous breakdown and left the state; the truck was sold, with all proceeds going to the bank who held the lien on it; and there were "no additional assets," but that she was "left with quite a lot of debt that I had signed for." She acknowledged that she told New Horizons that she "would try to take care" of the account "several times" after the business ceased operations. Finally, Haack testified that she had not filed articles of dissolution or notified creditors of the termination of the business when it ceased operations in the fall of 1997.[1]

[1] "Why bother?" — Haack, probably.

In response to questions from the court regarding her investment in the company, Haack testified that the company was taxed as a partnership, and that she had with her copies of a sale agreement whereby "the assets" of the company were sold and the proceeds were given to the bank in order to release the lien on the truck. None of those documents were introduced as exhibits, however, and they are not a part of the record.[2] Haack later testified that the assets that were sold consisted of a "truck, a pallet jack and the customer list." She did not testify as to the disposition of any cash or accounts receivable remaining at the time the business was dissolved.

[2] "Whatever." — Haack, probably.

The trial court began its oral decision by noting that "the problem the court has, nobody's filed with this court any documents to show what the limited liability agreement stated. I don't know who bore what responsibilities." The court went on to conclude that "the rules of dissolution apparently were not followed" because articles of dissolution had not been filed nor creditors notified. It awarded judgment to New Horizons in the amount claimed, on the following basis:

> Haack signed an agreement for Kickapoo Valley Freight LLC, but it would appear to me that the corporation was just a shell around which there were no real intentions to operate like a corporation because there was no intent even to dissolve the corporation, and the court's going to find that the corporate veil is pierced by the fact that the people were acting like a partnership, being taxed like a partnership, and haven't even dissolved the — I'm treating this as a partnership and assessing liability to the remaining partner. That's the evidence that's before me, and unless I would have some other evidence that was not presented, I have to treat this matter as a partnership and assume that the limited liability agreement did not alter the normal partnership liability situation.[3]

[3] As legal interpretation, this passage is totally and hilariously incoherent — is it an LLC or a corporation or a partnership or what, exactly? — but you can get a sense of how frustrated the judge was with Haack.

Haack appeals the judgment entered against her for $1,009.99 plus costs.

[W]e are called upon to decide a legal question: Were Haack's testimony and exhibits sufficient to establish a defense under [the LLC statute], which provides that "a member or manager of a limited liability company is not personally liable for any debt, obligation or liability of the limited liability company"?

New Horizons seeks to defend the trial court's judgment, and its rationale of "piercing the corporate veil," by noting that the [LLC statute] expressly permits the importation of concepts such as "piercing the veil" from business corporation law:

> "nothing in this chapter shall preclude a court from ignoring the limited liability company entity under principles of common law of this state that are similar to those applicable to business corporations and shareholders in this state and under circumstances that are not inconsistent with the purposes of this chapter."

The cooperative argues that the court properly applied the concept of "piercing the veil" to the facts adduced at the trial of this matter. We disagree, and conclude, as Haack contends, that the court's comments imply that it erroneously deemed Kickapoo Valley's treatment as a partnership for tax purposes to be conclusive. There is little in the record, moreover, to support a conclusion that Haack "organized, controlled and conducted" company affairs to the extent that it had "no separate existence of its own and [was Haack's] mere instrumentality," which she "used to evade an obligation, to gain an unjust advantage or to commit an injustice."

Rather, we conclude that entry of judgment against Haack on the New Horizons' claim was proper because she failed to establish that she took appropriate steps to shield herself from liability for the company's debts following its dissolution and the distribution of its assets.

"One or more persons may organize a limited liability company by signing and delivering articles of organization to the [Department of Financial Institutions] for filing." The filing of articles by the department constitutes "conclusive proof that the limited liability company is organized and formed." As we have noted, Haack testified that an attorney had drafted and filed the necessary paperwork to establish Kickapoo Valley Freight LLC, but no direct evidence of the filing of articles with the department was presented to the court. Be that as it may, a fact-finder could have inferred from Haack's testimony and from her exhibits showing that the Department of Revenue apparently recognized Kickapoo Valley as a "LLC," that Haack and her brother had properly formed a limited liability company.

The record is devoid, however, of any evidence showing that appropriate steps were taken upon the dissolution of the company to shield its members from liability for the entity's obligations. Although it appears that filing articles of dissolution is optional, the order for distributing the company's assets following dissolution is fixed by statute, and the company's creditors enjoy first priority. A dissolved limited liability company may "dispose of known claims against it" by filing articles of dissolution, and then providing written notice to its known creditors containing information regarding the filing of claims. The testimony at trial indicates that Haack knew of New Horizons' claim at the time Kickapoo Valley was dissolved. It is also clear from the record that articles of dissolution for Kickapoo Valley Freight LLC were not filed, nor was the cooperative formally notified of a claim filing procedure or deadline.

[The LLC statute] provides in relevant part as follows:

> If the dissolved limited liability company's assets have been distributed in liquidation, a member of the limited liability company to the extent of the member's proportionate share of the claim or to the extent of the assets of the limited liability company distributed to the member in liquidation, whichever is less, but a member's total liability for all claims under this section may not exceed the total value of assets distributed to the member in liquidation.

It appears from the record that certain of Kickapoo Valley's assets were sold, and that the proceeds from that sale were remitted to the bank which held a lien on the company's truck. There is nothing in the record, however, showing the disposition of other company assets, such as cash and accounts receivable. New Horizons' witness testified that, in October 1997, Haack had claimed to be attempting to collect the accounts of the dissolved company and hoped to pay the instant debt from those proceeds. We do not know the value of the accounts receivable in question, however, or the amounts of any other company debts to which the proceeds of the accounts may have been applied, because Haack presented no testimony on the issue.

In this regard, we agree with the trial court's comments regarding the lack of evidence in the record to show that Kickapoo Valley's affairs were properly wound up following its dissolution occasioned by Robert Koch's dissociation from the enterprise. Although Kickapoo Valley Freight LLC may have been properly formed and operated as an entity separate and distinct from its owners, Haack did not establish that she distributed the entity's assets in accordance with [the law] following Kickapoo's dissolution. Her failure to employ the [proper] procedures left her vulnerable to New Horizons' claim, absent proof that the value of any assets of the dissolved company she received were exceeded by the cooperative's claim.

Thus, although Haack correctly contends that the judgment cannot be sustained on the ground relied upon by the trial court, we "nevertheless look to facts in the record in favor of respondent which [seem] to be insurmountable."

Some discussion questions:

1. Could the defendant in this case have cared any less than she did?
2. What does this case tell you about the bare minimum evidence necessary to present to a court to prove the existence of an LLC?
3. What are the limits of what an LLC and its operating agreement covers? Is there an analogue to corporate law here?

13. Mergers and Acquisitions

Oh, yes. Hell yes. Yes! FUCK YES! It's time for M&A!

The noblest of all the legal practice areas, mergers and acquisitions lays bare not only the twin desires at the heart of the corporation — power and money — but also the fundamental tension between the interests of managers and the interests of investors that animates so many conflicts in corporate law generally. The M&A lawyer — kind, brave, warm, wonderful — is tasked with nimbly navigating the push and pull, the give and take, the sturm und drang of multilateral negotiation, contractual interpretation, and the (pretty much) inevitable deal litigation.

There are two key duos in every transaction, and each dyadic relationship is simultaneously both cooperative and adversarial:

- ***Buyer & Seller***. The buyer (that is, the board of the corporation looking to acquire another) must make several legally-informed judgments during the course of the proposed transaction. What is an informed (i.e., not unreasonably high) offer for the target? If they make an offer directly to the shareholders, what are the legal requirements they must follow? If they enter into a deal, how can they protect themselves from unanticipated outcomes, ward off rival bidders, and maintain the value of their purchase? Or, if they want in on a deal pursued by another buyer, how can they leverage the law to push out their rivals and take the prize?

  The seller (that is, the board of the corporation that is being pursued) must — as the Ginger Rogers to the buyer's Fred Astaire — make all the legally-informed judgments that the buyer makes, but backwards and in heels. In addition to making an informed decision about whether to sell, what price is reasonable (i.e., not unreasonably low), and who to sell to, they must also make judgments about fending off hostile buyers while maintaining their fiduciary duties to the corporation.

- ***Board & Shareholders***. Even before a deal is reached or rejected, the board of the corporation must consider the role of the shareholders in the process. If a buyer, is this a deal that will ultimately require shareholder approval? And if a seller, questions arise both regarding potential shareholder approval, but also whether the board is acting for their own benefit or for the benefit of the shareholders when considering a potential transaction. When is a board legally allowed to block a deal that shareholders might otherwise approve? And how can boards do this without violating the shareholder's right to vote?

  The shareholder is comparatively less burdened in these deals — they can vote, and they can sue, and they can seek appraisal in a merger (we'll discuss this shortly) — though if a buyer is also a shareholder, there can be complications. If a shareholder is attempting to take over the corporation by virtue of increasing their ownership stake, can a board use defensive measures against that shareholder to put a stop to it? Does a shareholder already holding a controlling stake in the corporation have any legal obligations to the corporation when they sell that stake?[1] Deals can get legally complicated for shareholders, too.

[1] Note also that if a controlling shareholder is itself the buyer, that situation triggers a different legal standard of review for the deal, which we discuss in Chapter 15.

Our eyes clear, our hearts full, in this chapter we first review shareholder transactions that involve a change of corporate control, with an eye towards what the seller can receive and what responsibilities the seller (either the seller's board or the selling shareholder) has. We then examine corporate acquisitions[2] — stock purchase agreements, asset purchases, and (most importantly) mergers — and consider the various ways that a deal can be structured, and the consequences of those decisions. Next up, we look at what boards can do to fend off hostile takeovers while still remaining faithful to the fiduciary duties they owe to the corporation. Finally, we flip it around and analyze the moves that sellers and buyers can make to protect a deal they've agreed upon, and how those moves run up against the heightened duties that attach to management of a corporation that has put itself up for sale.

[2] That is: deals where control of the whole-assed company is being purchased.

Change of Control

A CORPORATION CAN BE BOUGHT IN WHOLE OR IN PART. Owning 100% of a corporation is the ideal outcome — no pesky shareholders yelling at you, no shareholder lawsuits,[3] exclusive access to the fanciest bathroom in the office — but (a) it's more expensive than

[3] Neither direct nor derivative, because you need a shareholder for either, and what are you gonna do, sue yourself? Sure, you're self-loathing, but you're not *that* self-loathing.

owning part of the corporation, and (b) maybe some existing shareholders don't want to sell their shares, and you just aren't that persuasive. Having a "controlling" position in the corporation is the next-best thing — you have the ability to select all or at least a majority of the board seats, so you control the direction of the corporation (albeit indirectly),[1] without much in the way of formal interference from the other shareholders.

[1] Why is this valuable? Well, think about a corporation that is sitting on a mountain of cash ***cough cough **APPLE** cough cough*** — wouldn't it be nice to take control of the board and set a dividend policy that returns that money to shareholders like you?

This is great — for the controlling shareholder. Non-controlling shareholders may worry that the controlling shareholder will exploit their position to drain resources from the corporation, use their power over the board to greenlight self-interested transactions, or just generally mismanage the corporation without any ability to remove them from power. As such, controlling shareholders are generally held to the same fiduciary duties as directors and officers even if they hold no formal position in the corporation.[2]

[2] The "Fuck Around And Find Out Doctrine" from Chapter 4.

THE KEY QUESTION FOR THIS CHAPTER is whether these duties operate to restrict how the controlling shareholder can sell their shares, and for what price. Control, as we've established, is a valuable thing in a corporation, and buyers will typically pay extra for shares that give them control; this extra consideration for controlling shares is called a "control premium" and it is usually somewhere between 30-50% above the market price for the shares. A threshold question, then: is it legally permissible for a controlling shareholder to accept an above-market price for their shares?

The short answer is: **yes**, you can collect a premium for the sale of controlling shares. The long answer is: (1) a shareholder is *always* free to sell their shares to a third party, and that goes for a controlling shareholder, too;[3] (2) the whole reason for investing is to get something in return and even if a controlling shareholder might owe fiduciary duties to the corporation, they do not owe anything to the other shareholders such that they'd have to split their gains with them; and (3) to repeat myself from Chapter 1, in America when someone offers you money, you grab it with Both. Goddamn. Hands.

[3] Absent a shareholder agreement to the contrary.

By contrast, when a board distributes money from the corporation to its shareholders, it has an obligation to do so in a way that is fair to all the shareholders (conditional on any terms attached to their shares); here, a third party is offering money for shares to a single shareholder — it does not implicate the same issues of distributional fairness that board action (which is fundamentally the action of the corporation) would.

That being said, there are exceptions to the general rule of "fuck you, I got mine" that applies to controlling shareholders selling their stake. In each instance, the limitation on controlling shareholder sales has jack shit to do with the other shareholders; instead, when the sale can potentially hurt *the corporation*, a controlling shareholder has a duty to refrain from selling (or pay damages as a result). These instances involve: (1) sales to corporate looters, (2) sales that give the buyer a potential corporate opportunity, and (3) sales that come with corporate offices. The three cases we discuss next take up these issues in turn.

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

Allen, Ch.

The litigation arises from the negotiation and sale by one group of defendants (the Carter group) of a control block of Atlas stock to Frederic Mascolo; the resignation of the Carter group as directors and the appointment of the Mascolo defendants as directors of Atlas, and, finally, the alleged looting of Atlas by Mascolo and persons associated with him. Insofar as the Carter defendants are concerned it is alleged that they were negligent and that their negligence breached a duty that, in the circumstances, they owed to the corporation. It is not claimed that they stand as an insurer of the corporation generally, but that the specific circumstances of their sale of control should have raised a warning that Mascolo was dishonest. The claims against Mascolo are more conventional: effectuation of self-dealing transactions on unfair terms. The Mascolo group is principally Messrs. Mascolo and Ager. They are two of the four alleged co-conspirators who orchestrated the wrongs alleged. The other two named co-conspirators — a convicted felon named Riefler and a lawyer named Beall — were not named as defendants since they are not amenable to service of process in the jurisdiction.

Plaintiff is a minority shareholder of Atlas. He brought this action after the change in control from the Carter group to the Mascolo group had occurred. The action was brought originally as a class action to enjoin a transaction that plaintiff alleged would constitute a breach of the directors' fiduciary duty; to rescind certain transactions effected by the Mascolo group; and, to collect damages from the Mascolo group. In addition the original complaint sought to collect damages from the Carter defendants for an alleged breach of a duty of care to minority shareholders in connection with the sale of control of Atlas to Mascolo.

The transaction that was sought to be enjoined in the original pleading was abandoned without any judicial action. Thereafter, following discovery, plaintiff filed the amended complaint. The amended complaint for the first time purported to assert claims derivatively on behalf of Atlas.

In general the claims asserted against the Carter group in the amended complaint are of two types. More significantly it is alleged that the Carter group, qua shareholders, owed a duty of care to Atlas to take the steps that a reasonable person would take in the circumstances to investigate the bona fides of the person to whom they sold control. It is said that the duty was breached here, and that if it had been met the corporation would have been spared the losses that are alleged to have resulted from the transactions effected by the board under the domination of Mascolo. There is no allegation that the Carter group conspired with Mascolo. Indeed the Carter group did not sell for cash but for shares of common stock of a corporation that plaintiff claims was a worthless shell and which was later employed in the transactions that are said to constitute a looting of Atlas. Thus, accepting the allegations of the complaint, they suggest that the Carter group was misled to its own injury as well as the injury of Atlas and its other shareholders. This claim was set forth, albeit as a direct claim and perhaps less elaborately, in the original pleading.

With respect to the second group of defendants — the Mascolo defendants — the amended complaint alleges a series of complex corporate transactions effectuated once Mascolo took control of Atlas, and claims that those transactions wrongfully injured Atlas.

The amended complaint seeks appointment of a receiver, rescission, and damages.

The Company

Atlas Energy Corporation is a Delaware corporation which, before Mascolo acquired control of it, engaged in oil and gas exploration and production. It conducted its business primarily through the acquisition of oil and gas properties which were resold to drilling programs. It then acted as sponsor and general partner of the drilling programs.

The Stock Exchange Agreement

The Carter group, which collectively owned 52% of the stock of Atlas, and Mascolo entered into a Stock Exchange Agreement dated as of March 28, 1986. That agreement provided that the Carter group would exchange its Atlas stock for shares of stock held by Mascolo in a company called Insuranshares of America ("ISA")[1] and contemplated a later merger between ISA and Atlas. ISA was described in the preamble to the Stock Exchange Agreement as "a company engaged in the insurance field by and through wholly-owned subsidiaries." The Stock Exchange Agreement contained representations and warranties by Mascolo to the effect

[1] Terrible name. 0/10.

that ISA owned all of the issued and outstanding capital stock of Pioneer National Life Insurance Company and Western National Life Insurance Company. It is alleged that those representations were false. ISA did not own stock in either company and had no insurance subsidiaries.

In the course of negotiations, the Mascolo group furnished the Carter group with a draft financial statement of ISA that reflected an investment in Life Insurance Company of America, a Washington corporation ("LICA"). No representation concerning LICA was made in the Stock Exchange Agreement, however. The existence of a purported investment by ISA in LICA was fictitious. It is alleged that the draft ISA financial statement was sufficiently suspicious to put any reasonably prudent business person on notice that further investigation should be made. Indeed Atlas' chief financial officer analyzed the financial statement and raised several questions concerning its accuracy, none of which were pursued by the Carter group.

The Stock Exchange Agreement further provided that Mascolo would place in escrow 50,000 shares of Louisiana Bank-shares Inc. 8% cumulative preferred stock, $10 par value. It was agreed that if Atlas consummated an exchange merger for all of the outstanding common stock of ISA on agreed upon terms within 365 days of the date of the Stock Exchange Agreement, the bank stock would be returned to Mascolo. If no merger took place within the specified time, then that stock was to be distributed pro rata to the Carter group members.

It was agreed, finally, that as part of the stock exchange transaction, the members of the Carter group would resign their positions as Atlas directors in a procedure that assured that Mascolo and his designees would be appointed as replacements.

The gist of plaintiff's claim against the Carter defendants is the allegation that those defendants had reason to suspect the integrity of the Mascolo group, but failed to conduct even a cursory investigation into any of several suspicious aspects of the transaction: the unaudited financial statement, the mention of LICA in negotiations but not in the representations concerning ISA's subsidiaries, and the ownership of the subsidiaries themselves. Such an investigation, argues plaintiff, would have revealed the structure of ISA to be fragile indeed, with minimal capitalization and no productive assets.

The charges against the Mascolo defendants are that the Mascolo defendants caused the effectuation of self-dealing transactions designed to benefit members of the Mascolo group, at the expense of Atlas.

Mascolo purchased the Carter group's stock on March 28, 1986. Also on that day the newly elected Atlas board (i.e., the Mascolo defendants) adopted resolutions that, among other things:

(a) changed Atlas' name to Insuranshares of America, Inc.;[1]

[1] Stupid name, but fine.

(b) effectuated a reverse stock split converting each existing Atlas share into .037245092 new shares, thus reducing the 26,849,175 Atlas shares to approximately 1,000,000 shares;[2]

[2] Weird, but fine.

(c) reduced Atlas authorized capitalization to 10,000,000 shares, $.10 par value;[3]

[3] Ditto.

(d) approved the acquisition of all of the outstanding common stock of ISA in consideration for 3,000,000 post-reverse stock split Atlas shares;[4]

[4] Oh no. Now we're getting into selling the cow for magic beans territory.

(e) elected defendant Mascolo as chairman of the board, Johnson as president, Devaney as treasurer and Ager as vice president;[5]

[5] Perfectly fine — that's the point of buying control, right?

(f) approved the negotiation of the sale of Atlas' oil properties "with a series of potential buyers";[6]

[6] Uh oh.

(g) approved the purchase of 200,000 shares of the common stock of Hughes Chemical Corporation at $3 per share with an option to acquire an additional 1,000,000 shares at $5 per share for a 12-month period and for $10 per share for a consecutive 12-month period;[7]

[7] Blatant self-dealing, not good.

(h) ratified the actions of the company's prior officers and directors and released them from any liability arising as a consequence of their relationship to the company;[8] and

[8] "Aww, thanks." — the company's prior officers and directors, probably.

(i) authorized payment of a $100,000 commission to the company which found the buyers of the Carter group stock.[9]

[9] A little something for your trouble, kid.

It is alleged, essentially, that defendants approved the ISA and Hughes chemical transactions without any credible information about the business or assets of either of those companies. Messrs. Mascolo and Ager, it is alleged, knew of the poor financial condition of ISA and Hughes Chemical and fraudulently approved the challenged transaction. Each Mascolo defendant is charged with breach of fiduciary duty in connection with the approval of the payment of a finder's fee in connection with the Stock Exchange Agreement.

The ISA Transaction

Plaintiff asserts that ISA is nothing more than a corporate shell. Pursuant to the Stock Exchange Agreement Mascolo acquired a controlling (52%) stock interest in Atlas in exchange for 518,335 ISA shares. Atlas then acquired all the outstanding ISA shares in exchange for 3,000,000 newly issued shares of Atlas common stock. As a result of that transaction, the Mascolo group as a whole came to own 75% of Atlas' shares.

The minority shareholders of Atlas saw their proportionate ownership of Atlas reduced from 48% before the ISA transaction to 12% upon its consummation. For Atlas to exchange 3,000,000 of its shares for the stock of this "corporate shell" was, argues plaintiff, equivalent to issuing Atlas stock to the Mascolo group (the holders of the ISA stock) without consideration.

The Hughes Chemical Purchase

Hughes Chemical Corporation is a North Carolina corporation with its sole place of operations in Fletcher, North Carolina. Mr. Mascolo and two of his associates (who are referred to in the amended complaint as members of the Mascolo group but who are not named as defendants) were stockholders and directors of Hughes Chemical. Plaintiff asserts that in March, 1986, Mascolo caused Atlas to acquire shares of Hughes Chemical at a price unfair to Atlas and its stockholders.[1]

[1] Hughes Chemical, along with Mascolo and his associates, was the subject of a massive SEC investigation that alleged that Hughes was merely a shell corporation used for a pump-and-dump stock offering. One of Mascolo's associates (Riefler) was convicted of federal criminal charges in connection with it; Mascolo has defended his involvement, saying "they were the wrong people to trust".

The MPA Transaction

Defendant Devaney, elected by Mascolo to the Atlas board, was president and a principal stockholder of MPA Associates, Inc., a Utah corporation ("MPA"). On April 20, 1986, Atlas entered into an agreement with MPA for the sale to MPA of Atlas' oil and gas properties. In exchange for those properties, MPA issued to Atlas a $5,000,000 secured promissory note, and 2,000,000 shares of MPA common stock, representing 31.8% of the MPA shares issued and outstanding after such issuance. It was agreed that until the MPA Note was fully paid, Atlas would receive 40% of the net cash flow from the oil and gas properties attributable to sales of oil and gas in excess of certain specified prices. Plaintiff alleges that, as a result of the MPA transaction, the MPA Note and stock became Atlas' principal assets.

After MPA's acquisition of the oil and gas properties, Devaney discovered that certain Atlas creditors had claims on the cash flow from those properties. MPA did not make the payments to Atlas required by the MPA Note. On June 2, 1987, Devaney and Mascolo reached an agreement which essentially rescinded the MPA Agreement. Mascolo transferred his Atlas stock to Devaney in exchange for shares of an unrelated corporation. The MPA Note was canceled and Atlas transferred its 2,000,000 MPA shares to MPA, all in exchange for a return of the oil and gas properties originally sold to MPA. Devaney and/or his nominees assumed control of Atlas.

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Finally,[1] I turn to the Carter defendants motion to dismiss for failure to state a claim upon which relief may be granted. This motion raises novel questions of Delaware law. Stated generally the most basic of these questions is whether a controlling shareholder or group may under any circumstances owe a duty of care to the corporation in connection with the sale of a control block of stock. If such a duty may be said to exist under certain circumstances the questions in this case then become whether the facts alleged in the amended complaint would permit the finding that such a duty arose in connection with the sale to the Mascolo group and was breached.

[1] The opinion first addressed the requirements for a derivative suit and the standard for demand futility. Because we are now experts on both of those subjects, I have omitted them from this excerpt.

A number of cases may be cited in support of the proposition that when transferring control of a corporation to another, a controlling shareholder may, in some circumstances, have a duty to investigate the bona fides of the buyer — that is, in those circumstances, to take such steps as a reasonable person would take to ascertain that the buyer does not intend or is unlikely to plan any depredations of the corporation. The circumstance to which these cases refer is the existence of facts that would give rise to suspicion by a reasonably prudent person. The leading case is *Insuranshares Corporation of Delaware v. Northern Fiscal Corp.*, 35 F.Supp. 22 (E.D.Pa. 1940).[2]

[2] Reader, I gasped. In what is either an insane coincidence or an amazing troll job, the doofy name "Insuranshares" was *also* the name of the corporation in another case about corporate looting that occurred forty years prior. I choose to believe this was an intentional act designed to infuriate the minority shareholders here, as both Mascolo and his associate Beall were lawyers and could very well have been aware of the case. Incredible.

In that case defendants, who comprised the entire board of directors of the corporation involved, sold their 27% stock interest in the corporation and resigned as directors. The resignations were done seriatim, in a way that permitted the designation of the buyers as successor directors. The buyers proceeded to loot the corporation.

As here, the sellers contended that they could have no liability for the wrongs that followed their sale. They merely sold their stock and resigned. These were acts that they were privileged to do, they claimed. Judge Kirkpatrick rejected this position:

> Those who control a corporation, either through majority stock ownership, ownership of large blocks of stock less than a majority, officeholding, management contracts, or otherwise, owe some duty to the corporation in respect of the transfer of the control to outsiders. The law has long ago reached the point where it is recognized that such persons may not be wholly oblivious of the interest of everyone but themselves, even in the act of parting with control, and that, under certain circumstances, they may be held liable for whatever injury to the corporation made possible by the transfer. Without attempting any general definition, and stating the duty in minimum terms as applicable to the facts of this case, it may be said that the owners of control are under a duty not to transfer it to outsiders if the circumstances surrounding the proposed transfer are such as to awaken suspicion and put a prudent man on his guard — unless a

> reasonably adequate investigation discloses such facts as would convince a reasonable person that no fraud is intended or likely to result.
>
> If, after such investigation, the sellers are deceived by false representations, there might not be liability, but if the circumstances put the seller on notice and if no adequate investigation is made and harm follows, then liability also follows.

While Delaware law has not addressed this specific question, one is not left without guidance from our decided cases. Several principles deducible from that law are pertinent. First, is the principle that a shareholder has a right to sell his or her stock and in the ordinary case owes no duty in that connection to other shareholders when acting in good faith.

Equally well established is the principle that when a shareholder presumes to exercise control over a corporation, to direct its actions, that shareholder assumes a fiduciary duty of the same kind as that owed by a director to the corporation. A sale of controlling interest in a corporation, at least where, as is alleged here, that sale is coupled with an agreement for the sellers to resign from the board of directors in such a way as to assure that the buyer's designees assume that corporate office, does, in my opinion, involve or implicate the corporate mechanisms so as to call this principle into operation.

More generally, it does not follow from the proposition that ordinarily a shareholder has a right to sell her stock to whom and on such terms as she deems expedient, that no duty may arise from the particular circumstances to take care in the exercise of that right. It is established American legal doctrine that, unless privileged, each person owes a duty to those who may foreseeably be harmed by her action to take such steps as a reasonably prudent person would take in similar circumstances to avoid such harm to others. While this principle arises from the law of torts and not the law of corporations or of fiduciary duties, that distinction is not, I think, significant unless the law of corporations or of fiduciary duties somehow privileges a selling shareholder by exempting her from the reach of this principle. The principle itself is one of great generality and, if not negated by privilege, would apply to a controlling shareholder who negligently places others foreseeably in the path of injury.

That a shareholder may sell her stock (or that a director may resign his office) is a right that, with respect to the principle involved, is no different, for example, than the right that a licensed driver has to operate a motor vehicle upon a highway. The right exists, but it is not without conditions and limitations, some established by positive regulation, some by common-law. Thus, to continue the parallel, the driver owes a duty of care to her passengers because it is foreseeable that they may be injured if, through inattention or otherwise, the driver involves the car she is operating in a collision. In the typical instance a seller of corporate stock can be expected to have no similar apprehension of risks to others from her own inattention. But, in some circumstances, the seller of a control block of stock may or should reasonably foresee danger to other shareholders; with her sale of stock will also go control over the corporation and with it the opportunity to misuse that power to the injury of such other shareholders. Thus, the reason that a duty of care is recognized in any situation is fully present in this situation. I can find no universal privilege arising from the corporate form that exempts a controlling shareholder who sells corporate control from the wholesome reach of this common-law duty.[1]

[1] "ain't no rule says a ~~dog can't play basketball~~ controlling shareholder sale *can't* be a duty of care violation"

Thus, I conclude that while a person who transfers corporate control to another is surely not a surety for his buyer, when the circumstances would alert a reasonably prudent person to a risk that his buyer is dishonest or in some material respect not truthful, a duty devolves upon the seller to make such inquiry as a reasonably prudent person would make, and generally to exercise care so that others who will be affected by his actions should not be injured by wrongful conduct.

The cases that have announced this principle have laid some stress on the fact that they involved not merely a sale of stock, but a sale of control over the corporation. That circumstance is pleaded here as well.

That Mr. Carter may well have been misled to his own detriment may be a factor affecting the question whether a duty to inquire arose, as Carter might be assumed to be a prudent man when dealing with his own property. But that assumption is essentially evidentiary and can be given no weight on this motion.

For the foregoing reasons the pending motions will be denied.[2]

[2] In 1995, Mascolo ran for mayor of Waterbury, Connecticut. When this particular controversy surfaced, Mascolo noted that his opponent had himself been indicted for accepting bribes and was accused of bank fraud. Mascolo lost anyway.

Some discussion questions:

1. Tort law? What the hell is tort law doing here?

2. Why do you think the plaintiff is pursuing claims against the Carter group? It seems like the real bad actor here is Mascolo, no?

3. Did the Carter group profit from this sale? What did they get, really?

4. Does this apply to controlling shareholders only or board members too?

Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955)

Clark, C.J.

This is a derivative action brought by minority stockholders of Newport Steel Corporation to compel accounting for, and restitution of, allegedly illegal gains which accrued to defendants as a result of the sale in August, 1950, of their controlling interest in the corporation. The principal defendant, C. Russell Feldmann, who represented and acted for the others, members of his family, was at that time not only the dominant stockholder,[1] but also the chairman of the board of directors and the president of the corporation. Newport, an Indiana corporation, operated mills for the production of steel sheets for sale to manufacturers of steel products, first at Newport, Kentucky, and later also at other places in Kentucky and Ohio. The buyers, a syndicate organized as Wilport Company,[2] a Delaware corporation, consisted of end-users of steel who were interested in securing a source of supply in a market becoming ever tighter in the Korean War. Plaintiffs contend that the consideration paid for the stock included compensation for the sale of a corporate asset, a power held in trust for the corporation by Feldmann as its fiduciary. This power was the ability to control the allocation of the corporate product in a time of short supply, through control of the board of directors; and it was effectively transferred in this sale by having Feldmann procure the resignation of his own board and the election of Wilport's nominees immediately upon consummation of the sale.

[1] 37%. Remember: control can attach with less than a majority.

[2] Fun fact: Wilport originally proposed a merger with Newport (The name of the proposed company? That's right: Portport.) before deciding to buy control of Newport through Feldmann. Keep that in mind when you consider the minority shareholders' complaints here.

Plaintiffs argue here, as they did in the court below, that in the situation here disclosed the vendors must account to the non-participating minority stockholders for that share of their profit which is attributable to the sale of the corporate power. Judge Hincks[3] denied the validity of the premise, holding that the rights involved in the sale were only those normally incident to the possession of a controlling block of shares, with which a dominant stockholder, in the absence of fraud or foreseeable looting, was entitled to deal according to his own best interests. Furthermore, he held that plaintiffs had failed to satisfy their burden of proving that the sales price was not a fair price for the stock per se. Plaintiffs appeal from these rulings of law which resulted in the dismissal of their complaint.

[3] The lower court judge.

The essential facts found by the trial judge are not in dispute. Newport was a relative newcomer in the steel industry with predominantly old installations which were in the process of being supplemented by more modern facilities. Except in times of extreme shortage Newport was not in a position to compete profitably with other steel mills for customers not in its immediate geographical area. Wilport, the purchasing syndicate, consisted of geographically remote end-users of steel who were interested in buying more steel from Newport than they had been able to obtain during recent periods of tight supply. The price of $20 per share was found by Judge Hincks to be a fair one for a control block of stock, although the over-the-counter market price had not exceeded $12 and the book value per share was $17.03. But this finding was limited by Judge Hincks' statement that "[w]hat value the block would have had if shorn of its appurtenant power to control distribution of the corporate product, the evidence does not show." It was also conditioned by his earlier ruling that the burden was on plaintiff's to prove a lesser value for the stock.

Both as director and as dominant stockholder, Feldmann stood in a fiduciary relationship to the corporation and to the minority stockholders as beneficiaries thereof.[1] His fiduciary obligation must in the first instance be measured by the law of Indiana, the state of incorporation of Newport. Although there is no Indiana case directly in point, the most closely analogous one emphasizes the close scrutiny to which Indiana subjects the conduct of fiduciaries when personal benefit may stand in the way of fulfillment of trust obligations. Directors of a corporation are its agents, and they are governed by the rules of law applicable to other agents, and, as between themselves and their principal, the rules relating to honesty and fair dealing in the management of the affairs of their principal are applicable. They must not, in any degree, allow their official conduct to be swayed by their private interest, which must yield to official duty.

[1] Goddammit. This is why I hate this "duty to the shareholder" nonsense. This case, like *Harris* before it, is about injury to the corporation arising from the sale — not any injury to the other shareholders. Just pretend the court doesn't say this.

In Indiana, then, as elsewhere, the responsibility of the fiduciary is not limited to a proper regard for the tangible balance sheet assets of the corporation, but includes the dedication of his uncorrupted business judgment for the sole benefit of the corporation, in any dealings which may adversely affect it.

It is true, as defendants have been at pains to point out, that this is not the ordinary case of breach of fiduciary duty. We have here no fraud, no misuse of confidential information, no outright looting of a helpless corporation. But on the other hand, we do not find compliance with that high standard which we have just stated and which we and other courts have come to expect and demand of corporate fiduciaries. In the often-quoted words of Judge Cardozo: "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[2] The actions of defendants in siphoning off for personal gain corporate advantages to be derived from a favorable market situation do not betoken the necessary undivided loyalty owed by the fiduciary to his principal.

[2] I assume you have this passage from *Meinhard* memorized by now.

The corporate opportunities of whose misappropriation the minority stockholders complain need not have been an absolute certainty in order to support this action against Feldmann. If there was possibility of corporate gain, they are entitled to recover.

This rationale is equally appropriate to a consideration of the benefits which Newport might have derived from the steel shortage. In the past Newport had used and profited by its market leverage by operation of what the industry had come to call the "Feldmann Plan." This consisted of securing interest-free advances from prospective purchasers of steel in return for firm commitments to them from future production. The funds thus acquired were used to finance improvements in existing plants and to acquire new installations. In the summer of 1950 Newport had been negotiating for cold-rolling facilities which it needed for a more fully integrated operation and a more marketable product, and Feldmann plan funds might well have been used toward this end.

Further, as plaintiffs alternatively suggest, Newport might have used the period of short supply to build up patronage in the geographical area in which it could compete profitably even when steel was more abundant. Either of these opportunities was Newport's, to be used to its advantage only. Only if defendants had been able to negate completely any possibility of gain by Newport could they have prevailed.

Defendants seek to categorize the corporate opportunities which might have accrued to Newport as too unethical to warrant further consideration. It is true that reputable steel producers were not participating in the gray market brought about by the Korean War and were refraining from advancing their prices, although to do so would not have been illegal. But Feldmann plan transactions were not considered within this self-imposed interdiction; the trial court found that around the time of the Feldmann sale Jones Laughlin Steel Corporation, Republic Steel Company, and Pittsburgh Steel Corporation were all participating in such arrangements. In any event, it ill becomes the defendants to disparage as unethical the market advantages from which they themselves reaped rich benefits.

We do not mean to suggest that a majority stockholder cannot dispose of his controlling block of stock to outsiders without having to account to his corporation for profits or even never do this with impunity when the buyer is an interested customer, actual or potential. for the corporation's product. But when the sale necessarily results in a sacrifice of this element of corporate good will and consequent unusual profit to the fiduciary who has caused the sacrifice, he should account for his gains. So in a time of market shortage, where a call on a corporation's product commands an unusually large premium, in one form or another, we think it sound law that a fiduciary may not appropriate to himself the value of this premium. Such personal gain at the expense of his coventurers seems particularly reprehensible when made by the trusted president and director of his company. In this case the violation of duty seems to be all the clearer because of this triple role in which Feldmann appears, though we are unwilling to say, and are not to be understood as saying, that we should accept a lesser obligation for any one of his roles alone.

Hence to the extent that the price received by Feldmann and his co-defendants included such a bonus, he is accountable to the minority stockholders who sue here. And plaintiffs, as they contend, are entitled to a recovery in their own right, instead of in right of the corporation (as in the usual derivative actions), since neither Wilport nor their successors in interest should share in any judgment which may be rendered. Defendants cannot well object to this form of recovery, since the only alternative, recovery for the corporation as a whole, would subject them to a greater total liability.

The case will therefore be remanded to the district court for a determination of the question expressly left open below, namely, the value of defendants' stock without the appurtenant control over the corporation's output of steel. We reiterate that on this issue, as on all others relating to a breach of fiduciary duty, the burden of proof must rest on the defendants. Judgment should go to these plaintiffs and those whom they represent for any premium value so shown to the extent of their respective stock interests.

The judgment is therefore reversed and the action remanded for further proceedings pursuant to this opinion.

Swan, J., dissenting

With the general principles enunciated in the majority opinion as to the duties of fiduciaries I am, of course, in thorough accord. But, as Mr. Justice Frankfurter stated in *Securities and Exchange Comm. v. Chenery Corp.*, "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations?" My brothers' opinion does not specify precisely what fiduciary duty Feldmann is held to have violated or whether it was a duty imposed upon him as the dominant stockholder or as a director of Newport. Without such specification I think that both the legal profession and the business world will find the decision confusing and will be unable to foretell the extent of its impact upon customary practices in the sale of stock.

The power to control the management of a corporation, that is, to elect directors to manage its affairs, is an inseparable incident to the ownership of a majority of its stock, or sometimes, as in the present instance, to the ownership of enough shares, less than a majority, to control an election. Concededly a majority or dominant shareholder is ordinarily privileged to sell his stock at the best price obtainable from the purchaser. In so doing he acts on his own behalf, not as an agent of the corporation. If he knows or has reason to believe that the purchaser intends to exercise to the detriment of the corporation the power of management acquired by the purchase, such knowledge or reasonable suspicion will terminate the dominant shareholder's privilege to sell and will create a duty not to transfer the power of management to such purchaser. The duty seems to me to resemble the obligation which everyone is under not to assist another to commit a tort rather than the obligation of a fiduciary. But whatever the nature of the duty, a violation of it will subject the violator to liability for damages sustained by the corporation. Judge Hincks found that Feldmann had no reason to think that Wilport would use the power of management it would acquire by the purchase to injure Newport, and that there was no proof that it ever was so used. Feldmann did know, it is true, that the reason Wilport wanted the stock was to put in a board of directors who would be likely to permit Wilport's members to purchase more of Newport's steel than they might otherwise be able to get. But there is nothing illegal in a dominant shareholder purchasing from his own corporation at the same prices it offers to other customers. That is what the members of Wilport did, and there is no proof that Newport suffered any detriment therefrom.[1]

[1] In fact, Newport became immensely profitable after the sale, and there was no evidence that they sold their steel at below-market rates to Wilport or anyone else.

My brothers say that "the consideration paid for the stock included compensation for the sale of a corporate asset", which they describe as "the ability to control the allocation of the corporate product in a time of short supply, through control of the board of directors; and it was effectively transferred in this sale by having Feldmann procure the resignation of his own board and the election of Wilport's nominees immediately upon consummation of the sale." The implications of this are not clear to me. If it means that when market conditions are such as to induce users of a corporation's product to wish to buy a controlling block of stock in order to be able to purchase part of the corporation's output at the same mill list prices as are offered to other customers, the dominant stockholder is under a fiduciary duty not to sell his stock, I cannot agree. For reasons already stated, in my opinion Feldmann was not proved to be under any fiduciary duty as a stockholder not to sell the stock he controlled.

Judge Hincks went into the matter of valuation of the stock with his customary care and thoroughness. He made no error of law in applying the principles relating to valuation of stock. Concededly a controlling block of stock has greater sale value than a small lot. While the spread between $10 per share for small lots and $20 per share for the controlling block seems rather extraordinarily wide, the $20 valuation was supported by the expert testimony of Dr. Badger, whom the district judge said he could not find to be wrong. I see no justification for upsetting the valuation as clearly erroneous. The controlling block could not by any possibility be shorn of its appurtenant power to elect directors and through them to control distribution of the corporate product. It is this "appurtenant power" which gives a controlling block its value as such block. What evidence could be adduced to show the value of the block "if shorn" of such appurtenant power, I cannot conceive, for it cannot be shorn of it.

The final conclusion of my brothers is that the plaintiffs are entitled to recover in their own right instead of in the right of the corporation. This appears to be completely inconsistent with the theory advanced at the outset of the opinion, namely, that the price of the stock "included compensation for the sale of a corporate asset." If a corporate asset was sold, surely the corporation should recover the compensation received for it by the defendants. Moreover, if the plaintiffs were suing in their own right, Newport was not a proper party.

I would affirm the judgment on appeal.

SOME DISCUSSION QUESTIONS:

1. Selling control at a premium is A-OK; a controlling shareholder is absolutely not required to share their gains with the non-controlling shareholders.[1] So what was the problem here?

[1] That would be communism.

2. What was the fiduciary duty at issue? Who was injured? Who recovers?

3. How does the court calculate damages?

4. What's the dissent's position?

5. Here and in *Harris v. Carter*, the board just up and resigns — why? Does this count as the "sale of office" that is the core of the next case?

Essex Universal Corporation v. Yates, 305 F.2d 572 (2d Cir. 1962)

Lumbard, C.J.

This appeal from the district court's summary judgment in favor of the defendant raises the question whether a contract for the sale of 28.3% of the stock of a corporation is, under New York law, invalid as against public policy solely because it includes a clause giving the purchaser an option to require a majority of the existing directors to replace themselves, by a process of seriatim[2] resignation, with a majority designated by the purchaser. Despite the disagreement evidenced by the diversity of our opinions, my brethren and I agree that such a provision does not on its face render the contract illegal and unenforceable, and thus that it was improper to grant summary judgment.

[2] One-by-one.

The defendant Herbert J. Yates, a resident of California, was president and chairman of the board of directors of Republic Pictures Corporation, a New York corporation which at the time relevant to this suit had 2,004,190 shares of common stock outstanding. Republic's stock was listed and traded on the New York Stock Exchange. In August 1957, Essex Universal Corporation, a Delaware corporation owning stock in various diversified businesses, learned of the possibility of purchasing from Yates an interest in Republic. Negotiations proceeded rapidly, and on August 28 Yates and Joseph Harris, the president of Essex, signed a contract in which Essex agreed to buy, and Yates agreed "to sell or cause to be sold" at least 500,000 and not more than 600,000 shares of Republic stock. The price was set at eight dollars a share, roughly two dollars above the then market price on the Exchange. In addition to other provisions not relevant to the present motion, the contract contained the following paragraph:

> "6. Resignations.
>
> Upon and as a condition to the closing of this transaction if requested by Buyer at least ten (10) days prior to the date of the closing:
>
> (a) Seller will deliver to Buyer the resignations of the majority of the directors of Republic.
>
> (b) Seller will cause a special meeting of the board of directors of Republic to be held, legally convened pursuant to law and the by-laws of Republic, and simultaneously with the acceptance of the directors' resignations set forth in paragraph 6(a) immediately preceding will cause nominees of Buyer to be elected directors of Republic in place of the resigned directors."

Before the date of the closing, as provided in the contract, Yates notified Essex that he would deliver 566,223 shares, or 28.3 per cent of the Republic stock then outstanding, and Essex formally requested Yates to arrange for the replacement of a majority of Republic's directors with Essex nominees pursuant to paragraph 6 of the contract. This was to be accomplished by having eight of the fourteen directors resign seriatim, each in turn being replaced by an Essex nominee elected by the others; such a procedure was in form permissible under the charter and by-laws of Republic, which empowered the board to choose the successor of any of its members who might resign.

On September 18, the parties met as arranged for the closing at Republic's office in New York City. Essex tendered bank drafts and cashier's checks totalling $1,698,690, which was $37\frac{1}{2}$% of the total price of $4,529,784 due at this time.[1] Yates upon advice of his lawyer rejected the tender as "unsatisfactory" and said, according to his deposition testimony, "Well, there can be no deal. We can't close it."

[1] "I'm good for the rest, bro. Trust me."

Essex began this action in the New York Supreme Court, and it was removed to the district court on account of diversity of citizenship. Essex seeks damages of $2,700,000, claiming that at the time of the aborted closing the stock was in actuality worth more than $12.75 a share. Yates' answer raised a number of defenses, but the motion for summary judgment now before us was made and decided only on the theory that the provision in the contract for immediate transfer of control of the board of directors was illegal per se and tainted the entire contract.[1] We have no doubt, and the parties agree, that New York law governs.

[1] In essence, Yates is trying to use this provision of the agreement to get out of a contract with a flaky buyer.

It is established beyond question under New York law that it is illegal to sell corporate office or management control by itself (that is, accompanied by no stock or insufficient stock to carry voting control). The same rule apparently applies in all jurisdictions where the question has arisen. The rationale of the rule is undisputable: persons enjoying management control hold it on behalf of the corporation's stockholders, and therefore may not regard it as their own personal property to dispose of as they wish. Any other rule would violate the most fundamental principle of corporate democracy, that management must represent and be chosen by, or at least with the consent of, those who own the corporation.

Essex was, however, contracting with Yates for the purchase of a very substantial percentage of Republic stock. If, by virtue of the voting power carried by this stock, it could have elected a majority of the board of directors, then the contract was not a simple agreement for the sale of office to one having no ownership interest in the corporation, and the question of its legality would require further analysis. Such stock voting control would incontestably belong to the owner of a majority of the voting stock, and it is commonly known that equivalent power usually accrues to the owner of 28.3% of the stock. For the purpose of this analysis, I shall assume that Essex was contracting to acquire a majority of the Republic stock, deferring consideration of the situation where, as here, only 28.3% is to be acquired.

Republic's board of directors at the time of the aborted closing had fourteen members[2] divided into three classes, each class being "as nearly as may be" of the same size. Directors were elected for terms of three years, one class being elected at each annual shareholder meeting on the first Tuesday in April. Thus, absent the immediate replacement of directors provided for in this contract, Essex as the hypothetical new majority shareholder of the corporation could not have obtained managing control in the form of a majority of the board in the normal course of events until April 1959, some eighteen months after the sale of the stock. The first question before us then is whether an agreement to accelerate the transfer of management control, in a manner legal in form under the corporation's charter and by-laws, violates the public policy of New York.

[2] Grinding my teeth right now.

There is no question of the right of a controlling shareholder under New York law normally to derive a premium from the sale of a controlling block of stock. In other words, there was no impropriety per se in the fact that Yates was to receive more per share than the generally prevailing market price for Republic stock.

The next question is whether it is legal to give and receive payment for the immediate transfer of management control to one who has achieved majority share control but would not otherwise be able to convert that share control into operating control for some time. I think that it is.

A fair generalization may be that a holder of corporate control will not, as a fiduciary, be permitted to profit from facilitating actions on the part of the purchasers of control which are detrimental to the interests of the corporation or the remaining shareholders. There is, however, no suggestion that the transfer of control over Republic to Essex carried any such threat to the interests of the corporation or its other shareholders.

Given this principle that it is permissible for a seller thus to choose to facilitate immediate transfer of management control, I can see no objection to a contractual provision requiring him to do so as a condition of the sale.

The easy and immediate transfer of corporate control to new interests is ordinarily beneficial to the economy and it seems inevitable that such transactions would be discouraged if the purchaser of a majority stock interest were required to wait some period before his purchase of control could become effective. Conversely it would greatly hamper the efforts of any existing majority group to dispose of its interest if it could not assure the purchaser of immediate control over corporation operations. I can see no reason why a purchaser of majority control should not ordinarily be permitted to make his control effective from the moment of the transfer of stock.

Thus if Essex had been contracting to purchase a majority of the stock of Republic, it would have been entirely proper for the contract to contain the provision for immediate replacement of directors. Although in the case at bar only 28.3 per cent of the stock was involved, it is commonly known that a person or group owning so large a percentage of the voting stock of a corporation which, like Republic, has at least the 1,500 shareholders normally requisite to listing on the New York Stock Exchange, is almost certain to have share control as a practical matter. If Essex was contracting to acquire what in reality would be equivalent to ownership of a majority of stock, i.e., if it would as a practical certainty have been guaranteed of the stock voting power to choose a majority of the directors of Republic in due course, there is no reason why the contract should not similarly be legal. Whether Essex was thus to acquire the equivalent of majority stock control would, if the issue is properly raised by the defendants, be a factual issue to be determined by the district court on remand.

Because 28.3 per cent of the voting stock of a publicly owned corporation is usually tantamount to majority control, I would place the burden of proof on this issue on Yates as the party attacking the legality of the transaction. Thus, unless on remand Yates chooses to raise the question whether the block of stock in question carried the equivalent of majority control, it is my view that the trial court should regard the contract as legal and proceed to consider the other issues raised by the pleadings. If Yates chooses to raise the issue, it will, on my view, be necessary for him to prove the existence of circumstances which would have prevented Essex from electing a majority of the Republic board of directors in due course. It will not be enough for Yates to raise merely hypothetical possibilities of opposition by the other Republic shareholders to Essex' assumption of management control. Rather, it will be necessary for him to show that, assuming neutrality on the part of the retiring management, there was at the time some concretely foreseeable reason why Essex' wishes would not have prevailed in shareholder voting held in due course. In other words, I would require him to show that there was at the time of the contract some other organized block of stock of sufficient size to outvote the block Essex was buying, or else some circumstance making it likely that enough of the holders of the remaining Republic stock would band together to keep Essex from control.

Reversed and remanded for further proceedings not inconsistent with the judgment of this court.

Friendly, J., concurring

I have no doubt that many contracts, drawn by competent and responsible counsel, for the purchase of blocks of stock from interests thought to "control" a corporation although owning less than a majority, have contained provisions like paragraph 6 of the contract sub judice. However, developments over the past decades seem to me to show that such a clause violates basic principles of corporate democracy. To be sure, stockholders who have allowed a set of directors to be placed in office, whether by their vote or their failure to vote, must recognize that death, incapacity or other hazard may prevent a director from serving a full term, and that they will have no voice as to his immediate successor. But the stockholders are entitled to expect that, in that event, the remaining directors will fill the vacancy in the exercise of their fiduciary responsibility. A mass seriatim resignation directed by a selling stockholder, and the filling of vacancies by his henchmen[1] at the dictation of a purchaser and without any consideration of the character of the latter's nominees, are

[1] "It's Batman! Get him!"

beyond what the stockholders contemplated or should have been expected to contemplate. This seems to me a wrong to the corporation and the other stockholders which the law ought not countenance, whether the selling stockholder has received a premium or not. To hold the seller for delinquencies of the new directors only if he knew the purchaser was an intending looter is not a sufficient sanction. The difficulties of proof are formidable even if receipt of too high a premium creates a presumption of such knowledge, and, all too often, the doors are locked only after the horses have been stolen. Stronger medicines are needed — refusal to enforce a contract with such a clause, even though this confers an unwarranted benefit on a defaulter, and continuing responsibility of the former directors for negligence of the new ones until an election has been held. Such prophylactics are not contraindicated, as Judge Lumbard suggests, by the conceded desirability of preventing the dead hand of a former "controlling" group from continuing to dominate the board after a sale, or of protecting a would-be purchaser from finding himself without a majority of the board after he has spent his money. A special meeting of stockholders to replace a board may always be called, and there could be no objection to making the closing of a purchase contingent on the results of such an election. I perceive some of the difficulties of mechanics such a procedure presents, but I have enough confidence in the ingenuity of the corporate bar to believe these would be surmounted.

Hence, I am inclined to think that if I were sitting on the New York Court of Appeals, I would hold a provision like Paragraph 6 violative of public policy save when it was entirely plain that a new election would be a mere formality — i.e., when the seller owned more than 50% of the stock. I put it thus tentatively because, before making such a decision, I would want the help of briefs, including those of amici curiae, dealing with the serious problems of corporate policy and practice more fully than did those here, which were primarily devoted to argument as to what the New York law has been rather than what it ought to be. Moreover, in view of the perhaps unexpected character of such a holding, I doubt that I would give it retrospective effect.

Chief Judge Lumbard's proposal goes part of the way toward meeting the policy problem I have suggested. Doubtless proceeding from what, as it seems to me, is the only justification in principle for permitting even a majority stockholder to condition a sale on delivery of control of the board — namely that in such a case a vote of the stockholders would be a useless formality, he sets the allowable bounds at the line where there is "a practical certainty" that the buyer would be able to elect his nominees and, in this case, puts the burden of disproving that on the person claiming illegality.

Attractive as the proposal is in some respects, I find difficulties with it. When an issue does arise, the "practical certainty" test is difficult to apply. The existence of such certainty will depend not merely on the proportion of the stock held by the seller but on many other factors — whether the other stock is widely or closely held, how much of it is in "street names,"[1] what success the corporation has experienced, how far its dividend policies have satisfied its stockholders, the identity of the purchasers, the presence or absence of cumulative voting, and many others. Often, unless the seller has nearly 50% of the stock, whether he has "working control" can be determined only by an election; groups who thought they had such control have experienced unpleasant surprises in recent years. Judge Lumbard correctly recognizes that, from a policy standpoint, the pertinent question must be the buyer's prospects of election, not the seller's — yet this inevitably requires the court to canvass the likely reaction of stockholders to a group of whom they know nothing and seems rather hard to reconcile with a position that it is "right" to insert such a condition if a seller has a larger proportion of the stock and "wrong" if he has a smaller. At the very least the problems and uncertainties arising from the proposed line of demarcation are great enough, and its advantages small enough, that in my view a Federal court would do better simply to overrule the defense here, thereby accomplishing what is obviously the "just" result in this particular case, and leave the development of doctrine in this area to the State, which has primary concern for it.

[1] By brokerages for retail investors.

I would reverse the grant of summary judgment and remand for consideration of defenses other than a claim that the inclusion of paragraph 6 ex mero motu[2] renders the contract void.

[2] I don't speak Latin.

SOME DISCUSSION QUESTIONS:

1. What is the test for corporate control here? What would the dissent prefer as the test?

2. We are living in a material world ~~and I am a material girl~~ — why can't we sell corporate offices? Wouldn't the free market naturally select for the best possible candidate?

3. How does the rule against selling offices interact with the Business Judgment Rule?

Defending Against A Purchase Of Control

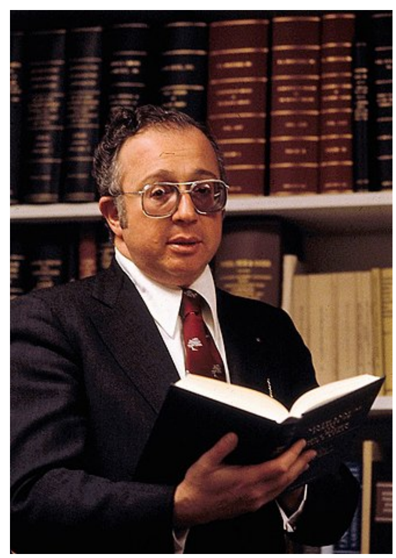
HOLDING A CONTROLLING POSITION IS PRETTY SWEET, as the previous cases illustrate, but in a large publicly-traded corporation there might not be a single shareholder (or group of shareholders) big enough to constitute a controlling group.[1] As such, a common strategy for buyers seeking to obtain control of a corporation is to purchase shares on the open market until they have enough to take control of the corporation's board. These strategies are generally undertaken without board approval — after all, the plan of the buyer is to kick out the existing board[2] — and as such are deemed "hostile takeovers".

[1] Or there might be, but they are uninterested in selling their shares.

[2] And if the board was interested in a sale, they could have engaged in merger discussions with the buyer, the contours of which we'll discuss later in this chapter.

Boards do not have to suffer hostile takeover attempts passively, however. At a minimum, boards have the responsibility to protect the corporation from abusive corporate looters, like we saw with controlling shareholders selling blocks of shares. Moreover, boards have — under the good ol' Business Judgment Rule — considerable latitude to act in a way that they consider the best interests of the corporation. This power to act is not unlimited — they cannot, for example, deny shareholders the effective right to vote under *Blasius* in order to entrench themselves — but it does allow a board to defend itself from challengers. The most popular defense to a purchaser acquiring a controlling interest in a corporation is colorfully called the "poison pill".[3] Developed by Martin Lipton of Wachtell, Lipton, Rosen & Katz LLP in 1982, a poison pill (or "shareholder rights plan" if we're trying to obscure what's really going on here) dilutes the living hell out of a corporation's shares if a particular shareholder triggers a certain threshold. The following case explains the poison pill, and evaluates whether its use might violate a board's fiduciary duties.

[3] My theory is that corporate law is replete with cool-sounding phrases — poison pills, clawbacks, internal affairs, raiders, etc. — because it is otherwise so goddamn boring.



Marty "Big Sexy" Lipton

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

McNeilly, J.

This case presents to this Court for review the most recent defensive mechanism in the arsenal of corporate takeover weaponry — the Preferred Share Purchase Rights Plan ("Rights Plan" or "Plan"). The validity of this mechanism has attracted national attention. Amici curiae briefs have been filed in support of appellants by the Security and Exchange Commission ("SEC") and the Investment Company Institute. An amicus curiae brief has been filed in support of appellees ("Household") by the United Food and Commercial Workers International Union.[4]

[4] Note the interesting politics of this — the labor union is fighting for the board of directors, because it (correctly) perceived that the end result of a hostile takeover would be an attempt to bust the unions operating in Household's businesses.

In a detailed opinion, the Court of Chancery upheld the Rights Plan as a legitimate exercise of business judgment by Household. We agree, and therefore, affirm the judgment below.

On August 14, 1984, the Board of Directors of Household International, Inc. adopted the Rights Plan by a fourteen to two vote. The intricacies of the Rights Plan are contained in a 48-page document entitled

"Rights Agreement". Basically, the Plan provides that Household common stockholders are entitled to the issuance of one Right per common share under certain triggering conditions. There are two triggering events that can activate the Rights. The first is the announcement of a tender offer for 30 percent of Household's shares ("30% trigger") and the second is the acquisition of 20 percent of Household's shares by any single entity or group ("20% trigger").[1]

[1] A tender offer being a public, open, legally binding offer to purchase a certain number of the company's shares at a certain price. The second trigger, by contrast, refers to private purchases of the company's shares.

If an announcement of a tender offer for 30 percent of Household's shares is made, the Rights are issued and are immediately exercisable to purchase $\frac{1}{100}$ share of new preferred stock for $100 and are redeemable by the Board for $.50 per Right. If 20 percent of Household's shares are acquired by anyone, the Rights are issued and become non-redeemable and are exercisable to purchase $\frac{1}{100}$ of a share of preferred.[2] If a Right is not exercised for preferred, and thereafter, a merger or consolidation occurs, the Rights holder can exercise each Right to purchase $200 of the common stock of the tender offeror for $100. This "flip-over" provision of the Rights Plan is at the heart of this controversy.

[2] These are called "flip-in" rights.

Household is a diversified holding company with its principal subsidiaries engaged in financial services, transportation and merchandising. HFC, National Car Rental and Vons Grocery[3] are three of its wholly-owned entities.

[3] Vons was later purchased by Safeway, which was later purchased by Albertsons, which was later purchased by Kroger's, which was later purchased by ...

Household did not adopt its Rights Plan during a battle with a corporate raider, but as a preventive mechanism to ward off future advances. The Vice-Chancellor found that as early as February 1984, Household's management became concerned about the company's vulnerability as a takeover target and began considering amending its charter to render a takeover more difficult. After considering the matter, Household decided not to pursue a fair price amendment.

In the meantime, appellant Moran, one of Household's own Directors and also Chairman of the Dyson-Kissner-Moran Corporation, ("D-K-M") which is the largest single stockholder of Household, began discussions concerning a possible leveraged buy-out of Household by D-K-M. D-K-M's financial studies showed that Household's stock was significantly undervalued in relation to the company's break-up value. It is uncontradicted that Moran's suggestion of a leveraged buy-out never progressed beyond the discussion stage.

Concerned about Household's vulnerability to a raider in light of the current takeover climate, Household secured the services of Wachtell, Lipton, Rosen and Katz ("Wachtell, Lipton") and Goldman, Sachs Co. ("Goldman, Sachs") to formulate a takeover policy for recommendation to the Household Board at its August 14 meeting. After a July 31 meeting with a Household Board member and a pre-meeting distribution of material on the potential takeover problem and the proposed Rights Plan, the Board met on August 14, 1984.

Representatives of Wachtell, Lipton and Goldman, Sachs attended the August 14 meeting. The minutes reflect that Mr. Lipton explained to the Board that his recommendation of the Plan was based on his understanding that the Board was concerned about the increasing frequency of "bust-up" takeovers, the increasing takeover activity in the financial service industry, such as Leucadia's attempt to take over Arco, and the possible adverse effect this type of activity could have on employees[1] and others concerned with and vital to the continuing successful operation of Household even in the absence of any actual bust-up takeover attempt. Against this factual background, the Plan was approved.

[1] Do you think they were able to stifle their laughter in the boardroom when they discussed how very concerned they were with the effects of a takeover on labor?

Thereafter, Moran and the company of which he is Chairman, D-K-M, filed this suit. The primary issue here is the applicability of the business judgment rule as the standard by which the adoption of the Rights Plan should be reviewed.

Other jurisdictions have also applied the business judgment rule to actions by which target companies have sought to forestall takeover activity they considered undesirable. *See Gearhart Industries, Inc. v. Smith International*, 5th Cir., 741 F.2d 707 (1984) (sale of discounted subordinate debentures containing springing warrants); *Treco, Inc. v. Land of Lincoln Savings and Loan*, 7th Cir., 749 F.2d 374 (1984) (amendment to by-laws); *Panter v. Marshall Field*, 7th Cir., 646 F.2d 271 (1981) (acquisitions to create antitrust problems); *Johnson v. Trueblood*, 3d Cir., 629 F.2d 287 (1980), cert. denied, 450 U.S. 999, 101 S.Ct. 1704, 68 L.Ed.2d 200 (1981) (refusal to tender); *Crouse-Hinds Co. v. InterNorth, Inc.*, 2d Cir., 634 F.2d 690 (1980) (sale of stock to favored party); *Treadway v. Cane Corp.*, 2d Cir., 638 F.2d 357 (1980) (sale to White Knight), *Enterra Corp. v. SGS Associates*, E.D.Pa., 600 F.Supp. 678 (1985) (standstill agreement); *Buffalo Forge Co. v. Ogden Corp.*, W.D.N.Y., 555 F.Supp. 892, aff'd, (2d Cir.) 717 F.2d 757, cert. denied, 464 U.S. 1018, 104 S.Ct. 550, 78 L.Ed.2d 724 (1983) (sale of treasury shares and grant of stock option to White Knight); *Whittaker Corp. v. Edgar*, N.D.Ill., 535 F.Supp. 933 (1982) (disposal of valuable assets); *Martin Marietta Corp. v. Bendix Corp.*, D.Md., 549 F.Supp. 623 (1982) (Pac-Man defense).[2]

[2] I include this string citation not because these cases are particularly important, but to highlight (a) how many boards were fending off hostile takeovers at this point in time, and (b) these names! "White Knights"! "Pac-Man defense"! What a world.

This case is distinguishable from the ones cited, since here we have a defensive mechanism adopted to ward off possible future advances and not a mechanism adopted in reaction to a specific threat. This distinguishing factor does not result in the Directors losing the protection of the business judgment rule. To the contrary, pre-planning for the contingency of a hostile takeover might reduce the risk that, under the pressure of a takeover bid, management will fail to exercise reasonable judgment.

Therefore, in reviewing a pre-planned defensive mechanism it seems even more appropriate to apply the business judgment rule.

Of course, the business judgment rule can only sustain corporate decision making or transactions that are within the power or authority of the Board. Therefore, before the business judgment rule can be applied it must be determined whether the Directors were authorized to adopt the Rights Plan.

Appellants vehemently contend that the Board of Directors was unauthorized to adopt the Rights Plan. First, appellants contend that no provision of the Delaware General Corporation Law authorizes the issuance of such Rights. Secondly, appellants, along with the SEC, contend that the Board is unauthorized to usurp stockholders' rights to receive hostile tender offers. Third, appellants and the SEC also contend that the Board is unauthorized to fundamentally restrict stockholders' rights to conduct a proxy contest. We address each of these contentions in turn.

A

Appellants begin by contending that § 157[1] cannot authorize the Rights Plan since § 157 has never served the purpose of authorizing a takeover defense. Appellants contend that § 157 is a corporate financing statute, and that nothing in its legislative history suggests a purpose that has anything to do with corporate control or a takeover defense. Appellants are unable to demonstrate that the legislature, in its adoption of § 157, meant to limit the applicability of § 157 to only the issuance of Rights for the purposes of corporate financing. Without such affirmative evidence, we decline to impose such a limitation upon the section that the legislature has not.

Secondly, appellants contend that § 157 does not authorize the issuance of sham rights such as the Rights Plan. They contend that the Rights were designed never to be exercised, and that the Plan has no economic value. Appellants' sham contention fails in both regards. As to the Rights, they can and will be exercised upon the happening of a triggering mechanism. As to the preferred shares, we agree with the Court of Chancery that they are distinguishable from sham securities. The Household preferred, issuable upon the happening of a triggering event, have superior dividend and liquidation rights.

Third, appellants contend that § 157 authorizes the issuance of Rights "entitling holders thereof to purchase from the corporation any shares of its capital stock of any class." (emphasis added). Therefore, their contention continues, the plain language of the statute does not authorize Household to issue rights to purchase another's capital stock upon a merger or consolidation.

[1] "Every corporation may issue 1 or more classes of stock or 1 or more series of stock within any class thereof, any or all of which classes may be of stock with par value or stock without par value and which classes or series may have such voting powers, full or limited, or no voting powers, and such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation or of any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by the provisions of its certificate of incorporation. Any of the voting powers, designations, preferences, rights and qualifications, limitations or restrictions of any such class or series of stock may be made dependent upon facts ascertainable outside the certificate of incorporation or of any amendment thereto, or outside the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by its certificate of incorporation, provided that the manner in which such facts shall operate upon the voting powers, designations, preferences, rights and qualifications, limitations or restrictions of such class or series of stock is clearly and expressly set forth in the certificate of incorporation or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors."

Household contends, inter alia, that the Rights Plan is analogous to "anti-destruction" or "anti-dilution" provisions which are customary features of a wide variety of corporate securities. While appellants seem to concede that "anti-destruction" provisions are valid under Delaware corporate law, they seek to distinguish the Rights Plan as not being incidental, as are most "anti-destruction" provisions, to a corporation's statutory power to finance itself. We find no merit to such a distinction. We have already rejected appellants' similar contention that § 157 could only be used for financing purposes. We also reject that distinction here.

Having concluded that sufficient authority for the Rights Plan exists in 8 Del. C. § 157, we note the inherent powers of the Board conferred by 8 Del. C. § 141(a), concerning the management of the corporation's "business and affairs", also provides the Board additional authority upon which to enact the Rights Plan.

B

Appellants contend that the Board is unauthorized to usurp stockholders' rights to receive tender offers by changing Household's fundamental structure. We conclude that the Rights Plan does not prevent stockholders from receiving tender offers, and that the change of Household's structure was less than that which results from the implementation of other defensive mechanisms upheld by various courts.

The evidence at trial also evidenced many methods around the Plan ranging from tendering with a condition that the Board redeem the Rights, tendering with a high minimum condition of shares and Rights, tendering and soliciting consents to remove the Board and redeem the Rights, to acquiring 50% of the shares and causing Household to self-tender for the Rights. One could also form a group of up to 19.9% and solicit proxies for consents to remove the Board and redeem the Rights. These are but a few of the methods by which Household can still be acquired by a hostile tender offer.

In addition, the Rights Plan is not absolute. When the Household Board of Directors is faced with a tender offer and a request to redeem the Rights, they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism, the same standard as they were held to in originally approving the Rights Plan.

C

Appellants' third contention is that the Board was unauthorized to fundamentally restrict stockholders' rights to conduct a proxy contest.

Appellants contend that the "20% trigger" effectively prevents any stockholder from first acquiring 20% or more shares before conducting a proxy contest and further, it prevents stockholders from banding together into a group to solicit proxies if, collectively, they own 20% or more of the stock. In addition, at trial, appellants contended that read literally, the Rights Agreement triggers the Rights upon the mere acquisition of the right to vote 20% or more of the shares through a proxy solicitation, and thereby precludes any proxy contest from being waged.

Appellants seem to have conceded this last contention in light of Household's response that the receipt of a proxy does not make the recipient the "beneficial owner" of the shares involved which would trigger the Rights. In essence, the Rights Agreement provides that the Rights are triggered when someone becomes the "beneficial owner" of 20% or more of Household stock. Although a literal reading of the Rights Agreement definition of "beneficial owner" would seem to include those shares which one has the right to vote, it has long been recognized that the relationship between grantor and recipient of a proxy is one of agency, and the agency is revocable by the grantor at any time. Therefore, the holder of a proxy is not the "beneficial owner" of the stock. As a result, the mere acquisition of the right to vote 20% of the shares does not trigger the Rights.

We conclude that there was sufficient evidence at trial to support the Vice-Chancellor's finding that the effect upon proxy contests will be minimal. Evidence at trial established that many proxy contests are won with an insurgent ownership of less than 20%, and that very large holdings are no guarantee of success. There was also testimony that the key variable in proxy contest success is the merit of an insurgent's issues, not the size of his holdings.

****

Having concluded that the adoption of the Rights Plan was within the authority of the Directors, we now look to whether the Directors have met their burden under the business judgment rule.

There are no allegations here of any bad faith on the part of the Directors' action in the adoption of the Rights Plan. There is no allegation that the Directors' action was taken for entrenchment purposes. Household has adequately demonstrated, as explained above, that the adoption of the Rights Plan was in reaction to what it perceived to be the threat in the market place of coercive two-tier tender offers. Appellants do contend, however, that the Board did not exercise informed business judgment in its adoption of the Plan.

To determine whether a business judgment reached by a board of directors was an informed one, we determine whether the directors were grossly negligent. Upon a review of this record, we conclude the Directors were not grossly negligent. The information supplied to the Board on August 14 provided the essentials of the Plan. The Directors were given beforehand a notebook which included a three-page summary of the Plan along with articles on the current takeover environment. The extended discussion between the Board and representatives of Wachtell, Lipton and Goldman, Sachs before approval of the Plan reflected a full and candid evaluation of the Plan. Moran's expression of his views at the meeting served to place before the Board a knowledgeable critique of the Plan. The factual happenings here are clearly distinguishable from the actions of the directors of Trans Union Corporation who displayed gross negligence in approving a cash-out merger.

While we conclude for present purposes that the Household Directors are protected by the business judgment rule, that does not end the matter. The ultimate response to an actual takeover bid must be judged by the Directors' actions at that time, and nothing we say here relieves them of their basic fundamental duties to the corporation and its stockholders. Their use of the Plan will be evaluated when and if the issue arises.

Some discussion questions:

1. What would be the effect for the would-be purchaser of a corporation if it triggered the poison pill? What would the other shareholders do?

2. What does the timing and the method of the board's adoption of the poison pill tell you about the business judgment rule?

3. What's the practical difference between a board implementing a poison pill to entrench itself and implementing a poison pill to deter a hostile takeover?

4. Could a board create a poison pill without a redemption mechanism?

Corporate Acquisitions and their Consequences

There are three broad categories of corporate acquisitions: stock purchases, asset purchases, and mergers. Each approach ends with the buyer having control of the target corporation (or its relevant assets), but the approaches vary in terms of (1) whether (and which) shareholders need to approve the transaction, (2) who legally owns the target's liabilities and obligations, and (3) what happens to the target's contracts.[1]

[1] Other fun stuff to consider — taxes, regulatory approval, etc. — is beyond the scope of this book. Take a class in tax! Or antitrust! Or national security law! Just leave me alone!!!

Stock Purchases

We have discussed these at length in the previous parts of this chapter, so we need not to dwell too long on them here. The basics are that a buyer may directly purchase shares from a seller under a Share Purchase Agreement.[2] This can be for enough shares to control the corporation[3] or, in the case of a corporation that is wholly owned by one party, 100% of the available shares. In the latter case, share ownership transfers seamlessly to the new buyer and business continues as usual. No shareholder vote is necessary, since the shareholder is directly involved in the transaction, and the target's assets and liabilities stay with the target. Nothing changes other than who is running the show.

[2] This instrument is distinct from a Shareholder Agreement, which pertains to the terms of share ownership (including voting, transfer, etc.) rather than the purchase of shares.

[3] Either 50% + 1 of the outstanding shares, or whatever amount is sufficient to effectuate control in a diffusely-held corporation.

A buyer may also accumulate shares by purchasing them on the open market.[4] This is subject to two important federal regulations: there is a mandatory disclosure requirement when an investor takes a large (> 5% share) position, and there is a procedural requirement for tender offers (public offers to purchase shares from a corporation's shareholders).

[4] The difference between buying on an exchange and buying shares directly from a shareholder is roughly the difference between buying paper towels at Costco and buying paper towels directly from Brawny.

The first requirement arises under the Exchange Act, and requires shareholders who acquire more than 5% of a publicly-traded corporation's outstanding shares to file what are called "beneficial owner reports" on Schedule 13D (for purchasers looking to take or influence control of the corporation) or Schedule 13G (for passive investors).[5] So, for example, when Elon Musk acquired a large chunk of Twitter's stock and breached the 5% threshold, he timely filed a Schedule 13D and put everyone on notice that — *touches finger to earpiece* wait, wait, I'm getting an update here ... okay, no, he completely fucked this up and filed the wrong form (the Schedule 13G) and filed it well after he was supposed to. Okay, well, podody's nerfect, I suppose.[6]

[5] These are often used by large institutional funds who own broad swaths of the market and as such have more than 5% of a corporation's shares, but no intent to launch a takeover.

[6] And he never made another mistake in the acquisition or running of Twitter. The End.

The second requirement arises under the Williams Act of 1968, which amended the Exchange Act to regulate tender offers where a potential purchaser does an end-run around the board and makes an offer directly to a corporation's shareholders to purchase a specified amount of a corporation's shares. In these, the bidder must disclose the source of the funds (cash, loans, etc.), the purpose of the bid, and the plans for the company after acquisition. Further, to prevent undue pressure on shareholders, the bid must be open for a minimum of twenty days,[1] the offer must specify the minimum percentage being acquired (this can be amended, so long as the deadline is extended), the price cannot be changed during that period, and the offer must be to all shareholders. False statements in the context of a tender offer can be the basis for fraud suits under the Williams Act.

[1] No exploding offers!

Back in ye olden days (the '80s), successful tender offers for majority control of a corporation would often be followed by a merger with the buyer (the ol' "two-step" merger).[2] This raised all sorts of complications — were shareholders who didn't tender going to get a fair price for their shares in the merger? — and defenses, so nowadays tender offers are mostly aimed at getting control of a corporation's board, rather than an all-out takeover.

[2] We'll see one of these in *Unocal v. Mesa*, in this chapter.

Asset Purchases

A buyer could also purchase the relevant assets of the target corporation. If these assets are only part of the target's business, then all that is needed is the approval of both boards of the corporations. If the assets form "all or substantially all" of the target's business, leaving the target a shell corporation after the acquisition of the assets by the buyer, then the target's shareholders must approve the deal. A buyer's shareholders don't need to approve anything — an acquisition of assets falls squarely in Business Judgment Land.

The benefit to the buyer of an asset purchase is that the buyer may choose to buy only the assets that are desirable, whereas a full-on purchase of the corporation may come with unproductive or unwanted assets. Another benefit is that the buyer may avoid being responsible for liabilities that the target corporation has (for example, from a previous business or from corporate mismanagement).

A downside is that any contracts that the target entered into are not enforceable by the buyer (unless the contractual language specified that they would transfer in an asset sale). Another downside is that under the doctrine of "successor liability" if an asset transfer would leave the target corporation unable to satisfy the liabilities associated with those assets, courts may hold the buyer responsible for those liabilities.[3] As such, major asset purchases are often conducted through a subsidiary of the buyer.

[3] In other words, you can't separate the assets from the liabilities in a sale if the liabilities are connected to those assets.

Mergers

Mergers are the combination of two corporate entities into one, and are specifically authorized by state corporate statutes. The boards of both corporations must agree to a plan of merger, and the corporations enter into a merger agreement that specifies the terms and the date of merger. Some important terminology:

Type

- "Statutory" mergers are plain jane mergers where the buyer and the target become a single entity.
- "Triangular" mergers are mergers where the buyer creates a subsidiary, which then merges with the target to become a single entity that is a subsidiary of the buyer.
- A "share exchange" is when the target gets shares of the buyer in exchange for shares of the target, and the target becomes a wholly owned subsidiary of the buyer while the target's shareholders become shareholders of the buyer. This is not technically a merger, but because this is functionally the same outcome as a triangular merger, corporate statutes often treat them as the same kind of transaction.
- "Short-form" mergers are statutory mergers between a parent company buyer and its majority- or wholly-owned subsidiary target.[1]

[1] These have a bunch of issues — as you might expect, given the potential for self-dealing here — which we'll cover in Chapter 15.

Surviving Entity

- "Forward" mergers – whether statutory or triangular – are mergers where the surviving entity is the buyer.
- "Reverse" mergers – whether statutory or triangular – are mergers where the surviving entity is the target.

Consideration

- "Cash-for-stock" mergers are mergers where the shareholders of the target are paid out by the buyer and do not become shareholders of the combined corporation.
- "Stock-for-stock" mergers are mergers where the shareholders of the target are given shares of the combined corporation as part of the merger and continue as shareholders.

The structure, method, and consideration for a merger determines: (1) whether shareholders must vote on a transaction, (2) whether shareholders of the target can get appraisal rights, and (3) where the assets (important) and the liabilities (really important) of the target wind up.

TARGET SHAREHOLDERS must always vote on the transaction, regardless of its form. Whether they are getting cash or stock in the combined corporation, a merger is a fundamental transaction that requires shareholder approval, as it functionally the end of the line for that corporation's existence.

The target's shareholders also have the right to seek **appraisal** for their shares instead of accepting the merger consideration. These appraisal rights vary by state, but they generally allow dissenting shareholders to obtain a judicial determination of the "fair value" of their shares when they are dissatisfied with the price they'd get in the merger. Delaware specifically allows for appraisal rights where the target's shareholders receive cash, but not if they were shareholders of a publicly-traded corporation and will receive shares of a publicly-traded corporation:

> "no appraisal rights under this section shall be available for the shares of any class or series of stock, which stock ... were either: (i) listed on a national securities exchange or (ii) held of record by more than 2,000 holders"[1]

[1] DGCL §262(b)(1)

This is called a "market out" exception, and it bars appraisal rights for shareholders if, at the end of the day, they'll be left holding shares of a publicly-traded corporation (or a corporation that has to file reports under the Exchange Act). The idea here is that the price of shares traded on a big liquid market is basically a fair price for the shares, and who is a judge to second-guess the efficiency of the glorious market, huh? In any event, when a target shareholder gets a cash offer, they can either vote for the merger and take the money if the vote succeeds or vote against the merger and pursue these appraisal rights with the other dissenters.[2]

[2] Under KRS §271B.13-020, "shall be entitled to dissent from, and obtain payment of the fair value of his shares in the event of, any of the following corporate actions ... (a) Consummation of a plan of merger to which the corporation is a party". Kentucky does not have a "market out" exception to this.

BUYER SHAREHOLDERS in every jurisdiction must vote on the transaction if it is a statutory merger.[3] In addition, in non-Delaware jurisdictions, including Kentucky, if a transaction involves a share exchange where the target's shareholders get more than 20% of the equity of the buyer corporation, shareholder approval is required (Delaware does not have this requirement).

[3] Delaware law exempts so-called "whale-minnow" mergers (mergers where the target's shareholders receive fewer than 20% of the outstanding shares of the buyer) from requiring buyer shareholder approval.

Triangular mergers, by contrast, sidestep the need for buyer shareholder approval entirely in all-cash transactions,[4] since the merger occurs between the target and a subsidiary corporation of the buyer.

[4] If there is an issuance of more than 20% of the corporation's equity to the target's shareholders in the transaction, non-Delaware corporations would need to get shareholder approval.

THE ASSETS AND LIABILITIES of the target transfer by operation of law to whatever corporation is merged with the target. As such, triangular mergers are popular because they allow buyers to cabin the liabilities of the target in the subsidiary rather than assuming the liabilities themselves as they would in a statutory merger. Triangular mergers are also popular for "reverse" mergers, because in a reverse merger the target survives and continues on its merry way with all its contracts valid and assets intact, while the buyer's subsidiary is extinguished.

Judicial Standards for Board Defensive Measures

There are three basic levels of judicial review available when a board deploys an anti-takeover measure to thwart a potential buyer. Courts can treat anti-takeover measures as matters of business judgment and apply the Business Judgment Rule to allow them (as they do in *Cheff*, below). Courts can inquire into the interests and motives of the board in enacting these measures (as they do in *Unocal*, below). And courts can step in and force the board to take a specific course of action to maximize shareholder value (as they do in *Revlon*, below). Which approach a court will take depends on the timing and the impact of the defensive measure in question. As we review some common defensive measures in the next section, think about the impact of the measure on both board decisionmaking and shareholder action.

A Children's Treasury of Defensive Measures

- **Poison Pill**. As elaborated in *Moran*, these are effectively options distributed to shareholders that every shareholder (*except* the insurgent) can exercise upon the insurgent breaching some threshold of share ownership (usually set at somewhere between 10% and 20%). When exercised, the typical poison pill gives the shareholder extra shares of the corporation ("flip-in") at a deep discount or shares of the buyer ("flip-over") at a deep discount. The board can effectively turn off ("redeem") the poison pill if it so chooses, allowing it to accept an offer that the board views as adequate.

- **Staggered Boards**. We've seen these in several cases (*Essex* most recently), but this is where a corporation's bylaws set board seats for multi-year terms, and thus shareholders elect only a fraction (usually $\frac{1}{3}$) of the board at any given annual meeting. Absent an agreement for the board to resign upon change of control, this dissuades hostile bidders by ensuring that it will take at least two cycles to effectively win control of the board even after purchasing a controlling share of stock.

- **Shooting The Raider With A High-Powered Rifle**. Quite effective, but also this is illegal. It is murder. Don't do it.

- **Greenmail**. Can corporations just pay insurgent shareholders to go away? You would think this would constitute waste or maybe entrenchment or just plain violate the Duty to Maintain Good Vibes, but this was (and remains) a viable strategy for dealing with corporate raiders. The insurgent shareholders in *Unocal v. Mesa*, which we'll read in a second, were the paradigmatic example of greenmailers — shareholders who took payoffs to drop proxy contests or tender offers — but the practice predates the cocaine-and-hair-gel '80s. Here's a fun case that explains why this practice is allowed:

Cheff v. Mathes, 41 Del. Ch. 494 (Del. 1964)

Carey, J.

This is an appeal from the decision of the Vice-Chancellor in a derivative suit holding certain directors of Holland Furnace Company liable for loss allegedly resulting from improper use of corporate funds to purchase shares of the company. Because a meaningful decision upon review turns upon a complete understanding of the factual background, a somewhat detailed summary of the evidence is required.

Holland Furnace Company, a corporation of the State of Delaware, manufactures warm air furnaces, air conditioning equipment, and other home heating equipment. At the time of the relevant transactions, the board of directors was composed of the seven individual defendants. Mr. Cheff had been Holland's Chief Executive Officer since 1933,[1] received an annual salary of $77,400, and personally owned 6,000 shares of the company.[2] He was also a director. Mrs. Cheff, the wife of Mr. Cheff, was a daughter of the founder of Holland and had served as a director since 1922.[3] As a director, Mrs. Cheff received a compensation of $200.00 for each monthly board meeting, whether or not she attended the meeting.

Prior to the events in question, Holland employed approximately 8500 persons and maintained 400 branch sales offices located in 43 states.[4] The volume of sales had declined from over $41,000,000 in 1948 to less than $32,000,000 in 1956. Defendants contend that the decline in earnings is attributable to the artificial post-war demand generated in the 1946-1948 period. In order to stabilize the condition of the company, the sales department apparently was reorganized and certain unprofitable branch offices were closed. By 1957 this reorganization had

[1] !

[2] There were 883,585 outstanding shares.

[3] !!

[4] Holland sold furnaces door-to-door. If you can explain to me how that makes any sense at all, please do.

been completed and the management was convinced that the changes were manifesting beneficial results. The practice of the company was to directly employ the retail salesman, and the management considered that practice — unique in the furnace business — to be a vital factor in the company's success.

During the first five months of 1957, the monthly trading volume of Holland's stock on the New York Stock Exchange ranged between 10,300 shares to 24,200 shares. In the last week of June 1957, however, the trading increased to 37,800 shares, with a corresponding increase in the market price. In June of 1957, Mr. Cheff met with Mr. Arnold H. Maremont, who was President of Maremont Automotive Products, Inc. and Chairman of the boards of Motor Products Corporation and Allied Paper Corporation. Mr. Cheff testified, on deposition, that Maremont generally inquired about the feasibility of merger between Motor Products and Holland. Mr. Cheff testified that, in view of the difference in sales practices between the two companies, he informed Mr. Maremont that a merger did not seem feasible. In reply, Mr. Maremont stated that, in the light of Mr. Cheff's decision, he had no further interest in Holland nor did he wish to buy any of the stock of Holland.

None of the members of the board apparently connected the interest of Mr. Maremont with the increased activity of Holland stock. The mystery was resolved, however, when Maremont called [Holland board member John D.] Ames in July of 1957 to inform the latter that Maremont then owned 55,000 shares of Holland stock. At this juncture, no requests for change in corporate policy were made, and Maremont made no demand to be made a member of the board of Holland.

Ames reported the above information to the board at its July 30, 1957 meeting. Because of the position now occupied by Maremont, the board elected to investigate the financial and business history of Maremont and corporations controlled by him. Apart from the documentary evidence produced by this investigation, which will be considered infra, [the Treasurer of Holland] Mr. Staal testified, on deposition, that "leading bank officials" had indicated that Maremont "had been a participant, or had attempted to be, in the liquidation of a number of companies." Mr. Cheff testified, at trial, of Maremont's alleged participation in liquidation activities. Mr. Cheff testified that: "Throughout the whole of the Kalamazoo-Battle Creek area, and Detroit too, where I spent considerable time, he is well known and not highly regarded by any stretch." This information was communicated to the board.

On August 23, 1957, at the request of Maremont, a meeting was held between Mr. Maremont and Cheff. At this meeting, Cheff was informed that Motor Products then owned approximately 100,000 shares of Holland stock. Maremont then made a demand that he be named to the board of directors, but Cheff refused to consider it. Since considerable controversy has been generated by Maremont's alleged threat to liquidate the company or substantially alter the sales force of Holland, we believe it desirable to set forth the testimony of Cheff on this point: "Now we have 8500 men, direct employees, so the problem is entirely different. He indicated immediately that he had no interest in that type of distribution, that he didn't think it was modern, that he felt furnaces could be sold as he sold mufflers, through half a dozen salesmen in a wholesale way."

Testimony was introduced by the defendants tending to show that substantial unrest was present among the employees of Holland as a result of the threat of Maremont to seek control of Holland. Thus, Mr. Cheff testified that the field organization was considering leaving in large numbers because of a fear of the consequences of a Maremont acquisition; he further testified that approximately "25 of our key men"[1] were lost as the result of the unrest engendered by the Maremont proposal. Staal, corroborating Cheff's version, stated that a number of branch managers approached him for reassurances that Maremont was not going to be allowed to successfully gain control. Moreover, at approximately this time, the company was furnished with a Dun and Bradstreet report,[2] which indicated the practice of Maremont to achieve quick profits by sales or liquidations of companies acquired by him. The defendants were also supplied with an income statement of Motor Products, Inc., showing a loss of $336,121.00 for the period in 1957.

[1] Top ... men.

[2] This was a consulting firm.

On August 30, 1957, the board was informed by Cheff of Maremont's demand to be placed upon the board and of Maremont's belief that the retail sales organization of Holland was obsolete. The board was also informed of the results of the investigation by Cheff and Staal. Predicated upon this information, the board authorized the purchase of company stock on the market with corporate funds, ostensibly for use in a stock option plan.

Subsequent to this meeting, substantial numbers of shares were purchased and, in addition, Mrs. Cheff made alternate personal purchases of Holland stock. As a result of purchases by Maremont, Holland and Mrs. Cheff, the market price rose. On September 13, 1957, Maremont wrote to each of the directors of Holland and requested a broad engineering survey to be made for the benefit of all stockholders. On September 4th, Maremont proposed to sell his current holdings of

Holland to the corporation for $14.00 a share. However, because of delay in responding to this offer, Maremont withdrew the offer. At this time, Mrs. Cheff was obviously quite concerned over the prospect of a Maremont acquisition, and had stated her willingness to expend her personal resources to prevent it.

Thereafter, [corporate counsel and yet another board member] Mr. Trenkamp arranged for a meeting with Maremont, which occurred on October 14-15, 1957, in Chicago. Prior to this meeting, Trenkamp was aware of the intentions of Hazelbank[1] and Mrs. Cheff to purchase all or portions of the stock then owned by Motor Products if Holland did not so act. As a result of the meeting, there was a tentative agreement on the part of Motor Products to sell its 155,000 shares at $14.40 per share. On October 23, 1957, at a special meeting of the Holland board, the purchase was considered. The dangers allegedly posed by Maremont were again reviewed by the board. Trenkamp and Mrs. Cheff agree that the latter informed the board that either she or Hazelbank would purchase part or all of the block of Holland stock owned by Motor Products if the Holland board did not so act. The board was also informed that in order for the corporation to finance the purchase, substantial sums would have to be borrowed from commercial lending institutions. A resolution authorizing the purchase of 155,000 shares from Motor Products was adopted by the board. The price paid was in excess of the market price prevailing at the time, and the book value of the stock was approximately $20.00 as compared to approximately $14.00 for the net quick asset value. In 1959, Holland stock reached a high of $15.25 a share.

[1] A corporation controlled by Mrs. Cheff.

On February 6, 1958, plaintiffs, owners of 60 shares of Holland stock, filed a derivative suit in the court below naming all of the individual directors of Holland, Holland itself and Motor Products Corporation as defendants. The complaint alleged that all of the purchases of stock by Holland in 1957 were for the purpose of insuring the perpetuation of control by the incumbent directors. The complaint requested that the transaction between Motor Products and Holland be rescinded and, secondly, that the individual defendants account to Holland for the alleged damages.

After trial, the Vice Chancellor found the following facts: (a) Holland directly sells to retail consumers by means of numerous branch offices. There were no intermediate dealers. (b) Immediately prior to the complained-of transactions, the sales and earnings of Holland had declined and its marketing practices were under investigation by the Federal Trade Commission.[2] (c) Mr. Cheff and Trenkamp had received substantial sums as Chief Executive and attorney of the company, re-

[2] Excuse me? What's all this, then?

spectively. (d) Maremont, on August 23rd, 1957, demanded a place on the board. (e) At the October 14th meeting between Trenkamp, Staal and Maremont, Trenkamp and Staal were authorized to speak for Mrs. Cheff as well as Holland. (g) There was no real threat posed by Maremont and no substantial evidence of intention by Maremont to liquidate Holland. (h) Any employee unrest could have been caused by factors other than Maremont's intrusion and "only one important employee was shown to have left, and his motive for leaving is not clear."

The Court then found that the actual purpose behind the purchase was the desire to perpetuate control, but because of its finding that only the four above-named directors knew of the "alternative", the remaining directors were exonerated. No appeal was taken by plaintiffs from that decision.

Our first problem is the allocation of the burden of proof to show the presence or lack of good faith on the part of the board in authorizing the purchase of shares. Initially, the decision of the board of directors in authorizing a purchase was presumed to be in good faith and could be overturned only by a conclusive showing by plaintiffs of fraud or other misconduct.

To say that the burden of proof is upon the defendants is not to indicate, however, that the directors have the same "self-dealing interest" as is present, for example, when a director sells property to the corporation. The only clear pecuniary interest shown on the record was held by Mr. Cheff, as an executive of the corporation, and Trenkamp, as its attorney. The mere fact that some of the other directors were substantial shareholders does not create a personal pecuniary interest in the decisions made by the board of directors, since all shareholders would presumably share the benefit flowing to the substantial shareholder. Accordingly, these directors other than Trenkamp and Cheff, while called upon to justify their actions, will not be held to the same standard of proof required of those directors having personal and pecuniary interest in the transaction.

Plaintiffs urge that the sale price was unfair in view of the fact that the price was in excess of that prevailing on the open market. However, as conceded by all parties, a substantial block of stock will normally sell at a higher price than that prevailing on the open market, the increment being attributable to a "control premium". Plaintiffs argue that it is inappropriate to require the defendant corporation to pay a control premium, since control is meaningless to an acquisition by a corporation of its own shares. However, it is elementary that a holder of a substantial number of shares would expect to receive the control premium as part of his selling price, and if the corporation desired to obtain the stock, it is unreasonable to expect that the corporation could avoid paying what any other purchaser would be required to pay for the stock. In any event, the financial expert produced by defendant at trial indicated that the price paid was fair and there was no rebuttal. Ames, the financial man on the board, was strongly of the opinion that the purchase was a good deal for the corporation. The Vice Chancellor made no finding as to the fairness of the price other than to indicate the obvious fact that the market price was increasing as a result of open market purchases by Maremont, Mrs. Cheff and Holland.

The question then presented is whether or not defendants satisfied the burden of proof of showing reasonable grounds to believe a danger to corporate policy and effectiveness existed by the presence of the Maremont stock ownership. It is important to remember that the directors satisfy their burden by showing good faith and reasonable investigation; the directors will not be penalized for an honest mistake of judgment, if the judgment appeared reasonable at the time the decision was made.

The unrebutted testimony before the court indicated: (1) Maremont had deceived Cheff as to his original intentions, since his open market purchases were contemporaneous with his disclaimer of interest in Holland; (2) Maremont had given Cheff some reason to believe that he intended to eliminate the retail sales force of Holland; (3) Maremont demanded a place on the board; (4) Maremont substantially increased his purchases after having been refused a place on the board; (5) the directors had good reason to believe that unrest among key employees had been engendered by the Maremont threat; (6) the board had received advice from Dun and Bradstreet indicating the past liquidation or quick sale activities of Motor Products; (7) the board had received professional advice from the firm of Merril Lynch, Fenner Beane, who recommended that the purchase from Motor Products be carried out; (8) the board had received competent advice that the corporation was over-capitalized; (9) Staal and Cheff had made informal personal investigations from contacts in the business and financial community and had reported to the board of the alleged poor reputation of Maremont. The board was within its rights in relying upon that investigation.

Accordingly, we are of the opinion that the evidence presented in the court below leads inevitably to the conclusion that the board of directors, based upon direct investigation, receipt of professional advice, and personal observations of the contradictory action of Maremont and his explanation of corporate purpose, believed, with justification, that there was a reasonable threat to the continued existence of Holland, or at least existence in its present form, by the plan of Maremont to continue building up his stock holdings. We find no evidence in the record sufficient to justify a contrary conclusion.

As noted above, the Vice-Chancellor found that the purpose of the acquisition was the improper desire to maintain control, but, at the same time, he exonerated those individual directors whom he believed to be unaware of the possibility of using non-corporate funds to accomplish this purpose. Such a decision is inconsistent with his finding that the motive was improper. If the actions were in fact improper because of a desire to maintain control, then the presence or absence of a non-corporate alternative is irrelevant, as corporate funds may not be used to advance an improper purpose even if there is no non-corporate alternative available. Conversely, if the actions were proper because of a decision by the board made in good faith that the corporate interest was served thereby, they are not rendered improper by the fact that some individual directors were willing to advance personal funds if the corporation did not. It is conceivable that the Vice Chancellor considered this feature of the case to be of significance because of his apparent belief that any excess corporate funds should have been used to finance a subsidiary corporation. That action would not have solved the problem of Holland's over-capitalization. In any event, this question was a matter of business judgment, which furnishes no justification for holding the directors personally responsible in this case.

Accordingly, the judgment of the court below is reversed and remanded with instruction to enter judgment for the defendants.

Some discussion questions:

1. They start off repurchasing shares from everyone — what happened then? Why didn't that work?
2. If Mrs. Cheff had purchased the shares from Maremont, would there have been an issue?
3. Why not give all the shareholders the premium they gave Maremont?
4. As I mentioned up top, the court applies the Business Judgment Rule here. Which prong of the Business Judgment Rule might not have been totally satisfied here?

Anyway, continuing on with our list of defenses:

- **White Knight**. Instead of being bought by a mean old grouchy activist, how about being bought by a nice, sweet investment fund who promises to not sack the board and gut the company and sell it off for parts? That's the White Knight defense, and I have to confess here that one of my clients in private practice was a conglomerate targeted by activist investors who chose to go private via a White Knight rather than let a bunch of corporate raiders attempt a takeover. The result was that the White Knight sold off all of the conglomerate's subsidiaries and divisions in order to pay down the debt they incurred as a result of the transaction, leaving the company in basically the same position as it would have been if an activist had taken it over. But, hey, management kept their jobs!

- **Lock-Up**. Rather passe now, a lock-up defense entailed either selling or promising to sell the core assets of a corporation (aka the "crown jewels") in the event of takeover. Often involves a White Knight as the buyer of the assets. The raider takes control of the corporation, opens the vault, and *gasp* IT'S EMPTY. Supervillain move. "Did you really think I'd just hand over control that easily, Mr. Bond? Come, come now ..."-type energy.

- **Pac-Man Defense**. The objectively hilarious maneuver whereby the target corporation mounts a bid for control of a potential buyer, such that the target becomes the buyer and the buyer becomes the target. "I'm not trapped in here with you, you're trapped in here with me", but make it business.[1] I don't think there's ever been a case where the shareholders of Company A have agreed to be bought by Company B but the shareholders of Company B have agreed to be bought by Company A, but one of these days that kind of O. Henry-assed outcome is bound to occur.

[1] We'll explore one of these at the end of the chapter with *Chesapeake Corp. v. Shore*.

WHILE SOME OF THESE DEFENSES are subject only to the Business Judgment Rule (such as the sale of assets or purchase of a rival, both of which are clearly within a board's zone of authority), more drastic defenses are subjected to a higher level of scrutiny because they interfere with the ability of shareholders to buy and sell shares of the corporation. After all, if some jerk wants to pay me a 50% premium for my shares, who the hell is the board to tell me I can't? The following case lays out the ground rules for employing truly hardcore defensive maneuvers (like the poison pill or the White Knight) in response to a corporate raider — and potentially keeping their shareholders from enjoying a nice little payday.

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

Moore, J.

We confront an issue of first impression in Delaware — the validity of a corporation's self-tender for its own shares which excludes from participation a stockholder making a hostile tender offer for the company's stock.

The Court of Chancery granted a preliminary injunction to the plaintiffs, Mesa Petroleum Co., Mesa Asset Co., Mesa Partners II, and Mesa Eastern, Inc. (collectively "Mesa"),[1] enjoining an exchange offer of the defendant, Unocal Corporation (Unocal) for its own stock. The trial court concluded that a selective exchange offer, excluding Mesa, was legally impermissible. We cannot agree with such a blanket rule. The factual findings of the Vice Chancellor, fully supported by the record, establish that Unocal's board, consisting of a majority of independent directors, acted in good faith, and after reasonable investigation found that Mesa's tender offer was both inadequate and coercive. Under the circumstances the board had both the power and duty to oppose a bid it perceived to be harmful to the corporate enterprise. On this record we are satisfied that the device Unocal adopted is reasonable in relation to the threat posed, and that the board acted in the proper exercise of sound business judgment. We will not substitute our views for those of the board if the latter's decision can be attributed to any rational business purpose. Accordingly, we reverse the decision of the Court of Chancery and order the preliminary injunction vacated.

[1] Run by the legendary corporate raider and Oklahoma State football booster T. Boone Pickens. You cannot find me a better name than that, honestly. Man should have been a blind blues musician, but here we are.

The factual background of this matter bears a significant relationship to its ultimate outcome.

On April 8, 1985, Mesa, the owner of approximately 13% of Unocal's stock, commenced a two-tier "front loaded" cash tender offer for 64 million shares, or approximately 37%, of Unocal's outstanding stock at a price of $54 per share. The "back-end" was designed to eliminate the remaining publicly held shares by an exchange of securities purportedly worth $54 per share. However, pursuant to an order entered by the United States District Court for the Central District of California on April 26, 1985, Mesa issued a supplemental proxy statement to Unocal's stockholders disclosing that the securities offered in the second-step merger would be highly subordinated, and that Unocal's capitalization would differ significantly from its present structure. Unocal has rather aptly termed such securities "junk bonds".

Unocal's board consists of eight independent outside directors and six insiders. It met on April 13, 1985, to consider the Mesa tender offer. Thirteen directors were present, and the meeting lasted nine and one-half hours. The directors were given no agenda or written materials prior to the session. However, detailed presentations were made by legal counsel regarding the board's obligations under both Delaware corporate law and the federal securities laws. The board then received a presentation from Peter Sachs on behalf of Goldman Sachs Co. (Goldman Sachs) and Dillon, Read Co. (Dillon Read) discussing the bases for their opinions that the Mesa proposal was wholly inadequate. Mr. Sachs opined that the minimum cash value that could be expected from a sale or orderly liquidation for 100% of Unocal's stock was in excess of $60 per share. In making his presentation, Mr. Sachs showed slides outlining the valuation techniques used by the financial advisors, and others, depicting recent business combinations in the oil and gas industry. The Court of Chancery found that the Sachs presentation was designed to apprise the directors of the scope of the analyses performed rather than the facts and numbers used in reaching the conclusion that Mesa's tender offer price was inadequate.

Mr. Sachs also presented various defensive strategies available to the board if it concluded that Mesa's two-step tender offer was inadequate and should be opposed. One of the devices outlined was a self-tender by Unocal for its own stock with a reasonable price range of $70 to $75 per share. The cost of such a proposal would cause the company to incur $6.1 — $6.5 billion of additional debt, and a presentation was made informing the board of Unocal's ability to handle it. The directors were told that the primary effect of this obligation would be to reduce exploratory drilling, but that the company would nonetheless remain a viable entity.

The eight outside directors, comprising a clear majority of the thirteen members present, then met separately with Unocal's financial advisors and attorneys. Thereafter, they unanimously agreed to advise the board that it should reject Mesa's tender offer as inadequate, and that Unocal should pursue a self-tender to provide the stockholders with a fairly priced alternative to the Mesa proposal. The board then reconvened and unanimously adopted a resolution rejecting as grossly inadequate Mesa's tender offer. Despite the nine and one-half hour length of the meeting, no formal decision was made on the proposed defensive self-tender.

On April 15, the board met again with four of the directors present by telephone and one member still absent. This session lasted two hours. Unocal's Vice President of Finance and its Assistant General Counsel made a detailed presentation of the proposed terms of the exchange offer. A price range between $70 and $80 per share was considered, and ultimately the directors agreed upon $72. The board was also advised about the debt securities that would be issued, and the necessity of placing restrictive covenants upon certain corporate activities until the obligations were paid. The board's decisions were made in reliance on the advice of its investment bankers, including the terms and conditions upon which the securities were to be issued. Based upon this advice, and the board's own deliberations, the directors unanimously approved the exchange offer. Their resolution provided that if Mesa acquired 64 million shares of Unocal stock through its own offer (the Mesa Purchase Condition), Unocal would buy the remaining 49% outstanding for an exchange of debt securities having an aggregate par value of $72 per share.[1] The board resolution also stated that the offer would be subject to other conditions that had been described to the board at the meeting, or which were deemed necessary by Unocal's officers, including the exclusion of Mesa from the proposal (the Mesa exclusion). Any such conditions were required to be in accordance with the "purport and intent" of the offer.

[1] Let me make this a little clearer: if Mesa's tender offer wins, the corporation will automatically buy up all the rest of the shares at a price higher than Mesa's bid, which would have the effect of (a) making shareholders less likely to sell to Mesa and (b) if Mesa wins, its prize is suddenly saddled with a shit-ton of debt.

Unocal's exchange offer was commenced on April 17, 1985, and Mesa promptly challenged it by filing this suit in the Court of Chancery. On April 22, the Unocal board met again and was advised by Goldman Sachs and Dillon Read to waive the Mesa Purchase Condition as to 50 million shares. This recommendation was in response to a perceived concern of the shareholders that, if shares were tendered to Unocal, no shares would be purchased by either offeror. The directors were also advised that they should tender their own Unocal stock into the exchange offer as a mark of their confidence in it.

Another focus of the board was the Mesa exclusion. Legal counsel advised that under Delaware law Mesa could only be excluded for what the directors reasonably believed to be a valid corporate purpose.[2] The directors' discussion centered on the objective of adequately compensating shareholders at the "back-end" of Mesa's proposal, which the latter would finance with "junk bonds". To include Mesa would defeat that goal, because under the proration aspect of the exchange offer (49%) every Mesa share accepted by Unocal would displace one held by another stockholder. Further, if Mesa were permitted to tender to Unocal, the latter would in effect be financing Mesa's own inadequate proposal.

[2] Yeah, no. Terrible advice. This move was, to put it politely, insane and the SEC ultimately stepped in and outlawed selective tender offers like this. Still, the test developed by the court here remains the gold standard for this sort of thing.

On April 29, 1985, the Vice Chancellor temporarily restrained Unocal from proceeding with the exchange offer unless it included Mesa. The trial court recognized that directors could oppose, and attempt to defeat, a hostile takeover which they considered adverse to the best interests of the corporation. However, the Vice Chancellor decided that in a selective purchase of the company's stock, the corporation bears the burden of showing: (1) a valid corporate purpose, and (2) that the transaction was fair to all of the stockholders, including those excluded.

The issues we address involve these fundamental questions: Did the Unocal board have the power and duty to oppose a takeover threat it reasonably perceived to be harmful to the corporate enterprise, and if so, is its action here entitled to the protection of the business judgment rule?

Mesa contends that the discriminatory exchange offer violates the fiduciary duties Unocal owes it.[1] Mesa argues that because of the Mesa exclusion the business judgment rule is inapplicable, because the directors by tendering their own shares will derive a financial benefit that is not available to all Unocal stockholders. Thus, it is Mesa's ultimate contention that Unocal cannot establish that the exchange offer is fair to all shareholders, and argues that the Court of Chancery was correct in concluding that Unocal was unable to meet this burden.

[1] Oh, you think a corporation owes fiduciary duties to a shareholder, do you? Looks like someone didn't hop in a time machine and read this book before they made this argument, becuase it is DEAD. WRONG.

Unocal answers that it does not owe a duty of "fairness" to Mesa, given the facts here. Specifically, Unocal contends that its board of directors reasonably and in good faith concluded that Mesa's $54 two-tier tender offer was coercive and inadequate, and that Mesa sought selective treatment for itself. Furthermore, Unocal argues that the board's approval of the exchange offer was made in good faith, on an informed basis, and in the exercise of due care. Under these circumstances, Unocal contends that its directors properly employed this device to protect the company and its stockholders from Mesa's harmful tactics.

We begin with the basic issue of the power of a board of directors of a Delaware corporation to adopt a defensive measure of this type. Absent such authority, all other questions are moot. Neither issues of fairness nor business judgment are pertinent without the basic underpinning of a board's legal power to act.

When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment. There are, however, certain caveats to a proper exercise of this function. Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.

This Court has long recognized that:

> We must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult.[2]

[2] *Bennett v. Propp*, Del.Supr., 187 A.2d 405, 409 (1962).

In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership. *Cheff v. Mathes*, 199 A.2d at 554-55. However, they satisfy that burden "by showing good faith and reasonable investigation." *Id.* at 555. Furthermore, such proof is materially enhanced, as here, by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards.

In the board's exercise of corporate power to forestall a takeover bid our analysis begins with the basic principle that corporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders. As we have noted, their duty of care extends to protecting the corporation and its owners from perceived harm whether a threat originates from third parties or other shareholders. But such powers are not absolute. A corporation does not have unbridled discretion to defeat any perceived threat by any Draconian means available.

The restriction placed upon a selective stock repurchase is that the directors may not have acted solely or primarily out of a desire to perpetuate themselves in office. Of course, to this is added the further caveat that inequitable action may not be taken under the guise of law. *Schnell v. Chris-Craft Industries*, Inc., Del.Supr., 285 A.2d 437, 439 (1971).[1] The standard of proof established in *Cheff v. Mathes* is designed to ensure that a defensive measure to thwart or impede a takeover is indeed motivated by a good faith concern for the welfare of the corporation and its stockholders, which in all circumstances must be free of any fraud or other misconduct. However, this does not end the inquiry.

[1] I never noticed this until now, but this opinion is a real greatest hits album of Delaware corporate law.

A further aspect is the element of balance. If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed. This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on "constituencies" other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange. While not a controlling factor, it also seems to us that a board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor. Here, the threat posed was viewed by the Unocal board as a grossly inadequate two-tier coercive tender offer coupled with the threat of greenmail.

Specifically, the Unocal directors had concluded that the value of Unocal was substantially above the $54 per share offered in cash at the front end. Furthermore, they determined that the subordinated securities to be exchanged in Mesa's announced squeeze out of the remaining shareholders in the "back-end" merger were "junk bonds" worth far less than $54. It is now well recognized that such offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction. Wholly beyond the coercive aspect of an inadequate two-tier tender offer, the threat was posed by a corporate raider with a national reputation as a "greenmailer".

In adopting the selective exchange offer, the board stated that its objective was either to defeat the inadequate Mesa offer or, should the offer still succeed, provide the 49% of its stockholders, who would otherwise be forced to accept "junk bonds", with $72 worth of senior debt. We find that both purposes are valid.

However, such efforts would have been thwarted by Mesa's participation in the exchange offer. First, if Mesa could tender its shares, Unocal would effectively be subsidizing the former's continuing effort to buy Unocal stock at $54 per share. Second, Mesa could not, by definition, fit within the class of shareholders being protected from its own coercive and inadequate tender offer.

Thus, we are satisfied that the selective exchange offer is reasonably related to the threats posed. [T]he board's decision to offer what it determined to be the fair value of the corporation to the 49% of its shareholders, who would otherwise be forced to accept highly subordinated "junk bonds", is reasonable and consistent with the directors' duty to ensure that the minority stockholders receive equal value for their shares.

Mesa contends that it is unlawful, and the trial court agreed, for a corporation to discriminate in this fashion against one shareholder. It argues correctly that no case has ever sanctioned a device that precludes a raider from sharing in a benefit available to all other stockholders. However, as we have noted earlier, the principle of selective stock repurchases by a Delaware corporation is neither unknown nor unauthorized. *Cheff v. Mathes*, 199 A.2d at 554. The only difference is that heretofore the approved transaction was the payment of "greenmail" to a raider or dissident posing a threat to the corporate enterprise. All other stockholders were denied such favored treatment, and given Mesa's past history of greenmail, its claims here are rather ironic.

More recently, as the sophistication of both raiders and targets has developed, a host of other defensive measures to counter such ever mounting threats has evolved and received judicial sanction. These include defensive charter amendments and other devices bearing some rather exotic, but apt, names: Crown Jewel,[1] White Knight, Pac Man, and Golden Parachute.[2] Each has highly selective features, the object of which is to deter or defeat the raider.

Thus, while the exchange offer is a form of selective treatment, given the nature of the threat posed here the response is neither unlawful nor

[1] aka a Lock-Up.

[2] This move — enriching the outgoing management upon a successful takover — has not deterred corporate raiders in the slightest. But it sure as shit made some C-suite types richer, so I guess it's a win?

unreasonable. If the board of directors is disinterested, has acted in good faith and with due care, its decision in the absence of an abuse of discretion will be upheld as a proper exercise of business judgment.

Mesa also argues that the exclusion permits the directors to abdicate the fiduciary duties they owe it. However, that is not so. The board continues to owe Mesa the duties of due care and loyalty. But in the face of the destructive threat Mesa's tender offer was perceived to pose, the board had a supervening duty to protect the corporate enterprise, which includes the other shareholders, from threatened harm.

Mesa contends that the basis of this action is punitive, and solely in response to the exercise of its rights of corporate democracy. Nothing precludes Mesa, as a stockholder, from acting in its own self-interest. However, Mesa, while pursuing its own interests, has acted in a manner which a board consisting of a majority of independent directors has reasonably determined to be contrary to the best interests of Unocal and its other shareholders. In this situation, there is no support in Delaware law for the proposition that, when responding to a perceived harm, a corporation must guarantee a benefit to a stockholder who is deliberately provoking the danger being addressed. There is no obligation of self-sacrifice by a corporation and its shareholders in the face of such a challenge.[1]

[1] "The articles of incorporation is not a suicide pact."

In conclusion, there was directorial power to oppose the Mesa tender offer, and to undertake a selective stock exchange made in good faith and upon a reasonable investigation pursuant to a clear duty to protect the corporate enterprise. Further, the selective stock repurchase plan chosen by Unocal is reasonable in relation to the threat that the board rationally and reasonably believed was posed by Mesa's inadequate and coercive two-tier tender offer. Under those circumstances the board's action is entitled to be measured by the standards of the business judgment rule. Thus, unless it is shown by a preponderance of the evidence that the directors' decisions were primarily based on perpetuating themselves in office, or some other breach of fiduciary duty such as fraud, overreaching, lack of good faith, or being uninformed, a Court will not substitute its judgment for that of the board.

With the Court of Chancery's findings that the exchange offer was based on the board's good faith belief that the Mesa offer was inadequate, that the board's action was informed and taken with due care, that Mesa's prior activities justify a reasonable inference that its principle objective was greenmail, and implicitly, that the substance of the offer itself was reasonable and fair to the corporation and its stockholders if Mesa were included, we cannot say that the Unocal directors have acted in such a manner as to have passed an "unintelligent and unadvised judgment". The decision of the Court of Chancery is therefore REVERSED, and the preliminary injunction is VACATED.

SOME DISCUSSION QUESTIONS:

1. Why did the board exclude Mesa from its offer?
2. What kind of things might reasonably pose a threat to a corporation?
3. When Unocal made its offer, was it reasonably trying to look out for its shareholders?
4. Mesa and T. Boone Pickens had spent the 1980s taking stakes in oil companies, and making a significant amount of money when those corporations bought his shares at a premium to make him go away. Was it appropriate to use that backstory in deciding this particular case?

Deal Protection Devices

Well, alrighty, you've fended off the wicked corporate raider, but in the meantime you've learned a lot about your corporation, your shareholders, and — most importantly — yourself. You're ready. Ready to find a partner. A partner who really, you know, *gets you* and *gets the discounted cash flows of your corporation.* It's time to get out there again! It's time to sell your corporation!

The next case establishes the heightened duties that apply once a corporate board has decided to take the plunge, to not look back, to learn to love again, and to sell the corporation to a White Knight to thwart a potential hostile takeover. What can and what must a board consider here, at the end of the line for the corporation, when it decides it is time to sell? And what can it do to fend off a rival bidder?

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

Moore, J.

In this battle for corporate control of Revlon, Inc. (Revlon), the Court of Chancery enjoined certain transactions designed to thwart the efforts of Pantry Pride, Inc. (Pantry Pride) to acquire Revlon.[1] The defendants are Revlon, its board of directors, and Forstmann Little Co. and the latter's affiliated limited partnership (collectively, Forstmann). The injunction barred consummation of an option granted Forstmann to purchase certain Revlon assets (the lock-up option), a promise by Revlon to deal exclusively with Forstmann in the face of a takeover (the no-shop provision), and the payment of a $25 million cancellation fee to Forstmann if the transaction was aborted. The Court of Chancery found that the Revlon

[1] The plaintiff, MacAndrews and Forbes, is the controlling shareholder of Pantry Pride.

directors had breached their duty of care by entering into the foregoing transactions and effectively ending an active auction for the company. The trial court ruled that such arrangements are not illegal per se under Delaware law, but that their use under the circumstances here was impermissible. We agree. Thus, we granted this expedited interlocutory appeal to consider for the first time the validity of such defensive measures in the face of an active bidding contest for corporate control. Additionally, we address for the first time the extent to which a corporation may consider the impact of a takeover threat on constituencies other than shareholders.

In our view, lock-ups and related agreements are permitted under Delaware law where their adoption is untainted by director interest or other breaches of fiduciary duty. The actions taken by the Revlon directors, however, did not meet this standard. Moreover, while concern for various corporate constituencies is proper when addressing a takeover threat, that principle is limited by the requirement that there be some rationally related benefit accruing to the stockholders. We find no such benefit here.

Thus, under all the circumstances we must agree with the Court of Chancery that the enjoined Revlon defensive measures were inconsistent with the directors' duties to the stockholders. Accordingly, we affirm.

The somewhat complex maneuvers of the parties necessitate a rather detailed examination of the facts. The prelude to this controversy began in June 1985, when Ronald O. Perelman, chairman of the board and chief executive officer of Pantry Pride, met with his counterpart at Revlon, Michel C. Bergerac, to discuss a friendly acquisition of Revlon by Pantry Pride. Perelman suggested a price in the range of $40-$50 per share, but the meeting ended with Bergerac dismissing those figures as considerably below Revlon's intrinsic value. All subsequent Pantry Pride overtures were rebuffed, perhaps in part based on Mr. Bergerac's strong personal antipathy to Mr. Perelman.[1]

[1] Lol.

Thus, on August 14, Pantry Pride's board authorized Perelman to acquire Revlon, either through negotiation in the $42-$43 per share range, or by making a hostile tender offer at $45. Perelman then met with Bergerac and outlined Pantry Pride's alternate approaches. Bergerac remained adamantly opposed to such schemes and conditioned any further discussions of the matter on Pantry Pride executing a standstill agreement prohibiting it from acquiring Revlon without the latter's prior approval.

On August 19, the Revlon board met specially to consider the impending threat of a hostile bid by Pantry Pride. At the meeting, Lazard Freres, Revlon's investment banker, advised the directors that $45 per share was a grossly inadequate price for the company. Felix Rohatyn and William Loomis of Lazard Freres explained to the board that Pantry Pride's financial strategy for acquiring Revlon would be through "junk bond" financing followed by a break-up of Revlon and the disposition of its assets. With proper timing, according to the experts, such transactions could produce a return to Pantry Pride of $60 to $70 per share, while a sale of the company as a whole would be in the "mid 50" dollar range. Martin Lipton,[1] special counsel for Revlon, recommended two defensive measures: first, that the company repurchase up to 5 million of its nearly 30 million outstanding shares; and second, that it adopt a Note Purchase Rights Plan. Under this plan, each Revlon shareholder would receive as a dividend one Note Purchase Right (the Rights) for each share of common stock, with the Rights entitling the holder to exchange one common share for a $65 principal Revlon note at 12% interest with a one-year maturity. The Rights would become effective whenever anyone acquired beneficial ownership of 20% or more of Revlon's shares, unless the purchaser acquired all the company's stock for cash at $65 or more per share. In addition, the Rights would not be available to the acquiror, and prior to the 20% triggering event the Revlon board could redeem the rights for 10 cents each. Both proposals were unanimously adopted.

[1] Marty "Big Sexy" Lipton! Back again!

Pantry Pride made its first hostile move on August 23 with a cash tender offer for any and all shares of Revlon at $47.50 per common share and $26.67 per preferred share, subject to (1) Pantry Pride's obtaining financing for the purchase, and (2) the Rights being redeemed, rescinded or voided.

At this point, both the Rights and the Note covenants stymied Pantry Pride's attempted takeover. The next move came on September 16, when Pantry Pride announced a new tender offer at $42 per share, conditioned upon receiving at least 90% of the outstanding stock. Pantry Pride also indicated that it would consider buying less than 90%, and at an increased price, if Revlon removed the impeding Rights. While this offer was lower on its face than the earlier $47.50 proposal, Revlon's investment banker, Lazard Freres, described the two bids as essentially equal in view of the completed exchange offer.

The Revlon board held a regularly scheduled meeting on September 24. The directors rejected the latest Pantry Pride offer and authorized management to negotiate with other parties interested in acquiring Revlon. Pantry Pride remained determined in its efforts and continued to make cash bids for the company, offering $50 per share on September 27, and raising its bid to $53 on October 1, and then to $56.25 on October 7.[2]

[2] My man is on tilt.

In the meantime, Revlon's negotiations with Forstmann and the investment group Adler Shaykin had produced results. The Revlon directors met on October 3 to consider Pantry Pride's $53 bid and to examine possible alternatives to the offer. Both Forstmann and Adler Shaykin made certain proposals to the board. As a result, the directors unanimously agreed to a leveraged buyout by Forstmann. The terms of this accord were as follows: each stockholder would get $56 cash per share; management would purchase stock in the new company by the exercise of their Revlon "golden parachutes"; Forstmann would assume Revlon's $475 million debt incurred by the issuance of the Notes; and Revlon would redeem the Rights and waive the Notes covenants for Forstmann or in connection with any other offer superior to Forstmann's. The board did not actually remove the covenants at the October 3 meeting, because Forstmann then lacked a firm commitment on its financing, but accepted the Forstmann capital structure, and indicated that the outside directors would waive the covenants in due course. Part of Forstmann's plan was to sell Revlon's Norcliff Thayer and Reheis divisions to American Home Products for $335 million. Before the merger, Revlon was to sell its cosmetics and fragrance division to Adler Shaykin for $905 million. These transactions would facilitate the purchase by Forstmann or any other acquiror of Revlon.

Pantry Pride countered with a new proposal on October 7, raising its $53 offer to $56.25, subject to nullification of the Rights, a waiver of the Notes covenants, and the election of three Pantry Pride directors to the Revlon board. On October 9, representatives of Pantry Pride, Forstmann and Revlon conferred in an attempt to negotiate the fate of Revlon, but could not reach agreement. At this meeting Pantry Pride announced that it would engage in fractional bidding and top any Forstmann offer by a slightly higher one.[1] It is also significant that Forstmann, to Pantry Pride's exclusion, had been made privy to certain Revlon financial data. Thus, the parties were not negotiating on equal terms.

[1] You really shouldn't say this out loud.

Again privately armed with Revlon data, Forstmann met on October 11 with Revlon's special counsel and investment banker. On October 12, Forstmann made a new $57.25 per share offer, based on several conditions. The principal demand was a lock-up option to purchase Revlon's Vision Care and National Health Laboratories divisions for $525 million, some $100-$175 million below the value ascribed to them by Lazard Freres, if another acquiror got 40% of Revlon's shares. Revlon also was required to accept a no-shop provision. The Rights and Notes covenants had to be removed as in the October 3 agreement. There would be a $25 million cancellation fee to be placed in escrow, and released to Forstmann if the new agreement terminated or if another acquiror got more than 19.9% of Revlon's stock. Finally, there would be no participation by Revlon management in the merger. Forstmann also demanded immediate acceptance of its offer, or it would be withdrawn. The board unanimously approved Forstmann's proposal. The board further agreed to redeem the rights and waive the covenants on the preferred stock in response to any offer above $57 cash per share.

Pantry Pride, which had initially sought injunctive relief from the

Rights plan on August 22, filed an amended complaint on October 14 challenging the lock-up, the cancellation fee, and the exercise of the Rights and the Notes covenants. Pantry Pride also sought a temporary restraining order to prevent Revlon from placing any assets in escrow or transferring them to Forstmann. Moreover, on October 22, Pantry Pride again raised its bid, with a cash offer of $58 per share conditioned upon nullification of the Rights, waiver of the covenants, and an injunction of the Forstmann lock-up.

On October 15, the Court of Chancery prohibited the further transfer of assets, and eight days later enjoined the lock-up, no-shop, and cancellation fee provisions of the agreement.

We turn first to Pantry Pride's probability of success on the merits. The ultimate responsibility for managing the business and affairs of a corporation falls on its board of directors. In discharging this function the directors owe fiduciary duties of care and loyalty to the corporation and its shareholders.[1] These principles apply with equal force when a board approves a corporate merger. While the business judgment rule may be applicable to the actions of corporate directors responding to takeover threats, the principles upon which it is founded — care, loyalty and independence — must first be satisfied.

[1] FUCK. COME ON.

The first relevant defensive measure adopted by the Revlon board was the Rights Plan, which would be considered a "poison pill" in the current language of corporate takeovers — a plan by which shareholders receive the right to be bought out by the corporation at a substantial premium on the occurrence of a stated triggering event.

The Revlon board approved the Rights Plan in the face of an impending hostile takeover bid by Pantry Pride at $45 per share, a price which Revlon reasonably concluded was grossly inadequate. Lazard Freres had so advised the directors, and had also informed them that Pantry Pride was a small, highly leveraged company bent on a "bust-up" takeover by using "junk bond" financing to buy Revlon cheaply, sell the acquired assets to pay the debts incurred, and retain the profit for itself. In adopting the Plan, the board protected the shareholders from a hostile takeover at a price below the company's intrinsic value, while retaining sufficient flexibility to address any proposal deemed to be in the stockholders' best interests.

To that extent the board acted in good faith and upon reasonable investigation. Under the circumstances it cannot be said that the Rights Plan as employed was unreasonable, considering the threat posed. Indeed, the Plan was a factor in causing Pantry Pride to raise its bids from a low of $42 to an eventual high of $58. At the time of its adoption the Rights Plan afforded a measure of protection consistent with the directors' fiduciary duty in facing a takeover threat perceived as detrimental to corporate interests. Far from being a "show-stopper," the measure spurred the bidding to new heights, a proper result of its implementation.

Although we consider adoption of the Plan to have been valid under the circumstances, its continued usefulness was rendered moot by the directors' actions on October 3 and October 12. At the October 3 meeting the board redeemed the Rights conditioned upon consummation of a merger with Forstmann, but further acknowledged that they would also be redeemed to facilitate any more favorable offer. On October 12, the board unanimously passed a resolution redeeming the Rights in connection with any cash proposal of $57.25 or more per share. Because all the pertinent offers eventually equalled or surpassed that amount, the Rights clearly were no longer any impediment in the contest for Revlon.

The second defensive measure adopted by Revlon to thwart a Pantry Pride takeover was the company's own exchange offer for 10 million of its shares. The directors' general broad powers to manage the business and affairs of the corporation are augmented by the specific authority conferred under 8 Del. C. § 160(a), permitting the company to deal in its own stock. However, when exercising that power in an effort to forestall a hostile takeover, the board's actions are strictly held to the fiduciary standards outlined in *Unocal*. These standards require the directors to determine the best interests of the corporation and its stockholders, and impose an enhanced duty to abjure any action that is motivated by considerations other than a good faith concern for such interests.

The Revlon directors concluded that Pantry Pride's $47.50 offer was grossly inadequate. In that regard the board acted in good faith, and on an informed basis, with reasonable grounds to believe that there existed a harmful threat to the corporate enterprise. The adoption of a defensive measure, reasonable in relation to the threat posed, was proper and fully accorded with the powers, duties, and responsibilities conferred upon directors under our law.

However, when Pantry Pride increased its offer to $50 per share, and then to $53, it became apparent to all that the break-up of the company was inevitable. The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit.[1] This significantly altered the board's responsibilities under the *Unocal* standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from

[1] This put the company into what is now known as *Revlon* mode.

defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.

This brings us to the lock-up with Forstman. The original threat posed by Pantry Pride — the break-up of the company — had become a reality which even the directors embraced. Selective dealing to fend off a hostile but determined bidder was no longer a proper objective. Instead, obtaining the highest price for the benefit of the stockholders should have been the central theme guiding director action. [W]hen the Revlon board entered into an auction-ending lock-up agreement with Forstmann on the basis of impermissible considerations at the expense of the shareholders, the directors breached their primary duty of loyalty.

A lock-up is not per se illegal under Delaware law. Its use has been approved in an earlier case. Such options can entice other bidders to enter a contest for control of the corporation, creating an auction for the company and maximizing shareholder profit. Current economic conditions in the takeover market are such that a "white knight" like Forstmann might only enter the bidding for the target company if it receives some form of compensation to cover the risks and costs involved. However, while those lock-ups which draw bidders into the battle benefit shareholders, similar measures which end an active auction and foreclose further bidding operate to the shareholders' detriment.

In this regard, we are especially mindful that some lock-up options may be beneficial to the shareholders, such as those that induce a bidder to compete for control of a corporation, while others may be harmful, such as those that effectively preclude bidders from competing with the optionee bidder.

The Forstmann option had a similar destructive effect on the auction process. Forstmann had already been drawn into the contest on a preferred basis, so the result of the lock-up was not to foster bidding, but to destroy it. The board's stated reasons for approving the transactions were: (1) better financing, (2) noteholder protection, and (3) higher price. As the Court of Chancery found, and we agree, any distinctions between the rival bidders' methods of financing the proposal were nominal at best, and such a consideration has little or no significance in a cash offer for any and all shares.

In addition to the lock-up option, the Court of Chancery enjoined the no-shop provision as part of the attempt to foreclose further bidding by Pantry Pride. The no-shop provision, like the lock-up option, while not per se illegal, is impermissible under the *Unocal* standards when a board's primary duty becomes that of an auctioneer responsible for selling the company to the highest bidder. The agreement to negotiate only with Forstmann ended rather than intensified the board's involvement in the

bidding contest.

It is ironic that the parties even considered a no-shop agreement when Revlon had dealt preferentially, and almost exclusively, with Forstmann throughout the contest. After the directors authorized management to negotiate with other parties, Forstmann was given every negotiating advantage that Pantry Pride had been denied: cooperation from management, access to financial data, and the exclusive opportunity to present merger proposals directly to the board of directors. Favoritism for a white knight to the total exclusion of a hostile bidder might be justifiable when the latter's offer adversely affects shareholder interests, but when bidders make relatively similar offers, or dissolution of the company becomes inevitable, the directors cannot fulfill their enhanced Unocal duties by playing favorites with the contending factions. Market forces must be allowed to operate freely to bring the target's shareholders the best price available for their equity. Thus, as the trial court ruled, the shareholders' interests necessitated that the board remain free to negotiate in the fulfillment of that duty.

The court below similarly enjoined the payment of the cancellation fee, pending a resolution of the merits, because the fee was part of the overall plan to thwart Pantry Pride's efforts. We find no abuse of discretion in that ruling.

In conclusion, the Revlon board was confronted with a situation not uncommon in the current wave of corporate takeovers. A hostile and determined bidder sought the company at a price the board was convinced was inadequate. The initial defensive tactics worked to the benefit of the shareholders, and thus the board was able to sustain its *Unocal* burdens in justifying those measures. However, in granting an asset option lock-up to Forstmann, we must conclude that under all the circumstances the directors allowed considerations other than the maximization of shareholder profit to affect their judgment, and followed a course that ended the auction for Revlon, absent court intervention, to the ultimate detriment of its shareholders. No such defensive measure can be sustained when it represents a breach of the directors' fundamental duty of care. In that context the board's action is not entitled to the deference accorded it by the business judgment rule. The measures were properly enjoined. The decision of the Court of Chancery, therefore, is AFFIRMED.

Some discussion questions:

1. Pantry Pride's final bid before this litigation was ultimately lower than Forstmann's — why?

2. For what reasons would a board prefer a sale to a White Knight? What can they do to make sure that happens?

3. If Revlon's board consistently answered "no" to offers to sell, would *Unocal* have protected what it did? What's the reason for the different outcome here?

4. When, exactly, does *Revlon* mode apply? And how is it meaningfully different than sicko mode?

A Children's Treasury of Deal Protection Measures

- **Termination Fees**. These can go to either or both of the buyer and target in the event that one or the other of them decides to back out of the deal. Courts have upheld them when they are "reasonable" — that is, big enough to deter backing out of the deal, but small enough that rival bidders can still emerge.

- **Lock-Ups With The Buyer**. As with the lock-ups with a White Knight, these allow buyers to procure at least some of the target's assets even if the target ultimately consummates a deal with another buyer. (We saw one of these in *Smith v. Van Gorkon*.) A little consolation prize for the loser, how nice.

- **No-Shops and Limited Go-Shops**. "No-shops" like the one in *Revlon* that prevent consideration of rival bids are strongly disfavored as violations of a board's fiduciary duties of care and loyalty. Instead, merger agreements will generally specify a "go-shop" — a period of time when a board is permitted to receive and consider rival bids, but which eventually ends so that the deal may proceed.

- **Matching Rights**. Weak matching rights give the buyer the right to match any offer that comes through the door. Strong matching rights give the buyer all the information that is submitted with a rival bid so that they can craft their counter-offer in a way that is guaranteed to beat the other bid.

- **Put It To A Vote**. Buyers can put a provision in the merger agreement that requires a board to submit their proposal to a shareholder vote even in the presence of a rival bid. Because shareholders are the ultimate arbiters of a fundamental transaction, their approval moots any complaints by a losing bidder.

14. Corporate Criminal Liability

Corporate criminality is horrifying and rampant. "Soft-on-crime" policies have let corporations and their managers run wild in the streets, putting fentanyl in Halloween candy, hacking into your computer to steal your identity, and playing the "knock-out game" on unsuspecting passersby.[1] Lax border enforcement has seen hordes of foreign corporations pour into the United States to take advantage of innocent consumers and unsuspecting investors. Making matters worse, weak-willed prosecutors and bleeding-heart judges have made the corporate death penalty a thing of the past, even as corporations loot and plunder without any sign of reproach. Sure, it's disgusting and awful, but given our newly "woke" criminal justice system, it's not clear that anything can be done about these increasingly common corporate predations.[2]

[1] Or, more accurately, putting carcinogens in shampoo and baby powder, unlawfully collecting and selling personal data, and releasing dangerous chemicals and pollutants into communities.

[2] Restorative justice? Non-carceral alternatives? Yes, yes — but what about the fact that I once saw a person with blue hair? I'm sorry, but: case closed.

Well, to that I say: **enough**. It's time to take the gloves off and quit mollycoddling these corporate criminals. If a couple of quarterly earnings reports get roughed up, so be it — and if they had just complied with their orders, none of this would have happened in the first place, right? If multinational corporations have nothing to conceal, let them show us what they're doing instead of hiding behind "constitutional rights" and other minor technicalities! Honestly, we need to just shut down the business formation offices in state governments until we learn more about what's *really* going on in these corporate boardrooms. Let's finally *get fucking tough* on these career corporate criminals, and make these bastards fear the long arm of the law.

Maybe then I'll be able to park my Ford F-150 Super Duty at a suburban office park and eat a soup-and-sandwich combo at a depressing chain restaurant without worrying about getting robbed by a white-collar criminal. *Maybe.*

In this chapter, we explore the intersection of criminal law and corporate law. We first analyze the uniquely corporate-specific crime of insider trading. We next ask the question of when should a corporation itself (rather than, or in addition to, its managers and employees) be held criminally liable? We then look at how and why corporate executives face criminal liability for the acts of the corporations they manage, using the case studies of Theranos and and Purdue Pharmaceuticals.

Insider Trading

Insider trading is an honestly delightful federal crime that applies to stock trading by a corporation's key decisionmakers and those who possess information about the corporation that is available only to those decisionmakers. It is prosecuted somewhat frequently (and often hilariously), and yet also not prosecuted as much as it could or should be. Why is that? We'll start with the text of the law before we discuss the reality on the ground.

To begin: which law governs insider trading? Well, guess what, it's Rule 10b-5 from our discussion of securities fraud!

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.[1]

[1] File this part away for when we discuss 10b5-1 safe harbor plans.

Look at that — the judicial oak from a legislative acorn shows up again! As developed by courts and the SEC, insider trading is a crime defined as: when an (1) insider (2) trades using (3) material (4) nonpublic information as to which he or she is (5) duty-bound not to trade on. Lotta numbers in there — let's break them down!

1. **Insider**. An insider is canonically a corporation's officer or director. However, because corporations often employ other professionals to assist managers, this also extends to "constructive insiders" that receive information that is meant for managers, including accountants, consultants, and — goddammit — lawyers. I can speak from personal experience that if lawyers were able to bet on (or, more importantly, against) their clients using information they gleaned from their legal representation, I'd be writing this book from a fucking tropical island.

2. **Trades**. To be liable for insider trading, a person must actually buy or sell the securities in question. This is a logical extension of the rule in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), that limited securities fraud claims to actual purchasers or sellers.

3. **Material**. Is it important? Yeah? Then it's material.

4. **Non-Public**. Did you get this information off of the corporation's website? Or by observing the state of the world with your own two eyes? Well, then, it doesn't count as non-public, does it? Non-public means that the information was produced or obtained by the corporation and not shared with the broader world at the time that it was produced or obtained. (Being later revealed to the public does not cure this component of insider trading, and often makes it worse.)

5. **Duty-bound**. Well, well, well, looks like state law fiduciary duties have something to contribute here. Once again, state corporate law works to supersede federal corp— I'm sorry ... what? The duty to keep the information confidential can arise under not just state law fiduciary duties, but in all sorts of formal and informal arrangements? Well, shut the front door! This duty — and, by extension, the prohibition on trading — is broader than just your typical corporate law duties, and extends into both contractual and social arrangements where confidentiality is important.[1]

[1] Ah, well, I'm sure corporate law pedants have made their peace with this and– I'm sorry ... what? Insider trading rules annoy the bootlicking weirdos who already hate civil securities fraud plaintiffs, and who are also reflexively hostile towards the existence of the administrative state, and who are also also wildly overrepresented among corporate law professors? Shocking! I mean, what kind of dipshit is inherently sympathetic towards a useless fraud who profits off an opportunity that they themselves had nothing to do with except being in the right place at the right time and ... oh.

Oh, I see.

The law of insider trading was first developed internally at the SEC. It has since taken a number of twists and turns, but it is worth examining the seminal case of insider trading, if only to get a sense of what the SEC was dealing with, and why they had to act.

In the Matter of Cady, Roberts & Co., 40 S.E.C. 907 (1961)

Cary, Ch.

This is a case of first impression and one of signal importance in our administration of the Federal securities acts. It involves a selling broker who executes a solicited order and sells for discretionary accounts (including that of his wife) upon an exchange. The crucial question is what are the duties of such a broker after receiving nonpublic information as to a company's dividend action from a director who is employed by the same brokerage firm.

These proceedings were instituted to determine whether Cady, Roberts & Co. ("registrant") and Robert M. Gintel ("Gintel"), the selling broker and a partner of the registrant, willfully violated the "anti-fraud" provisions of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Rule 10b-5 issued under that Act, and Section 17(a) of the Securities Act of 1933 ("Securities Act")[1] and, if so, whether any disciplinary action is necessary or appropriate in the public interest.

[1] Section 17 liability is totally unimportant now. Ignore this part.

The facts are as follows:

Early in November 1959, Roy T. Hurley, then President and Chairman of the Board of Curtiss-Wright Corporation, invited 2,000 representatives of the press, the military and the financial and business communities to a public unveiling on November 23, of a new type of internal combustion engine being developed by the company. On November 24,[2] 1959, press announcements concerning the new engine appeared in certain newspapers. On that day Curtiss-Wright stock was one of the most active issues on the New York Stock Exchange, closing at $35\frac{1}{4}$, up $3\frac{1}{4}$ on a volume of 88,700 shares. Gintel had purchased approximately 11,000 shares of Curtiss-Wright stock for about 30 discretionary accounts. With the rise in the price on November 24, he began selling Curtiss-Wright shares for these accounts and sold on that, day a total of 2,200 shares on the Exchange.

[2] Great day. Best day.

On the morning of November 25, the Curtiss-Wright directors, including J. Cheever Cowdin ("Cowdin"), then a registered representative of registrant met to consider, among other things, the declaration of a quarterly dividend. The company had paid a dividend, although not earned, of $.625 per share for each of the first three quarters of 1959. The Curtiss-Wright board, over the objections of Hurley, who favored declaration of a dividend at the same rate as in the prior quarters, approved a dividend for the fourth quarter at the reduced rate. of $.375 per share. At approximately 11:00 a.m., the board authorized transmission of information of this action by telegram to the New York Stock Exchange.[3]

[3] The Pony Express was unavailable, I guess.

The Secretary of Curtiss-Wright immediately left the meeting room to arrange for this communication. There was a short delay in the transmission of the telegram because of a typing problem and the telegram, although transmitted to Western Union at 11:12 a.m., was not delivered to the Exchange until 12:29 p.m. It had been customary for the company also to advise the Dow Jones News Ticker Service of any dividend action. However, apparently through some mistake or inadvertence, the Wall Street Journal was not given the news until approximately 11:45 a.m. and the announcement did not appear on the Dow Jones ticker tape[4] until 11:48 a.m.

[4] Might as well have announced the shit via semaphore.

Sometime after the dividend decision, there was a recess of the Curtiss-Wright directors' meeting, during which Cowdin telephoned registrant's office and left a message for Gintel that the dividend had been cut. Upon receiving this information, Gintel entered two sell orders for execution on the Exchange, one to sell 2,000 shares of Curtiss-Wright stock for 10 accounts, and the other to sell short 5,000 shares for 11 accounts. Four hundred of the 5,000 shares were sold for three of Cowdin's customers. According to Cowdin, pursuant to directions from his clients, he had given instructions to Gintel to take profits on these 400 shares if the stock took a "run-up." When the dividend announcement appeared on the Dow Jones tape at 11:48 a.m., the Exchange was compelled to suspend trading in Curtiss-Wright because of the large number of sell orders.

So many times that citation is unnecessary, we have indicated that the purchase and sale of securities is a field in special need of regulation for the protection of investors. To this end one of the major purposes of the securities acts is the prevention of fraud, manipulation or deception in connection with securities transactions. Consistent with this objective, Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act, and Rule 10b-5 issued under that Section are broad remedial provisions aimed at reaching misleading or deceptive activities, whether or not they are precisely and technically sufficient to sustain a common law action for fraud and deceit. Indeed, despite the decline in importance of a "federal rule" in the light of *Erie R. Co. v. Tompkins*,[1] the securities acts may be said to have generated a wholly new and far-reaching body of federal corporation law.

[1] Holy shit, do you remember this case??? I got called on the first fucking day of law school to answer questions about this case! I still have no goddamn idea what the point of this case was.

Section 17(a) and Rule 10b-5, in almost identical terms, make illegal the use of the mails or of the facilities of interstate commerce including the facility of any national exchange, by any person who directly or indirectly engages in any of the following prohibited kinds of conduct in connection with the sale of any security:

1. Employment of any device, scheme or artifice to defraud.
2. The obtaining of money or property by means of or the making of, any untrue statement of a material fact or the omission to state a material fact necessary in order to make statements made, in the light of the circumstances under which they were made not misleading.
3. Engaging in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person

These anti-fraud provisions are not intended as a specification of particular acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others.

Section 17 and Rule 10b-5 apply to securities transactions by "any person." Misrepresentations will lie within their ambit, no matter who the speaker may be. All affirmative duty to disclose material information has been traditionally imposed on corporate "insiders," particularly officers, directors, or controlling stockholders. We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment.

It was obvious that a reduction in the quarterly dividend by the Board of Directors was a material fact which could be expected to have an adverse impact on the market price of the company's stock. The rapidity with which Gintel acted upon receipt of the information confirms his own recognition of that conclusion.

The facts here impose on Ginte] the responsibilities of those commonly referred to as "insiders." He received the information prior to its public release from a director of Curtiss-Wright, Cowdin, who was associated with the registrant. Cowdin's relationship to the company clearly prohibited him from selling the securities affected by the information without disclosure. By logical sequence, it should prohibit Gintel, a partner of registrant.

All the surrounding circmnstances and the state of mind of the participants may be taken into consideration in determining what sanctions should appropriately be imposed here. It is clear that Gintel's conduct was willful in that he knew what he was doing. However, there is no evidence of a preconceived plan whereby Cowdin was to "leak" advance information of the dividend reduction so that Gintel could use it to advantage before the public announcement; on the contrary, the evidence points to the conclusion that Cowdin probably assumed, without thinking about it, that the dividend action was already a matter of public information and further that he called registrant's office to find out the effect, of the dividend news upon the market. The record, moreover, indicates that Gintel's conduct was a spontaneous reaction to the dividend news, that he intended primarily to benefit existing clients of Cady, Roberts & Co. and that he acted on the spur of the moment and so quickly as to preclude the possibility of review by registrant or of his own more deliberate consideration of his responsibilities under the securities acts.

Gintel has been fined $3,000 by the New York Stock Exchange in connection with the instant transactions. The publication of this opinion, moreover, will in itself serve as a further sanction upon Gintel and registrant and will also induce a more careful observance of the requirements of the anti-fraud provisions in the area in question. Furthermore, registrant had no opportunity to prevent Gintel's spontaneous transitions and no contention has been made that its procedures for handling accounts did not meet proper standards. Under all the circuanstances we conclude that the public interest and the protection of investors will be adequately and appropriately served if Gintel is suspended from the New York Stock Exchange for 20 days and if no sanction is imposed against the registrant.

Accordingly, we accept respondent's offer of settlement.[1]

[1] Big of you, surely.

SOME DISCUSSION QUESTIONS:

1. What kind of proceeding was this? And what kind of punishment?
2. Wait, wait, wait, wait, WAIT. Trading requires equal information between the parties? Or equal access to information? Or what, exactly?
3. Was the insider the one who traded here?

Classical Theory and Misappropriation Theory

After *Cady, Roberts*, courts picked up the metaphorical ball and metaphorically ran with metaphorically it, outlawing trading by corporate insiders on the basis of material non-public information. This "classical" theory of insider trading (prohibiting corporate actors who owed a fiduciary duty to the corporation from trading in the corporation's stock) soon ran up against a practical reality — namely: a whole hell of a lot of people had access to information possessed by insiders. Were all of these people (spouses, employees, clergy, mistresses, spouses-who-were-also-employees, clergy-who-were-also-mistresses, etc.) bound by insider trading prohibitions? The following case delineates the boundaries of the "classical" theory of insider trading.

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

Powell, J.

The question in this case is whether a person who learns from the confidential documents of one corporation that it is planning an attempt to secure control of a second corporation violates § 10(b) of the Securities Exchange Act of 1934 if he fails to disclose the impending takeover before trading in the target company's securities.

Petitioner is a printer by trade. In 1975 and 1976, he worked as a "markup man" in the New York composing room of Pandick Press, a financial printer. Among documents that petitioner handled were five announcements of corporate takeover bids. When these documents were delivered to the printer, the identities of the acquiring and target corporations were concealed by blank spaces or false names. The true names were sent to the printer on the night of the final printing.

The petitioner, however, was able to deduce the names of the target companies before the final printing from other information contained in the documents. Without disclosing his knowledge, petitioner purchased stock in the target companies and sold the shares immediately after the takeover attempts were made public. By this method, petitioner realized a gain of slightly more than $30,000 in the course of 14 months. Subsequently, the Securities and Exchange Commission (Commission or SEC) began an investigation of his trading activities. In May 1977, petitioner entered into a consent decree with the Commission in which he agreed to return his profits to the sellers of the shares. On the same day, he was discharged by Pandick Press.

In January 1978, petitioner was indicted on 17 counts[1] of violating § 10(b) of the Securities Exchange Act of 1934 (1934 Act) and SEC Rule 10b-5. After petitioner unsuccessfully moved to dismiss the indictment, he was brought to trial and convicted on all counts.

1 !

The Court of Appeals for the Second Circuit affirmed petitioner's conviction. We granted certiorari, and we now reverse.

Although the starting point of our inquiry is the language of the statute, § 10(b) does not state whether silence may constitute a manipulative or deceptive device. Section 10(b) was designed as a catchall clause to prevent fraudulent practices. But neither the legislative history nor the statute itself affords specific guidance for the resolution of this case.

The SEC took an important step in the development of § 10(b) when it held that a broker-dealer and his firm violated that section by selling securities on the basis of undisclosed information obtained from a director of the issuer corporation who was also a registered representative of the brokerage firm.

That the relationship between a corporate insider and the stockholders of his corporation gives rise to a disclosure obligation is not a novel twist of the law. At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."

The federal courts have found violations of § 10(b) where corporate insiders used undisclosed information for their own benefit. Accordingly, a purchaser of stock who has no duty to a prospective seller because he is neither an insider nor a fiduciary has been held to have no obligation to reveal material facts.

In this case, the petitioner was convicted of violating § 10(b) although he was not a corporate insider and he received no confidential information from the target company. Moreover, the "market information" upon which he relied did not concern the earning power or operations of the target company, but only the plans of the acquiring company. Petitioner's use of that information was not a fraud under § 10(b) unless he was subject to an affirmative duty to disclose it before trading. In this case, the jury instructions failed to specify any such duty. In effect, the trial court instructed the jury that petitioner owed a duty to everyone; to all sellers, indeed, to the market as a whole. The jury simply was told to decide whether petitioner used material, nonpublic information at a time when "he knew other people trading in the securities market did not have access to the same information."

This reasoning suffers from two defects. First, not every instance of financial unfairness constitutes fraudulent activity under § 10(b). Second, the element required to make silence fraudulent — a duty to disclose — is absent in this case. No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.

We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties should not be undertaken absent some explicit evidence of congressional intent.

As we have seen, no such evidence emerges from the language or legislative history of § 10(b). Moreover, neither the Congress nor the Commission ever has adopted a parity-of-information rule. Instead the problems caused by misuse of market information have been addressed by detailed and sophisticated regulation that recognizes when use of market information may not harm operation of the securities markets. For example, the Williams Act limits but does not completely prohibit a tender offeror's purchases of target corporation stock before public announcement of the offer. Congress' careful action in this and other areas contrasts, and is in some tension, with the broad rule of liability we are asked to adopt in this case.

In its brief to this Court, the United States offers an alternative theory to support petitioner's conviction. It argues that petitioner breached a duty to the acquiring corporation when he acted upon information that he obtained by virtue of his position as an employee of a printer employed by the corporation.[1] The breach of this duty is said to support a conviction

[1] This is the misappropriation theory, discussed at length in *O'Hagan*.

under § 10(b) for fraud perpetrated upon both the acquiring corporation and the sellers.

We need not decide whether this theory has merit for it was not submitted to the jury.

The jury instructions demonstrate that petitioner was convicted merely because of his failure to disclose material, non-public information to sellers from whom he bought the stock of target corporations. The jury was not instructed on the nature or elements of a duty owed by petitioner to anyone other than the sellers. Because we cannot affirm a criminal conviction on the basis of a theory not presented to the jury, we will not speculate upon whether such a duty exists, whether it has been breached or whether such a breach constitutes a violation of § 10(b).

The judgment of the Court of Appeals is Reversed.

Blackmun, J., dissenting

The Court continues to pursue a course, charted in certain recent decisions, designed to transform § 10(b) from an intentionally elastic "catchall" provision to one that catches relatively little of the misbehavior that all too often makes investment in securities a needlessly risky business for the uninitiated investor. Such confinement in this case is now achieved by imposition of a requirement of a "special relationship" akin to fiduciary duty before the statute gives rise to a duty to disclose or to abstain from trading upon material, nonpublic information. The Court admits that this conclusion finds no mandate in the language of the statute or its legislative history. Yet the Court fails even to attempt a justification of its ruling in terms of the purposes of the securities laws, or to square that ruling with the longstanding but now much abused principle that the federal securities laws are to be construed flexibly rather than with narrow technicality.

I, of course, agree with the Court that a relationship of trust can establish a duty to disclose under § 10(b) and Rule 10b-5. But I do not agree that a failure to disclose violates the Rule only when the responsibilities of a relationship of that kind have been breached. As applied to this case, the Court's approach unduly minimizes the importance of petitioner's access to confidential information that the honest investor, no matter how diligently he tried, could not legally obtain. In doing so, it further advances an interpretation of § 10(b) and Rule 10b-5 that stops short of their full implications. Although the Court draws support for its position from certain precedent, I find its decision neither fully consistent with developments in the common law of fraud, nor fully in step with administrative and judicial application of Rule 10b-5 to "insider" trading.

By its narrow construction of § 10(b) and Rule 10b-5, the Court places the federal securities laws in the rear-guard of this movement, a position opposite to the expectations of Congress at the time the securities laws were enacted. I cannot agree that the statute and Rule are so limited. The Court has observed that the securities laws were not intended to replicate the law of fiduciary relations. Rather, their purpose is to ensure the fair and honest functioning of impersonal national securities markets where common-law protections have proved inadequate.

Whatever the outer limits of the Rule, petitioner Chiarella's case fits neatly near the center of its analytical framework. He occupied a relationship to the takeover companies giving him intimate access to concededly material information that was sedulously guarded from public access. The information, in the words of Cady, Roberts Co., was "intended to be available only for a corporate purpose and not for the personal benefit of anyone." Petitioner, moreover, knew that the information was unavailable to those with whom he dealt. And he took full, virtually riskless advantage of this artificial information gap by selling the stocks shortly after each takeover bid was announced. By any reasonable definition, his trading was inherently unfair. This misuse of confidential information was clearly placed before the jury. Petitioner's conviction, therefore, should be upheld, and I dissent from the Court's upsetting that conviction.

SOME DISCUSSION QUESTIONS:

1. This scheme ... it wasn't easy, was it?

2. Who is hurt by all of this, really?

3. Shouldn't we just let him have his gains? It seems like it means a lot to him.

4. Okay, okay, real question: if Chiarella had disclosed where he got his information from, is any of this problematic?

5. Even though he wasn't convicted, Chiarella was fired from his job at the printing press. His union, however, being unmoved by the plight of stock market traders and also being totally badass, got him his job back. Do you think, in our lifetimes, corporate attorneys could form a union and get these kind of workplace protections?

THE CLASSICAL THEORY WASN'T THE ONLY GAME IN TOWN. The SEC, various circuit courts, and many bloodthirsty commentators had long pushed for a more expansive (but complementary) "misappropriation" theory of insider trading. This theory would codify the gut-level understanding that insider trading was not some sort of unfair advantage gained by one party over another, but instead was ***theft***

— theft of corporate information meant to be used for the benefit of the corporation, but instead used for the benefit of the taker of that information.

The misappropriation theory was an extremely logical and totally reasonable interpretation of the prohibition on fraudulent trading as enacted in §10 of the Exchange Act, so obviously it was met with fierce resistance by the Chamber of Commerce and their loyal stooges, which included the eminently forgettable Supreme Court Justice Lewis Powell. Powell — a long-time attorney for the tobacco industry, the author of the opinions in *Chiarella* and *Dirks* (below), and a complete and utter shill who openly advocated for the deployment of capitalist resources to return America to a wholly imaginary pre-New Deal glory — was the personification of "garbage in, garbage out", but by virtue of being the only corporate attorney on the Supreme Court at the time[1] he was assigned a number of corporate and securities law opinions, and so this dullard was briefly empowered to shape this area of law.

[1] And, apparently, the last attorney with any corporate law knowledge to be appointed to the Court.

Father Time, however, remains undefeated, and Powell left the court in 1987 and died some years later of Supreme Court Retirement Disease.[2] His attempted castration of insider trading liability died with him — much like the right to choose died with Saint Ginsburg — and the Supreme Court quickly moved to endorse the misappropriation theory once he was gone. All in all, an early sign that the Supreme Court was less an enlightened council of elders and more a squalid pig-fuck desperately pretending to be a debating society. Science advances one funeral at a time, and so does the law.[3]

[2] This disease also claimed Ruth Bader Ginsburg, although in her case it took her while she was still on the court, a full eight years after she should have retired. The graveyards are filled with the indispensable.

[3] Death comes for us all, Oroku Saki, but something much worse comes for you — for when you die, it will be without honor.

The following case takes the misappropriation theory that Powell rejected and applies it to possibly the least sympathetic defendant that has ever walked the Earth.

United States v. O'Hagan, 521 U.S. 642 (1997)

Ginsburg, J.[4]

[4] She had some bangers, though, and this is one of them.

This case concerns the interpretation and enforcement of § 10(b) and § 14(e) of the Securities Exchange Act of 1934, and rules made by the Securities and Exchange Commission pursuant to these provisions, Rule 10b-5 and Rule 14e-3(a). Two prime questions are presented. The first relates to the misappropriation of material, nonpublic information for securities trading; the second concerns fraudulent practices in the tender offer setting. In particular, we address and resolve these issues: (1) Is a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, guilty of violating § 10(b) and Rule 10b-5? (2) Did the

Commission exceed its rulemaking authority by adopting Rule 14e-3(a), which proscribes trading on undisclosed information in the tender offer setting, even in the absence of a duty to disclose? Our answer to the first question is yes, and to the second question, viewed in the context of this case, no.[1]

[1] Rule 14e-3(a) liability is not at all the point of this case, and so I've omitted the parts of the opinion relevant to it. It is strictly for real Sec Reg sickos.

Respondent James Herman O'Hagan was a partner in the law firm of Dorsey Whitney in Minneapolis, Minnesota. In July 1988, Grand Metropolitan PLC (Grand Met), a company based in London, England, retained Dorsey Whitney as local counsel to represent Grand Met regarding a potential tender offer for the common stock of the Pillsbury Company, headquartered in Minneapolis. Both Grand Met and Dorsey Whitney took precautions to protect the confidentiality of Grand Met's tender offer plans. O'Hagan did no work on the Grand Met representation. Dorsey Whitney withdrew from representing Grand Met on September 9, 1988. Less than a month later, on October 4, 1988, Grand Met publicly announced its tender offer for Pillsbury stock.

On August 18, 1988, while Dorsey Whitney was still representing Grand Met, O'Hagan began purchasing call options for Pillsbury stock.[2] Each option gave him the right to purchase 100 shares of Pillsbury stock by a specified date in September 1988. Later in August and in September, O'Hagan made additional purchases of Pillsbury call options.[3] By the end of September, he owned 2,500 unexpired Pillsbury options, apparently more than any other individual investor.[4] O'Hagan also purchased, in September 1988, some 5,000 shares of Pillsbury common stock, at a price just under $39 per share. When Grand Met announced its tender offer in October, the price of Pillsbury stock rose to nearly $60 per share. O'Hagan then sold his Pillsbury call options and common stock, making a profit of more than $4.3 million.[5]

[2] Oh no. The SEC tracks these.

[3] Oh no no no no no.

[4] THE. SEC. TRACKS. THESE.

[5] Hey, sweet! I wonder what he did with this profit?

The Securities and Exchange Commission (SEC or Commission) initiated an investigation into O'Hagan's transactions, culminating in a 57-count indictment. The indictment alleged that O'Hagan defrauded his law firm and its client, Grand Met, by using for his own trading purposes material, nonpublic information regarding Grand Met's planned tender offer. According to the indictment, O'Hagan used the profits he gained through this trading to conceal his previous embezzlement and conversion of unrelated client trust funds.[6] O'Hagan was charged with 20 counts of mail fraud; 17 counts of securities fraud; 17 counts of fraudulent trading in connection with a tender offer; and 3 counts of violating federal money laundering statutes. A jury convicted O'Hagan on all 57 counts, and he was sentenced to a 41-month term of imprisonment.

[6] Ah, shit.

A divided panel of the Court of Appeals for the Eighth Circuit reversed all of O'Hagan's convictions.

We address first the Court of Appeals' reversal of O'Hagan's convictions under § 10(b) and Rule 10b-5. Following the Fourth Circuit's lead, the Eighth Circuit rejected the misappropriation theory as a basis for § 10(b) liability. We hold, in accord with several other Courts of Appeals, that criminal liability under § 10(b) may be predicated on the misappropriation theory.

Under the "traditional" or "classical theory" of insider trading liability, § 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a "deceptive device" under § 10(b), we have affirmed, because a relationship of trust and confidence exists between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation. The classical theory applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation.

The "misappropriation theory" holds that a person commits fraud "in connection with" a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.

The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities. The classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information. The misappropriation theory is thus designed to "protec[t] the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect th[e] corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders."

In this case, the indictment alleged that O'Hagan, in breach of a duty of trust and confidence he owed to his law firm, Dorsey Whitney, and to its client, Grand Met, traded on the basis of nonpublic information regarding Grand Met's planned tender offer for Pillsbury common stock. This conduct, the Government charged, constituted a fraudulent device in connection with the purchase and sale of securities.

We agree with the Government that misappropriation, as just defined, satisfies § 10(b)'s requirement that chargeable conduct involve a "deceptive device or contrivance" used "in connection with" the purchase or sale of securities. We observe, first, that misappropriators, as the Government describes them, deal in deception. A fiduciary who "[pretends] loyalty to the principal while secretly converting the principal's information for personal gain," "dupes" or defrauds the principal.

Deception through nondisclosure is central to the theory of liability for which the Government seeks recognition. As counsel for the Government stated in explanation of the theory at oral argument: "To satisfy the common law rule that a trustee may not use the property that [has] been entrusted [to] him, there would have to be consent. To satisfy the requirement of the Securities Act that there be no deception, there would only have to be disclosure."

We turn next to the § 10(b) requirement that the misappropriator's deceptive use of information be "in connection with the purchase or sale of [a] security." This element is satisfied because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide. This is so even though the person or entity defrauded is not the other party to the trade,[1] but is, instead, the source of the nonpublic information. A misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public.

[1] Flagging this because it is a complete 180 from the original idea behind prohibiting insider trading.

The misappropriation theory targets information of a sort that misappropriators ordinarily capitalize upon to gain no-risk profits through the purchase or sale of securities. Should a misappropriator put such information to other use, the statute's prohibition would not be implicated. The theory does not catch all conceivable forms of fraud involving confidential information; rather, it catches fraudulent means of capitalizing on such information through securities transactions.

The Government notes another limitation on the forms of fraud § 10(b) reaches: "The misappropriation theory would not apply to a case in which a person defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds of the misdeed to purchase securities." In such a case, the Government states, "the proceeds would have value to the malefactor apart from their use in a securities transaction, and the fraud would be complete as soon as the money was obtained." In other words, money can buy, if not anything, then at least many things; its misappropriation may thus be viewed as sufficiently detached from a subsequent securities transaction that § 10(b)'s "in connection with" requirement would not be met.

The misappropriation theory comports with § 10(b)'s language, which requires deception "in connection with the purchase or sale of any security," not deception of an identifiable purchaser or seller. The theory is also well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence. Although informational disparity is inevitable in the securities markets,[1] investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-à-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill.

[1] Finally, someone acknowledges this! Thank you!

In sum, considering the inhibiting impact on market participation of trading on misappropriated information, and the congressional purposes underlying § 10(b), it makes scant sense to hold a lawyer[2] like O'Hagan a § 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder. The text of the statute requires no such result. The misappropriation at issue here was properly made the subject of a § 10(b) charge because it meets the statutory requirement that there be "deceptive" conduct "in connection with" securities transactions.

[2] Oof.

In sum, the misappropriation theory, as we have examined and explained it in this opinion, is both consistent with the statute and with our precedent. Vital to our decision that criminal liability may be sustained under the misappropriation theory, we emphasize, are two sturdy safeguards Congress has provided regarding scienter. To establish a criminal violation of Rule 10b-5, the Government must prove that a person "willfully" violated the provision. Furthermore, a defendant may not be imprisoned for violating Rule 10b-5 if he proves that he had no knowledge of the Rule. O'Hagan's charge that the misappropriation theory is too indefinite to permit the imposition of criminal liability thus fails not only because the theory is limited to those who breach a recognized duty. In addition, the statute's "requirement of the presence of culpable intent as a necessary element of the offense does much to destroy any force in the argument that application of the [statute]" in circumstances such as O'Hagan's is unjust.

The judgment of the Court of Appeals for the Eighth Circuit is reversed, and the case is remanded for further proceedings consistent with this opinion.

SOME DISCUSSION QUESTIONS:

1. To whom, precisely, did O'Hagan owe his duties to? Why is that relevant?

2. Who does the firm represent? Why is that problematic for the "classical" theory?

3. The court pretends that O'Hagan went out and obtained this information by himself, but I believe 100% that he learned all of this from various partners shit-talking this transaction. Does that change the analysis?

4. Would Chiarella have been found guilty of insider trading under the misappropriation theory?

5. Would *you* put your money in a market that allowed this kind of trading?

Tipper-Tippee Liability

OKAY, OKAY, BUT WHAT IF I got some material, non-public information and it's really, really good, and instead of trading on it myself I give it to friends and family to trade on? I mean, *they* don't owe any duty of confidentiality to the corporation, and *I'm* not personally benefiting from the trades, so c'mon, that's okay, right?

Nope. GO STRAIGHT TO JAIL. Honestly, this is like the first thing that the SEC thought of when it outlawed insider trading.[1] This is called "tipper-tippee liability" and it means that *both* the source of the information (the "tipper") and the party that trades on the information (the "tippee") will be found criminally liable for insider trading.

[1] "Oh, but what if I use code words to conceal my tipping?" Jesus Christ on a cracker, you will a thousand percent not be fooling anyone with that shit.

The following case is best understood as examining the circumstances under which a tippee would *not* be liable for insider trading — with the understanding that in most cases a tippee is guilty as all hell.

Dirks v. Securities & Exchange Commission, 463 U.S. 646 (1983)

Powell, J.

Petitioner Raymond Dirks received material nonpublic information from "insiders" of a corporation with which he had no connection. He disclosed this information to investors who relied on it in trading in the shares of the corporation.[2] The question is whether Dirks violated the antifraud provisions of the federal securities laws by this disclosure.

[2] Note right off the bat that Dirks is both a tippee and a tipper.

In 1973, Dirks was an officer of a New York broker-dealer firm who specialized in providing investment analysis of insurance company securities to institutional investors. On March 6, Dirks received information from Ronald Secrist, a former officer of Equity Funding of America. Secrist alleged that the assets of Equity Funding, a diversified corporation primarily engaged in selling life insurance and mutual funds, were vastly overstated as the result of fraudulent corporate practices. Secrist also stated that various regulatory agencies had failed to act on similar charges made by Equity Funding employees. He urged Dirks to verify the fraud and disclose it publicly.

Dirks decided to investigate the allegations. He visited Equity Funding's headquarters in Los Angeles and interviewed several officers and employees of the corporation. The senior management denied any wrongdoing, but certain corporation employees corroborated the charges of fraud.[1] Neither Dirks nor his firm owned or traded any Equity Funding stock, but throughout his investigation he openly discussed the information he had obtained with a number of clients and investors.[2] Some of these persons sold their holdings of Equity Funding securities, including five investment advisers who liquidated holdings of more than $16 million.[3]

[1] LOL at the employees being like "yeah this is a fraud, what do I care, the paycheck is the same."

[2] Huh.

[3] HUH.

While Dirks was in Los Angeles, he was in touch regularly with William Blundell, the Wall Street Journal's Los Angeles bureau chief. Dirks urged Blundell to write a story on the fraud allegations. Blundell did not believe, however, that such a massive fraud could go undetected and declined to write the story. He feared that publishing such damaging hearsay might be libelous.[4]

[4] "Wow, how did an obvious fraud like Theranos go undetected for so long?" WELL.

During the 2-week period in which Dirks pursued his investigation and spread word of Secrist's charges, the price of Equity Funding stock fell from $26 per share to less than $15 per share. This led the New York Stock Exchange to halt trading on March 27. Shortly thereafter California insurance authorities impounded Equity Funding's records and uncovered evidence of the fraud. Only then did the Securities and Exchange Commission (SEC) file a complaint against Equity Funding and only then, on April 2, did the Wall Street Journal publish a front-page story based largely on information assembled by Dirks. Equity Funding immediately went into receivership.

The SEC began an investigation into Dirks' role in the exposure of the fraud.[5] After a hearing by an Administrative Law Judge, the SEC found that Dirks had aided and abetted violations of § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 by repeating the allegations of fraud to members of the investment community who later sold their Equity Funding stock. The SEC concluded: "Where 'tippees' — regardless of their motivation or occupation — come into possession of material

[5] You have got to be kidding me.

'corporate information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading." Recognizing, however, that Dirks "played an important role in bringing [Equity Funding's] massive fraud to light," the SEC only censured him.

Dirks sought review in the Court of Appeals for the District of Columbia Circuit. The court entered judgment against Dirks "for the reasons stated by the Commission in its opinion." In view of the importance to the SEC and to the securities industry of the question presented by this case, we granted a writ of certiorari. 459 U.S. 1014 (1982). We now reverse.

The SEC's position, as stated in its opinion in this case, is that a tippee "inherits" the *Cady, Roberts* obligation to shareholders whenever he receives inside information from an insider:

"In tipping potential traders, Dirks breached a duty which he had assumed as a result of knowingly receiving confidential information from [Equity Funding] insiders. Tippees such as Dirks who receive non-public, material information from insiders become 'subject to the same duty as [the] insiders.' Such a tippee breaches the fiduciary duty which he assumes from the insider when the tippee knowingly transmits the information to someone who will probably trade on the basis thereof. Presumably, Dirks' informants were entitled to disclose the [Equity Funding] fraud in order to bring it to light and its perpetrators to justice. However, Dirks — standing in their shoes — committed a breach of the fiduciary duty which he had assumed in dealing with them, when he passed the information on to traders."

This view differs little from the view that we rejected as inconsistent with congressional intent in *Chiarella*. Here, the SEC maintains that anyone who knowingly receives nonpublic material information from an insider has a fiduciary duty to disclose before trading.

In effect, the SEC's theory of tippee liability in both cases appears rooted in the idea that the antifraud provisions require equal information among all traders. This conflicts with the principle set forth in *Chiarella* that only some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information. We reaffirm today that "[a] duty [to disclose] arises from the relationship between parties ... and not merely from one's ability to acquire information because of his position in the market."

Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to "ferret out and analyze information," and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.

The conclusion that recipients of inside information do not invariably acquire a duty to disclose or abstain does not mean that such tippees always are free to trade on the information. The need for a ban on some tippee trading is clear. Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain. Similarly, the transactions of those who knowingly participate with the fiduciary in such a breach are "as forbidden" as transactions "on behalf of the trustee himself."

Thus, some tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them improperly. And for Rule 10b-5 purposes, the insider's disclosure is improper only where it would violate his *Cady, Roberts* duty. Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach. Tipping thus properly is viewed only as a means of indirectly violating the *Cady, Roberts* disclose-or-abstain rule.

In determining whether a tippee is under an obligation to disclose or abstain, it thus is necessary to determine whether the insider's "tip" constituted a breach of the insider's fiduciary duty. All disclosures of confidential corporate information are not inconsistent with the duty insiders owe to shareholders. In contrast to the extraordinary facts of this case, the more typical situation in which there will be a question whether disclosure violates the insider's *Cady, Roberts* duty is when insiders disclose information to analysts. See n. 16, supra. In some situations, the insider will act consistently with his fiduciary duty to shareholders, and yet release of the information may affect the market. For example, it may not be clear — either to the corporate insider or to the recipient analyst — whether the information will be viewed as material nonpublic information. Corporate officials may mistakenly think the information already has been disclosed or that it is not material enough to affect the market. Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure. Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure.

Determining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts.[1] But it is essential, we think, to have a guiding principle for those whose daily activities must be limited and instructed by the SEC's inside-trading rules, and we believe that there must be a breach of the insider's fiduciary duty before the tippee inherits the duty to disclose or abstain.

[1] Prophetic!

Under the inside-trading and tipping rules set forth above, we find that there was no actionable violation by Dirks. It is undisputed that Dirks himself was a stranger to Equity Funding, with no pre-existing fiduciary duty to its shareholders. He took no action, directly or indirectly, that induced the shareholders or officers of Equity Funding to repose trust or confidence in him. There was no expectation by Dirks' sources that he would keep their information in confidence. Nor did Dirks misappropriate or illegally obtain the information about Equity Funding. Unless the insiders breached their Cady, Roberts duty to shareholders in disclosing the nonpublic information to Dirks, he breached no duty when he passed it on to investors as well as to the Wall Street Journal.

It is clear that neither Secrist nor the other Equity Funding employees violated their *Cady, Roberts* duty to the corporation's shareholders by providing information to Dirks. The tippers received no monetary or personal benefit for revealing Equity Funding's secrets, nor was their purpose to make a gift of valuable information to Dirks. As the facts of this case clearly indicate, the tippers were motivated by a desire to expose the fraud. In the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by Dirks.

We conclude that Dirks, in the circumstances of this case, had no duty to abstain from use of the inside information that he obtained. The judgment of the Court of Appeals therefore is reversed.

SOME DISCUSSION QUESTIONS:

1. Why did the tipper send along this information? Why did Dirks do what he did? Was this purely altruistic at every level — and did that matter?

2. This case comes before *O'Hagan* — would Dirks have been liable under a misappropriation theory of insider trading? Why or why not?

3. What counts as a personal benefit? Money? Sure thing. Enriching a potential client with the expectation of getting future work? Yup. Fame? Good will? Probably, yeah. Impressing your golfing buddies? Maybe, if that's what floats your boat! How about looking like a mensch in the eyes of your brother's brother-in-law (aka your sister-in-law's brother)?[1] Why not! Maybe a better question is: what doesn't count as a personal benefit?

[1] This was a real case!

4. What if you overhear someone talking about material non-public information in public? Would trading on that trigger insider trading liability?

Remedies

The most common remedy for insider trading is, well, prison. However, if pursued as a civil claim, a plaintiff could get the disgorgement of the wrongful profits of the trader.[2]

[2] If brought by the SEC, these damages can be trebled.

Honestly, though, most civil claimants pursue class-action securities fraud claims, as the payouts are higher and it is easier to establish standing.

One, final, interesting tidbit about civil penalties for insider trading is that, like other kinds of financial fraud, tipsters to the SEC can be granted a portion of funds recovered. So if you see something, say something (but hire a good lawyer first).

10b5-1 "Safe Harbor" Plans

WELL, HELL, how are corporate executives supposed to sell (or buy — unlikely, but why the hell not) shares in their corporations without triggering insider trading liability? Should they be expected to hang on to their shares until they retire or die?[3] What if they want to liquidate a particularly insane all-in position in a wildly overhyped electric vehicle company in order to purchase, in its entirety, a barely-profitable social media firm? Asking for a friend!

[3] Note to self: hold on, why wouldn't this be a requirement for the stock options given to corporate executives? Bequeath that shit to your heirs or go down with the ship, amirite?

The answer is — for now — to set up what is called a "10b5-1" plan to preschedule trades in a corporation's stock. I'll first explain how these are totally reasonable safe harbors for executives to sell company stock in, and then I'll explain how they are nothing more than cynically abused channels for the same sort of fraudulent bullshit that we have come to expect from corporate managers in this day and age.

Here's the statutory language:

(A) Before becoming aware of the information, the person had:

(1) Entered into a binding contract to purchase or sell the security,

(2) Instructed another person to purchase or sell the security for the instructing person's account, or

(3) Adopted a written plan for trading securities;

(B) The contract, instruction, or plan described in paragraph (c)(1)(i)(A) of this Section:

(1) Specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold;

(2) Included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or

(3) Did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must not have been aware of the material nonpublic information when doing so; and

(C) The purchase or sale that occurred was pursuant to the contract, instruction, or plan. A purchase or sale is not "pursuant to a contract, instruction, or plan" if, among other things, the person who entered into the contract, instruction, or plan altered or deviated from the contract, instruction, or plan to purchase or sell securities (whether by changing the amount, price, or timing of the purchase or sale), or entered into or altered a corresponding or hedging transaction or position with respect to those securities.

Well, that's clear as mud. Anyway, the takeaway here is that you can schedule trades to buy or sell company stock in advance, and those trades are A-OK even if you are in possession of material non-public information at the time you scheduled the trade, because by the time the trade rolls around that information is going to be either non-material or non-public (or both), and because **you let the SEC know in advance** that you were going to trade. Do you want to sell because you have to fund the purchase of a gigantic yacht to compensate for certain shortcomings? Or to fund a new mid-tier *Lord Of The Rings* miniseries that honestly could have dropped the entire halfling subplot? Or to fund a totally mutually-agreed-upon divorce? Or all of the above?[1] Selling with advance notice gives you protection from an insider trading investigation.

[1] All of these are theoretically and allegedly and parody, of course.

Is this subject to abuse? Well, LOL. LMAO, even. Of course! Here's how:

- Set up a 10b5-1 trading plan to sell stock.
- Set up a 10b5-1 trading plan to buy stock.
- If you learn that things are gonna be good, cancel the plans to sell.
- If you learn that things are gonna be bad, cancel the plans to buy.

Wait, hold on, it can't be that stupid. It can't, right? Can it?

Reader, it is. The legal-ass requirement for insider trading is that an insider actually trades. Cancelling a trade is, by definition, not insider trading. How wild is that? Pretty wild!

The SEC has recently noticed this fuckery, and has proposed new rules regarding the time frames of the trades,[1] public disclosure of plans, and executive manipulation through cancellation. As such, this section of the text is extremely ready to be revised, but for right now this bullshit is currently the safe harbor law for insider trading. Keep your eyes on it, though! It might not be this way for long.

[1] The newest rule requires that plans be filed 3 months before trading begins.

Short-Swing Profits

One other surprisingly strong but relatively rare recourse for going after market manipulators is the prohibition on "short-swing" profits. These are profits realized by someone who:

- Is or was either a director or officer of a corporation OR a beneficial owner ($\geq 10\%$) of same
- Who bought shares in that corporation
- And sold those shares within six months after buying them

This was codified in the original version of the Exchange Act, and as such has been relatively free from judicial pencil-fucking. While most securities law claims have to prove things like reliance and scienter, this cause of action requires neither. The recovery for violations of short-swing sales is disgorgement of profits to the corporation — but the availability of attorney's fees for successful challenges has kept this part of insider trading law alive.

The Corporation as a Criminal

LET'S GO BACK TO YE OLDEN DAYS. Way back. Way, way back. Huh? You see dinosaurs? No, that's too far back, come on now. Anyway, back in the early days of corporations, a corporation could not be held criminally liable, for the extremely silly reason that acting unlawfully was by definition outside of the corporate purpose (*ultra vires*) and anything a corporation did outside of its purpose was invalid. You can already see the potential problems with being able to punish individuals but not corporations for breaking the law, and this rule was ultimately discarded, allowing corporations to be charged with, tried for, and convicted of crimes.

Here's a representative case of how courts handled the new era of corporate criminality and the mildly awkward application of criminal law to corporate entities.

State v. Christy Pontiac-GMC, Inc., 354 N.W.2d 17, (Minn. 1984)

Simonett, J.

We hold that a corporation may be convicted of theft and forgery, which are crimes requiring specific intent, and that the evidence sustains defendant corporation's guilt.

In a bench trial, defendant-appellant Christy Pontiac-GMC, Inc., was found guilty of two counts of theft by swindle[1] and two counts of aggravated forgery, and was sentenced to a $1,000 fine on each of the two forgery convictions. Defendant argues that as a corporation it cannot, under our state statutes, be prosecuted or convicted for theft or forgery and that, in any event, the evidence fails to establish that the acts complained of were the acts of the defendant corporation.

[1] Love this name.

Christy Pontiac is a Minnesota corporation, doing business as a car dealership. It is owned by James Christy, a sole stockholder, who serves also as president and as director. In the spring of 1981, General Motors offered a cash rebate program for its dealers. A customer who purchased a new car delivered during the rebate period was entitled to a cash rebate, part paid by GM and part paid by the dealership. GM would pay the entire rebate initially and later charge back, against the dealer, the dealer's portion of the rebate. Apparently it was not uncommon for the dealer to give the customer the dealer's portion of the rebate in the form of a discount on the purchase price.

At this time Phil Hesli was employed by Christy Pontiac as a salesman and fleet manager. On March 27, 1981, James Linden took delivery of a new Grand Prix for his employer, Snyder Brothers.[1] Although the rebate period on this car had expired on March 19, the salesman told Linden that he would still try to get the $700 rebate for Linden. Later, Linden was told by a Christy Pontiac employee that GM had denied the rebate. Subsequently, it was discovered that Hesli had forged Linden's signature twice on the rebate application form submitted by Christy Pontiac to GM, and that the transaction date had been altered and backdated to March 19 on the buyer's order form. Hesli signed the order form as "Sales Manager or Officer of the Company."

[1] The 1981 Pontiac Grand Prix had a 4.3 liter V6 engine, gave the driver 205 pounds of pure Detroit torque, got 17.7 miles to the gallon, and would explode upon the slightest impact.

On April 6, 1981, Ronald Gores purchased a new Le Mans, taking delivery the next day.[2] The rebate period for this model car had expired on April 4, and apparently Gores was told he would not be eligible for a rebate. Subsequently, it was discovered that Christy Pontiac had submitted a $500 cash rebate application to GM and that Gores' signature had been forged twice by Hesli on the application. It was also discovered that the purchase order form had been backdated to April 3. This order form was signed by Gary Swandy, an officer of Christy Pontiac.

[2] The 1981 Pontiac Le Mans was a sweet little four door sedan with a top speed of 105 miles per hour, a perfectly rectangular body frame, and the curb weight of an M1-Abrams tank.

Both purchasers learned of the forged rebate applications when they received a copy of the application in the mail from Christy Pontiac. Both purchasers complained to James Christy, and in both instances the conversations ended in angry mutual recriminations. Christy did tell Gores that the rebate on his car was "a mistake" and offered half the rebate to "call it even." After the Attorney General's office made an inquiry, Christy Pontiac contacted GM and arranged for cancellation of the Gores rebate that had been allowed to Christy Pontiac. Subsequent investigation disclosed that of 50 rebate transactions, only the Linden and Gores sales involved irregularities.

In a separate trial, Phil Hesli was acquitted of three felony charges but found guilty on the count of theft for the Gores transaction and was given a misdemeanor disposition. An indictment against James Christy for theft by swindle was dismissed, as was a subsequent complaint for the same charge, for lack of probable cause. Christy Pontiac, the corporation, was also indicted, and the appeal here is from the four convictions on those indictments. Before trial, Mr. Christy was granted immunity and was then called as a prosecution witness.[3] Phil Hesli did not testify at the corporation's trial.

[3] I'm sorry, the controlling shareholder snitched on the corporation he controlled? Cold, man. Cold.

Christy Pontiac argues on several grounds that a corporation cannot be held criminally liable for a specific intent crime. Minn.Stat. § 609.52, subd. 2 (1982), says "whoever" swindles by artifice, trick or other means commits theft. Minn.Stat. § 609.625 (1982), says "whoever" falsely makes or alters a writing with intent to defraud, commits aggravated forgery. Christy Pontiac agrees that the term "whoever" refers to persons, and it agrees that the term "persons" may include corporations, see

Minn.Stat. § 645.44, subd. 7 (1982), but it argues that when the word "persons" is used here, it should be construed to mean only natural persons. This should be so, argues defendant, because the legislature has defined a crime as "conduct which is prohibited by statute and for which the actor may be sentenced to imprisonment, with or without a fine," Minn.Stat. § 609.02 (1982), and a corporation cannot be imprisoned.[1] Neither, argues defendant, can an artificial person entertain a mental state, let alone have the specific intent required for theft or forgery.

We are not persuaded by these arguments. The Criminal Code is to "be construed according to the fair import of its terms, to promote justice, and to effect its purposes." Minn.Stat. § 609.01 (1982). The legislature has not expressly excluded corporations from criminal liability[2] and, therefore, we take its intent to be that corporations are to be considered persons within the meaning of the Code in the absence of any clear indication to the contrary. See, e.g., Minn.Stat. § 609.055 (1982) (legislative declaration that children under the age of 14 years are incapable of committing a crime).[3] We do not think the statutory definition of a crime was meant to exclude corporate criminal liability; rather, we construe that definition to mean conduct which is prohibited and, if committed, may result in imprisonment. Interestingly, the specific statutes under which the defendant corporation was convicted, sections 609.52 (theft) and 609.625 (aggravated forgery), expressly state that the sentence may be either imprisonment or a fine.

Nor are we troubled by any anthropomorphic implications[4] in assigning specific intent to a corporation for theft or forgery. There was a time when the law, in its logic, declared that a legal fiction could not be a person for purposes of criminal liability, at least with respect to offenses involving specific intent, but that time is gone. If a corporation can be liable in civil tort for both actual and punitive damages for libel, assault and battery, or fraud, it would seem it may also be criminally liable for conduct requiring specific intent. Most courts today recognize that corporations may be guilty of specific intent crimes. Particularly apt candidates for corporate criminality are types of crime, like theft by swindle and forgery, which often occur in a business setting.

We hold, therefore, that a corporation may be prosecuted and convicted for the crimes of theft and forgery.

There remains, however, the evidentiary basis on which criminal responsibility of a corporation is to be determined. Criminal liability, especially for more serious crimes, is thought of as a matter of personal, not vicarious, guilt. One should not be convicted for something one does not do. In what sense, then, does a corporation "do" something for which it can be convicted of a crime? The case law, as illustrated by the authorities above cited, takes differing approaches. If a corporation is to be

[1] I like this argument! It doesn't win, but it's a pretty good argument regarding legislative intent. That being said, it'd be weird if acts that are criminal if committed by a person were legal if committed by a corporation, right?

[2] Ain't no rule says a dog CAN'T play basketball!

[3] Children are definitely capable of being criminals. Have you ever met a child? They are tiny sociopaths.

[4] When we get to *Citizens United*, let's circle back to these "anthropomorphic implications", shall we?

criminally liable, it is clear that the crime must not be a personal aberration of an employee acting on his own; the criminal activity must, in some sense, reflect corporate policy so that it is fair to say that the activity was the activity of the corporation.

We believe, first of all, the jury should be told that it must be satisfied beyond a reasonable doubt that the acts of the individual agent constitute the acts of the corporation. Secondly, as to the kind of proof required, we hold that a corporation may be guilty of a specific intent crime committed by its agent if: (1) the agent was acting within the course and scope of his or her employment, having the authority to act for the corporation with respect to the particular corporate business which was conducted criminally; (2) the agent was acting, at least in part, in furtherance of the corporation's business interests; and (3) the criminal acts were authorized, tolerated, or ratified by corporate management.[1]

[1] The Model Penal Code uses a slightly different test, requiring that the act was (1) authorized OR requested OR commanded OR performed OR recklessly tolerated, (2) by a "managerial agent" or board of directors.

This test is not quite the same as the test for corporate vicarious liability for a civil tort of an agent. The burden of proof is different, and, unlike civil liability, criminal guilt requires that the agent be acting at least in part in furtherance of the corporation's business interests. Moreover, it must be shown that corporate management authorized, tolerated, or ratified the criminal activity. Ordinarily, this will be shown by circumstantial evidence, for it is not to be expected that management authorization of illegality would be expressly or openly stated. Indeed, there may be instances where the corporation is criminally liable even though the criminal activity has been expressly forbidden. What must be shown is that from all the facts and circumstances, those in positions of managerial authority or responsibility acted or failed to act in such a manner that the criminal activity reflects corporate policy, and it can be said, therefore, that the criminal act was authorized or tolerated or ratified by the corporation.

Christy Pontiac argues that it cannot be convicted of aiding the very actor whose acts are deemed its own acts; in other words, it argues that it cannot aid itself. Perhaps because it was uncertain of the legal rationale for corporate criminal liability, the state, in each of the four counts of the indictment, alleged that Christy Pontiac "then and there being aided and abetted by another and aiding and abetting another" did commit the crime. We construe the indictment, however, to allege alternatively that Christy Pontiac committed the crimes as a principal or as an aider and abetter. The trial court, without objection, considered the corporation to be prosecuted and convicted as a principal, as do we.

This brings us, then, to the third issue, namely, whether under the proof requirements mentioned above, the evidence is sufficient to sustain the convictions. We hold that it is.

The evidence shows that Hesli, the forger,[2] had authority and respon-

[2] Hesli The Forger was my favorite character from *The Hobbit*.

sibility to handle new car sales and to process and sign cash rebate applications. Christy Pontiac, not Hesli, got the GM rebate money, so that Hesli was acting in furtherance of the corporation's business interests. Moreover, there was sufficient evidence of management authorization, toleration, and ratification. Hesli himself, though not an officer, had middle management responsibilities for cash rebate applications. When the customer Gores asked Mr. Benedict, a salesman, about the then discontinued rebate, Benedict referred Gores to Phil Hesli. Gary Swandy, a corporate officer, signed the backdated retail buyer's order form for the Linden sale. James Christy, the president, attempted to negotiate a settlement with Gores after Gores complained. Not until after the Attorney General's inquiry did Christy contact divisional GM headquarters. As the trial judge noted, the rebate money "was so obtained and accepted by Christy Pontiac and kept by Christy Pontiac until somebody blew the whistle." We conclude the evidence establishes that the theft by swindle and the forgeries constituted the acts of the corporation.

We wish to comment further on two aspects of the proof. First, it seems that the state attempted to prosecute both Christy Pontiac and James Christy, but its prosecution of Mr. Christy failed for lack of evidence. We can imagine a different situation where the corporation is the alter ego of its owner and it is the owner who alone commits the crime, where a double prosecution might be deemed fundamentally unfair. Secondly, it may seem incongruous that Hesli, the forger, was acquitted of three of the four criminal counts for which the corporation was convicted. Still, this is not the first time different trials have had different results. See, e.g., State v. Cegon, 309 N.W.2d 313 (Minn. 1981). We are reviewing this record, and it sustains the convictions.

Affirmed.

Some discussion questions:

1. How does the court deal with the idea of criminal intent (aka *mens rea*) with regard to the corporation?

2. What about moral culpability? Should that matter?

3. The corporation had a single shareholder (Christy). Does a corporate structure like that make it easier or harder to apply criminal law to the corporation?

4. What is the relationship between holding a corporation criminally liable and piercing the corporate veil? How are they similar and how do they differ?

5. What kind of punishment is appropriate for a corporation?

A CORPORATION CANNOT BE JAILED — it would be funny as hell if it could be — but other punishments are available. As we review these potential sanctions, keep in mind the various theories of criminal punishment that we apply to justify the punishment directed at natural persons convicted of a crime.

A person might be punished as a means of *incapacitation*, and/or as a *deterrent* to others,[1] and/or for reasons of *retribution*, and/or by a *restorative* method to make the victim whole, and/or to allow for the *rehabilitation* of the offender, and/or for *expressive* reasons.[2] Many of these theories are not mutually exclusive — hence the use of "and/or" throughout the paragraph. Let's take a look at some common corporate sanctions.

- **Fines**. I've said repeatedly that a corporation is a pile of money with a line drawn around it — one way to punish a corporation is to take some of that money as either restitution or as a deterrent. Some commentators have pointed out that taking money from a corporation ultimately punishes the shareholders of that corporation, who might be different people than the bad actors who brought the criminal liability on the corporation in the first place. To that I say: (a) the corporate and its shareholders are different parties, remember?; (b) that money isn't the shareholders' money, it's the corporation's money; and (c) the money was ill-gotten in the first place. Miss me with this one.

- **Consent Decrees, Policy Changes**. As a part of a criminal conviction or (more likely) a plea deal for a corporation, prosecutors can seek substantive changes in the way corporations do business. These can require corporation to cease a particular practice, set up stronger monitoring systems, or make certain disclosures — all under the penalty of enhanced sanctions if the required changes aren't made. How well do these do at rehabilitating corporations and preventing future crimes? Ehhhhhhhhhhhhhhhhh ...

- **Reputational Damage**. This isn't technically a form of punishment — you can't sentence a corporation to, like, "party foul, bro" — but there is evidence that punishing a corporation criminally (even if it is just through fines) has lasting reputational damage to both the corporation and the executives who oversaw the criminal conduct. A victory for the expressive theory, I suppose?

- **Corporate Death Penalty**. A corporation isn't a real life person (despite what the Supreme Court seems to think), it's a piece of paper in a Secretary of State's office somewhere. We've seen

[1] Cesare Beccaria was among the first to point out that disproportionate punishment might actually serve as an incentive to commit crime rather than as a deterrence — if the punishment for burglary is the same as for murder, a burglar may as well go ahead and murder their victim while they're at it.

[2] Most closely associated with the sociologist Emile "Don't Call Me Emily" Durkheim, a criminal punishment serves to label and shame deviant behavior, and thereby strengthen the social solidarity of the in-group.

> corporations dissolved due to board deadlock or corporate mismanagement or minority shareholder abuse, and courts can order the dissolution of the corporation as a punishment for criminal conduct, too. This is seen as particularly drastic, however, as the impact of the corporate death penalty is felt not just by a corporation or (indirectly) its shareholders, but also by its employees and customers and communities,[1] most of whom had nothing to do with whatever criminal acts occurred.

[1] I know, I know, this is a situation in which the word "stakeholders" actually makes sense. But still, I don't wanna use it and you can't make me, so there.

Simply pulling a corporation's charter isn't the only way to kill it, though. A fine could leave a corporation insolvent, a conviction can cause a corporation to default on its contractual obligations and saddle it with liabilities, or — as happened in the following case — a criminal conviction might cause a corporation to be unable to do certain kinds of work, leaving its clients to abandon it, and its employees to flee.

Arthur Andersen v. U.S., 544 U.S. 696 (2005)

Rehnquist, C.J.

As Enron Corporation's financial difficulties became public in 2001, petitioner Arthur Andersen LLP, Enron's auditor, instructed its employees to destroy documents pursuant to its document retention policy. A jury found that this action made petitioner guilty of violating 18 U. S. C. §§ 1512(b)(2)(A) and (B). These sections make it a crime to "knowingly us[e] intimidation or physical force, threate[n], or corruptly persuad[e] another person . . . with intent to . . . cause" that person to "withhold" documents from, or "alter" documents for use in, an "official proceeding." The Court of Appeals for the Fifth Circuit affirmed. We hold that the jury instructions failed to convey properly the elements of a "corrup[t] persua[sion]" conviction under § 1512(b), and therefore reverse.

Enron Corporation, during the 1990's, switched its business from operation of natural gas pipelines to an energy conglomerate, a move that was accompanied by aggressive accounting practices and rapid growth. Petitioner audited Enron's publicly filed financial statements and provided internal audit and consulting services to it. Petitioner's "engagement team" for Enron was headed by David Duncan. Beginning in 2000, Enron's financial performance began to suffer, and, as 2001 wore on, worsened. On August 14, 2001, Jeffrey Skilling, Enron's Chief Executive Officer (CEO), unexpectedly resigned. Within days, Sherron Watkins, a senior accountant at Enron, warned Kenneth Lay, Enron's newly reappointed CEO, that Enron could "implode in a wave of accounting scandals." She likewise informed Duncan and Michael Odom, one of petitioner's partners who had supervisory responsibility over Duncan, of the looming problems.

On August 28, an article in the Wall Street Journal suggested improprieties at Enron, and the SEC opened an informal investigation. By early September, petitioner had formed an Enron "crisis-response" team, which included Nancy Temple, an in-house counsel. On October 8, petitioner retained outside counsel to represent it in any litigation that might arise from the Enron matter. The next day, Temple discussed Enron with other in-house counsel. Her notes from that meeting reflect that "some SEC investigation" is "highly probable."

On October 10, Odom spoke at a general training meeting attended by 89 employees, including 10 from the Enron engagement team. Odom urged everyone to comply with the firm's document retention policy. He added: "'[I]f it's destroyed in the course of [the] normal policy and litigation is filed the next day, that's great. . . . [W]e've followed our own policy, and whatever there was that might have been of interest to somebody is gone and irretrievable.'"[1] On October 12, Temple entered the Enron matter into her computer, designating the "Type of Potential Claim" as "Professional Practice — Government/Regulatory Investigation." Temple also e-mailed Odom, suggesting that he "'remin[d] the engagement team of our documentation and retention policy.'"

[1] A real shame if incriminating materials were to get shredded, right? A. Real. *Shame*.

On October 16, Enron announced its third quarter results. That release disclosed a $1.01 billion charge to earnings. The following day, the SEC notified Enron by letter that it had opened an investigation in August and requested certain information and documents. On October 19, Enron forwarded a copy of that letter to petitioner.

On the same day, Temple also sent an e-mail to a member of petitioner's internal team of accounting experts and attached a copy of the document policy. On October 20, the Enron crisis-response team held a conference call, during which Temple instructed everyone to "[m]ake sure to follow the [document] policy." On October 23, Enron CEO Lay declined to answer questions during a call with analysts because of "potential lawsuits, as well as the SEC inquiry." After the call, Duncan met with other Andersen partners on the Enron engagement team and told them that they should ensure team members were complying with the document policy. Another meeting for all team members followed, during which Duncan distributed the policy and told everyone to comply. These, and other smaller meetings, were followed by substantial destruction of paper and electronic documents.[2]

[2] Memorably spoofed in a Heineken ad.

On October 26, one of petitioner's senior partners circulated a New York Times article discussing the SEC's response to Enron. His e-mail commented that "the problems are just beginning and we will be in the cross hairs. The marketplace is going to keep the pressure on this and is going to force the SEC to be tough." On October 30, the SEC opened a formal investigation and sent Enron a letter that requested accounting documents.

Throughout this time period, the document destruction continued, despite reservations by some of petitioner's managers. On November 8, Enron announced that it would issue a comprehensive restatement of its earnings and assets. Also on November 8, the SEC served Enron and petitioner with subpoenas for records. On November 9, Duncan's secretary sent an e-mail that stated: "Per Dave — No more shredding. . . . We have been officially served for our documents." Enron filed for bankruptcy less than a month later. Duncan was fired and later pleaded guilty to witness tampering.

In March 2002, petitioner was indicted in the Southern District of Texas on one count of violating §§ 1512(b)(2)(A) and (B). The indictment alleged that, between October 10 and November 9, 2001, petitioner "did knowingly, intentionally and corruptly persuade . . . other persons, to wit: [petitioner's] employees, with intent to cause" them to withhold documents from, and alter documents for use in, "official proceedings, namely: regulatory and criminal proceedings and investigations." A jury trial followed. When the case went to the jury, that body deliberated for seven days and then declared that it was deadlocked. The District Court delivered an *Allen* charge,[1] and, after three more days of deliberation, the jury returned a guilty verdict.[2] The District Court denied petitioner's motion for a judgment of acquittal.

[1] An *Allen* charge is an instruction to the jury to go back and, you know, deliberate **harder**.
[2] Because federal securities laws forbid convicted felons from serving as the auditor for a public company, this guilty verdict destroyed what remained of Arthur Andersen's business.

The Court of Appeals for the Fifth Circuit affirmed. It held that the jury instructions properly conveyed the meaning of "corruptly persuades" and "official proceeding"; that the jury need not find any consciousness of wrongdoing; and that there was no reversible error. Because of a split of authority regarding the meaning of § 1512(b), we granted certiorari.

Chapter 73 of Title 18 of the United States Code provides criminal sanctions for those who obstruct justice. Sections 1512(b)(2)(A) and (B), part of the witness tampering provisions, provide in relevant part:

> "Whoever knowingly uses intimidation or physical force, threatens, or corruptly persuades another person, or attempts to do so, or engages in misleading conduct toward another person, with intent to . . . cause or induce any person to . . . withhold testimony, or withhold a record, document, or other object, from an official proceeding [or] alter, destroy, mutilate, or conceal an object with intent to impair the object's integrity or availability for use in an official proceeding . . . shall be fined under this title or imprisoned not more than ten years, or both."

In this case, our attention is focused on what it means to "knowingly . . . corruptly persuad[e]" another person "with intent to . . . cause" that person to "withhold" documents from, or "alter" documents for use in, an "official proceeding."

"Document retention policies," which are created in part to keep certain information from getting into the hands of others, including the Government, are common in business. It is, of course, not wrongful for a manager to instruct his employees to comply with a valid document retention policy under ordinary circumstances.

Acknowledging this point, the parties have largely focused their attention on the word "corruptly" as the key to what may or may not lawfully be done in the situation presented here. Section 1512(b) punishes not just "corruptly persuad[ing]" another, but " knowingly . . . corruptly persuad[ing]" another. The Government suggests that "knowingly" does not modify "corruptly persuades," but that is not how the statute most naturally reads. It provides the mens rea — "knowingly" — and then a list of acts — "uses intimidation or physical force, threatens, or corruptly persuades." We have recognized with regard to similar statutory language that the mens rea at least applies to the acts that immediately follow, if not to other elements down the statutory chain. Long experience has not taught us to share the Government's doubts on this score, and we must simply interpret the statute as written.

The parties have not pointed us to another interpretation of "knowingly . . . corruptly" to guide us here. In any event, the natural meaning of these terms provides a clear answer. "[K]nowledge" and "knowingly" are normally associated with awareness, understanding, or consciousness. "Corrupt" and "corruptly" are normally associated with wrongful, immoral, depraved, or evil. Joining these meanings together here makes sense both linguistically and in the statutory scheme. Only persons conscious of wrongdoing can be said to "knowingly . . . corruptly persuad[e]." And limiting criminality to persuaders conscious of their wrongdoing sensibly allows § 1512(b) to reach only those with the level of "culpability . . . we usually require in order to impose criminal liability."

The outer limits of this element need not be explored here because the jury instructions at issue simply failed to convey the requisite consciousness of wrongdoing. Indeed, it is striking how little culpability the instructions required. For example, the jury was told that, "even if [petitioner] honestly and sincerely believed that its conduct was lawful, you may find [petitioner] guilty." The instructions also diluted the meaning of "corruptly" so that it covered innocent conduct.

The instructions also were infirm for another reason. They led the jury to believe that it did not have to find any nexus between the "persua[sion]" to destroy documents and any particular proceeding. In resisting any type of nexus element, the Government relies heavily on §

1512(e)(1), which states that an official proceeding "need not be pending or about to be instituted at the time of the offense." It is, however, one thing to say that a proceeding "need not be pending or about to be instituted at the time of the offense," and quite another to say a proceeding need not even be foreseen. A "knowingly . . . corrup[t] persaude[r]" cannot be someone who persuades others to shred documents under a document retention policy when he does not have in contemplation any particular official proceeding in which those documents might be material.

For these reasons, the jury instructions here were flawed in important respects. The judgment of the Court of Appeals is reversed, and the case is remanded for further proceedings consistent with this opinion.

SOME DISCUSSION QUESTIONS:

1. Arthur Andersen was a "big five" accounting firm, employing over 28,000 people prior to the Enron debacle. By the time the hammer came down on it with the guilty verdict, the damage to its credibility stemming from the Enron collapse[1] was so severe that it had lost most of its employees and customers to its non-indicted rivals. Why overturn their conviction so far down the line? (Arthur Andersen did not magically come back to life after this decision.)

[1] It didn't help that another Arthur Andersen client, WorldCom, had its own massive accounting fraud uncovered less than a year after Enron's.

2. How many people were involved in the destruction of documents? Is it important to establish that a critical mass of the corporation's employees were in on the criminal conduct?

3. Precisely whose mental state is the court concerned with? (In other words, who is the court looking to when imputing mental state to the corporation?)

4. What is the difference between "knowingly" and "corruptly"? Can you be unknowingly corrupt? What if some employees are corrupt and some are knowing — does that satisfy the requirements here?

Corporate Cooperation with Prosecutors

AFTER THE TOTAL OBLITERATION OF ARTHUR ANDERSEN, the threat of corporate criminal liability — after all, even an unfavorable indictment, let alone a successful prosecution, could wreck some major shit — caused the executives at major corporations to reach unprecedented levels of *scurred*.

Federal prosecutors noticed this sudden acquisition of leverage, and have since worked out a system whereby they agree to provide the corporation with favorable treatment (lesser penalties, deferred prosecution agreements, and the like) in return for cooperation with their investigations into potential corporate fraud. Let's walk through what that cooperation looks like.

- First things first, federal prosecutors are gonna need a whole hell of a lot of information from the corporation. Secrets? Confidences? Embarrassing stuff? Nah, nah, nah — you gotta give it all up.
- Second, they need someone to blame. As the DOJ puts it, they're going to want the "ability to assess individual culpability" and they're going to want it right now. Remember way back when we talked about whether the lawyer represents the corporation or the employees/founders/managers of the corporation? That's super important here, because when a corporation launches an internal investigation in response to a federal probe, those lawyers better make damn clear that they represent the corporation and not the person they are interviewing — because they are out for blood.
- Speaking of lawyers, remember attorney-client privilege? Yeah, sometimes the corporation has to waive that in order to give the feds the information they want — particularly if the corporation has engaged outside counsel to do an internal investigation. This one has resulted in some pushback from courts and random law professors, and the DOJ doesn't explicitly say that cooperation credit depends on this, but, you know. There's the *implication*.

Executive Criminality

CORPORATE CRIMINALITY AND EXECUTIVE CRIMINALITY are deeply intertwined. Determining whether a criminal act represents the workings of the executives, the corporation as a whole, or both can be difficult. The starting point for any inquiry is whether the person acting on behalf of the corporation was doing it to further the corporation's interests (as in *Christy Pontiac*) or doing it to further their own interests instead of the corporation's (as with insider trading liability). In practice, that line is not always clear.

The following stories — about Elizabeth Holmes and Theranos, Inc. on the one hand, and the Sackler Family and Purdue Pharmaceuticals on the other — wrestle with questions about how to assign criminal liability to corporate executives for acts that they undertook to benefit both themselves and the corporation they served; they also have some important lessons about how our criminal justice system assigns (or fails to assign) accountability for corporate malfeasance.

Elizabeth Holmes Is Sentenced to More Than 11 Years in Prison for Defrauding Theranos Investors

Elizabeth Holmes, the founder of Theranos Inc. who was convicted of defrauding investors, was sentenced to more than 11 years in prison, capping the extraordinary downfall of a onetime Silicon Valley wunderkind who promised to revolutionize blood testing.

U.S. District Judge Edward Davila, who oversaw the trial in which Ms. Holmes was found guilty of running a yearslong fraud scheme at her blood-testing company, delivered the sentence Friday in federal court. A jury convicted Ms. Holmes in January on four charges that she misrepresented the startup's technology, finances and business prospects to investors.

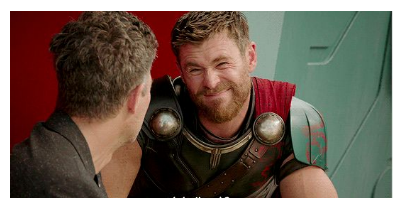
Judge Davila ordered Ms. Holmes to serve 135 months, or 11.25 years, and to surrender on April 27, 2023. The sentence length falls in the midrange of those received by the dozen white-collar criminals with similar offenses cited by the government in its sentencing memorandum.

In tearful remarks to the court before learning her fate, Ms. Holmes, 38 years old, said she was full of regret and that, looking back, there were many decisions she would have made differently.

"I am devastated by my failings," she said. "Every day for the past years I have felt deep pain for what people went through because I failed them."

Judge Davila, who also sentenced Ms. Holmes to a three-year supervised release, said he would schedule a hearing to discuss restitution.

He expressed some admiration for Ms. Holmes, saying her motivation with Theranos wasn't to gain personal wealth and praising her grit to break into a male-dominated industry. "The tragedy of this case is Ms. Holmes is brilliant," Judge Davila said.


"brilliant"?

He said he took into consideration letters he received in support of Ms. Holmes from venture capitalists and entrepreneurs who reminded him that failure in the startup world isn't uncommon. "But they didn't endorse failure by fraud," he said. "Those letter writers did not condone misrepresentation and manipulation."

U.S. Sentencing Commission data show the median prison term for offenders with economic crimes similar to Ms. Holmes's was 16 years, according to an analysis by consultant Empirical Justice LLC. The review, which covered 102 first-time offenders, excluded defendants who cooperated with authorities or entered guilty pleas, which often results in lighter sentences. Ms. Holmes didn't cooperate.

Ms. Holmes founded and ran Theranos as chief executive for close to 15 years, touting a technology solution to revolutionize the blood-testing industry. The case featured one of the most high-profile criminal fraud trials in years amid a decades-long decline in white-collar prosecutions.

Her prosecution followed a series of Wall Street Journal articles starting in 2015 that called into question Ms. Holmes's claims about the Theranos technology. The saga led to a bestselling book, an award-winning Hulu series and a planned movie.

Her sentence is a remarkable outcome for a startup executive buoyed by Silicon Valley's fake-it-until-you-make-it culture, in which a founder's vision and bravado are often the biggest draws of attention and money. Over the years, some have defended Ms. Holmes as no different from her startup founder peers who make the occasional exaggerated sales pitch.

In the case of Theranos, prosecutors showed that Ms. Holmes's hype and hubris went beyond acceptable norms, misleading investors with claims that unproven technology was ready for real-world use and risking patients' health by providing them with lab results that weren't reliable.

"The fact that she was prosecuted, taken to trial and convicted goes a long way of sending a message to Silicon Valley about the line between puffery and sales pitches on the one hand, and material misrepresentations on the other," said Amanda Kramer, a former federal prosecutor in New York and attorney with Covington & Burling LLP.

In court Friday, Judge Davila said he found enough evidence to determine there were at least 10 investors in Theranos who were victims of fraud, and that the total sum they were defrauded of was $121.1 million. Among them was Rupert Murdoch, executive chairman of News Corp, which owns the Journal.[1]

[1] Okay, but lol.

"Of course it was fraud," Mr. Murdoch said in an email after the sentencing. "But I only have myself to blame for not asking a lot more questions. One of a bunch of old men taken in by a seemingly great young woman! Total embarrassment."

Other Theranos investors didn't respond to requests for comment or declined to comment after the sentencing. Privately, some previously told the Journal that they blame themselves, not Ms. Holmes, for their losses or are embarrassed to have been duped by her claims.

Former employees said the sentencing ended years of Ms. Holmes evading accountability.

Erika Cheung, a former Theranos lab worker whose questions about the company's technology were answered with threats from its lawyers, said of the sentence, "Hopefully, it sends a signal that we need to start by taking more responsibility and more accountability in the tech industry because of the influence they have over people's lives."

For her, however, she said, "It is just sad. There are no winners. It didn't have to be this way."

Ms. Cheung, among the earliest voices raising concern over the safety of Theranos's tests, was followed by private investigators and resigned over her worries.

Alex Shultz, the father of former Theranos employee whistleblower Tyler Shultz, was the only victim to address the court ahead of Ms. Holmes's sentencing. Mr. Shultz discussed her vengeance against his son, who was also a source for the Journal's stories. Ms. Holmes had hired a private investigator to follow his family.

"My son slept with a knife under his pillow every night thinking that someone was going to come and murder him in the night," Mr. Shultz told the court. "We are happy that this is finally coming to an end."

Ms. Holmes was crying at the conclusion of Mr. Shultz's comments.

Ms. Holmes, who dreamed up Theranos as a 19-year-old Stanford University student, claimed her startup's technology could cheaply and quickly run more than 200 health tests using a proprietary finger-prick blood-testing device that made large needles and vials of blood obsolete. At its peak, investors valued Theranos at more than $9 billion, the 10th largest among venture-capital-backed startup companies at the time.

Ms. Holmes owned half of it, with a paper value of around $4.5 billion, she testified during her trial. With Ms. Holmes's marketing skills and a star-studded board of Washington insiders, Theranos raised about $945 million from investors.

The months-long trial showed a different reality. The company managed to use its proprietary blood-testing device for just 12 types of patient tests. Those results were unreliable. At its lab, Theranos secretly ran most of its blood tests on commercial devices from other companies, including some that Theranos altered to work with tiny blood samples.

Jurors learned during the trial that Ms. Holmes forged reports provided to some investors and partners such as Walgreens Boots Alliance Inc.'s U.S. drugstore unit by adding logos of Pfizer Inc. and other major drug companies without permission from the companies.[1] Prosecutors showed in court how text had been deleted and added to the documents, which some investors said in testimony made them appear to them to be complimentary validation reports, which they weren't.

[1] Should have had Hesli The Forger do it.

Despite Theranos's problems, Ms. Holmes and her top deputy and ex-boyfriend, Ramesh "Sunny" Balwani, showed investors projections of annual revenue that at one point was supposed to reach $990 million, when the real number was $500,000, and boasted of a partnership with the military to put Theranos devices on medevacs. There was no such partnership, according to evidence presented in trial.

"Elizabeth Holmes lied to me about saving soldiers' lives through military contracts," investor Craig Hall, whose firm put about $5 million into Theranos, wrote in a letter to the court to advocate for a tough sentence, according to a government filing. "Simply put, Holmes's actions were loathsome and un-American."[1]

[1] Christopher Weaver and Heather Somerville. Elizabeth Holmes Is Sentenced to More Than 11 Years in Prison for Defrauding Theranos Investors. Wall Street Journal, November 2022

SOME DISCUSSION QUESTIONS:

1. Holmes was *also* charged with endangering the health of patients that used Theranos' fake-ass blood testing technology.[2] She was cleared on those charges but convicted on the charges of defrauding her investors. Why do you think that was?

[2] One patient received an incorrect result regarding the health of her fetus; another received incorrect results about the progression of her cancer.

2. Why were so many of these wealthy sophisticated investors — "old men", in the words of Rupert Murdoch — taken in by this fraud? Any number of biotech-focused firms declined to invest, on the grounds that the technology was more or less physically impossible. What do you think made this such an attractive investment opportunity for these investors?

3. Holmes wasn't personally pocketing this money — she was raising it for Theranos.[3] Why didn't that matter? (Even though this case involves wire fraud, think back to our discussion of securities fraud.)

[3] Admittedly she owned half of Theranos's stock, so there's that.

4. Should Theranos have been charged with crimes, too?

CORPORATE EXECUTIVES CAN BE HELD CRIMINALLY LIABLE for more than just fraud.[4] Some statutes impose criminal liability on corporate managers that fail to supervise their subordinates when those subordinates break the law. For example, the Sarbanes-Oxley Act — passed directly after the Enron/Worldcom/Arthur Andersen accounting-and-document-shredding debacles — holds corporate managers criminally liable for the destruction of corporate records that happens under their watch.

[4] Fraud is, of course, the workhorse here. Enron, Worldcom, Theranos ... most prosecutions for corporate executive liability involve fraud.

Some statutes go even further and impose strict liability on corporate managers for the acts of the corporation they represent. The Food and Drug Act is one such statute, and allows for corporate managers to be held strictly liable for introducing mislabeled or adulterated drugs into the marketplace.[5] Like so much of criminal law, however, liability comes down to decisions made by prosecutors and judges regarding who deserves to be ground under the wheels of justice and who deserves mercy under the law.

[5] See *U.S. v. Dotterweich*, 320 U.S. 277 (1943).

When you read the following article about the Sackler family and Purdue Pharmaceuticals, keep in mind that some commentators (and politicians) think that corporate law has been overcriminalized and prosecutors are simply going too far and ruining the lives of too many good, honest, hard-working corporate executives with their overzealous tactics.[1] If you can find any evidence of that overcriminalization here, let me know.

[1] A number of these arguments are made by groups with ties to the Koch family, for what it's worth. Are they truly interested in the end of mass incarceration or the end of a *certain kind* of incarceration for a *certain kind* of defendant? You make the call!

The Sackler Family's Plan to Keep Its Billions

This past January, the Justice Department announced the results of investigations into Practice Fusion, a San Francisco-based company that maintains an online platform for health records. According to prosecutors, Practice Fusion had created a digital alert that prompted physicians to recommend strong opioid painkillers while meeting with patients. In return for adding the alert, Practice Fusion received a kickback from a pharmaceutical company, described in court papers as "Pharma Co. X." A federal prosecutor, Christina Nolan, said that the alert "effectively placed the pharma company pushing opioids into the exam room." Practice Fusion had suggested including a warning in the alert about how dangerous opioids can be, but, according to court filings, Pharma Co. X resisted the idea.

Practice Fusion agreed to pay a hundred and forty-five million dollars in fines and forfeiture. The settlement seemed to represent the first half of a two-act drama: if the company was now coöperating with authorities, then the Justice Department would surely turn next to Pharma Co. X — a prospect that became all the more intriguing when *Reuters* reported, the next day, that the drugmaker's identity was Purdue Pharma, the maker of the blockbuster opioid OxyContin.

Many pharmaceutical companies had a hand in creating the opioid crisis, an ongoing public-health emergency in which as many as half a million Americans have lost their lives. But Purdue, which is owned by the Sackler family, played a special role because it was the first to set out, in the nineteen-nineties, to persuade the American medical establishment that strong opioids should be much more widely prescribed—and that physicians' longstanding fears about the addictive nature of such drugs were overblown. With the launch of OxyContin, in 1995, Purdue unleashed an unprecedented marketing blitz, pushing the use of powerful opioids for a huge range of ailments and asserting that its product led to addiction in "fewer than one percent" of patients. This strategy was a spectacular commercial success: according to Purdue, OxyContin has since generated approximately thirty billion dollars in revenue, making the Sacklers one of America's richest families.

But OxyContin's success also sparked a deadly crisis of addiction. Other pharmaceutical companies followed Purdue's lead, introducing competing products; eventually, millions of Americans were struggling with opioid-use disorders. Many people who were addicted but couldn't afford or access prescription drugs transitioned to heroin and black-market fentanyl. According to a recent analysis by the *Wall Street Journal*, the disruptions associated with the coronavirus have only intensified the opioid epidemic, and overdose deaths are accelerating. For all the complexity of this public-health crisis, there is now widespread agreement that its origins are relatively straightforward. New York's attorney general, Letitia James, has described OxyContin as the "taproot" of the epidemic. A recent study, by a team of economists from the Wharton School, Notre Dame, and RAND, reviewed overdose statistics in five states where Purdue opted, because of local regulations, to concentrate fewer resources in promoting its drug. The scholars found that, in those states, overdose rates—even from heroin and fentanyl—are markedly lower than in states where Purdue did the full marketing push. The study concludes that "the introduction and marketing of OxyContin explain a substantial share of overdose deaths over the last two decades."

Given this context, the Practice Fusion investigation seemed like it might be a prelude to a definitive showdown between federal prosecutors and Purdue. But the company has a talent for evading meaningful retribution. It pleaded guilty to federal charges once before, in 2007, when prosecutors in Virginia alleged that the company had deceived doctors about the dangers of OxyContin. At the time, prosecutors wanted to indict three Purdue executives on numerous felonies. But the company hired influential lawyers who appealed to the political leadership in the Justice Department of President George W. Bush. Purdue ended up pleading guilty to felony "misbranding" and got off with a fine of six hundred million dollars—at the time, the equivalent of about six months' worth of OxyContin revenue. Separately, the three Purdue executives pleaded guilty to misdemeanors, and the Sacklers kept their name out of the case altogether.

Arlen Specter, then a Republican senator from Pennsylvania, was unhappy with the deal. When the government fines a corporation instead of sending its executives to jail, he declared, it is essentially granting "expensive licenses for criminal misconduct." After the settlement, Purdue kept marketing OxyContin aggressively and playing down its risks. (The company denies doing so.) Sales of the drug grew, eventually reaching more than two billion dollars annually. The fact that, thirteen years after the 2007 settlement, Purdue is alleged to have orchestrated another criminally overzealous campaign to push its opioids suggests that Specter was right: when the profits generated by crossing the line are enormous, fines aren't much of a deterrent.

In fact, Purdue is now being accused of a pattern of misconduct extending well beyond the scheme with Practice Fusion. In a little-noticed court filing by the Department of Justice this summer, federal prosecutors indicated that they had several other ongoing investigations into alleged misconduct by Purdue. The filing states that, between 2010 and 2018, Purdue sent sales representatives to call on prescribers who the company knew "were facilitating medically unnecessary prescriptions." The company also purportedly paid kickbacks to prescribers, motivating them to write yet more opioid prescriptions, and "paid kickbacks to specialty pharmacies to induce them to dispense prescriptions that other pharmacies refused to fill." Purdue's alleged conduct, Justice Department officials maintain, "gives rise to criminal liability."

The company faces other challenges. Last September, Purdue filed for Chapter 11 bankruptcy, and for the past year a judge in White Plains, New York, has been overseeing a process to satisfy the company's many creditors. Purdue is also a defendant in some three thousand lawsuits, brought by both public and private litigants. Forty-seven states have sued the drugmaker for its role in the opioid crisis; twenty-nine of those have specifically named members of the Sackler family as defendants. Both the family and the company have vigorously disputed the many allegations against them, maintaining that their conduct was always appropriate and blaming their woes on greedy lawyers and hysterical press coverage. In an interview with *Vanity Fair* last year, David Sackler, a former board member and a son of the company's one-time president, Richard Sackler, expressed acute grievance over the "endless castigation" of his family.

The Sacklers may be embattled, but they have hardly given up the fight. And a bankruptcy court in White Plains, it turns out, is a surprisingly congenial venue for the family to stage its endgame. Behind the scenes, lawyers for Purdue and its owners have been quietly negotiating with Donald Trump's Justice Department to resolve all the various federal investigations in an overarching settlement, which would likely involve a fine but no charges against individual executives. In other words, the deal will be a reprise of the way that the company evaded comprehensive accountability in 2007. Multiple lawyers familiar with the matter told me that members of the Trump Administration have been pushing hard to finalize the deal before Election Day. The Administration will likely present such a settlement as a major victory against Big Pharma—and as another "promise kept" to Trump's base.

If the deal goes forward, it would mark a stunning turn in the decades-long saga of trying to hold Purdue and the Sacklers responsible for their role in the opioid crisis. But even more stunning is the projected outcome of the bankruptcy proceeding in White Plains. At a recent hearing, the judge, Robert Drain, became defensive when a lawyer representing creditors suggested that the Sacklers might "get away with it." But, if the Sacklers achieve the result that the family's legal team is quietly engineering, they seem poised to do just that.

The 2007 case was not supposed to end the way it did. For four years, prosecutors in the Western District of Virginia gathered evidence on Purdue, subpoenaing millions of documents. They found a widespread pattern of illegal misconduct in which Purdue systematically misled doctors (and the general public) about the risks associated with OxyContin. In September, 2006, the prosecutors detailed their damning evidence in a hundred-and-twenty-page memo, suggesting that the wrongdoing at Purdue was so pervasive, and so consistent, that it could have been authorized only by the company's leaders. This memo, an internal government document, was not made public until August, 2019, when the *Times* published excerpts of it showing that the prosecutors had intended to bring felony charges against three top Purdue executives: Michael Friedman, Howard Udell, and Paul Goldenheim. The full memo, which I have reviewed, describes the Sacklers as "The Family" and notes that the company was owned and controlled by the brothers Mortimer and Raymond Sackler and their heirs. (The heirs of a third Sackler brother, Arthur, sold their interest in the company prior to the introduction of OxyContin.) The company "trained its sales representatives" to use "false and fraudulent" claims about OxyContin, the memo states. The prosecutors noted that the three executives they intended to charge "reported directly to The Family." (An attorney for Paul Goldenheim said that Goldenheim pleaded guilty to an "unjust misdemeanor," and that there was no evidence he had "participated in or approved off-label marketing"; Michael Friedman could not be reached for comment; Howard Udell died in 2013.)

The Sacklers have long maintained that they and their company are blameless when it comes to the opioid crisis because OxyContin was fully approved by the Food and Drug Administration. But some of the more shocking passages in the prosecution memo involve previously unreported details about the F.D.A. official in charge of issuing that approval, Dr. Curtis Wright. Prosecutors discovered significant impropriety in the way that Wright shepherded the OxyContin application through the F.D.A., describing his relationship with the company as conspicuously "informal in nature." Not long after Wright approved the drug for sale, he stepped down from his position. A year later, he took a job at Purdue. According to the prosecution memo, his first-year compensation package was at least three hundred and seventy-nine thousand dollars—roughly three times his previous salary. (Wright declined to comment.)

Before the prosecutors in Virginia could secure indictments in such an ambitious case, they needed approval from Washington. A Department of Justice official, Kirk Ogrosky, studied the evidence in the memo and concluded that the case was not just righteous but urgent. In an internal review of the charges, Ogrosky wrote, "Perhaps no case in our history rivals the burden placed on public health and safety as that articulated by our line prosecutors in the Western District of Virginia. OxyContin abuse has significantly impacted the lives of millions of Americans." He urged the department to proceed with indictments as soon as possible, noting that Purdue had a "direct financial incentive" to slow the case down, because any further delay "will merely allow the continued fraudulent sales and marketing of OxyContin and substantial additional revenue to the Defendants."

Purdue had assembled a team of high-powered attorneys, including Mary Jo White, the former U.S. Attorney for the Southern District of New York; Rudolph Giuliani, the former New York City mayor;[1] and Howard Shapiro, the former general counsel of the F.B.I. According to former officials involved in the case, Purdue's lawyers persuaded the political leadership in the Bush Justice Department to scuttle the prosecution. When the U.S. Attorney for the Western District of Virginia, John Brownlee, announced, in May, 2007, that Purdue had pleaded guilty to felony misbranding and had agreed to pay more than half a billion dollars in fines, he framed the news as a triumph for the department. But it wasn't. "This is the reason we have the Department of Justice, to prosecute these kinds of cases," Paul Pelletier, a senior department official at the time, told me. "When I saw the evidence, there was no doubt in my mind that if we had indicted these people—if these guys had gone to jail—it would have changed the way that people did business."

[1] Lol.

Purdue has long maintained that it did alter its behavior after the guilty plea, such as by instituting a robust compliance plan for its sales reps, while also suggesting there really wasn't much that needed changing. Members of the Sackler family and company lawyers have said that there was no systemic problem in the company; rather, it was a case of a few bad apples (or a "number of sales reps," as David Sackler told Vanity Fair). One indication of how seriously the company regarded its punishments came to light in a 2015 deposition of Richard Sackler. During Purdue's plea deal eight years earlier, the prosecutors and company lawyers had negotiated a so-called Agreed Statement of Facts: a list of transgressions to which Purdue was ready to concede. It was considerably more modest than the extravagant catalogue of misdeeds contained in the Department of Justice's prosecution memo; even so, an Agreed Statement of Facts can serve as a useful corrective for a company that has erred, offering a road map to better corporate responsibility. In the deposition, Richard Sackler was asked whether, as a longtime executive and board member of the family company, there was anything in the document that had surprised him.

"I can't say," he replied.

"As we sit here today, have you ever read the entire document?" he was asked.[1]

[1] Never a good question to hear.

"No," Sackler said.

In the past few years, it has become significantly more difficult for the Sacklers to display such willful disregard for the conduct of the family company. In January, 2019, the attorney general of Massachusetts, Maura Healey, unveiled a blistering two-hundred-and-seventy-four-page complaint against Purdue, in which she took the unprecedented step of naming not just the company but eight members of the Sackler family as defendants in a civil case. Her filing was studded with damning internal company e-mails revealing that, even in the face of a skyrocketing death toll from the opioid crisis, members of the Sackler family pushed Purdue staff to find aggressive new ways to market OxyContin and other opioids, and to persuade doctors to prescribe stronger doses for longer periods of time. Letitia James, the New York attorney general, soon followed with her own complaint, which also named the Sacklers and presented further evidence of the family's complicity. (The Sacklers and Purdue have strenuously denied the charges in both complaints.) Museums and universities, which had previously been happy to receive donations from the Sacklers and name buildings and wings after them, have distanced themselves, announcing that they will no longer accept contributions from the family. Tufts University and the Louvre Museum have gone so far as to take down all signs bearing the Sackler name.

In August, 2019, David Sackler flew to Cleveland, where he presented a proposal to a coalition of public and private attorneys who were suing the company. Purdue was facing nearly three thousand lawsuits from states, cities, counties, Native American tribes, school districts, hospitals, and a host of other plaintiffs. The company had just narrowly avoided a trial by settling with the state of Oklahoma, for two hundred and seventy million dollars. But, at the time, Purdue was being sued by forty-five other states, and David Sackler offered to resolve all the cases against the company and the family in a single grand gesture. A wave of headlines reported the news: "Purdue Pharma offers $10-12 billion to settle opioid claims."

This seemed like a significant figure, but the headlines were misleading. According to a term sheet in which attorneys for the Sacklers and Purdue laid out the particulars of this proposed "comprehensive settlement," the Sacklers were prepared to make a guaranteed contribution of only three billion dollars. Further funds could be secured, the family suggested, by selling its international businesses and by converting Purdue

Pharma into a "public benefit corporation" that would continue to yield revenue—by selling OxyContin and other opioids—but would no longer profit the Sacklers personally. This was a discomfiting, and somewhat brazen, suggestion: the Sacklers were proposing to remediate the damage of the opioid crisis with funds generated by continuing to sell the drug that had initiated the crisis. At the same time, the term sheet suggested, Purdue would supply new drugs to treat opioid addiction and counteract overdoses—though the practicalities of realizing this initiative, and the Sacklers' estimate that it would represent four billion dollars in value, remained distinctly speculative. (A family representative told me that the Sacklers want "to set aside divisive litigation based on misleading allegations to collaborate in working together to find real solutions that save lives.")

Roughly half of the states embraced the proposal. It was a great deal of money, and many states are reeling from the costs of the opioid crisis. But other attorneys general balked, complaining that the Sacklers were not contributing enough out of pocket. When they pushed the family to make a guaranteed contribution of four and a half billion dollars, the Sacklers refused to budge. According to Josh Stein, the attorney general of North Carolina, who negotiated directly with the family, their position was "take it or leave it."

It might seem reckless for a family facing potentially ruinous legal exposure to issue such a stark ultimatum, but the Sacklers had an important piece of leverage. Even as David Sackler was making his offer in Cleveland, Purdue Pharma was preparing to file for bankruptcy. If the company declared bankruptcy, it would leave virtually every state—and thousands of other claimants—with no choice but to fight over Purdue's remaining assets in bankruptcy court. Mary Jo White, who still represents the Sacklers, announced, "Purdue and the Sackler family members, given this litigation landscape, would like to resolve with the plaintiffs in a constructive way to get the monies to the communities that need them." Take the money now, she warned, or the alternative would be to "pay attorneys' fees for years and years and years to come."

When the attorneys general refused to consent to the deal, the Sacklers followed through on their threat, and Purdue declared bankruptcy. But, significantly, the Sacklers did not declare bankruptcy themselves. According to the case filed by James, the family had known as early as 2014 that the company could one day face the prospect of damaging judgments. To protect themselves on this day of reckoning, the lawsuit maintains, the Sacklers assiduously siphoned money out of Purdue and transferred it offshore, beyond the reach of U.S. authorities. A representative for Purdue told me that the drugmaker, when it declared bankruptcy, had cash and assets of roughly a billion dollars. In a deposition, one of the company's own experts testified that the Sacklers had removed as much as thirteen billion dollars from Purdue. When the company announced that it was filing for Chapter 11, Stein derided the move as a sham. The Sacklers had "extracted nearly all the money out of Purdue and pushed the carcass of the company into bankruptcy," he said. "Multi-billionaires are the opposite of bankrupt."

One curiosity of corporate-bankruptcy law is that a company can effectively pick the judge who will preside over its case. On March 1, 2019—just weeks after the first lawsuit that named the Sacklers as defendants, and six months before the company actually filed for bankruptcy—Purdue paid a thirty-dollar fee to change its address for litigation documents to an anonymous office building in White Plains, New York. There is a federal courthouse in White Plains, and only one bankruptcy judge presides there: Robert Drain. A former corporate lawyer, he was appointed to the bench during the George W. Bush Administration. When Purdue declared bankruptcy, Drain issued an injunction pausing all the state and federal lawsuits against the company until the bankruptcy could be resolved—a standard feature of bankruptcy proceedings. But then Drain did something more surprising. Attorneys for the Sacklers requested that he also issue a stay halting any litigation that was directed at members of the family. This was a bold gambit. James complained that the Sacklers were asking for "the benefits of bankruptcy protection without filing for bankruptcy themselves." Nevertheless, Drain granted the motion. This may be one of the reasons that Purdue selected him in the first place: in the past, he had shown a willingness to enjoin litigation even against so-called third parties who had not declared bankruptcy themselves. The decision was upheld on appeal.

A declaration of bankruptcy conjures images of failure and shame, but, for the Sacklers, Drain's court has been a safe harbor. As a bankruptcy judge, Drain seems to regard himself as a creative technocrat, a dealmaker whose chief concern is efficiency. In the Purdue case, he has frequently invoked the great expense of the bankruptcy process—with scores of attorneys billing by the hour—and has sought to streamline the proceedings, citing the needs of those who have suffered from the opioid crisis and suggesting, as Mary Jo White did, that whatever limited funds remain should go toward helping people struggling with addictions, rather than toward enriching lawyers. Given Drain's deliberately narrow conception of his own assignment, it is perhaps understandable that he has exhibited little interest in larger questions of justice and accountability, which may seem abstract or extraneous to the negotiation at hand. Indeed, at some proceedings in the past year, he has evinced frustration with state attorneys general and lawyers representing victims who have lost loved ones to the crisis. The Sacklers' offer to settle all claims for a guaranteed payment of three billion dollars is still on the table. In a hearing in March, Drain suggested that the continued refusal by some state attorneys general to agree to the proposal was, in effect, political grandstanding; the notion that any of the parties would "hold up something that is good for all" was, in his view, "almost repulsive."

The notion that the Sacklers might "get away with it" was raised this past July in a *Times* Op-Ed written by Gerald Posner, a journalist, and Ralph Brubaker, a bankruptcy scholar at the University of Illinois College of Law.[1] They suggested that Drain could "help them hold on to their wealth by releasing them from liability for the ravages caused by OxyContin." When one of the lawyers in the case subsequently invoked the Op-Ed in a hearing, the judge exploded. "It doesn't matter what some numbskull Op-Ed writer puts in," he said, maintaining that press coverage of the case had been "totally irresponsible" and "utterly misguided." He urged the lawyers in attendance not to "buy or click on" publications like the *Times*, and said, "I don't want to hear some idiot reporter or some bloggist quoted to me again in this case."

[1] Ralph Brubaker is both a reknowned expert in bankruptcy law (cited multiple times by the Supreme Court) and also the closest living thing to Ron Swanson from *Parks and Rec*.

Yet the Op-Ed writers were not wrong to question whether Drain will ultimately release the family from future liability, because that is precisely the scenario that the Sacklers have said they are pursuing. In fact, it is one of the conditions attached to their proposed settlement. In the term sheet, the family suggests that it will supply the three billion dollars and other inducements only in the event that it is released from "all potential federal liability arising from or related to opioid-related activities." All potential liability—meaning not just civil but criminal, too.

You might think that this would leave open the possibility of future suits brought by states, but Drain has signalled a desire to foreclose those as well, maintaining that a blanket dispensation is a necessary component of the bankruptcy resolution. In February, he remarked that the "only way to get true peace, if the parties are prepared to support it and not fight it in a meaningful way, is to have a third-party release" that grants the Sacklers freedom from any future liability. This is a controversial issue, and Drain indicated that he was raising it early because in some parts of the country it's illegal for a federal bankruptcy judge to grant a third-party release barring state authorities from bringing their own lawsuits. The case law is evolving, Drain said.

A Purdue lawyer, Marshall Huebner, assured the judge that his firm, Davis Polk, was tracking the case law "with an electron microscope."

"You may need to do more than track," Drain said, slipping into a register that sounded strangely like legal advice. "You may need to file an amicus"—a friend-of-the-court brief—"to counteract some of the . . ." He trailed off. "Well, I'm just leaving it at that."

Huebner, displaying a self-awareness that Drain seemed to lack, said, "I don't know if the world wants a Purdue Pharma amicus." He added, "But we'll have to take that one under advisement."

In a filing to the court, in March, the states opposing the Sacklers' settlement terms argued that such treatment at the hands of the legal system appears to be an exclusive prerogative of the wealthy. They wrote, "Allowing the Sacklers the special protection of a nationwide injunction against the law-enforcement actions brought against them, through a bankruptcy in which they are not the debtors, sends the wrong message to the public about the fairness of our courts and system of justice."

In June, Drain announced that any parties with a potential claim against Purdue in the bankruptcy proceeding had to file with the court by July 30th. It was in this context that the Department of Justice revealed its multiple ongoing investigations of Purdue. Initially, it seemed that the "true peace" that Drain envisaged for the Sacklers might be in jeopardy. But, in fact, attorneys for the Sacklers and Purdue have been aware of these investigations for years, and have been negotiating with attorneys at the Justice Department to resolve them. Purdue legal bills that have been submitted to the bankruptcy court show thousands of hours of lawyer time devoted to "DOJ resolution issues." A Purdue representative acknowledged to me that the company is engaged in "ongoing discussions" with the department regarding "a potential resolution of these investigations." According to multiple attorneys—both inside and outside the government—who are familiar with these cases, there is tremendous pressure inside the Justice Department to resolve the investigations before Election Day.

The Trump Administration has paid lip service to the importance of addressing the opioid crisis. Bill Barr, Trump's Attorney General, has said that his "highest priority is dealing with the plague of drugs." In practice, however, this has meant rhetoric about heroin coming from Mexico and fentanyl coming from China, rather than a sustained effort to hold the well-heeled malefactors of the American pharmaceutical industry to account. Richard Sackler once boasted, "We can get virtually every senator and congressman we want to talk to on the phone in the next seventy-two hours." Although the Sacklers may now be social pariahs, the family's money—and army of white-shoe fixers—means that they still exert political influence.

According to three attorneys familiar with the dynamics inside the Justice Department, career line prosecutors have pushed to sanction Purdue in a serious way, and have been alarmed by efforts by the department's political leadership to soften the blow. Should that happen, it will mark a grim instance of Purdue's history repeating itself: a robust federal investigation of the company being defanged, behind closed doors, by a coalition of Purdue lawyers and political appointees. And it seems likely, as was also the case in 2007, that this failure will be dressed up as a success: a guilty plea from the company, another fine.

If such a deal is struck, it is probable that no Purdue executives will face felony charges. This week, two Democratic U.S. senators—Maggie Hassan, of New Hampshire, and Sheldon Whitehouse, of Rhode Island—sent a letter to Barr citing "DOJ's history of leniency with Purdue" and expressing concern that the department "will once again let connected lawyers obtain a settlement that does not adequately address the harms caused by the company." In an added irony, if the Trump Administration does seek a fine, the funds could come not from the Sacklers but from the limited pool of money available from the bankruptcy proceeding. More than a hundred thousand individuals—victims of the opioid crisis, people who have lost loved ones or struggled with addiction themselves—have filed claims as "creditors" of Purdue. In the zero-sum calculus of a bankruptcy proceeding, the bigger the financial penalty extracted by federal prosecutors, the less money there will be left over for these and other creditors.

The company is apparently feeling emboldened: it recently sought permission from the bankruptcy court to pay millions of dollars in bonuses to company leaders—some of whom presided over Purdue during the period of alleged criminal activity outlined in the Justice Department's July 30th filing—including a three-and-a-half-million-dollar "incentive payment" to its C.E.O. In a separate letter to Drain last week, five U.S. senators argued that "no business should seek to reward any employee that has engaged in criminal practices."

In a statement to *The New Yorker*, a representative for the families of Raymond and Mortimer Sackler denied all wrongdoing, maintaining that family members on Purdue's board "were consistently assured by management that all marketing of OxyContin was done in compliance with law." The statement continued, "Our hearts go out to those affected by drug abuse and addiction," adding that "the rise in opioid-related deaths is driven overwhelmingly by heroin and illicit fentanyl smuggled by drug traffickers into the U.S. from China and Mexico." At "the conclusion of this process," the statement suggested, "all of Purdue's documents" will be publicly disclosed, "making clear that the Sackler family acted ethically and responsibly at all times."

The states have asserted in legal filings that the total cost of the opioid crisis exceeds two trillion dollars. Relative to that number, the three billion dollars that the Sacklers are guaranteeing in their offer is minuscule. It is also a small number relative to the fortune that the Sacklers appear likely to retain, which could be three or four times that amount. As the March filing by the states opposed to the deal argued, "When your illegal marketing campaign causes a national crisis, you should not get to keep most of the money." What the Sacklers are offering simply "does not match what they owe."

Nevertheless, in absolute terms, three billion dollars is still a significant sum—and the Sacklers have made it clear that they are prepared to pay it only in the event that they are granted a release from future liability. It may be that the magnitude of the dollars at stake will persuade Drain, the Justice Department officials on the case, and even the state attorneys general who initially rejected the Sacklers' proposal to sign off. The problem, one attorney familiar with the case said, is that "criminal liability is not something that should be sold," adding, "It should not depend on how rich they are. It's not right."[1]

[1] Patrick Radden Keefe. The Sackler Family's Plan to Keep Its Billions. The New Yorker, October 2020

Some discussion questions:

1. Purdue Pharma plead guilty in 2007 (along with several corporate executives) for misbranding, mislabeling, and misadvertising OxyContin. Was that liability justified under the *Christy Pontiac* test?

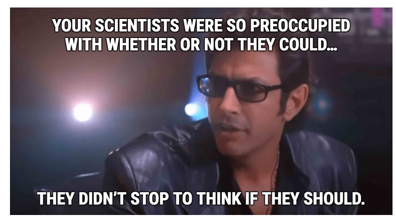
2. That guilty plea and fine didn't spell doom for Purdue Pharma — and the various changes that Purdue agreed to didn't exactly stop their malfeasance. What does that tell you about the powers of criminal law when it comes to corporations?

3. Should the Sackler family face criminal liability for Purdue Pharma's role in the opioid crisis? Leaving aside the bankruptcy court's controversial move to shield the family from liability (which looks shady as all hell, right?), examine how the Sacklers could be held criminally liable here, and why they should or should not.

Having kinda sorta dealt with the idea of a corporation having a mental state of its own in the context of corporate criminal liability, in the next chapter we will watch as various parties pick up the idea of corporate personhood and charge, headlong and heedless, into complete and utter incoherence. That's right, it's time to ask ourselves whether corporations have ... purposes? Values? Political beliefs? Constitutional rights? SOULS?!? It's all on the table, friends. Welcome to the mouth of madness.

15. *The Corporation in Society*

As the philosopher George Costanza once said: We live in a society. Corporations exist in our society, too, but not quite in the same way. Brought into existence by humans and unleashed on the public, constrained by whatever controls we place on them, but with no legal or moral obligations to anyone or anything — they live alongside us the same way the dinosaurs lived alongside the humans in *Jurassic Park*.



As long as corporations have existed, they have provoked considerable unease among the public. While many of the criticisms of corporations are really just criticisms of capitalism — Can you believe corporations extract *surplus value* from labor? And that shareholders *profit off of capital investment*?? — corporations come in for special criticism precisely because they are not. fucking. human. Specifically:

- A human's lifespan is finite; a corporation can potentially exist forever. Your great-great-grandchildren will still be complaining about Ticketmaster.

- A human can acquire a whole hell of a lot of money if they are lucky enough; a corporation can acquire way more than that (through the agglomeration of capital investment, via acquisitions and mergers, and also due to their infinite lifespans). And since our political system has long been governed by the "money talks and bullshit walks" doctrine, that money allows corporations to acquire outsized political influence.

- A human can feel bad; corporations cannot. Whether generated internally (guilt) or externally (shame), or via some combination of the two (embarrassment), humans are capable of feeling bad, whereas a corporation (whether it is best understood as a piece of paper filed with the state, or a legal fiction, or a golem, or a dinosaur, or anything else you can think of) is simply not capable of feeling bad about what it does. Likewise, a corporation cannot feel good about being helpful or giving or tolerant; any pro-social action taken on behalf of a corporation can benefit the corporation in the form of goodwill (and might indirectly benefit its managers), but it cannot cause the corporation to feel good about itself. A corporation simply does not feel at all.

Unsettling! One way of dealing with this disquieting phenomenon was to demand that corporations be run with a sort of *noblesse oblige* towards the public. The idea of a benevolent and patriotic corporation was popularized with the war effort during World War II, and continued well into the post-war period. In 1953, while testifying before Congress about his nomination to become Secretary of Defense, Charles Wilson, the President of General Motors, was asked what he would do if there was conflict between the interests of General Motors and the interests of the United States. He responded:

> "I cannot conceive of one because for years I thought what was good for our country was good for General Motors, and vice versa. The difference did not exist. Our company is too big. It goes with the welfare of the country. Our contribution to the Nation is quite considerable."

Of course, eight years after nominating the head of General freakin' Motors to be the Secretary of freakin' Defense, President Eisenhower was warning everyone about the dangers of a military-industrial complex — but nevermind that for now. The idea was that corporations were not just corporations — they were good, upstanding *citizens*, and they would act like it. In this chapter, we discuss this version of the corporation in the context of charitable giving, and explore whether there is a realistic limit to corporate altruism. We then consider a rival theory of the corporation — the shareholder primacy model — and consider whether it accords with our understanding of how power is distributed within a corporate entity. After that, we lose our grip entirely on law, logic, and sanity, and we explore the corporation as political actor and consider whether and when a corporation has constitutional rights. We conclude by examining the absurd consequences of allowing completely inconsistent theories of the corporation to coexist simultaneously in *Burwell v. Hobby Lobby*, a case about the strongly-held religious beliefs of a pile of money with a line drawn around it.

Corporate Charitable Giving

One thing a good citizen does is give to charity. Not me, personally — my presence is a gift to the world, so I do not give to charity — but most good citizens do. What about a corporation? Any expenditure of funds by a corporation for a legitimate business purpose is granted wide deference by courts and corporate statutes, but what about an expenditure that is made for purely charitable reasons? (Ignore for now the public relations angle of corporate charity.) To promote corporate charity, most states amended their corporate statutes to specifically authorize this sort of laudatory behavior. But what are the limits? The following case looks to answer that exact question.

Theodora Holding Corporation v. Henderson, 257 A.2d 398 (Del. Ch. 1969)

Marvel, V.C.

Plaintiff Theodora Holding Corporation, which was formed in May of 1967 by the defendant Girard B. Henderson's former wife, Theodora G. Henderson, is the holder of record of 11,000 of the 40,500 issued and outstanding shares of common stock of the defendant Alexander Dawson, Inc.[1] It sues derivatively as well as on its own behalf for an accounting by the individual defendants for the losses allegedly sustained by the corporate defendant and the concomitant improper gains allegedly received by the individual defendants as a result of certain transactions of which plaintiff complains. However, the basic relief sought by plaintiff after trial is the appointment of a liquidating receiver for the corporate defendant, such application being based on the alleged wrongs suffered by the corporate defendant at the hands of the individual defendants, which wrongs, according to plaintiff, if permitted to continue, threaten the very existence of such corporation.

[1] My second-least favorite type of corporation name is when it is named after some dude who doesn't even show up in the case.

Prior to plaintiff's formation in 1967 Mrs. Henderson had received dividends on both common and preferred shares of the corporate defendant until she transferred her 11,000 shares of the common stock of said company to plaintiff during the year 1967. Corporate dividends paid to Mrs. Henderson in recent years and now to plaintiff and Mrs. Henderson have increased substantially in recent years. As of December 3, 1968, dividends paid to plaintiff and Mrs. Henderson in that year totalled $385,240. In 1966, Mrs. Henderson had received dividends in the amount of $292,840, and in 1967, a year in which Alexander Dawson, Inc., made a controversial charitable contribution having a value of $528,000, the combined dividends of plaintiff and Mrs. Henderson totalled $286,240.

In January of 1955, the defendant Girard B. Henderson and his then wife, Theodora G. Henderson, had entered into a separation agreement looking towards a divorce, at which time Mrs. Henderson's dividends from the corporate defendant totalled approximately $50,000 per annum. Under the terms of such agreement Mrs. Henderson acknowledged that she had received from her then husband the shares of common stock of Alexander Dawson, Inc., here in issue as well as a number of shares of preferred stock of such corporation. Upon plaintiff's organization, it became the owner of Mrs. Henderson's 11,000 shares of common stock on May 3, 1967. As of April 30, 1967, the shares of Alexander Dawson, Inc., to be turned over to the plaintiff corporation had a fair market value of $15,675,000 and an underlying net asset value of $28,996,000. Mrs. Henderson has since placed certain Dawson shares in trust for her own benefit and that of her two daughters and their issue.[1]

[1] Ew.

The individual defendant Henderson by reason of the extent of his combined majority holdings of common and preferred stock of Alexander Dawson, Inc., each class of which has voting rights, exercises effective control over the affairs of such corporation, the net worth of the assets of which, at the time of the filing of this suit, was approximately $150,000,000.

It is claimed and the evidence supports such contention that on December 8, 1967, the defendant Girard B. Henderson, by virtue of his voting control over the affairs of Alexander Dawson, Inc., caused the board of directors of such corporation to be reduced in number from eight to three persons, namely himself, the defendant Bengt Ljunggren, an employee of the corporate defendant, and Mr. Henderson's daughter, Theodora H. Ives. It is alleged that thereafter the defendant Girard B. Henderson (over the objection of the director, Mrs. Ives) caused the board and the majority of the voting stock of Alexander Dawson, Inc., improperly to contribute stock held by it in the approximate value of $550,000 to the Alexander Dawson Foundation, a charitable trust, the affairs of which were then controlled and continue to be controlled by Mr. Henderson.[2]

[2] Theodora Holdings alleged other misdeeds, but these claims were unrelated to the charitable giving.

Alexander Dawson, Inc. has functioned as a personal holding company since 1935 when Mr. Henderson's mother exchanged a substantial number of shares held by her in a company which later became Avon Products, Inc.,[3] for all of the shares of her own company known as Alexander Dawson, Inc. Mr. Henderson and a brother later succeeded to their mother's interest in Alexander Dawson, Inc., the brother thereafter permitting his shares to be redeemed by the corporation. As noted earlier, Mr. Henderson, by reason of his combined holdings of common and preferred stock of the corporate defendant, is in clear control of the affairs of such corporation, which, for the most part, has been operated informally by Mr. Henderson with scant regard for the views of other board members.

[3] Makers of beauty products.

From 1960 to 1966 (except for the year 1965) gifts were in the range of approximately $63,000 to $70,000 or higher in each year other than 1963 when $27,923 was donated. In 1966, however, a gift in the form of a large tract of land in Colorado, having a value of some $467,750, was made. All of these gifts through 1966 were unanimously approved by all of the stockholders of Alexander Dawson, Inc., including Mrs. Theodora G. Henderson. The gift now under attack, namely one of the shares of stock of the corporate defendant having a value of some $528,000, was made to the Alexander Dawson Foundation in December of 1967. Such gift was first proposed by Mr. Henderson in April, 1967 before the board of the corporate defendant was reduced in number from eight to three. However, director reaction was thereafter confused, one of the directors, Mrs. Henderson's daughter, Theodora H. Ives, having expressed a desire that a corporate gift also be made to her own charitable corporation and that of her mother, Theodora G. Henderson. Accordingly, the matter was not pressed by Mr. Henderson until late December when the reduced board had taken over management of the corporate defendant.

It is claimed and admitted that such gift had an effect on the equity and dividends of shareholders of the corporate defendant although the tax consequences of such gift clearly soften the apparent impact of such transaction. It is significant, however, as noted above, that the 1966 corporate gift, consisting of a ranch located in Colorado,[1] had been approved by all of the directors and stockholders of the corporate defendant, and that the gift here under attack was apparently intended to be a step towards consummation of the purpose behind such grant of land, namely to provide a fund for the financing of a western camp for under privileged boys, particularly members of the George Junior Republic, a self-governing institution which has served the public interest for some seventy-five years at a school near Freeville, New York.

[1] Henderson himself had an underground (?) dwelling on this ranch, which makes this gift slightly weirder.

Title 8 Del. C. § 122 provides as follows:

> "Every corporation created under this chapter shall have power to —
>
> (9) 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."

There is no doubt but that the Alexander Dawson Foundation is recognized as a legitimate charitable trust by the Department of Internal Revenue. It is also clear that it is authorized to operate exclusively in the fields of "religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals". Furthermore, contemporary courts recognize that unless corporations carry an increasing share of the burden of supporting charitable and educational causes that the business advantages now reposed in corporations by law may well prove to be unacceptable to the representatives of an aroused public. The recognized obligation of corporations towards philanthropic, educational and artistic causes is reflected in the statutory law of all of the states, other than the states of Arizona and Idaho.[2]

[2] Arizona and Idaho: "Kids? Animals? Fuck 'em."

[T]he Delaware statute contains no [] limiting language and therefor must, in my opinion, be construed to authorize any reasonable corporate gift of a charitable or educational nature. Significantly, Alexander Dawson, Inc. was incorporated in Delaware in 1958 after 8 Del. C. § 122(9) was cast in its present form, therefor no constitutional problem arising out of the effect on a stockholder's property rights of the State's reserved power to amend corporate charters is presented.

I conclude that the test to be applied in passing on the validity of a gift such as the one here in issue is that of reasonableness, a test in which the provisions of the Internal Revenue Code pertaining to charitable gifts by corporations furnish a helpful guide. The gift here under attack was made from gross income and had a value as of the time of giving of $528,000 in a year in which Alexander Dawson, Inc.'s total income was $19,144,229.06, or well within the federal tax deduction limitation of 5% of such income. The contribution under attack can be said to have "cost" all of the stockholders of Alexander Dawson, Inc. including plaintiff, less than $80,000, or some fifteen cents per dollar of contribution, taking into consideration the federal tax provisions applicable to holding companies as well as the provisions for compulsory distribution of dividends received by such a corporation. In addition, the gift, by reducing Alexander Dawson, Inc.'s reserve for unrealized capital gains taxes by some $130,000, increased the balance sheet net worth of stockholders of the corporate defendant by such amount. It is accordingly obvious, in my opinion, that the relatively small loss of immediate income otherwise payable to plaintiff and the corporate defendant's other stockholders, had it not been for the gift in question, is far out-weighed by the overall benefits flowing from the placing of such gift in channels where it serves to benefit those in need of philanthropic or educational support, thus providing justification for large private holdings, thereby benefiting plaintiff in the long run.[1] Finally, the fact that the interests of the Alexander Dawson Foundation appear to be increasingly directed towards the rehabilitation and education of deprived but deserving young people is peculiarly appropriate in an age when a large segment of youth is alienated even from parents who are not entirely satisfied with our present social and economic system.[2]

[1] "Charity isn't doing good things for other people. It's doing good things for other people *while other people are watching*." —Bob Odenkirk, *Mr. Show*

[2] Damn hippies!

"It is plain, we think, that for a court to order a dissolution or liquidation of a solvent corporation, the proponents must show a failure of corporate purpose, a fraudulent disregard of the minority's rights, or some other fact which indicates an imminent danger of great loss resulting from fraudulent or absolute mismanagement." "[T]he remedy of a minority stockholder in a corporation who is dissatisfied with its management or method of operation is to withdraw from the corporate enterprise by the sale of his stock when the minority stockholder's complaint is not based on any illegality."

Finally, none of the separate transactions sought to be relied on by plaintiff to demonstrate gross mismanagement or a threat to the corporate defendant's existence as a viable business entity, considered separately or cumulatively, not only fail to demonstrate the type of corporate perversion or self-dealing which warrant interference by a court of equity but rather have been shown to be reasonable corporate acts within the business judgment rule. Plaintiff's application for the appointment of a liquidating receiver for Alexander Dawson, Inc. must be denied.

SOME DISCUSSION QUESTIONS:

1. Were the donations in questions linked to Alexander Dawson Inc.'s business? Did they have to have a legitimate business purpose?

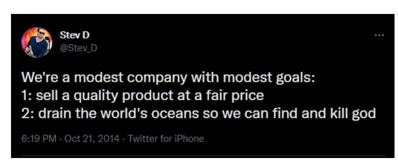
2. Would it be self-dealing if the donations went to a charity run by Mr. Henderson? What if it was an issue Mr. Henderson was particularly passionate about? (One of the easiest ways to get funding for a particular issue is if a major corporation's CEO is personally affected by it.)

3. Why did the rule regarding corporate tax deductions show up there? What kind of test for reasonableness is the court applying?

4. What would make a corporate charitable donation unreasonable?

Corporate Purpose

MUST A CORPORATION HAVE A PURPOSE? Legally, no. You'd think that'd be the end of the question, but that hasn't stopped anyone from declaring that the corporation *must* or *should* or *could be* or *needs to be* run for some sort of goal broader than making widgets or doing deals or whatever the hell the actual money-generating business of the corporation is. Saying "we're in it to win it" just doesn't cut it anymore, apparently.



But if we allow for a corporation to be run for some sort of broader goals in addition to the actual business of the corporation, what are the limits of that? Corporate charitable giving is A-OK and cannot be challenged as waste so long as the giving is reasonable; the decision whether to distribute money back to shareholders is 100,000% at the discretion of management;[1] and board judgments will be granted deference so long as they are informed and rational and disinterested. When does running a corporation for something other than ostensible profit cross one of those lines? If a corporation's shareholders have duly elected the corporation's management, and the corporation's

[1] Oppression in closely-held corporations notwithstanding.

management has articulated the corporation's purpose, what gives a court the power to intervene in that decision? The following case gives one possible answer — not the definitive answer, mind you — for when a corporate manager's megalomaniacal articulation of a corporation's purpose becomes just a little *too much*.

Dodge v. Ford Motor Co., 204 Mich. 459 (Mich. 1919)

Hall, C.J.

The Ford Motor Company is a corporation organized and existing under Act No. 232 of the Public Acts of 1903. The articles of association were executed June 16, 1903, and acknowledged on that day by the parties associating. Article 2 of the articles of association reads:

"The purpose or purposes of this corporation are as follows: To purchase, manufacture and placing of the market for sale of automobiles or the purchase, manufacture and placing on the market for sale of motors and of devices and appliances incident to their construction and operation."

The business of the company continued to expand. The cars it manufactured met a public demand, and were profitably marketed, so that in addition to regular quarterly dividends equal to 5 per cent. monthly on the capital stock of $2,000,000, its board of directors declared and the company paid special dividends:

December 13, 1911	$1,000,000
May 15, 1912	$2,000,000
July 11, 1912	$2,000,000
June 16, 1913	$10,000,000
May 14, 1914	$2,000,000
June 12, 1914	$2,000,000
July 6, 1914	$2,000,000
July 23, 1914	$2,000,000
August 23, 1914	$3,000,000
May 28, 1915	$10,000,000
October 13, 1915	$5,000,000

A total of $41,000,000 in special dividends.

The surplus above capital stock on September 30, 1912 was $14,745,095.67, and [it] was increased year by year to $28,124,173.68, $48,827,032.07, [and] $59,135,770.66. [On] July 31, 1916, it was $111,960,907.53. Originally, the car made by the Ford Motor Company sold for more than $900. From time to time, the selling price was lowered and the car itself improved until in the year ending July 31, 1916, it sold for $440. Up to

July 31, 1916, it had sold 1,272,986 cars at a profit of $173,895,416.06. As the cars in use multiplied, sales of parts and of repairs increased so that, in the year ending July 31, 1916, the gross profits from repairs and parts was $3,915,778.94, sales being more than $600,000 for each of the months of May, June and July. For the year beginning August 1, 1916, the price of the car was reduced $80 to $360.

From a mere assembling plant, the plant of the Ford Motor Company came to be a manufacturing plant, in which it made many of the parts of the car which in the beginning it had purchased from others. At no time has it been able to meet the demand for its cars or in a large way to enter upon the manufacture of motor trucks.

The plaintiff Dodge brothers, who together own 2,000 shares, or one-tenth of the entire capital stock of the Ford Motor Company, on the 2d of November, 1916, filed their bill of complaint, in which bill they charge that since 1914 they have not been represented on the board of directors of the Ford Motor Company, and that since that time the policy of the board of directors has been dominated and controlled absolutely by Henry Ford, the president of the company, who owns and for several years has owned 58 per cent. of the entire capital stock of the company.

[I]t is charged that notwithstanding the earnings for the fiscal year ending July 31, 1916, the Ford Motor Company has not since that date declared any special dividends, and Henry Ford, president of the company, has declared it to be the settled policy of the company not to pay in the future any special dividends, but to put back into the business for the future all of the earnings of the company, other than the regular dividend of five per cent.

This declaration of the future policy, it is charged in the bill, was published in the public press in the city of Detroit and throughout the United States in substantially the following language:

"'My ambition,' declared Mr. Ford, 'is to employ still more men; to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this, we are putting the greatest share of our profits back into the business.'"

It is charged further that the said Henry Ford stated to plaintiffs personally, in substance, that as all the stockholders had received back in dividends more than they had invested they were not entitled to receive anything additional to the regular dividend of 5 per cent, and that it was not his policy to have larger dividends declared in the future, and that the profits and earnings of the company would be put back into the business for the purpose of extending its operations and increasing the number of its employees, and that inasmuch as the profits were to be represented by investment in plants and capital investment the stockholders would have no right to complain.

It is charged that Henry Ford, "dominating and controlling the policy of said company, has declared it to be his purpose — and he has actually engaged in negotiations looking to carrying such purposes into effect — to invest millions of dollars of the company's money in the purchase of iron ore mines in the Northern Peninsula of Michigan or State of Minnesota; to acquire by purchase or have built ships for the purpose of transporting such ore to smelters to be erected on the River Rouge adjacent to Detroit in the county of Wayne and State of Michigan; and to construct and install steel manufacturing plants to produce steel products to be used in the manufacture of cars at the factory of said company;[1] and by this means to deprive the stockholders of the company of the fair and reasonable returns upon their investment by way of dividends to be declared upon their stockholding interest in said company." [I]t is charged that the present investment in capital and assets constitute an unlawful investment of the earnings and that the continued investment of earnings would be a continuation of such unlawful policy.

[It is charged] [t]hat during the year ending July 31, 1916, the output of the said Ford company's product amounted to approximately five hundred thousand (500,000) automobiles — yielding to the company, as stated, a net profit of sixty million dollars ($60,000,000). That although there was no reason to conclude that said company could not repeat its production of 500,000 cars during the succeeding year and sell the same readily at the price at which they had been sold in the previous year and although labor and material costs were increasing, the said Henry Ford forced upon the board of directors his policy of reducing the price of such cars by eighty dollars ($80) per car, making a difference in the net sales price of the product of said company for the year ending July 31, 1917, of forty million dollars ($40.000,000). That such policy was adopted only for the purpose of enabling him to continue to carry out the policy he had decided upon to extend the operations and increase the said company's output of manufactured automobiles and a production schedule for the year July 31, 1916, to July 31, 1917, for eight hundred thousand (800,000) cars was adopted. That in order to prepare for such increased production the company is now, in carrying out such policy of said Henry Ford, engaged in practically duplicating the enormous plant of the company at Highland Park in the county of Wayne and State of Michigan, and in making other large expenditures and preparing to make other expenditures involving millions of dollars in carrying out such plan of the expansion of the business plants and property of the company.

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When plaintiffs made their complaint and demand for further dividends

[1] Not for nothing, the Dodge brothers also alleged that Ford was trying to create a monopoly:

> "That unless restrained by the injunction of this honorable court, the said Henry Ford will cause the cash assets that would otherwise be available for dividends, to be disbursed and invested in fixed capital assets.
>
> In the face of the increased labor and material cost and the uncertain conditions that will prevail in the business world at the termination of the present world war, the policy of said Henry Ford, in continuing the expansion of the business of said corporation, is reckless in the extreme and seriously jeopardizes the interest of your orators as stockholders of said corporation.
>
> That if the said Henry Ford is permitted to continue the policy that he has inaugurated and announced he is determined to carry out, of increasing production, reducing the price of cars, and increasing the capital investments in the conduct of such business by withholding the dividends from stockholders to which they are entitled, the necessary result will be the destruction of competition on the sale of the class of cars manufactured by such corporation and the creation of a complete monopoly in the manufacture and sale of such cars in violation of the State, Federal and common law."

the Ford Motor Company had concluded its most prosperous year of business. The demand for its cars at the price of the preceding year continued. It could make and could market in the year beginning August 1, 1916, more than 500,000 cars. Sales of parts and repairs would necessarily increase. The cost of materials was likely to advance, and perhaps the price of labor, but it reasonably might have expected a profit for the year of upwards of $60,000,000. It had assets of more than $132,000,000, a surplus of almost $112,000,000, and its cash on hand and municipal bonds were nearly $54,000,000. Its total liabilities, including capital stock, was a little over $20,000,000.

Considering only these facts, a refusal to declare and pay further dividends appears to be not an exercise of discretion on the part of the directors, but an arbitrary refusal to do what the circumstances required to be done. These facts and others call upon the directors to justify their action, or failure or refusal to act. In justification, the defendants have offered testimony tending to prove, and which does prove, the following facts. It had been the policy of the corporation for a considerable time to annually reduce the selling price of cars, while keeping up, or improving, their quality. As early as in June, 1915, a general plan for the expansion of the productive capacity of the concern by a practical duplication of its plant had been talked over by the executive officers and directors and agreed upon, not all of the details having been settled and no formal action of directors having been taken. The erection of a smelter was considered, and engineering and other data in connection therewith secured. In consequence, it was determined not to reduce the selling price of cars for the year beginning August 1, 1915, but to maintain the price and to accumulate a large surplus to pay for the proposed expansion of plant and equipment, and perhaps to build a plant for smelting ore. It is hoped, by Mr. Ford, that eventually 1,000,000 cars will be annually produced. The contemplated changes will permit the increased output.

The plan, as affecting the profits of the business for the year beginning August 1, 1916, and thereafter, calls for a reduction in the selling price of the cars. It is true that this price might be at any time increased, but the plan called for the reduction in price of $80 a car. The capacity of the plant, without the additions thereto voted to be made (without a part of them at least), would produce more than 600,000 cars annually. This number, and more, could have been sold for $440 instead of $360, a difference in the return for capital, labor and materials employed of at least $48,000,000. In short, the plan does not call for and is not intended to produce immediately a more profitable business but a less profitable one; not only less profitable than formerly but less profitable than it is admitted it might be made. The apparent immediate effect will be to diminish the value of shares and the returns to shareholders.

It is the contention of plaintiffs that the apparent effect of the plan is intended to be the continued and continuing effect of it and that it is deliberately proposed, not of record and not by official corporate declaration, but nevertheless proposed, to continue the corporation henceforth as a semi-eleemosynary institution and not as a business institution. In support of this contention they point to the attitude and to the expressions of Mr. Henry Ford.

Mr. Henry Ford is the dominant force in the business of the Ford Motor Company. No plan of operations could be adopted unless he consented, and no board of directors can be elected whom he does not favor. One of the directors of the company has no stock. One share was assigned to him to qualify him for the position, but it is not claimed that he owns it. A business, one of the largest in the world, and one of the most profitable, has been built up. It employs many men, at good pay.

"My ambition," said Mr. Ford, "is to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this we are putting the greatest share of our profits back in the business."

"With regard to dividends, the company paid sixty per cent. on its capitalization of two million dollars, or $1,200,000, leaving $58,000,000 to reinvest for the growth of the company. This is Mr. Ford's policy at present, and it is understood that the other stockholders cheerfully accede to this plan."

The record, and especially the testimony of Mr. Ford, convinces that he has to some extent the attitude towards shareholders of one who has dispensed and distributed to them large gains and that they should be content to take what he chooses to give. His testimony creates the impression, also, that he thinks the Ford Motor Company has made too much money, has had too large profits, and that although large profits might be still earned, a sharing of them with the public, by reducing the price of the output of the company, ought to be undertaken. We have no doubt that certain sentiments, philanthropic and altruistic, creditable to Mr. Ford, had large influence in determining the policy to be pursued by the Ford Motor Company — the policy which has been herein referred to.

It is said by his counsel that:

> "Although a manufacturing corporation cannot engage in humanitarian works as its principal business, the fact that it is organized for profit does not prevent the existence of implied powers to carry on with humanitarian motives such charitable works as are incidental to the main business of the corporation."

We do not draw in question, nor do counsel for the plaintiffs do so, the validity of the general propositions stated by [Ford's counsel] nor the soundness of the opinions cited [by Ford's counsel]. The case presented here is not like any of them. The difference between an incidental humanitarian expenditure of corporate funds for the benefit of the employees, like the building of a hospital for their use and the employment of agencies for the betterment of their condition, and a general purpose and plan to benefit mankind at the expense of others, is obvious. There should be no confusion (of which there is evidence) of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his codirectors owe to protesting, minority stockholders. 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 nondistribution of profits among stockholders in order to devote them to other purposes.

There is committed to the discretion of directors, a discretion to be exercised in good faith, the infinite details of business, including the wages which shall be paid to employees, the number of hours they shall work, the conditions under which labor shall be carried on, and the prices for which products shall be offered to the public. It is said by appellants that the motives of the board members are not material and will not be inquired into by the court so long as their acts are within their lawful powers. As we have pointed out, and the proposition does not require argument to sustain it, it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others, and no one will contend that if the avowed purpose of the defendant directors was to sacrifice the interests of shareholders it would not be the duty of the courts to interfere.

We are not, however, persuaded that we should interfere with the proposed expansion of the business of the Ford Motor Company. In view of the fact that the selling price of products may be increased at any time, the ultimate results of the larger business cannot be certainly estimated. The judges are not business experts. It is recognized that plans must often be made for a long future, for expected competition, for a continuing as well as an immediately profitable venture. The experience of the Ford Motor Company is evidence of capable management of its affairs. It may be noticed, incidentally, that it took from the public the money required for the execution of its plan and that the very considerable salaries paid to Mr. Ford and to certain executive officers and employees were not diminished. We are not satisfied that the alleged motives of the directors, in so far as they are reflected in the conduct of the business, menace the interests of shareholders. It is enough to say, perhaps, that the court of equity is at all times open to complaining shareholders having a just grievance.

The decree of the court below fixing and determining the specific amount to be distributed to stockholders is affirmed. In other respects, except as to the allowance of costs, the said decree is reversed.

SOME DISCUSSION QUESTIONS:

1. The Dodge brothers make for interesting plaintiffs here. What business were the Dodge brothers engaged in? Are they really, truly concerned with the success and profit of the Ford Corporation? What do you think is going on here?

2. The Dodge brothers argue that buying the plants, reducing the car prices, and suspending the dividends are all unlawful abdications of the corporation's responsibility to profit. Which of them looks most like the abandonment of profit? Which claim wins, though?

3. Is there an argument that Ford was actually engaged in self-dealing with regard to his grandiose plans?

4. If Ford had said "yeah, I'm reinvesting this money into my workforce to make them more productive and lowering prices to build goodwill, both of which will make more money for the corporation in the future", would that have worked? (In other words, is this just about reciting the appropriate "magic words" to justify managerial decisions?)

DODGE V. FORD is seen as the leading case endorsing a view called "shareholder primacy" — that a corporation must be run for the benefit of the shareholders. Developed first as a reason to curtail managerial discretion,[1] it was later taken up as a reason to oppose the idea of corporate social responsibility. This view, most closely associated with economist Milton Friedman, makes the reasonable point that if shareholders want to use *their* money to promote socially responsible activity, they are free to do so, but that a corporation's money should be used for the benefit of the corporation (and its shareholders). In making this point, however, the advocates for "shareholder primacy" more or less merged it with the idea of "shareholder wealth maximization" — the idea that generating the largest amount of profit (within the bounds of the law) is the sole goal of shareholders and thus the sole purpose of the corporation.

[1] A position associated with the early corporate law scholars Adolf Berle and Gardiner Means, who felt that excessive management power was depressing shareholder returns and that shareholders deserved more power in the corporation.

However, as Thomas E. Rutledge (among many others[2]) has pointed out, in the ensuing decades after *Dodge v. Ford* no court or legislature has ever formalized shareholder wealth maximization as a duty:

[2] Including liberal law professor Lynn Stout, conservative law professor Stephen A. Bainbridge, former Chief Justice of the Delaware Supreme Court Leo Strine, sitting Supreme Court Justice Sam Alito ... all of my peers, basically.

> While typically every "Business Associations" class will include a review of the decision rendered in *Dodge v. Ford*, a nearly century old decision of the Michigan Supreme Court, what is seldom identified is the fact that this case is nearly unique in espousing the shareholder wealth maximization principal. A review of the commentary espousing current shareholder wealth maximization as a norm implicitly acknowledges that shareholder wealth maximization is not an existing binding obligation, but is rather more in the nature of a proposal. The recent prominence of the shareholder wealth maximization obligation can be traced not to either statutory or case law, but rather to commentary substantially beginning with a short article by Milton Friedman and from there developed in the "law and economics" scholarship.[1]

[1] Thomas E. Rutledge. The 2017 Amendments to Kentucky's Business Entity Statutes. University of Louisville Law Review, 56(1):55–82, 2017

Not only does shareholder wealth maximization not really exist as a legal obligation, but it is hard to understand how exactly it *could* fit with the rest of corporate law. Shareholder wealth maximization proponents are put in the awkward position of having to simultaneously argue that:

- A corporation's actual shareholders (who often want corporations they invest in to be socially responsible, environmentally friendly, culturally tolerant, etc., etc.) should not have the power to decide what is in the best interests of the corporation; but also that
- A corporation's managers (who often want the corporations they run to be socially responsible, environmentally friendly, culturally tolerant, etc., etc.) should not have the power to decide what is in the best interests of the corporation.[2]

[2] Note that at the end of a corporation's independent existence, *Revlon* duties do operate to override management discretion and require management to get the best possible price in a sale of the corporation. This does not, however, create a legal duty to maximize shareholder wealth for a going concern.

In rejecting both shareholder primacy and board supremacy in order to enforce this profit-maximizing norm, these advocates leave precisely nobody in charge of the corporation, a situation rejected by both the yin (shareholder democracy) and yang (board discretion) of corporate law. The argument for shareholder profit maximization is, in short, legally silly.

On a practical level, however, it is not an unpersuasive argument. If I invest my money in a corporation, I expect a monetary return; if the Ford Motor Company[3] were to tell me that instead of giving me a dividend they're planting a tree in my name, I'd probably tell them to fuck off with that tree shit and demand that they pay me. (I'm already mad at Tim Apple for not giving me some of the $200 billion or so that Apple is just sitting on.) In the following case, the court considers a modern twist on *Dodge v. Ford*: what happens when the freewheeling collaborative culture of the early internet collides with the monopolistic world-eating-behemoth-creating culture of the new Silicon Valley?

[3] Which I own shares in, as an homage to the Dodge brothers.

eBay Domestic Holdings Inc. v. Newmark, 16 A.3d 1 (Del. Ch. 2010)

Chandler, Ch.[1]

[1] FYI, this is the same judge that decided *In re eBay*. Lotsa eBay in this dude's life.

On June 29, 2007, eBay launched the online classifieds site www.Kijiji.com in the United States. eBay designed Kijiji to compete with www.craigslist.org, the most widely used online classifieds site in the United States, which is owned and operated by craigslist, Inc. ("craigslist" or "the Company"). At the time of Kijiji's launch, eBay owned 28.4% of craigslist and was one of only three craigslist stockholders. The other two stockholders were Craig Newmark ("Craig") and James Buckmaster ("Jim"), who together own a majority of craigslist's shares and dominate the craigslist board. eBay purchased its stake in craigslist in August 2004 pursuant to the terms of a stockholders' agreement between Jim, Craig, craigslist, and eBay that expressly permits eBay to compete with craigslist in the online classifieds arena. Under the stockholders' agreement, when eBay chose to compete with craigslist by launching Kijiji, eBay lost certain contractual consent rights that gave eBay the right to approve or disapprove of a variety of corporate actions at craigslist. Another consequence of eBay's choice to compete with craigslist, however, was that the craigslist shares eBay owns were freed of the right of first refusal Jim and Craig had held over the shares, and the shares became freely transferable.

Notwithstanding eBay's express right to compete, Jim and Craig were not enthusiastic about eBay's foray into online classifieds. Accordingly, they asked eBay to sell its stake in craigslist, indicating a preference that eBay either sell its craigslist shares back to the Company or to a third party who would be compatible with Jim, Craig, and craigslist's unique corporate culture. When eBay refused to sell, Jim and Craig deliberated with outside counsel for six months about how to respond. Finally, on January 1, 2008, Jim and Craig, acting in their capacity as directors, responded by (1) adopting a rights plan that restricted eBay from purchasing additional craigslist shares and hampered eBay's ability to freely sell the craigslist shares it owned to third parties, (2) implementing a staggered board that made it impossible for eBay to unilaterally elect a director to the craigslist board, and (3) seeking to obtain a right of first refusal in craigslist's favor over the craigslist shares eBay owns by offering to issue one new share of craigslist stock in exchange for every five shares over which any craigslist stockholder granted a right of first refusal in craigslist's favor. As to the third measure, Jim and Craig accepted the right of first refusal offer in their capacity as craigslist stockholders and received new shares; eBay, however, declined the offer, did not receive new shares, and had its ownership in craigslist diluted from 28.4% to 24.9%.

eBay filed this action challenging all three measures on April 22, 2008.

eBay asserts that, in approving and implementing each measure, Jim and Craig, as directors and controlling stockholders, breached the fiduciary duties they owe to eBay as a minority stockholder of the corporation. After lengthy discovery and pre-trial motion practice, the Court held an extensive nine-day trial from December 7, 2009 to December 17, 2009. During trial, the parties examined nine live witnesses, offered seven witnesses by deposition, and presented over one thousand exhibits. The parties completed post-trial briefing on May 14, 2010. I conclude that Jim and Craig breached the fiduciary duties they owe to eBay by adopting the rights plan and by making the right of first refusal offer. I order rescission of these two measures. I also conclude that Jim and Craig did not breach the fiduciary duties they owe to eBay by implementing a staggered board. Accordingly, I leave that measure undisturbed, and craigslist may continue to operate with a staggered board.

Since the time the parties completed their post-trial briefing, I have examined carefully the briefs, exhibits, deposition testimony and trial transcript. I have also reflected at length on my observations of witness testimony during trial, including my impressions regarding the credibility and demeanor of each witness. The following are my findings of the relevant facts in this dispute, based on evidence introduced at trial and my post-trial review.

Oil and Water

In 1995, two individuals in northern California began to develop modest ideas that would take hold in cyberspace and grow to become household names. Craig Newmark, founder of craigslist, started an email list for San Francisco events that in time has morphed into the most-used classifieds site in the United States. Pierre Omidyar, founder of eBay, Inc., started an online auction system that has grown to become one of the largest auction and shopping websites in the United States. As they grew, both companies expanded overseas and established a presence in international markets.

Now, even though both companies enjoy household-name status, craigslist and eBay are, to put it mildly, different animals. Indeed, the two companies are a study in contrasts, with different business strategies, different cultures, and different perspectives on what it means to run a successful business. It is curious these two companies ever formed a business relationship. Each, however, felt it had something to offer to and gain from the other. Thus, despite all differences, eBay and craigslist formed a relationship.

The dissimilarities between these two companies drive this dispute, so I will spend a moment discussing them. I will begin with craigslist. Though a for-profit concern, craigslist largely operates its business as a community service. Nearly all classified advertisements are placed on craigslist free of charge. Moreover, craigslist does not sell advertising space on its website to third parties. Nor does craigslist advertise or otherwise market its services, craigslist's revenue stream consists solely of fees for online job postings in certain cities and apartment listings in New York City.

Despite ubiquitous name recognition, craigslist operates as a small business. It is headquartered in an old Victorian house in a residential San Francisco neighborhood. It employs approximately thirty-four employees. It is privately held and has never been owned by more than three stockholders at a time. It is not subject to the reporting requirements of federal securities laws, and its financial statements are not in the public domain. It keeps its internal business data, such as detailed site metrics, confidential.

Almost since its inception, the craigslist website has maintained the same consistent look and simple functionality. Classified categories the site offers are broad (for example, antiques, personal ads, music gigs, and legal services), but craigslist has largely kept its focus on the classifieds business. It has not forayed into ventures beyond its core competency in classifieds, craigslist's management team—consisting principally of defendants Jim, CEO and President of craigslist, and Craig, Chairman and Secretary of the craigslist board—is committed to this community-service approach to doing business. They believe this approach is the heart of craigslist's business. For most of its history, craigslist has not focused on "monetizing" its site. The relatively small amount of monetization craigslist has pursued (for select job postings and apartment listings) does not approach what many craigslist competitors would consider an optimal or even minimally acceptable level. Nevertheless, craigslist's unique business strategy continues to be successful, even if it does run counter to the strategies used by the titans of online commerce. Thus far, no competing site has been able to dislodge craigslist from its perch atop the pile of most-used online classifieds sites in the United States, craigslist's lead position is made more enigmatic by the fact that it maintains its dominant market position with small-scale physical and human capital. Perhaps the most mysterious thing about craigslist's continued success is the fact that craigslist does not expend any great effort seeking to maximize its profits or to monitor its competition or its market share.

Now to eBay. Initially a venture with humble beginnings, eBay has grown to be a global enterprise. eBay is a for-profit concern that operates its business with an eye to maximizing revenues, profits, and market share. Sellers who use eBay's site pay eBay a commission on each sale. These commissions formed the initial revenue stream for eBay, and they continue to be an important source of revenue today. Over the years eBay has tapped other revenue sources, expanding its product and service offerings both internally and through acquisitions of online companies such as PayPal, Skype, Half.com, and Rent.com. eBay advertises its services and actively seeks to drive web traffic to its sites. It has a large management team and a formal management structure. It employs over 16,000 people at multiple locations around the world. It actively monitors its competitive market position. Its shares trade on the NASDAQ. It maintains a constant focus on monetization, turning online products and services into revenue streams. In terms of business objectives, eBay is vastly different from craigslist; eBay focuses on generating income from each of the products and services it offers rather than from only a small subset of services. It might be said that "eBay" is a moniker for monetization, and that "craigslist" is anything but.

Analysis

I will review Jim and Craig's adoption of the Rights Plan using the intermediate standard of enhanced scrutiny, typically referred to as the *Unocal* test. Framed generally, enhanced scrutiny "requires directors to bear the burden to show their actions were reasonable." The directors must "(1) identify the proper corporate objectives served by their actions; and (2) justify their actions as reasonable in relationship to those objectives."

Enhanced scrutiny has been applied universally when stockholders challenge a board's use of a rights plan as a defensive device. In the typical scenario, the decision to deploy a rights plan will fall within the range of reasonableness if the directors use the plan in a good faith effort to promote stockholder value. For example, the Delaware Supreme Court originally validated the use of a rights plan so that boards could protect target stockholders from two-tiered, front-end loaded, structurally coercive offers. Subsequent case law has established that a board can use the protection of a rights plan to respond to an underpriced bid, counter the tender offeror's timing and informational advantages, and force the hostile acquirer to negotiate with the board. What remains fairly litigable is the degree to which a board can keep the shield of a rights plan in place under the situationally specific circumstances of a given case. A board similarly can use a rights plan creatively to protect the value of a corporate asset for the benefit of its stockholders or to block a creeping takeover. Using a rights plan to promote stockholder value is a legitimate exercise of board authority that accords with the directors' fiduciary duties.

Like any strong medicine, however, a pill can be misused. The Delaware Supreme Court understood from the outset that a rights plan can be deployed inappropriately to benefit incumbent managers and directors at the stockholders' expense. Therefore when deploying a rights plan, "directors must at minimum convince the court that they have not acted for an inequitable purpose." And more than mere subjective good faith is required. Human judgment can be clouded by subtle influences like the prestige and perquisites of board membership, personal relationships with management, or animosity towards a bidder. Because of the omnipresent specter that directors could use a rights plan improperly, even when acting subjectively in good faith, *Unocal* and its progeny require that this Court also review the use of a rights plan objectively. Like other defensive measures, a rights plan cannot be used preclusively or coercively; nor can its use fall outside the "range of reasonableness."

This case involves a unique set of facts heretofore not seen in the context of a challenge to a rights plan. To my knowledge, no decision under Delaware law has addressed a challenge to a rights plan adopted by a privately held company with so few stockholders. The ample case law addressing rights plans almost invariably involves publicly traded corporations with a widely dispersed, potentially disempowered, and arguably vulnerable stockholder base. In cases involving rights plans to date, Delaware courts have typically and understandably approved the use of rights plans to remedy the collective action problems that stockholders face, including but not limited to the classically coercive prisoner's dilemma imposed by a two-tiered offer. At the same time, Delaware courts have guarded against the overt risk of entrenchment and the less visible, yet more pernicious risk that incumbents acting in subjective good faith might nevertheless deprive stockholders of value-maximizing opportunities.

In this unique case, I do not face those same concerns. Jim and Craig are not dispersed, disempowered, or vulnerable stockholders. They are the majority. Jim and Craig are not using the Rights Plan improperly to preclude craigslist stockholders from considering and opting for a value-maximizing transaction. As the majority, Jim and Craig can consider and opt-for a value-maximizing transaction whenever they want.

Nor are Jim and Craig using the Rights Plan to protect their board seats. Together Jim and Craig own an overwhelming majority of craigslist's voting power, and they have entered into the Jim-Craig Voting Agreement which ensures that each votes the other onto the board. If eBay were to sell its entire interest in craigslist to some third party, that third party would not be able to unseat either Jim or Craig because, like eBay, it would only own a minority interest. Neither eBay nor any third party who might purchase eBay's craigslist shares could threaten Jim or Craig with a proxy fight. Under their voting agreement, Jim cannot grant a proxy to unseat Craig, and Craig cannot grant a proxy to unseat Jim. Furthermore, as rationally self-interested actors, Jim and Craig will not give someone a proxy to unseat themselves.

These unique factors do not, however, eliminate *Unocal*'s usefulness. *Unocal* has correctly been described as "the most innovative and promising" case in our corporation law and one whose insights "will [] continue to resonate with judges." The intermediate standard of review is not limited to the historic and now classic paradigm. Fiduciary duties apply regardless of whether a corporation is "registered and publicly traded, dark and delisted, or closely held." It is entirely possible that the board of a closely held company such as craigslist could deploy a rights plan improperly. The Unocal standard of review is best equipped to address this concern.

Thus, the two main issues I confront are: First, did Jim and Craig properly and reasonably perceive a threat to craigslist's corporate policy and effectiveness? Second, if they did, is the Rights Plan a proportional response to that threat?

As discussed above, there are several recognized and accepted corporate purposes for adopting a rights plan. Nevertheless, there is no formal exhaustive list of valid reasons for doing so. As Vice Chancellor Noble demonstrated earlier this year, the Court of Chancery is mindful of changing conditions in the corporate world that may warrant the Court's recognition of a new, valid corporate purpose for adopting a rights plan. In that spirit, I have carefully considered Jim and Craig's contentions in this case and the evidence they presented in support of those contentions. I conclude, based on all of the evidence, that Jim and Craig in fact did not adopt the Rights Plan in response to a reasonably perceived threat or for a proper corporate purpose.

Jim and Craig contend that they identified a threat to craigslist and its corporate policies that will materialize after they both die and their craigslist shares are distributed to their heirs. At that point, they say, "eBay's acquisition of control [via the anticipated acquisition of Jim or Craig's shares from some combination of their heirs] would fundamentally alter craigslist's values, culture and business model, including departing from [craigslist's] public-service mission in favor of increased monetization of craigslist." To prevent this unwanted potential future reality, Jim and Craig have adopted the Rights Plan now so that their vision of craigslist's culture can bind future fiduciaries and stockholders from beyond the grave. Having given new meaning to the concept of a "dead-hand pill," Jim and Craig ask this Court to validate their attempt to use a pill to shape the future of the space-time continuum.

It is true that on the unique facts of a particular case – *Paramount Communications, Inc. v. Time Inc.* – this Court and the Delaware Supreme Court accepted defensive action by the directors of a Delaware corporation as a good faith effort to protect a specific corporate culture. It was a muted embrace. Chancellor Allen wrote only that he was "not persuaded that there may not be instances in which the law might recognize as valid a perceived threat to a 'corporate culture' that is shown to be palpable (for lack of a better word), distinctive and advantageous." This conditional, limited, and double-negative-laden comment was offered in a case that involved the journalistic independence of an iconic American institution. Even in that fact-specific context, the acceptance of the amorphous purpose of "cultural protection" as a justification for defensive action did not escape criticism.

More importantly, *Time* did not hold that corporate culture, standing alone, is worthy of protection as an end in itself. Promoting, protecting, or pursuing non-stockholder considerations must lead at some point to value for stockholders. When director decisions are reviewed under the business judgment rule, this Court will not question rational judgments about how promoting non-stockholder interests – be it through making a charitable contribution, paying employees higher salaries and benefits, or more general norms like promoting a particular corporate culture – ultimately promote stockholder value. Under the *Unocal* standard, however, the directors must act within the range of reasonableness.

Ultimately, defendants failed to prove that craigslist possesses a palpable, distinctive, and advantageous culture that sufficiently promotes stockholder value to support the indefinite implementation of a poison pill. Jim and Craig did not make any serious attempt to prove that the craigslist culture, which rejects any attempt to further monetize its services, translates into increased profitability for stockholders. I am sure that part of the reason craigslist is so popular is because it offers a free service that is also extremely useful. It may be that offering free classifieds is an essential component of a successful online classifieds venture. After all, by offering free classifieds, craigslist is able to attract such a large community of users that real estate brokers in New York City gladly pay fees to list apartment rentals in order to access the vast community of craigslist users. Likewise, employers in select cities happily pay fees to advertise job openings to craigslist users. Neither of these fee-generating activities would have been possible if craigslist did not provide brokers and employers access to a sufficiently large market of consumers, and brokers and employers may not have reached that market without craigslist's free classifieds.

Giving away services to attract business is a sales tactic, however, not a corporate culture. Jim, Craig, and the defense witnesses advisedly described craigslist's business using the language of "culture" because that was what carried the day in *Time*. To the extent business measures like loss-leading products, money-back coupons, or putting products on sale are cultural artifacts, they reflect the American capitalist culture, not something unique to craigslist. Having heard the evidence and judged witness credibility at trial, I find that there is nothing about craigslist's corporate culture that *Time* or *Unocal* protects. The existence of a distinctive craigslist "culture" was not proven at trial. It is a fiction, invoked almost talismanically for purposes of this trial in order to find deference under *Time*'s dicta.

The defendants also failed to prove at trial that when adopting the Rights Plan, they concluded in good faith that there was a sufficient connection between the craigslist "culture" (however amorphous and intangible it might be) and the promotion of stockholder value. No evidence at trial suggested that Jim or Craig conducted any informed evaluation of alternative business strategies or tactics when adopting the Rights Plan. Jim and Craig simply disliked the possibility that the Grim Reaper someday will catch up with them and that a company like eBay might, in the future, purchase a controlling interest in craigslist. They considered this possible future state unpalatable, not because of how it affects the value of the entity for its stockholders, but rather because of their own personal preferences. Jim and Craig therefore failed to prove at trial that they acted in the good faith pursuit of a proper corporate purpose when they deployed the Rights Plan. Based on all of the evidence, I find instead that Jim and Craig resented eBay's decision to compete with craigslist and adopted the Rights Plan as a punitive response. They then cloaked this decision in the language of culture and post mortem corporate benefit. Although Jim and Craig (and the psychological culture they embrace) were the only known beneficiaries of the Rights Plan, such a motive is no substitute for their fiduciary duty to craigslist stockholders.

Jim and Craig did prove that they personally believe craigslist should not be about the business of stockholder wealth maximization, now or in the future. As an abstract matter, there is nothing inappropriate about an organization seeking to aid local, national, and global communities by providing a website for online classifieds that is largely devoid of monetized elements. Indeed, I personally appreciate and admire Jim's and Craig's desire to be of service to communities. The corporate form in which craigslist operates, however, is not an appropriate vehicle for purely philanthropic ends, at least not when there are other stockholders interested in realizing a return on their investment. Jim and Craig opted to form craigslist, Inc. as a for-profit Delaware corporation and voluntarily accepted millions of dollars from eBay as part of a transaction whereby eBay became a stockholder. Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. The "Inc." after the company name has to mean at least that. Thus, I cannot accept as valid for the purposes of implementing the Rights Plan a corporate policy that specifically, clearly, and admittedly seeks not to maximize the economic value of a for-profit Delaware corporation for the benefit of its stockholders – no matter whether those stockholders are individuals of modest means or a corporate titan of online commerce. If Jim and Craig were the only stockholders affected by their decisions, then there would be no one to object. eBay, however, holds a significant stake in craigslist, and Jim and Craig's actions affect others besides themselves.

Some discussion questions:

1. Why were eBay's actions not a breach of the duty of loyalty?

2. Why does the Court reject craigslist's "corporate culture" as a reason to enact defensive measures? Culture and concerns about the future of a business have been held to be valid reasons under a *Unocal* analysis before, so why not now?

B-Corps

In order to avoid conflicts about whether boards can consider stakeholders, many states (including Delaware and Kentucky) adopted a "public benefit corporation" statute that explicitly allows corporations to articulate a public benefit purpose (a benefit of an "artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific, or technological nature") and allows directors to consider that purpose when making corporate decisions.[1] Note that these statutes do not *create* any new duties for directors, however, other than having to produce periodic reports about how the corporation is fulfilling its beneficial purpose. Neither shareholders nor stakeholders may sue management of a B-Corp for failing to meet its social obligations.

How are these public benefit corporations different than traditional corporations? Maybe — and I'm not alone in thinking this — they aren't. Existing corporate law already gives managers broad discretion to consider stakeholder constituencies, along with intangibles like goodwill and reputation and morale. Moreover, outside of your *Dodge v. Ford* outlier cases, managers have no requirement to distribute profits to shareholders. In addition, pretty much everything covered by a stated "beneficial purpose" would already be protected by the business judgment rule, and nothing is stopping a corporation's shareholders from amending the corporate charter to add a binding "corporate purpose" under current law.[2]

In 2019, the Business Roundtable — a lobbyist group for CEOs of major corporations[3] — essentially made this point when it issued a new "Statement on the Purpose of a Corporation." Rather than argue that only a public benefit corporation could consider stakeholder

[1] Not to be confused with a "Certified B-Corp", which is a third party certification done by an NGO called "B Labs" (which collects dues for the certification). B Labs examines whether the corporation undertakes socially beneficial policies and has a good governance structure – but it is not actually a legally meaningful status.

[2] B-Corps, in all honesty, seem like the product of the typical liberal defensive-crouch-style politics, where rather than challenge their opponents' incorrect framing (here, the shareholder wealth maximization norm), they capitulate in advance and put forward a toothless yet pluralistic "solution" that does next to nothing. "Civil unions" but make it corporate, basically.

[3] A bunch of Marxists, obviously.

interests, the group (which heretofore was most notable for arguing for lower corporate taxes and fewer regulations) endorsed a broader conception of a corporation's mandate.

Statement on the Purpose of a Corporation

America's economic model, which is based on freedom, liberty and other enduring principles of our democracy,[1] has raised standards of living for generations, while promoting competition, consumer choice and innovation. America's businesses have been a critical engine to its success.

[1] "Colonialism", "exploitation" and "violence" got cut from the first draft.

Yet we know that many Americans are struggling. Too often hard work is not rewarded, and not enough is being done for workers to adjust to the rapid pace of change in the economy. If companies fail to recognize that the success of our system is dependent on inclusive long-term growth, many will raise legitimate questions about the role of large employers in our society.

With these concerns in mind, Business Roundtable is modernizing its principles on the role of a corporation.

Since 1978, Business Roundtable has periodically issued Principles of Corporate Governance that include language on the purpose of a corporation. Each version of that document issued since 1997 has stated that corporations exist principally to serve their shareholders. It has become clear that this language on corporate purpose does not accurately describe the ways in which we and our fellow CEOs endeavor every day to create value for all our stakeholders, whose long-term interests are inseparable.

We therefore provide the following Statement on the Purpose of a Corporation, which supersedes previous Business Roundtable statements and more accurately reflects our commitment to a free market economy that serves all Americans. This statement represents only one element of Business Roundtable's work to ensure more inclusive prosperity, and we are continuing to challenge ourselves to do more.

Just as we are committed to doing our part as corporate CEOs, we call on others to do their part as well. In particular, we urge leading investors to support companies that build long-term value by investing in their employees and communities.

Americans deserve an economy that allows each person to succeed through hard work and creativity and to lead a life of meaning and dignity. We believe the free-market system is the best means of generating good jobs, a strong and sustainable economy, innovation, a healthy environment and economic opportunity for all.

Businesses play a vital role in the economy by creating jobs, fostering innovation and providing essential goods and services. Businesses make and sell consumer products; manufacture equipment and vehicles; support the national defense; grow and produce food; provide health care; generate and deliver energy; and offer financial, communications and other services that underpin economic growth.

> While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to:
>
> - Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.
> - Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.
> - Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.
> - Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.
> - Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.
> - Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.

Some discussion questions:

1. The letter is signed by the executives of insurance companies, banks, investment funds, and many large corporations — at least two of which have massive asbestos liabilities, and at least five of which are in the business of drilling for and selling fossil fuels. For which firms is this sort of social responsibility actually important? For which firms is this just marketing?

2. What prevents a shareholder of one of these corporations from suing the CEO for violating their fiduciary duties by endorsing this fundamentally anti-shareholder position?

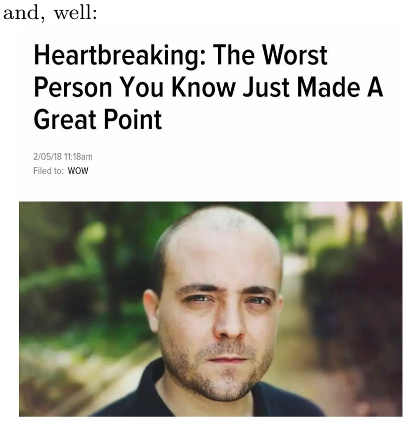
ESG Investing

Environmental/Social/Governance (ESG) investing is the new new hotness. Investing according to ESG principles means choosing to invest in corporations that are engaged in “sustainable growth”, which functionally means that the demand for investment will be higher for corporations that are taking steps to address pollution and climate change ("environmental"), on the one hand, and/or ameliorate various forms of global inequality ("social") on the other.[1] The idea behind ESG investing is — depending on who you ask — either that (a) those corporations are being good corporate citizens and they should be rewarded for such, or (b) those corporations are smartly positioning themselves for higher-than-average profits in the future. Reacting to investor demand for ESG opportunities, organizations started ranking companies by how well they address ESG matters, which include things like managing environmental risk, protecting natural resources, promoting human rights, offering livable wages, making sure that the products the company sells are safe, committing to anti-discrimination policies, and so on and so forth.

[1] The "governance" part was sort of tacked on there. Ensuring one-share-one-vote corporate governance structures and low thresholds for calling special meetings doesn't really move the needle for a lot of people.

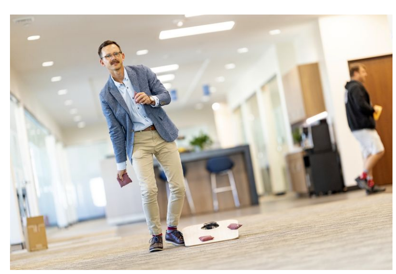
ESG investing is a huge and growing business, and it is not without controversy. First, ESG ratings are extremely subjective, and can be prone to inaccuracy and manipulation.[2] Second, because this sort of investment strategy has an obvious liberal tilt, ambitious politicians (primarily in Texas and Florida, but it may very well spread) have tried to gin up a backlash to ESG investing as a sort of business-class culture war, claiming that it is the result of "woke corporations" run amok and that it raises the cost of capital for their beloved fossil fuel industry. It's not entirely clear how they would legally stop ESG investing — do corporations have a constitutional right to a certain interest rate on their corporate bonds, or what? — and it is not entirely clear under what authority they would restrict the private investment decisions of individual investors, but they're trying, man ... they're trying.

[2] Elon Musk, of all people, has been banging this drum for a while now, and, well:



A broadly liberal-ish form of ESG investing isn't the only game in town, however. There are other forms of ESG investing that bring different sets of principles to the same ultimately doomed attempt to reconcile human values with the brutal realities of capitalism. Let's take a look at one!

> **What Would Jesus Buy: Investor Charts Course for $2 Billion Fund**
>
> It's a good day on Wall Street, high temple of Mammon, when Robert Netzly proclaims the power of God.
>
> At 4 p.m. New York time, 2 p.m. here in Idaho, Netzly takes a break after the market close, gathers his analysts and sales reps and turns to the Book of Romans. He's been praying on a question you never hear on the Street: What would Jesus buy?
>
> Netzly has his list: 24,000-or-so stocks that do and don't conform to his reading of the Bible. A hard no: Amazon.com Inc. Never mind that its stock has appreciated 845% in 10 years. Amazon supports LBGTQ



coastal hipster or youth pastor?

rights and, post-Roe, is covering employees' travel expenses for abortions—decisions that Netzly, an evangelical Christian whose firm oversees about $2 billion, says disqualify a company from "God's portfolios."

Lloyd Blankfein, the former boss of Goldman Sachs Group Inc., once joked that he was doing God's work. Netzly, a former Wells Fargo wealth adviser, insists he really is doing it. He wants corporate America to answer to a higher CEO, and he's picking stocks such as gunmaker Sturm Ruger & Co.,[1] discount retailer Dollar Tree Inc.[2] and Rupert Murdoch's Fox Corp. to hasten the day.[3]

[1] !
[2] ?
[3] ...

Here in Boise — a fast-growing city of Brooklyn-esque lattes and out-of-state transplants grafted upon deep-red America — Netzly is positioning himself as an evangelical answer to big money. His idea is that the US is so riven by politics, culture, faith and more that even the stock market can tear us apart. Netzly's small firm, Inspire Investing — which follows a strategy that he calls biblically responsible — is part of something larger: a Republican backlash to the trillions of dollars committed to environmental, social and governance investing.

When one thinks about the role corporations play in American life, solving society's problems probably isn't the first thing that springs to mind. Many would argue that companies aren't doing nearly enough, particularly given our overheating planet (Netzly said he cares about the environment but isn't especially worried about climate change). And yet, prominent figures on the right paint ESG as a threat to the nation.

Former US Vice President Mike Pence and Florida Governor Ron DeSantis insist corporate elites are foisting liberal agendas on everyone else—a claim that resonates with the millions of White evangelicals who embraced Donald Trump as president and remain a potent force in US politics. Looming large are hardening positions on race, diversity and reproductive rights.

Enter Inspire Investing. Netzly's seven-year-old firm oversees exchange-traded funds with tickers such as BIBL, BLES, GLRY and WWJD, short for "What Would Jesus Do?" This year, his biggest ETF, Inspire 100 (ticker BIBL), is posting wider losses than the S&P 500.

Until recently, Netzly was marketing a Christian, conservative version of ESG. Now, with Republicans trashing ESG as "woke capitalism," Netzly has stripped the label from his products. He said "hard-left liberal activists" and "Marxists" have "weaponized" the whole idea of investing with a broader purpose.

Where Netzly sees providence, others see prejudice. He dreams of a day when all corporations will hew to his evangelical reading of the Bible. He's aligned himself with Alliance Defending Freedom, an influential conservative Christian group that's fought to limit the separation of church and state and to roll back laws on same-sex marriage and reproductive rights.

"I love my LBGTQ brothers and sisters, I don't want them to be discriminated against," said the 41-year-old Netzly. "But I don't want companies promoting their 'lifestyles.'"

Nearly all of corporate America disagrees, according to Bill George, an executive fellow at Harvard Business School. "Companies represent all employees, and LGBTQ employees are integral to the work force," he said. Almost three quarters of Americans say they support legal same-sex marriage, according to a May poll conducted by Gallup.

Mixing faith and finance can get tricky. But in some ways, religion-oriented investing isn't so different from ESG. The idea dates back to at least the 1700s, when the Quakers forbade their members from owning slaves. Today, a range of faith-driven investment firms — mostly Christian, but Islamic and Jewish too — form an influential fringe industry.[1]

[1] For a Muslim take on religiously motivated investing, check out How to Keep Your Investments Halal.

"They are a niche within a niche," said Todd Rosenbluth, head of research at VettaFi, an ETF data and analytics company. In all, the faith-based firms oversee $139 billion under the broad umbrella of sustainable investments. That's a tiny fraction of the $2.5 trillion of assets in this category industrywide.

Which companies qualify for "God's portfolios" at Inspire? The lines can get blurry. Inspire screens companies by a variety of categories under the "E," "S" and "G" of ESG. But it's the S—social—where things get particularly contentious for Netzly.

Inspire recently singled out the 125-year-old J.M. Smucker Co., best known for its jams and peanut butter, for "choosing LGBTQ+ political activism over wholesome family values." On his website, Netzly urges investors to "push back" with an online petition to Chief Executive Officer Mark Smucker.

Smucker spokesman Frank Cirillo said the company has expressed support for legislation that includes LGBTQ civil rights protections. "We are committed to ensuring equitable rights for our employees, their families and those in the communities we serve," he said.

Netzly urges all investors to heed 1 Corinthians 10:31: Whatever you do, do all to the glory of God. But, so far, his investment performance has been mixed. His largest ETF, Inspire 100 (ticker BIBL) has returned an annualized 8.9% since it opened in 2017, compared with 10.7% for the S&P 500 Index during the same period, with most of the underperformance occurring this year. The Inspire International ETF (WWJD) gained at annual rate of 5% since the start of 2019, exceeding the 1.6% advance of the MSCI ACWI Excluding US Index.

In Netzly's telling, there are huge sums of money at stake. He said Christians in the US have about $20 trillion of investments, savings and retirement accounts.

A few months ago, phones began lighting up at Inspire. Elon Musk, the world's richest person, was attacking ESG as "the devil incarnate."

> DeSantis, the Florida governor and White House hopeful, was piling on. Fox News firebrand Tucker Carlson, along with right-wing radio host Glenn Beck, were blaming ESG for everything from high gasoline prices to economic trouble in Sri Lanka.
>
> If ESG was so bad, Inspire clients wanted to know why was Netzly wrapping himself in label? His answer: "I'm not anymore." He formally renounced the tag and rallied behind the so-called anti-woke campaign.
>
> Netzly demurs when describing what he does as "stakeholder capitalism." That's the label prominent executives have adopted when talking about corporations' broader social purpose. Like ESG, the phrase has been maligned by conservatives.
>
> "It's a loaded term," Netzly said of the phrase. He prefers a different one: Companies, he said, should be a "blessing" to everyone.[1]

[1] Saijel Kishan. What Would Jesus Buy: Investor Charts Course for $2 Billion Fund. Bloomberg, September 2022

Some discussion questions:

1. How, exactly, are these funds "biblically"-oriented? What seems to be the priority for the fund manager?
2. The funds are (so far) underperforming the broader market. Is that gonna be an issue for the anti-ESG crowd? What if an ESG fund outperforms the broader market? (This has happened, btw.) How would the anti-ESG crowd treat that?
3. Is the pious being loved by the gods because it is pious, or is it pious because it is being loved by the gods?

Cards on the Table: The Author's View On All This

> "I want to believe — and so do you — in a complete, transcendent, and immanent set of propositions about right and wrong, findable rules that authoritatively and unambiguously direct us how to live righteously. I also want to believe — and so do you — in no such thing, but rather that we are wholly free, not only to choose for ourselves what we ought to do, but to decide for ourselves, individually and as a species, what we ought to be.
>
> What we want, Heaven help us, is simultaneously to be perfectly ruled and perfectly free, that is, at the same time to discover the right and the good and to create it."[2]

[2] Arthur Allen Leff. Unspeakable Ethics, Unnatural Law. Duke Law Journal, 1979(6):1229, 1979

All of the arguments about corporate social responsibility basically amount to the idea that corporations **must** be bound to the right course of action, which (1) as a matter of law: *nuh uh*; and (2) as a matter of morality: *sez who?* And even if one were to assert that a focus on profit exclusively was the right approach, you'd still be left with a host of unanswerable questions. Namely:

- How are we supposed to know *ex ante* the exact right method to generate profits? Maybe "anti-wokeness" is profitable, but maybe "wokeness" is profitable?[1] How is anyone supposed to definitively know the difference between the profit-reducing and profit-increasing types of socially responsible actions?

[1] Elon Musk appears to be betting on the former when it comes to his management of Twitter. Let's see how that goes for him!

- What's the appropriate timeline for realizing that profit? Even if we are trying to maximize shareholder wealth, which shareholders: present or future?
- Who enforces any of this? With what standard? Is there a naturally occurring baseline rate of profit that corporations or investment funds *should* return to their investors? Are we going to say that it is a breach of fiduciary duty to miss that target?

This entire exercise — and all of the bluster and argumentation — is almost entirely rhetorical, and (as articulated earlier in this chapter) legally *silly*.

How To Use Shareholder/Stakeholder Arguments

This is not to say, however, that this stuff has no use. To wit:

- If you represent an insurgent investor against management, make the case that management has an obligation to *maximize profits*.
  - Unless the insurgent investor is targeting the corporation for ESG reasons, in which case make the case that management has an obligation to *its stakeholders*, not merely to maximize profit.
- If you represent management against an insurgent investor, make the case that management has an obligation to *its stakeholders*, not merely to maximize profit.
  - Unless the insurgent investor wants the corporation to adopt anti-ESG initiatives, in which case argue that management has an obligation to *maximize profits* and ESG initiatives best position the corporation to generate future profits.
- Repeat and modify as needed. (And send me a reasonable percentage of your billables while you're at it.)

Got that? First, take the version of this story you think will work (corporation as shareholder property, corporation as social entity, corporation as an emperor penguin, whatever ...), and run it up the flag pole to see if anyone salutes. Second, take the money your client pays you and use it to buy nice things. You might think I'm being cynical here, but when it comes to this sort of thing you literally cannot be too cynical.

Corporate Political Activity and First Amendment Rights

THERE IS ONE AREA WHERE this silly little slapfight over "what even is a corporation, *really*?" is not strictly rhetorical. When it comes to corporate political activity and the Supreme Court's application of the First Amendment to corporations, the implications of recognizing corporate personhood are quite significant and raise a whole host of questions, none of which will be answered in anything like a coherent or consistent manner. That's politics, baby!

Pre-Citizens United Corporate Political Speech

The Court's treatment of corporate political speech has more or less tracked their general treatment of election-related expenditures in terms of spending and speech. In *First National Bank of Boston v. Bellotti*, 435 U.S. 765 (1978), the Court held that the First Amendment prohibited states from banning corporations from placing political ads for or against a voter referendum. The Court reasoned that if the state *really* wanted to ban the use of corporate money, the state should have *also* banned lobbying by corporations in addition to advertising — a.k.a. the supremely annoying debate-club-bro argument that government action must be all-or-nothing-at-all to be legitimate.[1] In addition, the Court found no evidence that "the relative voice of corporations has been overwhelming or even significant" in influencing state politics, which gives you an idea of how they probably would have handled a ban on corporate lobbying, too.

[1] I believe this rule is codified in the Eleventy-Twelfth Amendment.

More importantly for our purposes, the Court held that worries about compelling shareholders to support political positions they opposed using the corporation's money was not a pressing problem, because ~~the corporation's money does not belong to the shareholders, it belongs to the corporation~~[2] the "procedures of corporate democracy" already give shareholders the power to tell corporate management "whether their corporation should engage in debate on public issues", to which I say: I'm sorry, what? Huh? Did I somehow forget to include a chapter on this amazing mechanism by which shareholders can directly instruct management about how to use corporate treasury funds? Reader: I did not.

[2] Psych! No, it didn't say that — that rationale would have actually made sense.

Later, in *Federal Election Comm'n v. Massachusetts Citizens for Life, Inc. (MCFL)*, 479 U .5. 238 (1986), the Court held that the First Amendment also protected the independent political expenditures of *non-profit* corporations, allowing an anti-abortion non-profit to finance a newsletter to voters supporting certain anti-abortion candidates for election. The Court reasoned that non-profits were "formed for the express purpose of promoting political ideas" — which is pretty close to correct, honestly — and as such held views that were essentially those of the individual members that supported the non-profit. All very reasonable, all very logical, and all very inapplicable to for-profit corporations, which are very much an entity separate and apart from their equity holders.

Finally, the Court reversed its approach in *Bellotti* and held in *Austin v. Michigan Chamber of Commerce*, 494 U.S. 652 (1990), that states could prohibit for-profit corporations from using corporate money for direct campaign contributions or expenditures in support of particular candidates. The law in question effectively prevented for-profit corporations from making political donations and independent expenditures, and also prevented them from funneling their political spending through a third party — in this case, the Michigan Chamber of Commerce. The Court reasoned that because corporations had "unique legal and economic characteristics" bestowed on them by the state, it was appropriate for the state to regulate corporate political spending and prevent the "corrosive and distorting effect of immense aggregations of wealth" that corporations can acquire. The Court also noted that the corporation's political spending may be adverse to the interests of its shareholders and/or its stakeholders, which exacerbates the problem of corporate cash distorting the political marketplace, since those groups do not have the ability to direct spending that corporate management does.

ALL OF THIS WAS A MESS, obviously, but the Supreme Court wasn't done yet. For its next act, the Supreme Court in *Citizens United* addressed the political expenditures of for-profit corporations ... in a case involving a non-profit organization? Distributing a movie? About a candidate who had already lost in the primary? Yeah, okay, sure, why not, go nuts.

Listen, I'm not gonna lie, this decision is — from a corporate law perspective — one of the single dumbest opinions that has ever been written. As a result, I am going to get **especially** insufferable and back-on-my-bullshit in the margins; I'm sorry, I just can't help myself.

I don't know or care about what the First Amendment is supposed to say or do — it has always seemed extremely incoherent to me — but I do know that Anthony Kennedy basically gets everything wrong when it comes to what a corporation is or how a corporation works, and also that Antonin Scalia basically gets everything wrong when it comes to the history of the corporation.

Other than that, Mrs. Lincoln, how was the play?

Citizens United v. Fed. Election Comm'n, 558 U.S. 310 (2010)

Kennedy, J.

Federal law prohibits corporations and unions from using their general treasury funds to make independent expenditures for speech defined as an "electioneering communication" or for speech expressly advocating the election or defeat of a candidate. *Austin v. Michigan Chamber of Commerce* held that political speech may be banned based on the speaker's corporate identity.

It has been noted that *Austin* was a significant departure from ancient First Amendment principles. We agree with that conclusion and hold that stare decisis does not compel the continued acceptance of *Austin*. The Government may regulate corporate political speech through disclaimer and disclosure requirements, but it may not suppress that speech altogether. We turn to the case now before us.

Citizens United is a nonprofit corporation.[1] Citizens United has an annual budget of about $12 million. Most of its funds are from donations by individuals; but, in addition, it accepts a small portion of its funds from for-profit corporations. In January 2008, Citizens United released a film entitled *Hillary: The Movie*.[2] We refer to the film as *Hillary*. It is a 90–minute documentary about then-Senator Hillary Clinton, who was a candidate in the Democratic Party's 2008 Presidential primary elections. *Hillary* mentions Senator Clinton by name and depicts interviews with political commentators and other persons, most of them quite critical of Senator Clinton. *Hillary* was released in theaters and on DVD, but Citizens United wanted to increase distribution by making it available through video-on-demand.[3]

[1] It is also the *de facto* successor to a political action organization called Americans For Bush, which ran the infamous Willie Horton ad in 1988.

[2] Not to be confused with *Hillary's America*, which was released in 2016 when Hillary Clinton was *actually* the Democratic Party nominee.

[3] By the time any of this becomes a real issue, Hillary Clinton's campaign was dead in the water, and nobody at Citizens United had thought to make *Barack: The Movie*, which is a real shame.

To implement the proposal, Citizens United was prepared to pay for the video-on-demand; and to promote the film, it produced two 10–second ads and one 30–second ad for Hillary. Each ad includes a short (and, in our view, pejorative) statement about Senator Clinton, followed by the name of the movie and the movie's Website address. Citizens United desired to promote the video-on-demand offering by running advertisements on broadcast and cable television.

******

Before the Bipartisan Campaign Reform Act of 2002 (BCRA), federal law prohibited — and still does prohibit — corporations and unions from using general treasury funds to make direct contributions to candidates or independent expenditures that expressly advocate the election or defeat of a candidate, through any form of media, in connection with certain qualified federal elections. BCRA § 203 amended § 441b to prohibit any "electioneering communication" as well. An electioneering communication is defined as "any broadcast, cable, or satellite communication" that "refers to a clearly identified candidate for Federal office" and is made within 30 days of a primary or 60 days of a general election.

Citizens United wanted to make Hillary available through video-on-demand within 30 days of the 2008 primary elections. It feared, however, that both the film and the ads would be covered by § 441b's ban on corporate-funded independent expenditures, thus subjecting the corporation to civil and criminal penalties under § 437g. In December 2007, Citizens United sought declaratory and injunctive relief against the FEC. It argued that (1) § 441b is unconstitutional as applied to Hillary; and (2) BCRA's disclaimer and disclosure requirements, BCRA §§ 201 and 311, are unconstitutional as applied to Hillary and to the three ads for the movie.[1]

[1] Citizens United also unsuccessfully argued that the movie was not an "electioneering communication", which like, c'mon, guys, who do you think you're fooling?

Citizens United also asks us to carve out an exception to § 441b's expenditure ban for nonprofit corporate political speech funded overwhelmingly by individuals. As an alternative to reconsidering *Austin*, the Government also seems to prefer this approach. This line of analysis, however, would be unavailing.[2]

[2] In point of fact, this was all the original suit was about — the application of BCRA to non-profit corporations. The Court itself raised the issue of for-profit corporations, and requested further briefing on the issue of whether BCRA could apply to for-profit corporate speech, as well — suggesting that it was in a hurry to reach this particular outcome.

In *MCFL*, the Court found unconstitutional § 441b's restrictions on corporate expenditures as applied to nonprofit corporations that were formed for the sole purpose of promoting political ideas, did not engage in business activities, and did not accept contributions from for-profit corporations or labor unions. Citizens United does not qualify for the *MCFL* exemption, however, since some funds used to make the movie were donations from for-profit corporations. We decline to adopt an interpretation that requires intricate case-by-case determinations to verify whether political speech is banned, especially if we are convinced that, in the end, this corporation has a constitutional right to speak on this subject.

*****

The law before us is an outright ban, backed by criminal sanctions. Section 441b makes it a felony for all corporations — including nonprofit advocacy corporations — either to expressly advocate the election or defeat of candidates or to broadcast electioneering communications within 30 days of a primary election and 60 days of a general election. Thus, the following acts would all be felonies under § 441b: The Sierra Club runs an ad, within the crucial phase of 60 days before the general election, that exhorts the public to disapprove of a Congressman who favors logging in national forests; the National Rifle Association publishes a book urging the public to vote for the challenger because the incumbent U.S. Senator supports a handgun ban; and the American Civil Liberties Union creates a Web site telling the public to vote for a Presidential candidate in light of that candidate's defense of free speech.[3] These prohibitions are classic

[3] Not a single one of those is a for-profit corporation.

examples of censorship.

Section 441b is a ban on corporate speech notwithstanding the fact that a PAC created by a corporation can still speak. A PAC is a separate association from the corporation. So the PAC exemption from § 441b's expenditure ban, § 441b(b)(2), does not allow corporations to speak. Even if a PAC could somehow allow a corporation to speak — and it does not — the option to form PACs does not alleviate the First Amendment problems with § 441b. PACs are burdensome alternatives; they are expensive to administer and subject to extensive regulations.[1] PACs, furthermore, must exist before they can speak. Given the onerous restrictions, a corporation may not be able to establish a PAC in time to make its views known regarding candidates and issues in a current campaign.

[1] So ... are ... corporations?

Section 441b's prohibition on corporate independent expenditures is thus a ban on speech. As a "restriction on the amount of money a person or group can spend on political communication during a campaign," that statute "necessarily reduces the quantity of expression by restricting the number of issues discussed, the depth of their exploration, and the size of the audience reached." *Buckley v. Valeo*.[2] If § 441b applied to individuals, no one would believe that it is merely a time, place, or manner restriction on speech. Its purpose and effect are to silence entities whose voices the Government deems to be suspect.

[2] *Buckley* was the original speech-is-money, suck-it-poors, shoulda-worked-harder campaign finance opinion.

Speech is an essential mechanism of democracy, for it is the means to hold officials accountable to the people. The right of citizens to inquire, to hear, to speak, and to use information to reach consensus is a precondition to enlightened self-government and a necessary means to protect it.[3] Premised on mistrust of governmental power, the First Amendment stands against attempts to disfavor certain subjects or viewpoints. Prohibited, too, are restrictions distinguishing among different speakers, allowing speech by some but not others. As instruments to censor, these categories are interrelated: Speech restrictions based on the identity of the speaker are all too often simply a means to control content.

[3] I think Anthony Kennedy thinks that corporations can vote.

Quite apart from the purpose or effect of regulating content, moreover, the Government may commit a constitutional wrong when by law it identifies certain preferred speakers. By taking the right to speak from some and giving it to others, the Government deprives the disadvantaged person or class of the right to use speech to strive to establish worth, standing, and respect for the speaker's voice.[4] The Government may not by these means deprive the public of the right and privilege to determine for itself what speech and speakers are worthy of consideration. The First Amendment protects speech and speaker, and the ideas that flow from each.

[4] I think Anthony Kennedy thinks that corporations have self-esteem.

We find no basis for the proposition that, in the context of political speech, the Government may impose restrictions on certain disfavored speakers. Both history and logic lead us to this conclusion.

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In its defense of the corporate-speech restrictions in § 441b, the Government notes the antidistortion rationale on which *Austin* and its progeny rest in part, yet it all but abandons reliance upon it. It argues instead that two other compelling interests support *Austin*'s holding that corporate expenditure restrictions are constitutional: an anticorruption interest and a shareholder-protection interest. We consider the three points in turn.

As for *Austin*'s antidistortion rationale,[1] the Government does little to defend it. And with good reason, for the rationale cannot support § 441b. If the First Amendment has any force, it prohibits Congress from fining or jailing citizens, or associations of citizens, for simply engaging in political speech. If the antidistortion rationale were to be accepted, however, it would permit Government to ban political speech simply because the speaker is an association that has taken on the corporate form.

[1] *Austin* found that the government had a compelling interest in preventing "the corrosive and distorting effects of immense aggregations of wealth that are accumulated with the help of the corporate form and that have little or no correlation to the public's support for the corporation's political ideas."

Political speech is indispensable to decisionmaking in a democracy, and this is no less true because the speech comes from a corporation rather than an individual. This protection for speech is inconsistent with *Austin*'s antidistortion rationale. Austin sought to defend the antidistortion rationale as a means to prevent corporations from obtaining an unfair advantage in the political marketplace by using resources amassed in the economic marketplace. But *Buckley* rejected the premise that the Government has an interest "in equalizing the relative ability of individuals and groups to influence the outcome of elections." The rule that political speech cannot be limited based on a speaker's wealth is a necessary consequence of the premise that the First Amendment generally prohibits the suppression of political speech based on the speaker's identity.

Either as support for its antidistortion rationale or as a further argument, the *Austin* majority undertook to distinguish wealthy individuals from corporations on the ground that "[s]tate law grants corporations special advantages — such as limited liability, perpetual life, and favorable treatment of the accumulation and distribution of assets." This does not suffice, however, to allow laws prohibiting speech. "It is rudimentary that the State cannot exact as the price of those special advantages the forfeiture of First Amendment rights."[2] *Austin* (Scalia, J., dissenting).

[2] Wait, *whose* First Amendment rights are being forfeited, exactly?

All speakers, including individuals and the media, use money amassed from the economic marketplace to fund their speech. The First Amendment protects the resulting speech, even if it was enabled by economic transactions with persons or entities who disagree with the speaker's ideas. "Many persons can trace their funds to corporations, if not in the form of donations, then in the form of dividends, interest, or salary". *Austin* (Kennedy, J., dissenting).[1]

Austin's antidistortion rationale would produce the dangerous, and unacceptable, consequence that Congress could ban political speech of media corporations. Media corporations are now exempt from § 441b's ban on corporate expenditures.[2] Yet media corporations accumulate wealth with the help of the corporate form, the largest media corporations have "immense aggregations of wealth," and the views expressed by media corporations often "have little or no correlation to the public's support" for those views. Thus, under the Government's reasoning, wealthy media corporations could have their voices diminished to put them on par with other media entities. There is no precedent for permitting this under the First Amendment.

The media exemption discloses further difficulties with the law now under consideration. There is no precedent supporting laws that attempt to distinguish between corporations which are deemed to be exempt as media corporations and those which are not.[3] With the advent of the Internet and the decline of print and broadcast media, moreover, the line between the media and others who wish to comment on political and social issues becomes far more blurred. And the exemption results in a further, separate reason for finding this law invalid: Again by its own terms, the law exempts some corporations but covers others, even though both have the need or the motive to communicate their views. The exemption applies to media corporations owned or controlled by corporations that have diverse and substantial investments and participate in endeavors other than news. So even assuming the most doubtful proposition that a news organization has a right to speak when others do not,[4] the exemption would allow a conglomerate that owns both a media business and an unrelated business to influence or control the media in order to advance its overall business interest. At the same time, some other corporation, with an identical business interest but no media outlet in its ownership structure, would be forbidden to speak or inform the public about the same issue.[5] This differential treatment cannot be squared with the First Amendment.

The Framers may not have anticipated modern business and media corporations. Yet television networks and major newspapers owned by media corporations have become the most important means of mass communication in modern times. The First Amendment was certainly not understood to condone the suppression of political speech in society's most salient media. It was understood as a response to the repression of speech and the press that had existed in England and the heavy taxes on the press that were imposed in the colonies. At the founding, speech was open, comprehensive, and vital to society's definition of itself; there were

[1] Many persons can trace their funds to the government, if not in the form of salary, then in the form of tax rebates, indirect subsidies, or the maintenance of a system of laws that upholds capitalism.

So fucking what?

[2] And yet, we discuss a purely hypothetical ban on media corporations at length, for reasons.

[3] I mean, doesn't the First Amendment itself do this?

[4] Literally the text of the First Amendment, man.

[5] Actually, this is a halfway decent point about the not-at-all-arms-length relationship between a parent and a subsidiary. Still, seems like the answer is that they need to be treated as separate entities, no? Let's bring veil-piercing to election law!

no limits on the sources of speech and knowledge. The Framers may have been unaware of certain types of speakers or forms of communication, but that does not mean that those speakers and media are entitled to less First Amendment protection than those types of speakers and media that provided the means of communicating political ideas when the Bill of Rights was adopted.[1]

[1] "Ain't no rule says a dog *can't* be a speaker under the First Amendment."

Austin interferes with the "open marketplace" of ideas protected by the First Amendment. It permits the Government to ban the political speech of millions of associations of citizens.[2] Most of these are small corporations without large amounts of wealth. This fact belies the Government's argument that the statute is justified on the ground that it prevents the "distorting effects of immense aggregations of wealth." It is not even aimed at amassed wealth.[3]

[2] Associations of citizens? *This* is what we're calling a for-profit corporation now? THIS?

[3] Oh, I'm sure they'd be cool with it if it was aimed at amassed wealth, though.

When Government seeks to use its full power, including the criminal law, to command where a person may get his or her information or what distrusted source he or she may not hear, it uses censorship to control thought. This is unlawful. The First Amendment confirms the freedom to think for ourselves.[4]

[4] I think Anthony Kennedy thinks that a corporation can think for itself.

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For the most part relinquishing the antidistortion rationale, the Government falls back on the argument that corporate political speech can be banned in order to prevent corruption or its appearance. When *Buckley* identified a sufficiently important governmental interest in preventing corruption or the appearance of corruption, that interest was limited to quid pro quo corruption. The fact that speakers may have influence over or access to elected officials does not mean that these officials are corrupt.

The appearance of influence or access, furthermore, will not cause the electorate to lose faith in our democracy. By definition, an independent expenditure is political speech presented to the electorate that is not coordinated with a candidate. The fact that a corporation, or any other speaker, is willing to spend money to try to persuade voters presupposes that the people have the ultimate influence over elected officials. In fact, there is only scant evidence that independent expenditures even ingratiate. Ingratiation and access, in any event, are not corruption.

When Congress finds that a problem exists, we must give that finding due deference; but Congress may not choose an unconstitutional remedy. If elected officials succumb to improper influences from independent expenditures; if they surrender their best judgment; and if they put expediency before principle, then surely there is cause for concern. We must give weight to attempts by Congress to seek to dispel either the appearance or the reality of these influences. The remedies enacted by law, however, must comply with the First Amendment; and, it is our law and our tradition that more speech, not less, is the governing rule. An outright ban on corporate political speech during the critical preelection period is not a permissible remedy. Here Congress has created categorical bans on speech that are asymmetrical to preventing quid pro quo corruption.

The Government contends further that corporate independent expenditures can be limited because of its interest in protecting dissenting shareholders from being compelled to fund corporate political speech. This asserted interest, like *Austin*'s antidistortion rationale, would allow the Government to ban the political speech even of media corporations. Assume, for example, that a shareholder of a corporation that owns a newspaper disagrees with the political views the newspaper expresses. Under the Government's view, that potential disagreement could give the Government the authority to restrict the media corporation's political speech. The First Amendment does not allow that power. There is, furthermore, little evidence of abuse that cannot be corrected by shareholders "through the procedures of corporate democracy."

Those reasons are sufficient to reject this shareholder-protection interest; and, moreover, the statute is both underinclusive and overinclusive. As to the first, if Congress had been seeking to protect dissenting shareholders, it would not have banned corporate speech in only certain media within 30 or 60 days before an election. A dissenting shareholder's interests would be implicated by speech in any media at any time. As to the second, the statute is overinclusive because it covers all corporations, including nonprofit corporations and for-profit corporations with only single shareholders. As to other corporations, the remedy is not to restrict speech but to consider and explore other regulatory mechanisms. The regulatory mechanism here, based on speech, contravenes the First Amendment.

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Corporations, like individuals, do not have monolithic views. On certain topics corporations may possess valuable expertise, leaving them the best equipped to point out errors or fallacies in speech of all sorts, including the speech of candidates and elected officials. Rapid changes in technology—and the creative dynamic inherent in the concept of free expression—counsel against upholding a law that restricts political speech in certain media or by certain speakers. Today, 30–second television ads may be the most effective way to convey a political message. Soon, however, it may be that Internet sources, such as blogs and social networking Web sites, will provide citizens with significant information about political candidates and issues. Yet, § 441b would seem to ban a blog post expressly advocating the election or defeat of a candidate if that blog were created with corporate funds. The First Amendment does not permit Congress to make these categorical distinctions based on the corporate identity of the speaker and the content of the political speech.

Due consideration leads to this conclusion: *Austin* should be and now is overruled. We return to the principle that the Government may not suppress political speech on the basis of the speaker's corporate identity. No sufficient governmental interest justifies limits on the political speech of nonprofit or for-profit corporations.

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Citizens United next challenges BCRA's disclaimer and disclosure provisions as applied to Hillary and the three advertisements for the movie. Under BCRA § 311, televised electioneering communications funded by anyone other than a candidate must include a disclaimer that "... is responsible for the content of this advertising." The required statement must be made in a "clearly spoken manner," and displayed on the screen in a "clearly readable manner" for at least four seconds. It must state that the communication "is not authorized by any candidate or candidate's committee"; it must also display the name and address (or Web site address) of the person or group that funded the advertisement. Under BCRA § 201, any person who spends more than $10,000 on electioneering communications within a calendar year must file a disclosure statement with the FEC. That statement must identify the person making the expenditure, the amount of the expenditure, the election to which the communication was directed, and the names of certain contributors.

Disclaimer and disclosure requirements may burden the ability to speak, but they "impose no ceiling on campaign-related activities" "do not prevent anyone from speaking."

Citizens United argues that the disclaimer requirements in § 311 are unconstitutional as applied to its ads. It contends that the governmental interest in providing information to the electorate does not justify requiring disclaimers for any commercial advertisements, including the ones at issue here. We disagree. The disclaimers required by § 311 "provid[e] the electorate with information" and "insure that the voters are fully informed" about the person or group who is speaking. At the very least, the disclaimers avoid confusion by making clear that the ads are not funded by a candidate or political party.

The Court has explained that disclosure is a less restrictive alternative to more comprehensive regulations of speech. And the Court has upheld registration and disclosure requirements on lobbyists, even though Congress has no power to ban lobbying itself. For these reasons, we reject Citizens United's contention that the disclosure requirements must be limited to speech that is the functional equivalent of express advocacy.

Last, Citizens United argues that disclosure requirements can chill donations to an organization by exposing donors to retaliation. Some amici point to recent events in which donors to certain causes were blacklisted, threatened, or otherwise targeted for retaliation. The examples cited by amici are cause for concern. Citizens United, however, has offered no evidence that its members may face similar threats or reprisals. To the contrary, Citizens United has been disclosing its donors for years and has identified no instance of harassment or retaliation.[1]

[1] Oh, so NOW we're limiting this opinion to the parties before the court???

Shareholder objections raised through the procedures of corporate democracy can be more effective today because modern technology makes disclosures rapid and informative. A campaign finance system that pairs corporate independent expenditures with effective disclosure has not existed before today. It must be noted, furthermore, that many of Congress' findings in passing BCRA were premised on a system without adequate disclosure. With the advent of the Internet, prompt disclosure of expenditures can provide shareholders and citizens with the information needed to hold corporations and elected officials accountable for their positions and supporters. Shareholders can determine whether their corporation's political speech advances the corporation's interest in making profits, and citizens can see whether elected officials are "in the pocket" of so-called moneyed interests. The First Amendment protects political speech; and disclosure permits citizens and shareholders to react to the speech of corporate entities in a proper way. This transparency enables the electorate to make informed decisions and give proper weight to different speakers and messages.

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When word concerning the plot of the movie *Mr. Smith Goes to Washington* reached the circles of Government, some officials sought, by persuasion, to discourage its distribution. Under *Austin*, though, officials could have done more than discourage its distribution — they could have banned the film. After all, it, like *Hillary*, was speech funded by a corporation that was critical of Members of Congress.[2] Mr. Smith Goes to Washington may be fiction and caricature; but fiction and caricature can be a powerful force.

[2] I think Anthony Kennedy thinks that Jimmy Stewart was an actual congressperson.

Some members of the public might consider *Hillary* to be insightful and instructive; some might find it to be neither high art nor a fair discussion on how to set the Nation's course; still others simply might suspend judgment on these points but decide to think more about issues and candidates.[3] Those choices and assessments, however, are not for the Government to make. "The First Amendment underwrites the freedom to experiment and to create in the realm of thought and speech. Citizens must be free to use new forms, and new forums, for the expression

[3] I think Anthony Kennedy lacks object permanence.

of ideas. The civic discourse belongs to the people, and the Government may not prescribe the means used to conduct it."

Scalia, J., concurring

I write separately to address Justice Stevens' discussion of "Original Understandings". This section of the dissent purports to show that today's decision is not supported by the original understanding of the First Amendment. The dissent attempts this demonstration, however, in splendid isolation from the text of the First Amendment. It never shows why "the freedom of speech" that was the right of Englishmen did not include the freedom to speak in association with other individuals, including association in the corporate form.[1] To be sure, in 1791 (as now) corporations could pursue only the objectives set forth in their charters; but the dissent provides no evidence that their speech in the pursuit of those objectives could be censored.

[1] *rubs temples*

Though faced with a constitutional text that makes no distinction between types of speakers, the dissent feels no necessity to provide even an isolated statement from the founding era to the effect that corporations are not covered, but places the burden on petitioners to bring forward statements showing that they are ("there is not a scintilla of evidence to support the notion that anyone believed [the First Amendment] would preclude regulatory distinctions based on the corporate form").

Even if we thought it proper to apply the dissent's approach of excluding from First Amendment coverage what the Founders disliked, and even if we agreed that the Founders disliked founding-era corporations; modern corporations might not qualify for exclusion. Most of the Founders' resentment towards corporations was directed at the state-granted monopoly privileges that individually chartered corporations enjoyed.

Modern corporations do not have such privileges, and would probably have been favored by most of our enterprising Founders[2] — excluding, perhaps, Thomas Jefferson and others favoring perpetuation of an agrarian society. Moreover, if the Founders' specific intent with respect to corporations is what matters, why does the dissent ignore the Founders' views about other legal entities that have more in common with modern business corporations than the founding-era corporations? At the time of the founding, religious, educational, and literary corporations were incorporated under general incorporation statutes, much as business corporations are today.[3]

[2] How in the flying fuck does he know this???

[3] (a) This is extremely not true, and (b) You think there might be a difference between those sorts of organizations?

The dissent says that when the Framers "constitutionalized the right to free speech in the First Amendment, it was the free speech of individual Americans that they had in mind." That is no doubt true. All the provisions of the Bill of Rights set forth the rights of individual men and women — not, for example, of trees or polar bears.[1] But the individual person's right to speak includes the right to speak in association with other individual persons. Surely the dissent does not believe that speech by the Republican Party or the Democratic Party can be censored because it is not the speech of "an individual American."[2] It is the speech of many individual Americans, who have associated in a common cause, giving the leadership of the party the right to speak on their behalf. The association of individuals in a business corporation is no different[3] — or at least it cannot be denied the right to speak on the simplistic ground that it is not "an individual American."

[1] The famed "Scalia wit" in action!

[2] If you took a shot every time Scalia listed something that wasn't at all like a corporation and pretended it was like a corporation, you'd have passed out by now.

[3] Ah, yes, that classic definition of a corporation: individual Americans associated in a common cause.

The Amendment is written in terms of "speech," not speakers. Its text offers no foothold for excluding any category of speaker, from single individuals to partnerships of individuals, to unincorporated associations of individuals, to incorporated associations of individuals — and the dissent offers no evidence about the original meaning of the text to support any such exclusion. We are therefore simply left with the question whether the speech at issue in this case is "speech" covered by the First Amendment. No one says otherwise. A documentary film critical of a potential Presidential candidate is core political speech, and its nature as such does not change simply because it was funded by a corporation. Indeed, to exclude or impede corporate speech is to muzzle the principal agents of the modern free economy. We should celebrate rather than condemn the addition of this speech to the public debate.

Stevens, J., dissenting

The real issue in this case concerns how, not if, the appellant may finance its electioneering. Citizens United is a wealthy nonprofit corporation that runs a political action committee (PAC) with millions of dollars in assets. Under the Bipartisan Campaign Reform Act of 2002 (BCRA), it could have used those assets to televise and promote *Hillary: The Movie* wherever and whenever it wanted to. Neither Citizens United's nor any other corporation's speech has been "banned." All that the parties dispute is whether Citizens United had a right to use the funds in its general treasury to pay for broadcasts. The notion that the First Amendment dictates an affirmative answer to that question is, in my judgment, profoundly misguided. Even more misguided is the notion that the Court must rewrite the law relating to campaign expenditures by for-profit corporations and unions to decide this case.

In the context of elections to public office, the distinction between corporate and human speakers is significant. Although they make enormous contributions to our society, corporations are not acti.ially members of it. They cannot vote or run for office. Because they may be managed and controlled by nonresidents, their interests may conflict in fundamental respects with the interests of eligible voters. The financial resources, legal structure, and instrumental orientation of corporations raise legitimate concerns about their role in the electoral process. Our lawmakers have a compelling constitutional basis, if not also a democratic duty, to take measures designed to guard against the potentially deleterious effects of corporate spending in local and national races.

Thomas Jefferson famously fretted that corporations would subvert the Republic. General incorporation statutes, and widespread acceptance of business corporations as socially useful actors, did not emerge until the 1800's.

The Framers thus took it as a given that corporations could be comprehensively regulated in the service of the public welfare. Unlike our colleagues, they had little trouble distinguishing corporations from human beings, and when they constitutionalized the right to free speech in the First Amendment, it was the free speech of individual Americans that they had in mind. While individuals might join together to exercise their speech rights, business corporations, at least, were plainly not seen as facilitating such associational or expressive ends. Even "the notion that business corporations could invoke the First Amendment would probably have been quite a novelty," given that "at the time, the legitimacy of every corporate activity was thought to rest entirely in a concession of the sovereign." In light of these background practices and understandings, it seems to me implausible that the Framers believed "the freedom of speech" would extend equally to all corporate speakers, much less than it would preclude legislatures from taking limited measures to guard against corporate capture of elections.

These basic points help explain why corporate electioneering is not only more likely to impair compelling governmental interests, but also why restrictions on that electioneering are less likely to encroach upon First Amendment freedoms. One fundamental concern of the First Amendment is to "protect the individual's interest in self-expression." Freedom of speech helps "make men free to develop their faculties," it respects their "dignity and choice," and it facilitates the value of "individual self-realization." Corporate speech, however, is derivative speech, speech by proxy. A regulation such as the one challenged here may affect the way in which individuals disseminate certain messages through the corporate form, but it does not prevent anyone from speaking in his or her own voice.

It is an interesting question "who" is even speaking when a business corporation places an advertisement that endorses or attacks a particular candidate.[1] Presumably it is not the customers or employees, who typically have no say in such matters. It cannot realistically be said to be the

[1] Banger of a paragraph here.

shareholders, who tend to be far removed from the day-to-day decisions of the firm and whose political preferences may be opaque to management. Perhaps the officers or directors of the corporation have the best claim to be the ones speaking, except their fiduciary duties generally prohibit them from using corporate funds for personal ends. Some individuals associated with the corporation must make the decision to place the ad, but the idea that these individuals are thereby fostering their self-expression or cultivating their critical faculties is fanciful. It is entirely possible that the corporation's electoral message will conflict with their personal convictions. Take away the ability to use general treasury funds for some of those ads, and no ones autonomy, dignity, or political equality has been impinged upon in the least.

The majority's unwillingness to distinguish between corporations and humans similarly blinds it to the possibility that corporations' "war chests" and their special "advantages" in the legal realm may translate into special advantages in the market for legislation. Corporations, that is, are uniquely equipped to seek laws that favor their owners, not simply because they have a lot of money but because of their legal and organizational structure. Remove all restrictions on their electioneering, and the door may be opened to a type of rent seeking that is "far more destructive" than what noncorporations are capable of.

The PAC mechanism, by contrast, helps assure that those who pay for an electioneering communication actually support its content and that managers do not use general treasuries to advance personal agendas. It "allows corporate political participation without the temptation to use corporate funds for political influence, quite possibly at odds with the sentiments of some shareholders or members." A rule that privileges the use of PACs thus does more than facilitate the political speech of like-minded shareholders; it also curbs the rent-seeking behavior of executives and respects the views of dissenters. *Austin*'s acceptance of restrictions on general treasury spending "simply allows people who have invested in the business corporation for purely economic reasons" — the vast majority of investors, one assumes — "to avoid being taken advantage of, without sacrificing their economic objectives."

Today's decision is backwards in many senses. It elevates the majority's agenda over the litigants' submissions, facial attacks over as-applied claims, broad constitutional theories over narrow statutory grounds, individual dissenting opinions over precedential holdings, assertion over tradition, absolutism over empiricism, rhetoric over reality. Our colleagues have arrived at the conclusion that *Austin* must be overruled and that § 203 is facially unconstitutional only after mischaracterizing both the reach and rationale of those authorities, and after bypassing or ignoring rules of judicial restraint used to cabin the Court's lawmaking power.

Their conclusion that the societal interest in avoiding corruption and the appearance of corruption does not provide an adequate justification for regulating corporate expenditures on candidate elections relies on an incorrect description of that interest, along with a failure to acknowledge the relevance of established facts and the considered judgments of state and federal legislatures over many decades.

In a democratic society, the longstanding consensus on the need to limit corporate campaign spending should outweigh the wooden application of judge-made rules. The majority's rejection of this principle "elevate[s] corporations to a level of deference which has not been seen at least since the days when substantive due process was regularly used to invalidate regulatory legislation thought to unfairly impinge upon established economic interests." At bottom, the Court's opinion is thus a rejection of the common sense of the American people, who have recognized a need to prevent corporations from undermining self-government since the founding, and who have fought against the distinctive corrupting potential of corporate electioneering since the days of Theodore Roosevelt. It is a strange time to repudiate that common sense. While American democracy is imperfect, few outside the majority of this Court would have thought its flaws included a dearth of corporate money in politics.[1]

[1] "I have always found it quaint, and rather touching, that there is a movement in the US that thinks Americans are not yet selfish enough." — Christopher Hitchens, on libertarianism.

Thomas, J., concurring in part and dissenting in part

Political speech is entitled to robust protection under the First Amendment. Section 203 of the Bipartisan Campaign Reform Act of 2002 (BCRA) has never been reconcilable with that protection. By striking down § 203, the Court takes an important first step toward restoring full constitutional protection to speech that is indispensable to the effective and intelligent use of the processes of popular government. I dissent from Part IV of the Court's opinion, however, because the Court's constitutional analysis does not go far enough. The disclosure, disclaimer, and reporting requirements in BCRA §§ 201 and 311 are also unconstitutional.

Congress may not abridge the right to anonymous speech based on the simple interest in providing voters with additional relevant information. In continuing to hold otherwise, the Court misapprehends the import of "recent events" that some amici describe "in which donors to certain causes were blacklisted, threatened, or otherwise targeted for retaliation." The Court properly recognizes these events as "cause for concern," but fails to acknowledge their constitutional significance. Amici's examples relate principally to Proposition 8, a state ballot proposition that California voters narrowly passed in the 2008 general election. Proposition 8 amended California's constitution to provide that "[o]nly marriage between a man and a woman is valid or recognized in California." Any donor who gave more than $100 to any committee supporting or opposing

Proposition 8 was required to disclose his full name, street address, occupation, employer's name (or business name, if self-employed), and the total amount of his contributions.

Some opponents of Proposition 8 compiled this information and created Web sites with maps showing the locations of homes or businesses of Proposition 8 supporters. Many supporters (or their customers) suffered property damage, or threats of physical violence or death, as a result. The director of the nonprofit California Musical Theater gave $1,000 to support the initiative; he was forced to resign after artists complained to his employer. The director of the Los Angeles Film Festival was forced to resign after giving $1,500 because opponents threatened to boycott and picket the next festival. And a woman who had managed her popular, family-owned restaurant for 26 years was forced to resign after she gave $100, because "throngs of [angry] protesters" repeatedly arrived at the restaurant and "shout[ed] 'shame on you' at customers."

These instances of retaliation sufficiently demonstrate why this Court should invalidate mandatory disclosure and reporting requirements. My point is not to express any view on the merits of the political controversies I describe.[1] Rather, it is to demonstrate — using real-world, recent examples[2] — the fallacy in the Court's conclusion that "[d]isclaimer and disclosure requirements ... impose no ceiling on campaign-related activities, and do not prevent anyone from speaking."Of course they do. Disclaimer and disclosure requirements enable private citizens and elected officials to implement political strategies specifically calculated to curtail campaign-related activity and prevent the lawful, peaceful exercise of First Amendment rights.

[1] O rly?

[2] Weirdly, none of these examples involve retaliatory firings, threats of violence, or social sanctions for left-leaning political activity. Must have been an oversight!

I cannot endorse a view of the First Amendment that subjects citizens of this Nation to death threats, ruined careers, damaged or defaced property, or pre-emptive and threatening warning letters as the price for engaging in core political speech, the "primary object of First Amendment protection." Accordingly, I respectfully dissent from the Court's judgment.

Some discussion questions:

1. What conception of the corporation is the majority working with here? It's kind of a new one, right? Almost as if it's a complete 180 from everything that we've learned in this book, huh?

2. As the dissent asks: when a corporation speaks, who is talking?

3. How exactly does the corporation get First Amendment rights? And what do those rights protect?

4. Not even a decade after every single conservative justice voted to hold that for-profit corporations have First Amendment rights,

the anti-ESG types got all up in arms about "woke" corporate speech.[1] Do you think that if the Supreme Court had to do it all over again, they'd still find that corporations have expressive free speech rights? Could this ruling have been limited to corporate political contributions (and maybe some anti-regulatory expressive rights) and just left it there?

[1] The flashpoint for the anti-woke-corporation backlash was arguably the decision in 2015 by NFL quarterback Colin Kaepernick to take a knee during the pre-game playing of the national anthem — which, to quote Vince Staples, doesn't even slap — and the subsequent refusal of Nike (a shoe manufacturer) to drop him as an endorser of their products.

5. Kennedy seems to think it'd be easy for shareholders to sue directors for furthering their personal interests. Do you think after all of the stuff we've read so far — *waves hands excitedly* — that it'd be easy for a shareholder to bring a derivative suit on behalf of the corporation against a manager for using corporate funds for a independent expenditure in favor of a political candidate? What are some barriers to that sort of litigation?

6. How can shareholders express their displeasure with management's political expenditures? Would these methods have more or less impact than throwing a pebble into the Atlantic Ocean?

7. In his concurrence, Justice Thomas is big mad about rules requiring disclosure of "soft money" political expenditures.

   Justice Thomas' wife, Ginni, is:

   - On the board of C.N.P. Action (a part of the Council for National Policy, a conservative activist organization); and is also
   - On the board of Turning Point USA (a pro-Trump "student" group run by a 29-year-old college dropout and funded by elderly billionaires); and is also
   - On the board of the National Association of Scholars (an advocacy organizations promoting "conservative values in academia", which is code for "firing professors they don't like"); and is also
   - On the board of Crowdsourcers (some vague organization that apparently works with the Public Interest Legal Foundation, a conservative election-law nonprofit); and was also
   - A paid consultant at the Center for Security Policy (which argued for Trump's Muslim travel ban); and also
   - Currently runs a conservative lobbying firm called Liberty Consulting, through which she is connected to a number of people implicated in the attempt to violently overturn the 2020 presidential election, which she arguably aided and abetted.

   Wait, hold on — I don't know why I mentioned all that. Those things are clearly unrelated. Nevermind.

Well, if corporations are now people for the speech part of the First Amendment (or, at least, the money-is-speech part of the First Amendment), what about the free exercise of religion part? Should corporations have protection under the First Amendment (and related legislation like the Religious Freedom Restoration Act) for their sincerely held beliefs?

Well, wait a minute, what the hell would it mean for a corporation's beliefs to be "sincerely held"? Once upon a time, even in cases that upheld general free speech rights for corporations, the Supreme Court rejected such questions as absurd:

> "Extension of the individual freedom of conscience decisions to business corporations strains the rationale of those cases beyond the breaking point. To ascribe to such artificial entities an 'intellect' or 'mind' for freedom of conscience purposes is to confuse metaphor with reality."[1]

Not no more! With freedom of religious expression claims being pressed more and more,[2] it was inevitable that the Supreme Court would eventually validate a corporation's right to religious liberty. It was equally as inevitable that the opinion would be written by Sam Alito, and that it would make absolutely no damn sense from a corporate law perspective.

[1] *Pac. Gas & Elec. Co v. Pub. Utils. Comm'n of Ca.*, 475 U.S. 1, 33 (1986) (Rehnquist, J., dissenting)

[2] In what is surely a coincidence, claims of religious oppression by government regulations seem to have increased along with the expansion of civil rights for sexual minorities. Weird, right?

Burwell v. Hobby Lobby Stores, Inc., 573 U.S. 682 (2014)

Alito, J.

We must decide in these cases whether the Religious Freedom Restoration Act of 1993 (RFRA), 107 Stat. 1488, 42 U.S.C. § 2000bb et seq ., permits the United States Department of Health and Human Services (HHS) to demand that three closely held corporations provide health-insurance coverage for methods of contraception that violate the sincerely held religious beliefs of the companies' owners. We hold that the regulations that impose this obligation violate RFRA, which prohibits the Federal Government from taking any action that substantially burdens the exercise of religion unless that action constitutes the least restrictive means of serving a compelling government interest.

In holding that the HHS mandate is unlawful, we reject HHS's argument that the owners of the companies forfeited all RFRA protection when they decided to organize their businesses as corporations rather than sole proprietorships or general partnerships. The plain terms of RFRA make it perfectly clear that Congress did not discriminate in this way against men and women who wish to run their businesses as for-profit corporations in the manner required by their religious beliefs.

At issue in these cases are HHS regulations promulgated under the Patient Protection and Affordable Care Act of 2010 (ACA), 124 Stat. 119. ACA generally requires employers with 50 or more full-time employees to offer "a group health plan or group health insurance coverage" that provides "minimum essential coverage." Any covered employer that does not provide such coverage must pay a substantial price.

Unless an exception applies, ACA requires an employer's group health plan or group-health-insurance coverage to furnish "preventive care and screenings" for women without "any cost sharing requirements." Congress itself, however, did not specify what types of preventive care must be covered. Instead, Congress authorized the Health Resources and Services Administration (HRSA), a component of HHS, to make that important and sensitive decision. The HRSA in turn consulted the Institute of Medicine, a nonprofit group of volunteer advisers, in determining which preventive services to require. In August 2011, based on the Institute's recommendations, the HRSA promulgated the Women's Preventive Services Guidelines. The Guidelines provide that nonexempt employers are generally required to provide "coverage, without cost sharing" for "[a]ll Food and Drug Administration [(FDA)] approved contraceptive methods, sterilization procedures, and patient education and counseling." Although many of the required, FDA-approved methods of contraception work by preventing the fertilization of an egg, four of those methods (those specifically at issue in these cases) may have the effect of preventing an already fertilized egg from developing any further by inhibiting its attachment to the uterus. In its Guidelines, HRSA exempted [churches and religious nonprofit organizations] from the requirement to cover contraceptive services.

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Norman and Elizabeth Hahn and their three sons are devout members of the Mennonite Church, a Christian denomination. The Mennonite Church opposes abortion and believes that "[t]he fetus in its earliest stages ... shares humanity with those who conceived it."

Fifty years ago, Norman Hahn started a wood-working business in his garage, and since then, this company, Conestoga Wood Specialties, has grown and now has 950 employees. Conestoga is organized under Pennsylvania law as a for-profit corporation. The Hahns exercise sole ownership of the closely held business; they control its board of directors and hold all of its voting shares. One of the Hahn sons serves as the president and CEO.

The Hahns believe that they are required to run their business "in accordance with their religious beliefs and moral principles." To that end, the company's mission, as they see it, is to "operate in a professional environment founded upon the highest ethical, moral, and Christian principles." In opposing the requirement to provide coverage for the contraceptives to which they object, the Hahns argued that "it is immoral and sinful for [them] to intentionally participate in, pay for, facilitate, or otherwise support these drugs." The District Court denied a preliminary injunction, and the Third Circuit affirmed in a divided opinion, holding that "for-profit, secular corporations cannot engage in religious exercise" within the meaning of RFRA or the First Amendment. The Third Circuit also rejected the claims brought by the Hahns themselves because it concluded that the HHS "[m]andate does not impose any requirements on the Hahns" in their personal capacity.

David and Barbara Green and their three children are Christians who own and operate two family businesses. Forty-five years ago, David Green started an arts-and-crafts store that has grown into a nationwide chain called Hobby Lobby. There are now 500 Hobby Lobby stores, and the company has more than 13,000 employees. Hobby Lobby is organized as a for-profit corporation under Oklahoma law. One of David's sons started an affiliated business, Mardel, which operates 35 Christian bookstores and employs close to 400 people. Mardel is also organized as a for-profit corporation under Oklahoma law.

Though these two businesses have expanded over the years, they remain closely held, and David, Barbara, and their children retain exclusive control of both companies. David serves as the CEO of Hobby Lobby, and his three children serve as the president, vice president, and vice CEO. Hobby Lobby's statement of purpose commits the Greens to "[h]onoring the Lord in all [they] do by operating the company in a manner consistent with Biblical principles." In accordance with those commitments, Hobby Lobby and Mardel stores close on Sundays, even though the Greens calculate that they lose millions in sales annually by doing so. The businesses refuse to engage in profitable transactions that facilitate or promote alcohol use; they contribute profits to Christian missionaries and ministries; and they buy hundreds of full-page newspaper ads inviting people to "know Jesus as Lord and Savior."

The Greens, Hobby Lobby, and Mardel sued HHS and other federal agencies and officials to challenge the contraceptive mandate under RFRA and the Free Exercise Clause. The District Court denied a preliminary injunction, and the plaintiffs appealed, moving for initial en banc consideration. The Tenth Circuit granted that motion and reversed in a divided opinion. Contrary to the conclusion of the Third Circuit, the Tenth Circuit held that the Greens' two for-profit businesses are "persons" within the meaning of RFRA and therefore may bring suit under that law.

The court then held that the corporations had established a likelihood of success on their RFRA claim. The court concluded that the contraceptive mandate substantially burdened the exercise of religion by requiring the companies to choose between "compromis[ing] their religious beliefs"[1] and paying a heavy fee—either "close to $475 million more in taxes every year" if they simply refused to provide coverage for the contraceptives at issue, or "roughly $26 million" annually if they "drop[ped] health-insurance benefits for all employees."

[1] Wait . . . *whose* religious beliefs?

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RFRA prohibits the "Government [from] substantially burden[ing] a person's exercise of religion even if the burden results from a rule of general applicability" unless the Government "demonstrates that application of the burden to the person —(1) is in furtherance of a compelling governmental interest; and (2) is the least restrictive means of furthering that compelling governmental interest." The first question that we must address is whether this provision applies to regulations that govern the activities of for-profit corporations like Hobby Lobby, Conestoga, and Mardel.

HHS contends that neither these companies nor their owners can even be heard under RFRA. According to HHS, the companies cannot sue because they seek to make a profit for their owners, and the owners cannot be heard because the regulations, at least as a formal matter, apply only to the companies and not to the owners as individuals. HHS's argument would have dramatic consequences.[2]

[2] If there's anything Sam Alito hates, it's dramatic consequences.

Consider this Court's decision in *Braunfeld v. Brown*, 366 U.S. 599 (1961). In that case, five Orthodox Jewish merchants[3] who ran small retail businesses in Philadelphia challenged a Pennsylvania Sunday closing law as a violation of the Free Exercise Clause. Because of their faith, these merchants closed their shops on Saturday, and they argued that requiring them to remain shut on Sunday threatened them with financial ruin. The Court entertained their claim (although it ruled against them on the merits), and if a similar claim were raised today under RFRA against a jurisdiction still subject to the Act, the merchants would be entitled to be heard. According to HHS, however, if these merchants chose to incorporate their businesses—without in any way changing the size or nature of their businesses—they would forfeit all RFRA (and free-exercise) rights. HHS would put these merchants to a difficult choice: either give up the right to seek judicial protection of their religious liberty or forgo the benefits, available to their competitors, of operating as corporations.

[3] I'm sorry, I know it's a minor nitpick in the grand scheme of things, but why are the Christians who run a business called "businessmen" but the Jews who run a business are called "merchants"? A little weird, right?

As we have seen, RFRA was designed to provide very broad protection for religious liberty. By enacting RFRA, Congress went far beyond what this Court has held is constitutionally required. Is there any reason to think that the Congress that enacted such sweeping protection put small-business owners[4] to the choice that HHS suggests? An examination of RFRA's text, to which we turn in the next part of this opinion, reveals

[4] What constitutes a small business to the court?

that Congress did no such thing.

As we will show, Congress provided protection for people like the Hahns and Greens by employing a familiar legal fiction: It included corporations within RFRA's definition of "persons." But it is important to keep in mind that the purpose of this fiction is to provide protection for human beings. A corporation is simply a form of organization used by human beings to achieve desired ends. An established body of law specifies the rights and obligations of the people (including shareholders, officers, and employees) who are associated with a corporation in one way or another. When rights, whether constitutional or statutory, are extended to corporations, the purpose is to protect the rights of these people. For example, extending Fourth Amendment protection to corporations protects the privacy interests of employees and others associated with the company.[1] Protecting corporations from government seizure of their property without just compensation protects all those who have a stake in the corporations' financial well-being.[2] And protecting the free-exercise rights of corporations like Hobby Lobby, Conestoga, and Mardel protects the religious liberty of the humans who own and control those companies.

[1] This is incorrect.

[2] Also incorrect.

In holding that Conestoga, as a "secular, for-profit corporation," lacks RFRA protection, the Third Circuit wrote as follows: "General business corporations do not, separate and apart from the actions or belief systems of their individual owners or employees, exercise religion. They do not pray, worship, observe sacraments or take other religiously-motivated actions separate and apart from the intention and direction of their individual actors." All of this is true—but quite beside the point. Corporations, "separate and apart from" the human beings who own, run, and are employed by them, cannot do anything at all.

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As we noted above, RFRA applies to "a person's" exercise of religion, and RFRA itself does not define the term "person." We therefore look to the Dictionary Act, which we must consult "[i]n determining the meaning of any Act of Congress, unless the context indicates otherwise." 1 U.S.C. § 1.

Under the Dictionary Act, "the wor[d] 'person' ... include[s] corporations, companies, associations, firms, partnerships, societies, and joint stock companies, as well as individuals." Thus, unless there is something about the RFRA context that "indicates otherwise," the Dictionary Act provides a quick, clear, and affirmative answer to the question whether the companies involved in these cases may be heard.

The principal argument advanced by HHS and the principal dissent regarding RFRA protection for Hobby Lobby, Conestoga, and Mardel focuses not on the statutory term "person," but on the phrase "exercise of religion." According to HHS and the dissent, these corporations are not protected by RFRA because they cannot exercise religion. Neither HHS nor the dissent, however, provides any persuasive explanation for this conclusion.

Some lower court judges have suggested that RFRA does not protect for-profit corporations because the purpose of such corporations is simply to make money. This argument flies in the face of modern corporate law. While it is certainly true that a central objective of for-profit corporations is to make money, modern corporate law does not require for-profit corporations to pursue profit at the expense of everything else,[1] and many do not do so. For-profit corporations, with ownership approval, support a wide variety of charitable causes, and it is not at all uncommon for such corporations to further humanitarian and other altruistic objectives. Many examples come readily to mind. So long as its owners agree, a for-profit corporation may take costly pollution-control and energy-conservation measures that go beyond what the law requires. A for-profit corporation that operates facilities in other countries may exceed the requirements of local law regarding working conditions and benefits. If for-profit corporations may pursue such worthy objectives, there is no apparent reason why they may not further religious objectives as well.

[1] Sam Alito, closet socialist.

HHS would draw a sharp line between nonprofit corporations (which, HHS concedes, are protected by RFRA) and for-profit corporations (which HHS would leave unprotected), but the actual picture is less clear-cut. Not all corporations that decline to organize as nonprofits do so in order to maximize profit. For example, organizations with religious and charitable aims might organize as for-profit corporations because of the potential advantages of that corporate form, such as the freedom to participate in lobbying for legislation or campaigning for political candidates who promote their religious or charitable goals. In fact, recognizing the inherent compatibility between establishing a for-profit corporation and pursuing nonprofit goals, States have increasingly adopted laws formally recognizing hybrid corporate forms. Over half of the States, for instance, now recognize the "benefit corporation,"[2] a dual-purpose entity that seeks to achieve both a benefit for the public and a profit for its owners.

[2] Oh, splendid.

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Finally, HHS contends that Congress could not have wanted RFRA to apply to for-profit corporations because it is difficult as a practical matter to ascertain the sincere "beliefs" of a corporation. HHS goes so far as to raise the specter of "divisive, polarizing proxy battles over the religious identity of large, publicly traded corporations such as IBM or General Electric."

These cases, however, do not involve publicly traded corporations, and it seems unlikely that the sort of corporate giants to which HHS refers will often assert RFRA claims. HHS has not pointed to any example of a publicly traded corporation asserting RFRA rights, and numerous practical restraints would likely prevent that from occurring. For example, the idea that unrelated shareholders — including institutional investors with their own set of stakeholders — would agree to run a corporation under the same religious beliefs seems improbable. In any event, we have no occasion in these cases to consider RFRA's applicability to such companies. The companies in the cases before us are closely held corporations, each owned and controlled by members of a single family, and no one has disputed the sincerity of their religious beliefs.[1]

[1] It'd be funny as hell if one of the family members in this closely-held corporation converted to a completely different religion and fucked up the whole "single set of beliefs" thing.

For all these reasons, we hold that a federal regulation's restriction on the activities of a for-profit closely held corporation must comply with RFRA. The contraceptive mandate, as applied to closely held corporations, violates RFRA. Our decision on that statutory question makes it unnecessary to reach the First Amendment claim raised by Conestoga and the Hahns.

Ginsburg, J., dissenting.

In a decision of startling breadth, the Court holds that commercial enterprises, including corporations, along with partnerships and sole proprietorships, can opt out of any law (saving only tax laws) they judge incompatible with their sincerely held religious beliefs.

RFRA's compelling interest test applies to government actions that "substantially burden a person's exercise of religion." This reference, the Court submits, incorporates the definition of "person" found in the Dictionary Act, 1 U.S.C. § 1, which extends to "corporations, companies, associations, firms, partnerships, societies, and joint stock companies, as well as individuals." The Dictionary Act's definition, however, controls only where "context" does not "indicat[e] otherwise." Here, context does so indicate. RFRA speaks of "a person's exercise of religion." There is in that case law no support for the notion that free exercise rights pertain to for-profit corporations.

Until this litigation, no decision of this Court recognized a for-profit corporation's qualification for a religious exemption from a generally applicable law, whether under the Free Exercise Clause or RFRA. The absence of such precedent is just what one would expect, for the exercise of religion is characteristic of natural persons, not artificial legal entities. As Chief Justice Marshall observed nearly two centuries ago, a corporation is "an artificial being, invisible, intangible, and existing only in contemplation of law." Corporations, Justice Stevens more recently reminded, "have no consciences, no beliefs, no feelings, no thoughts, no desires."

The First Amendment's free exercise protections, the Court has indeed recognized, shelter churches and other nonprofit religion-based organizations. The Court's "special solicitude to the rights of religious organizations," however, is just that. No such solicitude is traditional for commercial organizations. Indeed, until today, religious exemptions had never been extended to any entity operating in "the commercial, profit-making world."

The reason why is hardly obscure. Religious organizations exist to foster the interests of persons subscribing to the same religious faith. Not so of for-profit corporations. Workers who sustain the operations of those corporations commonly are not drawn from one religious community. Indeed, by law, no religion-based criterion can restrict the work force of for-profit corporations. The distinction between a community made up of believers in the same religion and one embracing persons of diverse beliefs, clear as it is, constantly escapes the Court's attention. One can only wonder why the Court shuts this key difference from sight. Had Congress intended RFRA to initiate a change so huge, a clarion statement to that effect likely would have been made in the legislation. The text of RFRA makes no such statement and the legislative history does not so much as mention for-profit corporations.

The Court notes that for-profit corporations may support charitable causes and use their funds for religious ends, and therefore questions the distinction between such corporations and religious nonprofit organizations. Again, the Court forgets that religious organizations exist to serve a community of believers. For-profit corporations do not fit that bill. To reiterate, "for-profit corporations are different from religious non-profits in that they use labor to make a profit, rather than to perpetuate the religious values shared by a community of believers."

Citing *Braunfeld v. Brown*, the Court questions why, if "a sole proprietorship that seeks to make a profit may assert a free-exercise claim, [Hobby Lobby and Conestoga] can't ... do the same?" But even accepting, arguendo, the premise that unincorporated business enterprises may gain religious accommodations under the Free Exercise Clause, the Court's conclusion is unsound. In a sole proprietorship, the business and its owner are one and the same. By incorporating a business, however, an individual separates herself from the entity and escapes personal responsibility for the entity's obligations. One might ask why the separation should hold only when it serves the interest of those who control the corporation. In any event, *Braunfeld* is hardly impressive authority for the entitlement Hobby Lobby and Conestoga seek. The free exercise claim asserted there was promptly rejected on the merits.

The Court's determination that RFRA extends to for-profit corporations is bound to have untoward effects. Although the Court attempts to cabin its language to closely held corporations, its logic extends to corporations of any size, public or private. Little doubt that RFRA claims will proliferate, for the Court's expansive notion of corporate personhood—combined with its other errors in construing RFRA—invites for-profit entities to seek religion-based exemptions from regulations they deem offensive to their faith.

SOME DISCUSSION QUESTIONS:

1. I have strongly held religious beliefs. I also have a Toyota RAV4.[1] If I am the sole shareholder of a corporation, are my religious beliefs transferred to the corporation? Is my RAV4 transferred to the corporation? Why or why not?

2. If a corporation is merely an extension of its controlling shareholder(s) (or, say, an "alter ego"), does that implicate any other doctrine that we've discussed? Could that be an issue here?

3. Is it a problem when there seems to be nobody on the Supreme Court of the United States (which, according to Wikipedia, is the highest court in the federal judiciary of the United States) who can correctly articulate the distinction between a corporation, its managers, and its investors — when that *exact distinction* is the beating heart of corporate law?

[1] "What you think I rap for? To push a fuckin' RAV4?"

– Old Poem

THE SWISS NOVELIST MAX FRISCH, commenting on post-war immigration to Europe, archly observed that "we asked for workers ... but we got people instead." Here, over a century after introducing the corporation into society, watching it amass power and capital, and ingrain itself deeply into public life, we face a similar twist. What we asked for was corporate *citizenship*; what we got was corporate *personhood*. Heaven help us.

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