Recall the roles in a corporation:

- Shareholders elect board of directors
- Board of directors
  - Pay out dividends
  - Make major decisions
  - Select and compensate officers

Within the corporate scope, today we will discuss **duty of care** and **duty of loyalty**.

Business Judgement Rule

Important

Definition 11.1: Business Judgement Rule

Directors **win** any lawsuit brought by shareholders alleging that the board made a wrong decision as long as:

1. The directors were **informed**
   - Were not making a grossly negligent decision
2. No directors had an **unacceptable conflict of interest**

Info

Case: Smith vs. Van Gorkom

- Van Gorkom: CEO of transunion (D)
  - Allegedly didn't consult financial experts nor anyone on the board has financial expertise when selling the company at price of $55 per share
  - No due diligence and therefore were **NOT informed**
- Smith: Shareholder (P)
  - Believed the merger price is too low
  - Claimed breach of fiduciary duty

Duty of Care

Recall the definition of **duty of care**:

> **Important**
>
> **Definition 5.2**: Duty of Care
>
> Generally, duty of care requires a person with a **legal duty** to another must act like a **reasonable person** to avoid harming the other person.

To satisfy duty of care, directors must

1. Implement and oversee appropriate risk management and compliance programs, and
2. Are **informed** all the time

If breach of duty were to found, the directors that were responsible for the breach would be **personally liable** for the loss.

- **Limited liability** only applies to shareholders
- The legal damage is defined as the **difference** between the fair value (w/o the breach) and the actual value

Risk Avoidance

To avoid such risks, company may either

1. Purchase Directors and Officers Liability Insurance (DNL Insurance), or
2. Make bylaws that specify directors don't need to pay for damages related to breach of duty of care
    - This helps the corporation attract talents by taking a *risk on* attitude

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Duty of Loyalty

Important

Definition 11.2: Duty of Loyalty

An employee should put the company's interest above one's personal interest at all time.

All agents owe their principal (their employer) a duty of loyalty and should treat opportunities in this same way.

A transaction made under a conflict of interest is **ONLY acceptable** if after **full disclosure of the conflict** and **approval** of either:

1. A majority of **disinterested directors**, or
2. The majority of **disinterested shareholders**

In other words, it means an employee must disclose any personal conflicts of interest when making a decision.

Usually the former will decide unless the entire board is conflicted.

If breach of loyalty is found, the actions are **reversed**, and the director who breached the duty would be **personally liable** for the cost.

- **NO bylaws** can be made

Corporate Opportunity Doctrine

Important

Definition 11.3: Corporate Opportunity Doctrine

The specialized rule for situations where an **officer or director** considers taking a business opportunity states that they need to **disclose and offer** the opportunity to the business first before taking on it themselves if the following **corporate opportunity test** is passed:

1. Is the opportunity within company's regular business?
2. Is the opportunity what the business is likely to pursue?
3. Does the company have the capacity to pursue such opportunity?

Directors **CANNOT** resign from the board to break free from their fiduciary duties.

Fiduciary Duties for M&A

Now, we will delve into some more details regarding duties of directors in situations related to mergers & acquisitions. This involves the business judgement rule plus some extra requirements.

First, let's start off with a few definitions.

💧 **Important**

Definition 11.4: Hostile Takeover, Tender Offer
A third-party aiming to directly take over the company by **directly buying from shareholders** with a **tender offer**.

A **tender offer** is an announcement to the public of buying shares **at a premium**. The goal of a tender offer is to get 51% of total shares of the company.

If a shareholder owns **more than 10%** of a publicly traded company's share, they will need to disclose it to the SEC.

Poison Pill/Shareholder Rights Plan

This is seen as a **threat** and should **NOT be enacted** at any time.

💧 **Important**

Definition 11.5: Poison Pill

A shareholder rights plan, colloquially known as a "poison pill", is a type of **defensive tactic** used by a corporation's board of directors against a takeover.

It achieves **TWO things**:

1. Makes it harder for the company to be taken over, and
2. Even if the acquisition happened, this would be an unfavorable scenario

The plan doesn't expire until the company specifies.

Essentially, the company is destroying its own market value.

A company may want to adopt the poison pill for the following reasons:

1. Prevent unfavorable acquisition, or

2. Negotiate a better deal
    - E.g. Twitter

There are also quite a few disadvantages to the plan:

1. It is intrinsically not good for the company, and
2. There exists potential personal conflict of interest

To determine if the directors are acting with fiduciary duties when dealing with M&A decisions, the business judgement rule **DOES NOT apply**. Instead, we have the following two tests.

Unocal Test

Applies when the board wants to block a deal.

> **Important**
>
> **Definition 11.6**: Unocal Test
> For the board of directors to block a M&A deal, it must show the **following two**:
>
> 1. The hostile bidder presents a **reasonable threat**, and
> 2. The board's defensive tactic was **proportional to** the threat

The test was almost always determined by the first condition. In essence, the Unocal test ensures that the directors must be **informed** and **act in good faith** when making a decision.

Revlon Rule

Applies when the board wants to sell the company.

> **Important**
>
> **Definition 11.7**: Revlon Rule
>
> A company's board of directors shall make a **reasonable effort** to obtain the **highest value** for a company, when a hostile takeover is imminent.
>
> It applies when the board of directors
>
> - Determines sale or break-up of company is **inevitable**,
> - Agrees to a deal resulting in a **change in control**, or

- Majority of consideration for deal is **cash**

The Revlon Rule is viewed as a part of the company's fiduciary duty.

- They have to do this even knowing it's bad for the shareholders
- This also implies that when a third party suddenly swaps in a preliminary merger agreement with **better cash deal**, the company **MUST** take the latter deal

The motivation behind the Revlon is to **protect shareholders** who are greatly impacted by the sale of the company.

- Thus the company is responsible for getting the best outcome for the shareholders to compensate