Corporations – Professor Marks – Fall 2010

Partnerships

I. Partnerships
    a. An organizational form comprised of an aggregate of individuals
        i. Basically an agreement to contribute capital and to share in the profits and losses and jointly decide how the company will be run
            1. **Contribution** – **Profits** – **Control**
        ii. A default organization – informal entity
            1. If you mess up forming a corporation somehow, the default may be that you formed a partnership
            2. No formalities (paperwork, e.g.) are needed to create a partnership, but the parties must voluntarily agree to set up an organizational form with characteristics that essentially make it a partnership
                a. Substance over form
    b. Can be sued as an entity
    c. Can hold property as an entity
    d. All individuals are personally liable for any debts of the partnership
        i. Jointly and severally
        ii. Because of this liability, partnerships are currently only established:
            1. Informally, or
            2. Between corporations
                a. Partnerships between corporations = joint ventures, but they incur no personal liability since the corporations have limited liability
    e. Partnerships are not entities for tax purposes
        i. Partners are tax individually – single taxation
        ii. The partnership itself does not pay any federal taxes
    f. Partners have the right to manage
    g. Decentralized organization, absent any agreement to the contrary
    h. Partnerships are personal/specific to the partners (i.e. nontransferable)
        i. As a partner, you cannot have someone take your place in the partnership or sell your stake to anyone you want
            1. Need permission to do this, if at all
        ii. Because of this, partnerships tend to have limited lives (i.e. if a partner leaves or dies, or a new partner joins, the partnership is dissolved)
            1. This can be modified by contract with provisions that address certain events that may occur in the future
    i. Ex: *Vohland v. Sweet* (Indiana 1982): dispute is whether the arrangement between the parties created a partnership or a contract of employment; argument came down to the fact that Sweet made a capital contribution; it is the <u>substance</u>, and not the name of the arrangement between the parties, which determines their legal relationship toward each other, and if, from a consideration of all the fact and circumstances, it appears that the parties intended, between themselves, that there should be a community of interest of both the property and profits of a common business or venture, the law treats it as their intention to become partners, in the absence of other controlling factors
        i. A partnership is an association of two or more persons to carry on as co-owners a business for profit
            1. <u>Factors</u>:
                a. ***Intent*** to enter into a relationship that the law regards as a partnership (whether or not you understand the relationship as a partnership or not)
                    i. Direct evidence of intent: tax forms, agreements, documents
                    ii. Indirect evidence: how the parties act

b. Sharing of profits and losses
    i. Sharing of gross returns does not of itself establish a partnership
    ii. The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business
        1. But no such inference shall be drawn if such profits were received in payment: as a debt by installments, as wages or an employee or rent to a landlord, as interest on a loan, as consideration for the sale of a goodwill of a business or other property by installment
c. Contribution of capital or skill/labor
d. Lack of daily involvement for one partner is not per se indicative of absence of a partnership

II. Proprietorship
    a. One person organization

Other Organizational Forms

I. Corporations

a. C-Corporation (standard corporation)
    i. Formal entity – have to file incorporation paperwork
    ii. Limited liability
        1. Limited liability protects the people behind the company from personal liability to creditors, shareholders, etc.
        2. Shareholders can generally only lose their investment (i.e. the money they paid for the shares)
        3. Limited liability can sometimes be modified by contract
            a. Ex: bank may want unlimited/personal liability guaranteed for a certain transaction
    iii. Independent entity
        1. Personhood in the sense that corporations can own property and can sue and be sued
    iv. Corporate taxation → double taxation (corporate level and individual level)
        1. Profits are taxed by attribution on the corporate level
            a. The corporation itself has to file tax returns and pay taxes
        2. Dividends are taxed at the individual level when profits are distributed
            a. Shareholders are required to pay taxes when the corporation makes a dividend payment
        3. Corporate taxation is the price you pay for having publicly traded shares – for being able to go into the capital market in that way
    v. Centralized management
        1. Corporations are not necessarily run by the owners (i.e. shareholders), but rather are managed by the board of directors
    vi. Owners do not typically have a right to manage
        1. Owners do have the right to vote
        2. Owners do not have veto rights over management though
    vii. Unlimited life (i.e. shareholders and ownership can come and go and the corporation will endure)
    viii. Ownership is alienable – freely transferrable
    ix. Modifiable
        1. Corporate charter can be modified, usually by contract
            a. Ex: may modify by contract that current shareholders may have first purchase rights (modifying the free alienability)

b. S-Corporation
    i. A regular corporation that the IRS has given favorable tax treatment
        1. S-tax treatment = single partnership tax treatment
            a. S-corporations get taxed to the shareholders, rather than taxed as an entity
    ii. At most 100 shareholders (so an option for a small business)
        1. For the most part, shareholders must be natural persons
        2. Shareholders must be residents (citizens or resident aliens)
    iii. One class of stock

II. Limited Partnership

a. An entity that has *both* general partners and limited partners (need at least one of each)
    i. Limited partners get limited liability, like a corporation
    ii. General partners have unlimited liability, like a partnership
        1. General partners can be a corporation
        2. Only general partners participate in management
            a. If limited partners participate in management they may lose their limited liability

b. A formal entity

c. Used frequently in real estate

III. Master Limited Partnership

a. A limited partnership was formed with a corporate general partner and thousands of limited partners, whose shares were listed on the NYSE and traded like regular shares would trade
    i. IRS did not like this corporate form because all of the profits were going to the limited partners and the corporate general partner was just there to facilitate the corporate form and did not get any profits (i.e. corporate general partner was there so the organization did not pay any tax as an entity, but rather only the limited partners paid taxes)
        1. IRS decided that this form looked like a corporation, but the IRS was not collecting any corporate tax
            a. IRS promulgated a new rule that *if it looks like a corporation, it is getting taxed like a corporation*
                i. This reduced the popularity of master limited partnerships

IV. Limited Liability Companies (LLCs)

a. Designed to exploit IRS regulations – to avoid corporate taxation
    i. CHARACTERISTICS: limited liability + partnership taxation
        1. LLCs qualify for the partnership taxation even if they have other corporate attributes like free transferability and perpetual existence
        2. *Cannot* have actively traded ownership interests/shares
            a. Organizations will be taxed like a corporation if the ownership interests are actively traded

b. Favored organizational form for small businesses
    i. Has largely taken over for the S-corporation because LLCs have less restrictions/requirements

V. Limited Liability Partnership

a. Established after the success of LLCs because formal partnerships want to, but could not, convert to an LLC
    i. Limited liability partnerships allow formal partnerships to change their form and elect limited liability

b. While LLCs look relatively similar across all jurisdictions, LLPs are treated differently by jurisdiction
    i. Some states only allow professionals to create this form (law firms, medical offices, e.g.)
    ii. Some states do not confer absolute limited liability

            1. Ex: might be protected from the negligence of their partners, but not protected from their own negligence or the negligence of the partnership
    c. Not nearly as common as LLCs

VI. Taxation
    a. Today, organizations are taxed as corporations if:
        i. They are a corporation
        ii. They have publicly traded ownership interests
        iii. They elect to be taxed as a corporation

<u>Corporate Form</u>

I. Law
    a. Corporate law is determined largely by state law
        i. Each state has an incorporation act that sets out any requirements or boundaries for corporations
    b. SEC is the main federal body of law working on corporations

II. Structure
    a. Board of Directors: heads of the company who make directional and financial decisions for the corporation
        i. Inside directors: full-time jobs <u>running the company</u> day-to-day
            1. CEO, CFO, COO, corporate counsel, etc.
        ii. Outside directors: meet four times a year, e.g., to help make big policy decisions, strategic moves, dividend decisions, etc.
            1. Outside directors have less risk of entrenchment and less conflicts of interest
                a. Typically disinterested
    b. Shareholders: <u>own the company</u>
        i. Shareholders have the right to vote
        ii. Shareholders do not have the right to manage

III. Voting
    a. Board member elections are typically held once a year
        i. Can stagger the members up for election
            1. Sometimes staggered elections are considered a takeover defense because an acquirer will not be able to take over the entire board at one time (but often times board members will just step down)
        ii. Typically only one person is running per position
            1. Proxy contests are rare
                a. Proxy contests: appeals to current shareholders to oust incumbent board members and install new ones
                b. Regulated by the 34 Act: if you solicit proxies, there are federal rules that specify the information that must be included in the proxy solicitation
        iii. Shareholders vote for the board members
    b. Voting type is determined by the corporate charter (sometimes by statute)
        i. Straight Voting:
            1. You can divide your votes as you wish among the candidates
                a. You do not have to use all of your votes
                b. You cannot put more than your number of shares toward one person
                    i. Ex: if you have 300 shares and there are 5 directors, you can vote a max of 300 for each position
            2. Majority shareholder will always beat minority shareholder
                a. Minority can never vote more than the shares it has for a candidate, and the majority has more shares
        ii. Cumulative Voting:
            1. You can distribute your votes any way you want

a. Ex: if you have 300 shares and there are 5 directors, you can put all of your 1,500 votes for one person

2. Better for minority shareholders because the opportunity to get someone on the board (even if it is not a majority) is there

3. Majority might want to distribute all of its shares to 3 of the 5 directors, rather than equally for all 5, to secure a majority of the board

c. Proxy Process: Shareholders have the option to send their votes to management and management is bound to vote accordingly

i. Absentee ballot, essentially

IV. Corporate Liabilities

a. De facto corporations and corporations by estoppel are common law doctrines that were in every jurisdiction until the Model Code Business Act was enacted

i. De Facto Corporation: not a corporation by law (i.e. de jure corporation), but the law will treat it like a corporation and will confer limited liability, even though all of the incorporation formalities were not satisfied

1. Elements:

a. A law of incorporation

b. A colorable (i.e. good faith) attempt to incorporate under that law

c. Use → attempted incorporator treated the organizational form as if it was a corporation

2. Focus is on the incorporator's mental state, intent, how they acted

ii. Corporation by Estoppel: if a third party (someone dealing with the organization) treats the organization as a corporation then they are later estopped from denying the existence of the corporation

1. If both parties believe they are dealing with a corporation, both parties are estopped from denying that the entity was a corporation

a. Can protect shareholders from unlimited liability

i. Third party will not be allowed to go after shareholders personally for "corporation's" debts

b. Can protect a corporation to enforce a contract

c. Can protect a third party to enforce a contract

i. Shareholders cannot get out of a contract because of defective incorporation

2. Equitable doctrine, so corporation needs clean hands (i.e. must in good faith believe it is a corporation)

3. Focus is on the third party's treatment of the organization

4. Policy for allowing:

a. Allowing personal liability would be a windfall to the third party because they thought they were dealing with a corporation

b. Risk of personal liability may discourage entrepreneurial activities

5. Note that this differs from equitable estoppel in contract law because it does not require detrimental reliance

iii. Ex: *Thompson v. Music City Lumber Co.* (Tenn. 1984): D entered into a contract to buy equipment with P; D thought he was incorporated, P thought D was incorporated – turns out D was not incorporated until the day after the contract was signed; D defaulted on the payments – if a corporation, then not personally liable for the balance because of limited liability; P wants to sue D personally, even though D signed the contract as a corporation; Tenn. adopted the Model Code, which arguably abolished the concept of de facto corporations; Model Code does not provide any exceptions that permit corporation by estoppel corporation, so D cannot claim that either; D is held personally liable

b. Revised Model Business Corporations Act, §2.04: Liability for Preincorporated Transactions

i. "All persons purporting to act as or on behalf of a corporation, knowing there was no incorporation under this Act, are jointly and severally liable for all liabilities created while so acting"
    1. If you *know* you are not a corporation and you try to deceive third parties, you are personally liable
    2. If you erroneously but in good faith believe you are incorporated, then you are not personally liable
        a. D in *Thompson* would likely not be held personally liable under this Act because he did not ***know*** he was not incorporated
    3. Official Comment: Incorporation under modern statutes is so simple and inexpensive that a strong argument may be made that nothing short of filing articles of incorporation should create the privilege of limited liability (suggests strict liability except for exceptional situations)

ii. Act is silent with respect to corporation by estoppel
    1. *Unless* both parties know that the organization is not a corporation and insist on proceeding as if it is a corporation, then the third party is estopped from denying the corporate form and cannot go after the personal assets of the shareholders
        a. This usually happens when the third party is economically stronger and insists on doing the transaction before the incorporation is finalized

V. Piercing the Corporate Veil

a. General Rule: when corporations go bankrupt, the shareholders are not liable (and creditors understand this risk)
    i. Piercing the corporate veil is an (narrow) exception – an equitable doctrine invoked to prevent fraud or to achieve equity
        1. Occurs when the company is properly incorporated, but someone is nonetheless trying to get to the shareholders or officers/directors personally (i.e. pierce the corporate – limited liability – veil)
            a. Courts will pierce the corporate veil and hold shareholder(s) liable for corporate debt when the shareholder(s) use the corporate form in an illegitimate way
                i. **Legitimate**: corporation is set up to make a profit, and creditors rely on this purpose when doing business with corporations because they know they have a legitimate chance to get paid back
                ii. **Illegitimate**: using the corporation for reasons other than to make money – here, creditors are defrauded and courts will remedy that by piecing the corporate veil and holding the shareholder(s) personally liable

b. How do you show the corporate form is being abused?
    i. Multiple corporations owned by one shareholder not doing profitable deals
        1. Each corporation should be acting in its own best interest
            a. Cannot set up a corporation solely to further a personal goal or to help another corporation you own unrelated to the maximization of profits
        2. Corporations are intended to be profit-making organizations – so if they are not making a profit, then risk piercing
            a. Exception: if creditors know corporation is not a profit-making institution when they initially make the loan
    ii. Commingling of assets (i.e. mixing personal and corporate assets, using corporate money for personal purposes) – almost 100% likely corporate veil will be pierced
        1. Must keep corporate and personal assets distinct
        2. Must keep corporation and shareholder distinct

iii. Purposeful undercapitalization is evidence (not dispositive though)
   1. Undercapitalization alone is not enough because most new ventures are undercapitalized
   2. Argument would go that the company is purposefully undercapitalized so as to avoid having to pay any corporate liabilities
      a. Argument is not often accepted by courts unless the undercapitalization is egregious

c. It is easier to pierce the corporate veil when the dispute is a tort claim versus a contract claim
   i. Tort: innocent party – did not decide beforehand whether to enter into a transaction with defendant
   ii. Contract: the third party was aware it was dealing with a corporation and voluntarily transacted with it
      1. Therefore, the party seeking relief is expected to suffer the consequences of the limited liability associated with the corporate business form

d. <u>Alter-Ego Theory</u>: courts will piece the corporate veil if D is using the corporation in such a way to blur the notion of where the person stops and the corporation begins
   i. D used corporate form as an alter ego, alias, stooge, or dummy ***and*** did so to commit or disguise fraud or wrong
   ii. Because D disregarded the separate corporate entity, merging the shareholder entities with that of the corporation and making the corporation merely an alter ego (by commingling assets, e.g.) of the shareholder, recognizing the corporation and shareholders as separate entities would result in fraud or cause an unfair result

e. <u>Instrumentality Rule</u>: courts will disregard the fiction of separate legal entity when a corporation is a mere instrumentality or agent of another corporation or individual owning all or most of its stock and impose liability on the real actor
   i. D exercised complete domination and control over the corporate form ***and*** did so to commit or disguise fraud or wrong
   ii. Requirements (in any case but an express agency):
      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 (rather the controlled corporation is merely a business conduit for its principal)
      2. Such control must have been used by the defendant **to commit *fraud or wrong***, to perpetuate the violation of a statutory or other positive legal duty, or a dishonest or unjust act in contravention of plaintiff's legal rights
      3. **Causation**: the aforesaid control and breach of duty must proximately cause the injury or unjust loss complained of
   iii. Ex: *Zaist v. Olson* (Conn. 1967): the relationship between D's corporations was suspicious; D held multiple positions within the corporations (director, president, e.g.), and he *misused* these positions; D used East Haven to benefit Olson and Olson, Inc. through the contracts awarded; court pierced the corporate veil because no evidence of any formal corporate action by the directors or stockholders; East Haven was not set up to be profitable, it had no sufficient funds of its own, took no corporate action of its own and was a mere instrumentality to benefit Olson and Olson, Inc.
   iv. Ex: *Perpetual Real Estate Services v. Michaelson* (4th Cir. 1992): PRES wants to hold Michaelson personally liable for half of the settlement owed by the AAA partnership (PRES + Michaelson's MPI); MPI is liable as well from the partnership agreement, but MPI has no money because it was all paid to Michaelson personally as a dividend (not in anticipation of owing any liability though); court does not pierce the veil because even if D used corporate form as an "**alter ego, alias, stooge, or dummy**" or that he exercised "undue domination and control" over the corporation, he did not use the corporation to

disguise wrongs, obscure fraud or conceal crime; distributing profits via a dividend is OK as long as it was not a fraudulent conveyance to avoid a liability or debt

1. **Piercing the Corporate Veil** = **control** + **using the corporation as a device or sham to disguise wrongs, obscure fraud, or conceal crime**
    a. Unfairness/unfair result is <u>not</u> enough reason to pierce the corporate veil
2. Factors to consider:
    a. Were corporate formalities observed
    b. Were corporate records kept
    c. Were dividends paid
    d. Were there other officers and directors

v. Ex: *Bartle v. Home Owners Cooperative* (N.Y. 1955): D is HOC and P is HOC's sub (well, trustee in bankruptcy); sub was formed to build and sell houses to HOC at a low cost (for veterans) – not for the sub to make money; trustee claims misuse of the corporate form, creditors relied on the corporate purpose (i.e. that sub would make money); court does not pierce the corporate veil because the creditors were aware that the corporation was not formed to make money, so they assumed the risk that the loans would not be repaid; dissent does think the corporate form was misused and notes that it is unclear how much creditors knew before transacting

1. Generally speaking, the doctrine of piercing the corporate veil is invoked to prevent fraud or to achieve equity
    a. Court did not pierce the corporate veil here because there was no fraud, misrepresentation or illegality
        i. Incorporating for the very purpose of escaping personal liability is permitted

f. <u>Enterprise-Entity Liability</u>

i. If you have one enterprise that is comprised of many smaller corporations but acts as one enterprise, then all corporations are treated as one

1. This allows a plaintiff to go after the assets of a group of corporations being operated as a single entity
    a. If both are insolvent in bankruptcy, pool assets and liabilities
    b. Creditors can only get to the aggregate of corporations, not to the individual shareholders
        i. So piercing the veil only to get to the larger corporation behind it all
    c. Not available if the corporations are truly distinct businesses
    d. Can apply to corporations in a parent/sub relationship

ii. Notion that it is improper use of the corporate form to operate several small risky corporations as subs when profits are really flowing to the parent

iii. Ex: *Walkovszky v. Carlton* (N.Y. 1966): P injured by a taxi cab that was owned by Seon; D is a stockholder of 10 corporations (including Seon), each of which has but 2 cabs registered in its name and carries only the minimum liability insurance; each corporation does not have enough to satisfy P's harm, so P alleges that the corporations are operated as a single entity, but even the single entity as a whole is relatively broke, so P wants to hold D personally liable, alleging that the multiple corporate structure constitutes an unlawful attempt to defraud general members of the public (i.e. purposefully designed to avoid legitimate corporate liability); court does not hold D liable because P failed to state a valid cause of action against D (i.e. that the company did something fraudulent, like conducting business in his individual capacity or commingling assets); court rejects inadequate capitalization argument because the companies had the state required minimum insurance

1. P's options to argue this:

a. Enterprise-entity liability: ask for recovery from the larger corporation, but not from D personally
b. Ask for recovery from D personally, but going to have to show that the corporate form was abused, there was fraud, and D was using the corporations for personal benefit and not for the benefit of the other shareholders
    i. Basically that the corporation as a dummy for its individual stockholders who are in reality carrying on the business in their personal capacities

g. <u>Equitable Subordination</u>
    i. Situation: parent is a shareholder of the sub; to get to the assets of the parent when the sub goes bankrupt, the creditors of the sub must pierce the corporate veil
    ii. In the event of a subsidiary's bankruptcy, there are three options:
        1. **Respect Corporate Formalities**: parent is treated as a creditor, so money gets distributed to the parent and to the other creditors of the sub in proportion to their respective debts
            a. (Respecting corporate formalities is the general rule and other doctrines are equitable exceptions)
        2. **Consolidation** – treat them as one company: pool all of the assets and give equal priority to all creditors
            a. This is done when the sub has no real independent existence and is just an instrumentality of the parent (same as enterprise-entity liability)
            b. Ex: *Stone v. Eacho* (4th Cir. 1942): parent is a Del. Corporation that set up a store and incorporated it in Virginia; parent had other stores that were run in the exact same way as the Virginia store but that were not separately incorporated; parent and sub are both in bankruptcy and appellant wants the bankruptcies consolidated because creditors thought they were dealing with the parent (versus the sub); the parent and the sub were basically the same entity – sub was completely dependent and was treated just like the other stores that were not incorporated; court consolidates/applies enterprise-entity liability; if they were not consolidated, Virginia's creditors would have their claims paid off and those of Del. will not receive much of anything; court feels it is unfair to pay off debt to a parent company and as a result stiff the sub's creditors
        3. **Equitable Subordination**: court will subordinate the parent's claim, paying off the other outside creditors of the sub first, and then anything that is left over will go to the parent company
            a. Appropriate when the sub transacts business as a clearly independent corporation and credit was extended to it on faith of its own assets
                i. Pierces the veil in the sense that the parent's claims are treated differently, but does not allow the sub's creditors to seize the parent's assets
            b. Notion that loans from a parent to a sub look like debt, but it is really an investment in equity
    iii. Example:
        1. Parent
            a. A: $14,000
            b. L: $40,000 to creditor A
        2. Subsidiary
            a. A: $8,000
            b. L: $10,000 to creditor B; $30,000 to Parent

3. Which creditor gets what?
    a. Respecting the Corporate Identities
        i. A gets $20,000 [(75% of 8,000) + 14,000]
        ii. B gets $2,000 (25% Sub's assets)
    b. Consolidation (Enterprise-Entity Liability)
        i. New Balance Sheet
            1. A: $22,000
            2. L: $50,000 (Sub's debt to parent ERASED)
        ii. A gets $17,600 (80% of 22,000)
            1. 80% because 80% of debts are to A
        iii. B gets $4,400 (20% of $22,000)
    c. Equitable Subordination
        i. A gets $14,000 (nothing from Sub)
        ii. B gets $8,000

VI. Successor Liability – When Will Acquiring Company be Liable for Target's Liabilities?
- a. E&E:
    - i. In a *statutory merger*, all of the outstanding claims pass to the surviving corporation
    - ii. In an *asset acquisition*, however, none of the liabilities are transferred unless the parties agree
        1. This makes a sale of assets significantly more advantageous than a merger for the buying-successor corporation, if the seller retains some or all of the liabilities
        2. But the buying corporation cannot completely escape liabilities by agreement
            - a. Courts have fashioned a successor liability doctrine that imposes liability on the buying corporation (or another successor down the chain) when the claims were unknown or contingent at the time the assets were sold [known claims must be satisfied by the selling corporation when it is dissolved and wound up]
                - i. Courts use the doctrine to provide a source of compensation for tort claimants (particularly products liability victims) even though the buyer disclaimed liability for such claims
                - ii. Courts that impose successor liability often refer to the plaintiff's inability to seek relief against the original owner, the buying corporation's ability to assume a risk-spreading role (such as through insurance), and the continuity of the original business after the sale of assets
                - iii. Other courts have been less sympathetic to successor liability claims and have required that there be a continuity in the business, management, assets, and shareholders of the selling corporation, and that the selling corporation dissolve and liquidate after the buyer assumed known liabilities
- b. General Rule: where a corporation has purchased the assets of another corporation, the successor corporation <u>does not</u> assume the liabilities of the selling corporation
    - i. Four exceptions under which liability may be imposed upon a purchasing corporation:
        1. When the purchasing corporation expressly or impliedly agreed to assume the selling corporation's liabilities
        2. When the transaction amounts to a consolidation or merger of the purchaser and seller corporations
        3. When the purchaser corporation is merely a continuation of the seller corporation
        4. When the transaction is entered into fraudulently to escape liability for such obligations
            - a. Ex: inadequate consideration for the sale or transfer

ii. Typical case YES successor liability: a corporation transfers its *assets* to a newly-formed corporation and takes back *shares* of the newly-formed corporation, then dissolves, distributing that newly-formed corporation stock to the shareholders of the predecessor so they become shareholders of the newly-formed corporation
iii. Typical case NO successor liability: a corporation transfers its assets to a newly-formed corporation for cash, and that cash is fair consideration, and is used to pay creditors of the predecessor corporation … only wrinkle is if future creditors arrives (i.e. products liability issues) – then it depends on foreseeability of the liability

c. Ex: *Tift v. Forage King* (Wis. 1982): court holds that the general rule and its exceptions are applicable, irrespective of whether a prior organization was a corporation or a different form of business organization (partnership, e.g.); second and third exceptions at issue in this case – where either one is applicable, there is "identity," because in substance the successor business organization which P sues is, despite organizational metamorphosis, the same business organization which manufactured the product which caused his injury
    i. <u>Identity Test</u>: the present corporation is, for the practical purposes relevant to consumer protection, the continuation of the same entity that operated as a sole proprietorship, e.g., before
        1. The present organization has undergone a structural metamorphosis (proprietorship → corporation), but remains in substance the identical organization manufacturing the same product
        2. Identity test applies *at the point of* transformation/organizational change – look at identity at the point of organizational change (i.e. partnership → corporation; corporation A → corporation B)
            a. When the assets are moved, liability does not follow unless one of the four exceptions applies
            b. No identity issue if corporation just changes its name, board, shareholder, business product, e.g. – still liable for debts
                i. A corporation will have a liability as long as it exists, so changing the way the corporation looks does not affect the fact that the money is still owed to the creditors
                    1. Only way to get out from under the liability is through bankruptcy or buy paying them off
            c. If liability was there post-transformation, then it will be there no matter how much the corporation changes itself
            d. If at the time of transformation, the successor organization does not look like the predecessor and there is not much in common (because maybe they only purchased some assets, rather than all), then the court will not find successor liability
        3. Notion that a company cannot shed liability, yet retain assets, simply by moving the same business from one corporation to another
            a. Can incorporate to avoid liability to protect the shareholders
            b. Cannot incorporate/change the organizational form to avoid legitimate debt of the corporation
    ii. Circuit Split: some courts have held that successor liability only exists if the predecessor organization was also a corporation (i.e. transformation was corporation A → corporation B)
        1. If predecessor was partnership or proprietorship, no successor liability because the creditors can still go after the partners or proprietor (because partnerships/proprietorships do not dissolve like corporations)
            a. P would get a windfall if he was allowed to go after both the partners and the corporation

d. Ex: *Anderson Lumber v. Myers* (Minn. 1973): P is a sub for RTL, RTL did not pay P for P's work; if RTL does not pay, Anderson has a security interest in home RTL was contractor for, and Meyers will have to pay; after trial, but before judgment, RTL transfers all assets to L Inc. in exchange for cash (not shares); RTL and L are both wholly owned by the same shareholder; dispute over whether L is liable for RTL's debts; result: no – RTL transferred assets to L, L paid RTL cash in exchange which was then distributed to creditors and Leekley/personal reputation (the shareholder of RTL and L) was an intangible asset that did not have a cash value that could be distributed to creditors

  i. <u>Rule</u>: Where one corporation transfers its assets to another corporation, absent consolidation, merger, or a mere continuation of the selling corporation such as a reorganization, the receiving corporation is not responsible for the debts of the transferring corporation except (a) where the purchaser agrees, expressly or impliedly, to assume such debts, or (b) the transfer of assets is entered into for inadequate consideration, or otherwise fraudulently, in order to escape liability for such debts

e. Bankruptcy Policy
  i. Solvent corporations cannot change to avoid liability
    1. In *Tift*, there was an ongoing, solvent company that was trying to shed liabilities
      a. When the prior firm is solvent, liabilities will follow a change of form if the firm's identity is the same
  ii. Insolvent corporations, on the other hand, should be able to pay creditors with what they have left and get a fresh start – generally through bankruptcy
    1. In *Anderson*, the prior firm was insolvent, and therefore protected by bankruptcy policies even though identity was the same
      a. The company dissolved and made a good faith effort to pay its creditors
        i. In such a case, P cannot go after assets of successor/reformed corporation
      b. Key: bankruptcy principles, not identity – once a firm files bankruptcy, old firm is 100% protected from creditors

f. Tift <u>vs.</u> Anderson
  i. Tift
    1. P won
    2. Transaction: assets for shares
    3. Predecessor (i.e. Tift) solvent
  ii. Anderson
    1. P lost
    2. Transaction: assets for cash (fair consideration)
    3. Predecessor insolvent
  iii. **Consideration is important → if the consideration is cash, the asset seller can pay off its creditors; if the consideration is stock then it is likely just to shed liabilities (old corporation becomes shareholders of new corporation)

VII. Ultra Vires Transactions – What Do Corporations Have the Power to Do and For What Purposes?

a. Ultra Vires: unauthorized – beyond the scope of power of the corporation as granted by the corporate charter or by law, so transaction is void
  i. Situations: when a corporation acts beyond its purpose (the object of its incorporation) or powers (the means by which the purpose is to be carried out)
  ii. When you argue something is ultra vires, you are arguing incapacity
    1. Traditionally, this meant the contract was void/unenforceable
    2. Today, almost every jurisdiction allows P to sue to enjoin it, but if it has already been executed, courts will protect the third party and allow P to sue the directors who got them into this mess in the first place

b. Modern Ultra Vires Law:
  i. Today, the doctrine is not as relevant because corporations have very expansive charters that allow them to do almost anything

            1. Most corporation charters have a purpose clause that says the corporation has the power to engage in any legal activity so long as it is for the benefit of the shareholders
                a. But, even with such clauses, a court can still determine something was outside corporation power and void the transaction
        ii. Revised Model Business Corporation Act (accepted by most jurisdictions)
            1. Cannot challenge the validity of a corporate action based on lack of power *unless*:
                a. The shareholder is challenging the corporation
                b. The corporation (i.e. shareholders) is challenging an officer or director
                c. Attorney General brings a claim
                    i. Generally exercised in cases of illegality
            2. Ultra vires doctrine is recognized, but with limited remedies
                a. Ultra vires is <u>not</u> a defense to a claim by 3rd parties for damages
                b. Ultra vires exists to allow injunctive relief or to give shareholders a cause of action against officers/directors who take impermissible actions
        iii. Illegal actions cannot ever be within corporate power (even if they benefit the corporation)
    c. Ex: *Real Estate Capital Corp. v. Thunder Corp.* (Ohio 1972): Cohen (80% shareholder of Thunder Corp.) got a loan from RECC to Winthrop Homes (Cohen 100% shareholder), but using the mortgage on a Thunder Corp. property as collateral; no consideration passed to Thunder Corp. for its mortgage on the property – the loan money went to Winthrop Homes – so basically, Thunder Corp. is securing the obligation of another person and received no benefit from the loan; since there was no consideration for the mortgage (i.e. does not further the corporate purpose), it constitutes a voluntary transfer ("gift"), which are binding *only if* all the shareholders agree; Berman (20% shareholder) objected so the transaction is void
        i. Corporate officers and agents may deal only within their authority, but when a corporation allows it to appear that the officer or agent has the authority to perform certain business or to engage in certain transactions, the corporation is bound by those acts of the agent, even though he in fact lacks such authority
            1. However, a corporation has only that authority which is granted to it by the Ohio Revised Code, and acts of the agent which are outside the authority granted to it by the Ohio Statutes cannot be performed even though such acts may be within the authority granted to the agent by the corporation
    d. Ultra vires protects the implied purpose of a corporation – to make money
        i. Corporations must be run in such a way so as to make money for the shareholders
            1. Management cannot change the corporation from profit maximization into a charity organization ("semi-eleemosynary institution")
        ii. Ex: *Dodge v. Ford Motor Co.* (Mich. 1919): D, a shareholder of F, wants to force F to issue a divided; F wants to re-invest the money to grow the company and create more jobs; D alleges that the corporate purpose has changed from profit-making to charity; court determines that F should have declared a dividend because they do not need to carry such a surplus to execute their business plan; court notes that there was not an abuse of power by the directors, but courts will imply to all corporations the purpose to make money
            1. <u>Only</u> the directors of a corporation have the power to declare a dividend and to determine its amount (they have discretion)
                a. Except:
                    i. When you can show fraud or misappropriation of corporate funds, or
                    ii. When directors refuse to declare a dividend even though they have such a surplus that they can distribute it without a

detriment to business – and – a failure to do so would amount to such an abuse of discretion as to constitute fraud or a breach of good faith

2. 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 benefitting others

iii. Ex: *Shlensky v. Wrigley* (1968): P (minority shareholder) wants lights installed (with the ultimate goal of increasing revenue); Wrigley (80% owner of the Chicago Cubs) refuses to install lights or have night games because baseball is a daytime sport and night games + lights would have a detrimental effect on the neighborhood – so a legitimate decision by the board to not disturb the neighborhood; P alleges this is motivated by his personal beliefs and not a good faith concern as to the interests of the corporation

1. The judgment of directors 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
   a. Court is not convinced that the directors acted contrary to the best interests of the corporation and its stockholders
      i. While the court might have made a different decision, the decision made by Wrigley shows no fraud, illegality or conflict of interest, so will get the benefit of the business judgment rule

iv. Ex: *Miller v. AT&T* (3rd Cir. 1974): AT&T never tried to collect on $1.5M debt owed by the DNC; Ps (AT&T stockholders) are suing to force the corporation to collect; Ps also allege that this is a corporate donation to a political party, which was a violation of federal law at the time

1. *If* this was a business decision made by disinterested directors in good faith (and not illegal), then it is protected by the business judgment rule
   a. There are legitimate reasons not to try to collect on a client's debt
      i. Corporations typically have relatively wide latitude re: loan forgiveness decisions
2. *If* this really is illegal against federal law, then the business judgment rule does not apply
   a. The business judgment rule will not insulate a corporation if they did in fact breach the federal law at the time
   b. FN 5: under New York law, Ps will have to prove harm to the corporation, even if the corporation breached a federal statute

VIII. What Should the Goals of a Corporation Be?

a. Theories:

i. Value-Max: corporations should maximize their value within the bounds of the law

1. Charitable contributions are OK, but only if they maximize value
2. Considerations:
   a. Social responsibility of corporations undermines capitalism and looks more like socialism
   b. It would be better to give the money to the shareholders and then they can make charitable contributions if they want – more of a bright-line rule
   c. Gives CEO too much discretion if he can unilaterally choose where and who to donate to (i.e. he is giving away the shareholders' money)
3. Social responsibility is a function of government and the democratic process and should not be made by elite executives (esp. if the donations are made to controversial causes)

ii. Social Responsibility/Corporate Citizen Model: concerns beyond maximizing profits

1. Corporations are like people in society and they should (or at least be allowed to) give something back
2. Considerations:
    a. Raises awareness
    b. Potential for doing good – and often doing good more quickly than other avenues (government, e.g.)
    c. Quid pro quo for being allowed to exist (i.e. corporations benefit from a lot of society's resources, so why shouldn't they be able to give back to society?)
    d. Efficient for large-scale giving

b. State of the Law
    i. Modern law has essentially adopted the value-max model with some exceptions
    ii. The law does make a distinction between charitable donations on the one hand and corporate actions on the other hand
        1. Charitable Donations
            a. Corporations can make charitable donations for the public welfare or for other charitable purposes as long as they are reasonable in size and for a proper purpose
        2. Corporate Actions
            a. Corporate actions can be taken in light of what directors find to be unethical (even if they have a dramatic effect on the stock price)
                i. Ex: directors and officers can pull out of big markets or give up big contracts for social and ethical reasons
    iii. Remember, turning the corporation from profit maximization to a charitable organization is **ultra vires**

IX. Lawyers' Responsibilities
  a. Massachusetts Rules of Professional Conduct
    i. Rule 1.6: Confidentiality of Information
        1. A lawyer *may* reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
            a. To prevent the commission of a criminal or fraudulent act that the lawyer reasonably believes is likely to result in death or substantial bodily harm
    ii. Rule 1.16: Declining or Terminating Representation
        1. A lawyer *may* withdraw from representing a client if withdrawal can be accomplished without material adverse effect on the interests of the client, or if:
            a. The client persists in a course of action involving the lawyer's services that the lawyer reasonably believes is criminal or fraudulent
            b. The client has used the lawyer's services to perpetrate a crime or fraud
            c. A client insists upon pursuing an objective that the lawyer considers repugnant or imprudent
            d. Or for other good cause
  b. Model Rules
    i. MRPC were adopted from the Model Rules (so obviously very similar), but the Model Rules were later revised
        1. Revised version has <u>no</u> requirement in Rule 1.6 that the act be "criminal or fraudulent" … only that death or substantial bodily harm is likely to result
  c. Attorney-Client Privilege
    i. To facilitate more and honest communication
    ii. Notion that the lawyer is better able to represent the client if they are fully informed
    iii. Full/Autonomous Citizenship Model:

1. We are a society of laws and of economist individuals who make decisions within those laws, and the problem has become that the laws have become too complex for the average person to navigate
    a. To solve this problem we give lawyers, who do not have the ability to disclose, knowledge of all of these laws
        i. And this is considered a good thing

<u>Duties of Directors</u>

I. Introduction
    a. Duty of Care – which can be statutorily eliminated by a provision in the corporate charter
        i. Business judgment rule benefit if:
            1. Reasonable process/investigation
                a. Judged by a *gross* negligence standard
            2. Rational basis for the actual decision
        ii. Burden is on P
    b. Duty of Loyalty – which involves self-interested transactions
        i. Intrinsic fairness
            1. Burden is on D to prove fairness
        ii. Interested Transaction will not automatically be voided because of their self-dealing nature if they are approved by (i) disinterested directors, (ii) shareholders, or (ii) fair
    c. Duty of Good Faith – which requires intentional dereliction of duties, conscious disregard of responsibilities (*Disney*)
        i. Some people consider a subset of the duty of loyalty (Del. courts)
            1. Ex: *Stone v. Ritter*: violation of the duty of good faith is really a violation of the duty of loyalty
        ii. But in many ways the violation of duty of good faith seems more like a duty of care violation because there is not necessarily an allegation of self-interest
            1. And Ps may try to rely on the duty of good faith if the duty of care has been eliminated by the corporate charter

II. Duty of Care
    a. Business Judgment Rule
        i. The judgment of directors gets the benefit of a rebuttable presumption that acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interest of the company
            1. Shields directors from personal liability if they did a reasonable investigation (i.e. the process) – judged by a *gross* negligence standard
                a. If the board is merely negligent, then the decision is still protected under the business judgment rule
                b. Gross negligence is the standard arguably to counteract hindsight bias (i.e. decisions that may have looked perfectly reasonable at the time look unreasonable once the bad outcome occurs)
            2. Insulates board decisions from judicial review if the decision had a rational basis (i.e. the outcome) – judged by a rational basis/waste standard
        ii. Why give the presumption of the business judgment rule?
            1. Directors are more competent to make business decisions than courts
                a. Court will not substitute its judgment for that of the directors'
            2. Need to offer management some protection in order to get qualified people in those positions
            3. Encourages risk-taking because without the business judgment rule, directors might exercise moribund caution
        iii. To overcome the business judgment rule and show a breach of the duty of care, plaintiff must show:
            1. The process by which the decision was made was unreasonable

            a. Reasonableness judged by a gross negligence standard
            b. [No reasonable investigation is where a majority of the duty of care cases are – did not get enough information, did not deliberate long enough, relied on inadequate representations, e.g.]
        2. The outcome (i.e. the decision itself) had no rational basis
            a. Difficult to show
            b. Ex: assets given away with no inherent purpose – waste
            c. Ex: corporation makes a gift to a past executive – could be waste
        3. The directors are interested in the transaction (fraud, illegality, or a conflict of interest)
            a. Interested transactions do not get the benefit of the business judgment rule
            b. Becomes a duty of loyalty case, which is easier to win

b. ALI §4.01(c) & (d): Duty of Care of Directors and Officers; the Business Judgment Rule
    i. A director or officer who makes a business judgment in good faith fulfills the duty under this Section if the director or officer:
        1. Is not interested in the subject of the business judgment
        2. Is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
            a. Process = reasonableness standard
        3. Rationally believes that the business judgment is in the best interests of the corporation
            a. Decision = rational basis standard (pretty low threshold)
    ii. A person challenging the conduct of a director or officer under this Section has the burden of proving a breach of the duty of care

c. Directors of a corporation have a duty to exercise good business judgment and use ordinary care and prudence in the operation/management of the business
    i. They must discharge their actions in good faith and in the best interest of the corporation
        1. The violation of the duty of care results in personal liability of the directors
            a. The directors have to reimburse the corporation for their gross negligence from their personal assets
            b. This is not piercing the corporate veil though
            c. Duty of care is a tough case to win
                i. Duty of care cases are implicated in disinterested transactions when the shareholders feel that management was incompetent, lazy – fell asleep at the wheel
    ii. Ex: *Francis v. United Jersey Bank* (N.J. 1981): P wants to hold D personally liable for negligence due to the fact that her sons were taking out "shareholder loans" in the amount of $12M – sons basically robbed the company – and D had a duty to P; D argues that she was not involved in the business at all and had no general knowledge of the business; court determines that D was grossly negligent and did breach her duty of care (she fell asleep at the wheel)
        1. A director should acquire at least a rudimentary understanding of the business of the corporation
            a. Notion that if she even took a cursory glance at the financial books, she would have discovered what her sons were doing
        2. If a director cannot fulfill her duties, she should resign
        3. **Directors cannot be passive, "dummy" or "figure head" directors**
    iii. Ex: *Smith v. Van Gorkom* (Del. 1985): P alleges (and court agrees) directors failed to inquire as to VG's role in setting merger terms, to review merger documents, to inquire into the fairness of the $55 purchase price, question the CFO's opinion that $55 was

"within a fair range," seek an outside opinion from investment bankers re: fairness of $55 price, and acted at 2-hour emergency meeting without prior notice; D claims protection of the business judgment rule; court determined that the directors failed to conduct a reasonable investigation (process) by failing to inform themselves of all information reasonably available to them and relevant to their decision to recommend the merger – instead of protecting the shareholders' interests, they just rubber stamped VG's price

1. By relying only on the presentation of the CEO re: the fairness of the $55 price (and doing no valuation studies or seeking any verification), the directors were grossly negligent in approving the merger
    a. <u>Rule</u>: A board has to act reasonably to inform themselves of all material information reasonably available and to make sure that shareholders are reasonably informed of material information

d. Delaware §102(b)(7) was enacted after *Van Gorkom* (bombshell decision) out of fear that Del. would lose their stronghold on corporations
    i. This section allows corporations to include a provision in the charter/certificate of incorporation that effectively eliminates liability for violations of the duty of care
        1. This provision exists in most corporations
            a. And if the corporation does, you cannot try to prove lack of a reasonably investigation or lack of good faith
        2. Do not excuse violations of the duty of loyalty, acting in bad faith, intentional misconduct, knowing violations of the law
        3. This provision eliminates liability for <u>monetary damages</u>
            a. If P objects to a transaction and wants to get it <u>enjoined</u>, then §102(b)(7) will ***not*** be relevant
    ii. A similar section has been enacted in just about every other state – to encourage incorporation there

e. Summary:
    i. Duty of care = if you show lack of a reasonable investigation and/or lack of a rational a rational basis
    ii. Duty of good faith = if you show there is a lack of good faith; conscious disregard
    iii. Duty of loyalty = if you show that the director is interested

III. Duty of Good Faith

a. Duty of Good Faith applies to situations where directors are disinterested
    i. Relevant in two situations:
        1. When there is an exculpatory clause relieving the board from liability for breach of duty of care, so P brings case under the duty of good faith for cases where the disinterested directors are alleged to have fallen asleep at the wheel
            a. Board took some action that allegedly harmed the corporation, for which there was no reasonable investigation, no rational basis, e.g.
                i. But must show *more than* gross negligence (which is the duty of care standard)
        2. Duty to Monitor cases (i.e. board failed to take some action; inaction)
            a. Applicable whether or not there is an exculpatory clause
            b. Good faith standard

b. <u>Bad Faith Standard</u> = intentional dereliction of a duty, a conscious disregard for one's responsibilities as a director
    i. Must be something more than gross negligence – even without exculpatory clause, you need a breach above and beyond just a breach of duty of care (so as not to nullify Del. §102(b)(7))
        1. Need something like recklessness (should have known) or intent
    ii. Harder to prove than a breach of a duty of care
        1. A failure to act in good faith may be shown, for example:

a. Where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation
b. Where the fiduciary acts with the intent to violate applicable positive law
c. Where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties

iii. Directors are not protected by Del. §102(b)(7)'s exculpatory clause for violations of the duty of good faith or loyalty

iv. Ex: *In re Disney* (Del. 2003 & 2006): P allege board of directors violated the duty of good faith because they made decisions without informing themselves at all (i.e. no reasonable investigation); D contends that they violated the duty of care at most (and they had an exculpatory clause, so no liability); court shockingly lets this case survive D's motion to dismiss, even though the case looks an awful lot like a duty of care case (i.e. that board just fell asleep at the wheel); in 2006 (the ultimate decision): court determined that the directors did act in good faith

1. ***Disney* court recognized a cause of action for breach of the duty of good faith**
   a. Ps can bring disinterested directors to trial for decisions they took alleging bad faith, but the court adopts a standard that makes it almost impossible to win those cases (as the *Disney* facts were pretty egregious)
   b. <u>Standard</u>: P must show intentional dereliction of the board's duties, conscious disregard of responsibilities

c. <u>Duty to Monitor</u> (cases evolve from *Graham* → *Stone*)

i. **Standard**: conscious disregard of directors' responsibilities (same as the duty of good faith)

ii. Ex: *Graham v. Allis-Chalmers Mfg. Co.* (Del. 1963): P is bringing a failure to monitor claim, alleging that Ds are liable for failure to take action designed to learn of and prevent anti-trust activity on the part of employees of the corporation; D alleges no actual knowledge and no reason to suspect anti-trust violations; court finds for D, holding no failure to monitor

1. Absent cause for suspicion (i.e. absent any red flags), 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
   a. Directors are entitled to rely on the good faith/honesty of subordinates until given a reason not to
   b. Directors are only bound to use the amount of care a reasonable and prudent man would use in similar circumstances

iii. Ex: *In re Caremark International* (Del. 1996): P alleges a failure to monitor/ensure compliance; D alleges that they had a system in place and took initiatives; court finds that D is not guilty of a sustained failure to exercise their oversight function – the corporation's information systems appear to have represented a good faith attempt to be informed of relevant facts

1. **Standard**: generally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation, <u>only a sustained or systematic failure of the board to exercise oversight</u> – such as an utter failure to attempt to assure a reasonable information and reporting system exists – will establish the lack of good faith that is a necessary condition to liability
2. From *Graham* → *Caremark* the nature of corporations changed
   a. *Caremark* distances itself from and narrows *Graham*'s holding (i.e. no duty unless red flags): nowadays, it would be unreasonable for a corporation to not have some sort of monitoring system in place

                i. Now corporate liability is mitigated in the sentencing guidelines if there is a monitoring and compliance mechanisms were in place

      iv. Ex: *Stone v. Ritter* (Del. 2006): Ps allege that the directors breached their oversight duties; D alleges it had a system in place to monitor employees; court adopts *Caremark* re: **a necessary condition for director oversight liability is a sustained or systematic failure of the board of directors to exercise oversight**
         1. Boards must stay reasonably informed and reporting systems must exist which are reasonably designed to provide to the board timely, accurate information regarding misconduct
            a. Must exercise good faith judgment as to whether the reporting system is adequate
         2. <u>The necessary conditions predicate for director oversight liability</u>:
            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
         3. Court uses the good faith standard (from *Disney*) that only a conscious disregard for the duties of a director will result in liability
            a. Court explicitly adopts the good faith standard for failure to monitor cases (even though *Disney* was not a failure to monitor case)
               i. Duty to monitor standard = Duty of good faith standard
         4. Court declares the duty of good faith a subset of the duty of loyalty
            a. So now directors can violate the duty of loyalty by (i) engaging in self-dealing, or (ii) having an utter and complete, conscious disregard for their duties as directors

IV. Duty of Loyalty
   a. Introduction:
      i. Duty of Loyalty cases:
         1. Interested Transactions
            a. Standard: fairness
            b. Burdens
               i. P has the burden to show that the directors are interested
               ii. D has the burden to show that the transaction was fair to the corporation
         2. Duty of Good Faith Cases
            a. 102(b)(7) clause, so trying good faith argument
            b. Duty to monitor cases
            c. Standard for both: conscious disregard
   b. Self-Dealing
      i. Transactions involving a director that is on both sides of the transaction (i.e. not at arms-length) – either directly or indirectly – and creates a conflict of interest between the director and the shareholders
         1. Ex: director who contracts with his own corporation, receiving a benefit not equally shred with the other shareholders
         2. Ex: corporation contracts with another corporation or entity in which the director has an interest
      ii. Business judgment rule does <u>not</u> apply to self-dealing transactions
         1. Showing that an interested director is on both sides of the transaction rebuts the business judgment rule's presumption that business decisions are made with the corporation's best interests in mind

        a. This does not mean that the self dealing transaction is always void as bad for the corporation – just requires a higher level of scrutiny for precaution

iii. Ex: *Meinhard v. Salmon* (N.Y. 1928): parties were partners in a joint real estate venture; P is alleging breach of the duty of loyalty because D renewed the lease (without informing or inviting P), therefore P did not get a chance to compete or share in the profits; D alleges he satisfied his duty of loyalty to the partnership, no fraud, no misrepresentation; P wins because D breach duty of loyalty by not bringing the possibility of the lease extension to the partnership
    1. **Key**: management has a duty of loyalty to the organization
        a. "*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"

iv. Ex: *Case v. New York Central Railroad* (N.Y. 1965): P (minority shareholders of Mahoning) and D (Central, majority shareholder) enter an agreement to allow Central to consolidate their tax returns; the agreement resulted in a tax saving of $3.8M ($3.5M to Central, and $.3M to Mahoning); self-dealing transaction because there is dramatic overlap of the board of directors for both companies; while D did get significantly more in the allocation, P actually saved money on the transaction, so D argues still advantageous to P; court held that D satisfied its burden to show fairness to both sides
    1. When both sides benefit from a self-dealing transaction that is reasonable and fair, courts will likely let it stand
        a. Courts find it very difficult to void self-interested transactions when both sides benefit and there is a reasonable argument as to why the allocation should be as it was (and P does not have a rebuttable persuasive argument)

v. Ex: *Cookies Food Products v. Herrig* (Iowa 1988): P alleges that Herrig caused Cookies to enter into contractual agreements with other companies he owns and with himself = self-dealing; court notes that corporate profitability should *not* be the sole criteria by which to test the fairness – might also show fairness of the bargain to the interests of the corporation
    1. Transactions will not automatically be voided because of their self-dealing nature if:
        a. The transaction is approved/ratified by a disinterested board, which knows of the relationship or interest
        b. The transaction is approved/ratified by shareholders who know of the relationship or interest
        c. The transaction is fair and reasonable to the corporation
    2. … these transactions still require scrutiny to make sure they are fair
        a. Ratification renders the transactions voidable, rather than automatically void (like common law

vi. Two types of duty of loyalty cases affected by ratification:
    1. <u>A transaction between a controlling shareholder and the corporation</u>
        a. Getting it approved by disinterested directors or shareholders **shifts** the burden of proof to the plaintiff, but it **does not change** the standard of fairness
            i. Note that *disinterested* is a requirement even if the statute does not appear to require it – courts will
    2. <u>A transaction that does not involve controlling shareholders</u> (between a director and the corporation, e.g.)
        a. Getting the transaction approved by disinterested directors or disinterested shareholders **changes** the standard of review to the

business judgment rule and **shifts** the burden of proof to the plaintiff to prove no rational basis

i. Ex: *In re Wheelabrator* (Del. 1995): WTI merged into a subsidiary of Waste and the sub was created solely for this merger; P alleging this is an interested transaction because 22% of WTI's shares are owned by Waste, making Waste the largest stockholder, and P wants an entire fairness standard; D contending that the informed, disinterested shareholder vote (a) serves to defeat the duty of care claim, and (b) shifts the burden to the plaintiff to show no rational basis for the duty of loyalty claim; court: an informed, disinterested shareholder vote shifts the burden to the plaintiff to prove no rational basis/waste
    1. **The informed shareholder vote extinguished the duty of care claim**
        a. Failure of the board to reach an informed business judgment constitutes a voidable, rather than void, act
            i. A validly accomplished shareholder ratification cures an otherwise voidable director act (i.e. actions performed in the interest of the corporation but beyond the authority of management, or when directors fail to reach an informed business decision in approving a transaction)
    2. **Informed shareholder votes do <u>not</u> extinguish duty of loyalty cases**
        a. Ratification only alters the standard of review and/or shifts the burden of proof

c. Corporate Opportunity
    i. **Threshold Q: Is this a corporate opportunity?**
        1. Answers:
            a. Yes = duty of loyalty case
            b. No = not a duty of loyalty case because you are not taking anything from the corporation
        2. Two main tests to determine whether something is a corporate opportunity:
            a. <u>Line of Business</u>: the opportunity is in the corporation's line of business, or is of practical advantage or interest to it
            b. <u>Interest or Expectancy</u>: the opportunity is essential to the corporation, or the corporation has an interest or expectancy in it – a legal or relational interest that strongly ties the corporation to that opportunity
                i. Requires something more than the line of business test
                ii. Note that sometimes the issue of devoting corporate assets to the development of an opportunity *may* cause the corporation to have an interest or expectancy in the opportunity
                    1. Some courts just treat use and conversion of assets as a separate inquiry though
        3. Jurisdictions are all over the place re: whether something is a corporate opportunity

        a. Some courts have adopted the Guth Rule/Guth Corollary (Del., e.g.)
        b. Some courts just look at the circumstances and decide what test is appropriate
            i. Ex: line of business test for corporations with professional management – paying them to put corporation's interests first
            ii. Ex: interest/expectancy test for smaller corporations
        c. Some courts just use a fairness test – not really articulating a test, just whether it looks fair or not
        d. *BUT*, all ask the same threshold Q & if the answer is "yes" = duty of loyalty case
ii. Ex: *Burg v. Horn* (2d Cir.): P argues that D took opportunities that belonged to the corporation; D argues that they did not have an agreement that all low-rent buildings would go to the corporation first and that P *knew* D was involved in a similar venture on his own; court adopts the interest or expectancy test, noting that interest must be legal or quasi-legal (suggests a relatively strong connection)
    1. A person's involvement in more than one venture of the same kind may negate the obligation which might otherwise be implied to offer similar opportunities to any one of them, absent some contrary understanding
iii. Ex: *Rapistan v. Michael* (Mich. 1994): which test applies depends on in what capacity the director received the opportunity
    1. **Guth Rule** (Del.): If the opportunity came to the director in his <u>personal</u> capacity, the opportunity will be deemed corporate only if it satisfies the interest or expectancy test
        a. When a business opportunity comes to a director in his individual capacity
            i. Is one which is not essential to his corporation, and
            ii. Is one in which the corporation has no interest or expectancy,
            iii. The officer or director is entitled to treat the opportunity as his own, as long as the officer or director has not wrongfully embarked the corporation's resources therein
    2. **Guth Corollary** (Del.): If the opportunity came to the director in his <u>official</u> capacity, the opportunity will be deemed corporate if it satisfies either the interest or expectancy test ***or*** the line of business test
        a. If a director is presented an opportunity in his official capacity, that the corporation is
            i. Financially able to take,
            ii. Is in the line of the corporation's business and is of practical advantage to the corporation,
            iii. Is one in which the corporation has an interest or a reasonable expectancy, and
            iv. By embracing the opportunity the self-interest of the officer or director will be in conflict with the corporation's interest,
            v. The law will not permit him to seize the opportunity for himself
    3. Summary:
        a. If opportunity presented in *official* capacity → interest, expectancy – **OR** – line of business test applies
        b. If opportunity present in *individual* capacity → only interest, expectancy test applies
        c. So, if the corporation has an interest or expectancy, the opportunity always belongs to the corporation

            i. Line of business test only applies if it comes to you in official capacity

iv. **Once you decide that something is a corporate opportunity, what should be the standard re: whether a director can take the opportunity personally?**

1. Majority Rule: duty of loyalty standard applies (with self-dealing exceptions) → Fairness
    a. Burden is on the directors to show that taking the opportunity was fair to the corporation
        i. Was it fair and reasonable?
            1. If director can show that the corporation was not capable of taking the opportunity, then taking it would not have been unfair to the corporation … can be a defense in most jurisdictions
    b. If the decision was ratified, director will get the business judgment rule
        i. Did the board approve the director's use of this corporate opportunity?
        ii. Did the shareholders?
    c. Ex: *Fliegler v. Lawrence* (Del. 1976): corporation could not take the opportunity, so directors took it, but entered an option agreement where the opportunity could be sold back to the corporation; P alleged this was unfair and harmed the corporation; D alleged this was fair and beneficial to the corporation, and that it was approved by the shareholders; P counters that the majority of shareholders were directors of both corporations ≠ disinterested
        i. This was a corporate opportunity which should have been (and was) offered to the corporation, but because the corporation was not in a position, either financially or legally, to accept the opportunity at that time, the individual defendants were entitled to acquire it for themselves after the corporation rejected it
            1. D still has the burden of showing intrinsic fairness (and D ultimately satisfied this burden)
                a. The standard was not changed despite the shareholder ratification because the shareholders were not disinterested
2. Minority Rule: incapacitation is not a defense (for taking advantage of the opportunity for yourself)
    a. Directors cannot, under any circumstances, take advantage of a corporate opportunity without first passing it to the corporation
    b. Ex: *Irving Trust v. Deutsch* (2d Cir. 1934): if something is a corporate opportunity, the directors cannot take the opportunity for themselves on the basis that the corporation was financially unable to take the opportunity
        i. If something is indeed a corporate opportunity, directors cannot use as a defense (for taking the opportunity themselves) the incapacitation of the corporation to take the opportunity
            1. Directors are categorically excluded from taking the opportunity on the basis of incapacity
            2. Note that incapacity is only an issue ***after*** something is deemed a corporate opportunity

            ii. Rationale: maximizes the incentive for the board to find a way for the corporation to take the opportunity; removes the temptation for directors to take it for themselves
    v. Estoppel Rule: If director wrongfully uses the corporation's assets in the acquisition or development of an opportunity, he is estopped from saying it is his … it is the corporation's
        1. Corporate assets: need nexus between assets and development of opportunity
            a. Hard assets: cash, facilities, contracts
                i. Estoppel is more likely here because these are more clear-cut
            b. Soft assets: goodwill, working time, corporate information
    vi. Strategy: (1) argue it was not a corporate opportunity; (2) if it was a corporate opportunity, it was fair and reasonable to the corporation – or – was ratified by disinterested board or shareholders

<u>Derivative Suits</u> **look at flow chart**

I. The derivative action developed in equity to enable shareholders to sue in the corporation's name when those in control of the company refuse to asset a claim belonging to it
    a. The nature of the action is two-fold:
        i. First, it is the equivalent of a suit by the shareholders to compel the corporation to sue
        ii. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it
    b. If successful, personal liability will be imposed on the directors
    c. If damages are awarded, they will flow into the corporate treasury
    d. Any shareholder can bring a derivative suit – no special standing needed
    e. By its very nature, the derivative action impinges on the managerial freedom of directors
        i. Therefore, the demand requirement of Chancery Rule 23.1 exists at the threshold to ensure that shareholders exhaust all intracorporate remedies
            1. And the demand requirement also acts to conserve judicial resources and the corporation's resources
II. Demand Required: when demand is required, the board decides the fate of the claim, and the board's decision is judged by the business judgment rule (i.e. reasonable investigation?), so plaintiffs usually lose
    a. Demand Granted: the board will go forward with the shareholders' claim (never happens)
    b. Demand Refused: the board's decision is judged by the business judgment rule (Ps usually lose)
        i. If P makes demand, he is conceding the independence of the board and that the directors are disinterested (because P is admitting that the board is the proper place to make this decision)
            1. Making demand effectively places the fate of the derivative suit in the hands of the board
III. Demand Excused: claim will go forward – board cannot dismiss
    a. In order to get past a motion to dismiss, must show:
        i. Duty of loyalty case, or
        ii. Have some chance of winning a duty of care case
    b. Essentially having a mini trial on the substance of the claim, using specific facts you can prove in substance at trial
IV. *Aronson v. Lewis* (Del. 1984) → by which demand excused cases are judged
    a. <u>Demand is excused when</u>: the court decides under the particularized facts alleged that there is **reasonable doubt** that:
        i. The directors are independent and disinterested (i.e. P has a valid duty of loyalty claim), or
        ii. The transaction was the product of a valid exercise of business judgment (i.e. P has a valid duty of care claim)

1. How can you cast reasonable doubt? Particularized facts re: directors were misinformed, ill-informed, grossly negligent, did not take required steps when investigating the matter, e.g.

b. Focus is on the underlying transaction – the decision the board has already made
c. P alleges that making demand is futile

V. *Levine v. Smith* (Del. 1991) → by which demand refused cases are judged
  a. In demand refused cases, shareholder concedes independent of the board by making a demand
    i. Demonstrates that P thinks the board is capable of rendering a disinterested decision
  b. <u>Demand refusal</u> is judged by the business judgment rule
    i. P's only argument is that rejection was wrongful (i.e. not a product of informed business judgment, reasonable investigation, etc.)
      1. This argument will probably lose
        a. Therefore, you almost never made demand in Del. and similar jurisdictions because all the board has to do to get rid of you is make a reasonable, good faith investigation of your request and then decide not to do it

VI. *Zapata v. Maldonado* (Del. 1981) → by which recommendations by SLC are judged
  a. When a corporation forms a <u>special litigation committee</u> (SLC), it concedes self-dealing and that demand should be excused
    i. SLC is typically made up of disinterested, outside directors who did not participate in the underlying decision (and thus could not be named as defendants)
  b. When, if at all, should an authorized SLC be permitted to cause litigation, properly initiated by a derivative stockholder in his own right, to be dismissed?
    i. Business judgment rule is not sufficient because SLC may have subconscious bias and/or not want to sue their colleagues
    ii. **Courts should apply a two-part test to SLC's motion to dismiss**:
      1. Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions
        a. The corporation has the burden of proving independence, good faith and a reasonable investigation
        b. If the court *is not* satisfied that the SLC was independent, e.g., it may deny their motion
        c. If the court *is* satisfied that the SLC was independent and showed reasonable bases for good faith findings and recommendations, the court may proceed, in its discretion, to the next step
      2. Court should apply <u>its own independent business judgment</u> to determine whether to grant the motion
        a. Consequences of this: there may be instances where SLC establishes its independence and sound bases for its good faith decisions and nonetheless has its motion denied
          i. This occurs when SLC technically satisfied step (1) but does not "satisfy its spirit"
        b. Court should consider public policy here
    iii. Enhanced test (1) because SLCs never approve a suit against the directors; and (2) courts are experts at making litigation decisions (as opposed to the business judgment rule notion that courts should not get involved because they are not competent to make business decisions)
  c. Ex: *In re Oracle*: (Del. 2003): P is suing the directors alleging insider trading; P did not make demand on the corporation; corporation appointed a SLC, which determined to dismiss the action because it was not in the best interest of the corporation; P is alleging that the SLC is not in fact disinterested – they are unable to be impartial to the investigation because (in a nutshell) they are Stanford professors and the directors are accused of having strong ties to Stanford (i.e.

donate lots of money); court denied the SLC's motion to terminate the action because the possibility of bias was too substantial to ignore (using *Zapata* test)

   i. **The question of independence turns on whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind**
      1. The independence test ultimately focuses on impartiality and objectivity
   ii. *Oracle* expanded meaning of "interested"
      1. Normally "interested" means directors were involved in/somehow benefitted financially from the underlying transaction (self-dealing, e.g.)
      2. Here, SLC directors received no financial benefit, but court still found that they were not sufficiently independent because they might be reluctant to render a decision against their peers (i.e. had a connection that throws doubt on whether they can make a decision in the best interest of the corporation)

VII. Jurisdictional Treatment
   a. A lot of jurisdictions follow the Del. model (**see flow chart**)
   b. Some jurisdictions absolutely require demand, but if so, they do not apply the business judgment rule for the demand refused cases (i.e. by filing demand you are not presumptively conceding that the board is disinterested)

<u>Federal Securities Fraud Law: Rule 10b-5 & Section 10(b)</u>

I. **Section 10(b)**: general anti-fraud regulation; the statute
   a. §10: Manipulative and Deceptive Devices: 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 –
      i. (b)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, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors
   b. §10(b) = manipulative or deceptive device <u>and</u> violate a rule promulgated by the SEC (i.e. Rule 10b-5)

II. **Rule 10b-5**: the rule promulgated by the SEC to enforce the statute
   a. Rule 10b-5: Employment of Manipulative and Deceptive Devices: 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,
      i. (a) To employ any device, scheme, or artifice to defraud,
      ii. (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
      iii. (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person …
      iv. In connection with the purchase or sale of any security

III. Substantive Offense that can Trigger a Rule 10b-5 Action:
   a. Misstatement/Misrepresentation – false statement
   b. Omission – must have a duty to disclose + nondisclosure
      i. Duty is *not* found in Rule 10b-5

IV. Rule 10b-5 Elements:
   a. (1) **Conduct/Substantive Offense**
      i. Deception:
         1. Misrepresentation
         2. Omission + Duty
            a. Need affirmative duty (for omissions) outside of Rule 10b-5 (*Financial Industrial*)

ii. No aiding & abetting private right of action – only the SEC has this authority

b. (2) **Standing**
   i. Must be a buyer or seller of securities (*Blue Chip Stamps*)
      1. Derivative action works if the corporation was the buyer/seller

c. (3) **Materiality**
   i. Reasonable investor standard (*Basic*)
   ii. Bespeaks caution doctrine (*Trump*)

d. (4) **Reliance**
   i. Must have changed behavior based on the misstatement or omission
   ii. Presume reliance for omissions (*Affiliated Ute*)
   iii. Fraud on the market theory (omissions or misstatements) (*Basic*)
      1. Misstatement must be public to affect price and use fraud on the market theory (*West*)
      2. Presumption does not apply to private misstatements unless P brings forth evidence that the private statements were incorporated into the price – no presumption (*West*)
   iv. No private right of action under Rule 10b-5 for aider & abettor
      1. Only rely on companies who disseminate the statements
         a. Statements can be implied by actions (but did not happen in *Stoneridge*)

e. (5) **Scienter**
   i. Must be intentional or reckless
   ii. Negligence is **<u>not</u>** sufficient

f. (6) **Damages**
   i. Out of Pocket (Actual)
   ii. Rescission
   iii. Restitution
   iv. Cover

V. <u>Conduct</u>

a. Ex: *Financial Industrial v. McDonnell Douglas* (10th Cir. 1973): P bought shares of D and a few days later D announced that earnings are going to be drastically below what analysts predicted; value of shares dropped and P sold at a loss; court: there is no general fiduciary duty to disclose – and this is true for good and bad information
   i. **No generalized duty to disclose under §10(b) or Rule 10b-5**, even for material information … must find the duty elsewhere (common law, state fiduciary laws, other parts of the securities laws)
      1. Timing of disclosure of material facts is an exercise of business judgment
         a. Can be valid corporate reasons not to disclose (ore discovery and want to buy the land for cheap, e.g.)
         b. To disclose, information must be "ripe for publication"
            i. Verified sufficiently to permit the officers and directors to have full confidence in their accuracy
            ii. No valid purpose which dictates the information not be disclosed
            iii. Undue delay, not in good faith, in revealing facts, can become a deceptive, misleading, or a device to defraud under Rule 10b-5
   ii. To prevail in a silence (i.e. omission) case, P has the burden of proving:
      1. Exercised due care in making stock purchase,
      2. D failed to issue special earnings statement when sufficient information was available for an accurate release (or could have been collected by the exercise of due diligence), <u>and</u>

3. D owed a duty to P to disclose and his failure to do so was a violation of Rule 10b-5
4. P relied on D's inaction to his detriment

iii. Defense: D can show either good faith or the exercise of good business judgment in its acts or inaction
1. Once D can show exercise of due care in the gathering and consideration of the facts, the business judgment rule presumption arises – although subsequent events might show the decision to have been in error

b. Ex: *Santa Fe Industries v. Green* (U.S. 1977): SF acquired Kirby through short-form merger (owned 95% of Kirby before the merger); Ps are upset about the merger and allege that the price offered to the minority shareholders is unfair – arguing there was a fraudulent appraisal; D argues that the provisions to complete a short-form merger were 100% satisfied and Ps can get an appraisal in Del. court if they do not think they are getting enough, but 10b-5 is not the appropriate action; Ps are in federal court because shareholders almost always lose in state court in appraisal suits; court determines that a 10b-5 action requires deception or manipulation – something more than just acting bad towards your shareholders (even if securities are involved); no omission or misstatement here – Ps had all of the information about the appraisal and had the chance to get a separate appraisal in state court

i. Rule 10b-5 <u>only</u> covers conduct involving deception or manipulation
1. Manipulation: a practice intended to deceive or mislead investors by artificially affecting market activity
2. SCOTUS declines to create broader coverage in the securities area that would cover unfair or non-deceptive breaches of fiduciary duties
   a. §10(b) and 10b-5 are <u>not</u> meant to regulate internal corporate mismanagement
3. Purpose of Rule 10b-5: disclosure
   a. So if everything is disclosed, even if unfair, no Rule 10b-5 action
      i. Whenever the shareholders feel the corporation is not treating them right, they should pursue a remedy at state law: derivative actions on the basis of violating the duty of care and/or loyalty

VI. <u>Standing</u>

a. Possible Plaintiffs:
i. Plaintiffs that have standing can bring a 10b-5 civil action
ii. SEC can bring a 10b-5 action and have automatic standing
iii. DOJ can bring a 10b-5 action if they believe the action was criminal

b. Ex: *Blue Chip Stamps v. Manor Drug Stores* (U.S. 1975): P claims Blue Chip intentionally released an overly pessimistic prospectus to discourage the offerees from purchasing shares so they could later sell the stock at a higher price; Ps allege prospectus was misleading and contained material misstatements and Ps relied on this and did not buy shares, which later turned out to be very valuable; D argues that Ps are non-purchasers and therefore have no standing to bring a 10b-5 action; SCOTUS adopts the <u>Birnbaum Rule</u>; Ps were persuaded not to buy, and this is not enough to have standing

i. Standing in a private action under Rule 10b-5 requires that P be a purchaser *or* seller of securities
1. This limits the class of potential plaintiffs
   a. Problems will allowing non-purchasers to sue: (i) proof in intent to purchase; (ii) proof of reliance on corporation's statement; (iii) potential for nuisance suits and settlements; (iv) Congress had the opportunity to protect potential buyers and refused to do so; (v) anyone could claim they were a potential buyer
2. Avoids speculation about whether and how much P might have traded

        3. As a practical matter, the Birnbaum Rule encourages overly pessimistic prospectuses so if shares do go down, notion that purchasers can't sue; and if the shares go up, purchasers are happy
   c. Purchaser-Seller Doctrine also applies to shareholders who do not sell their shares in reliance on an optimistic misstatement
      i. Shareholders have no standing to sue for lost profits that would have been made if they sold their shares at the time of the misstatement
   d. Purchaser-Seller Doctrine only applies to Ps – D does not need to be a purchaser or seller to be sued

VII. <u>Materiality</u>
   a. In general, if disclosure would affect the stock price, it is material
   b. Ex: *Basic v. Levinson* I (U.S. 1988): Ps are shareholders who sold their shares after the corporation made statements denying a merger, but before confirmation of the merger was announced; Ps not alleging there was a duty to disclose, but that corporation cannot make voluntary statements that are false; D argues the statement was not material
      i. **To fulfill the materiality requirement, P must show a substantial likelihood that disclosure of the omitted fact would have been significant to the reasonable investor's trading decision** (*TCS Industries* test adopted)
         1. Materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information
            a. Materiality = fact-specific inquiry
      ii. In the <u>merger context</u>, whether the information is material depends on *balancing*:
         1. The probability that the merger will occur – with –
            a. Potential indicia of interest: board resolutions, instructions to investment bankers, actual negotiations between principals or their intermediaries
         2. The magnitude of the transaction
            a. Look at the size of the two corporations and potential premiums over market value
      iii. SCOTUS rejected: (i) agreement-in-principle test (i.e. prelim merger discussions do not become material until agreement-in-principle as to the price and structure of the transaction has been reached), and (ii) any untrue statement becomes material test
   c. Bespeaks Caution Doctrine
      i. When offering document's forecasts, opinions or projections are accompanied by meaningful cautionary statements, the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the total mix of information the document provided investors
         1. Cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law – it negates the materiality of an alleged misrepresentation or omission
            a. Statements are sufficient if it they are substantive and tailored to the specific future projections
               i. Vague, boilerplate warnings are not enough
            b. Why?
               i. If there is enough cautionary language, it does not matter that the statements might not have been truthful, because the cautionary language renders the falsehood immaterial
                  1. With enough cautionary language, no reasonable investor would find the statement material when making and investment decision
      ii. Ex: *In re Donald Trump Casino* (3d Cir. 1993): Ps purchased bonds in this investment (standing) and allege that the prospectus contained a material misstatement because a reasonable investor would want to know whether a company will derive sufficient

revenue to cover its debt service; D's argue there was an abundance or cautionary language, v. specific to this particular investment (i.e. not boilerplate); court holds that *the prospectus bespeaks caution* because in general it conveys the riskiness of the investment and its warnings and cautionary language directly address the substance of the statement Ps challenge – the cautionary statements were tailored precisely to address the uncertainty concerning the partnership's prospective ability to repay the bondholders; therefore Ps do not satisfy the materiality requirement and cannot bring a 10b-5 action

iii. Bespeaks Caution Doctrine is codified in the Securities Litigation Reform Act

1. §21E(c): Safe Harbor for Forward-Looking Statements

d. Note: a corporation never has to disclose merger talks, <u>but</u> if you say something about it (including denying it), the statements better be truthful

i. May be able to get out of this if there is sufficient cautionary language to render the statement immaterial, but hard to show, looking back

VIII. <u>Reliance</u>

a. Quick:

i. The reliance requirement tests the link between the alleged misinformation and P's buy-sell decision – it weeds out claims where the misinformation had little or no impact on P's decision to enter the transaction

1. Omission cases do not need positive proof of reliance

2. Fraud on the Market theory gives presumption of reliance where there is a *public* material misstatement <u>or</u> omission

b. Omissions

i. Ex: *Affiliated Ute v. United States* (U.S. 1972): bank was hired to manage AU stock; bank employees were active in encouraging a secondary market for the stock among non-Indians, which traded at higher prices than Indians were selling for; employees **had a duty to disclose** the true market value of the stock because they were actively engaging in creating a market for the stock – they were market makers – rather than being mere transfer agents (i.e. what they were hired to be) [source of duties: contractual duties and duties as a transfer agent]; nondisclosure was to the true market price at which the stock was trading → so we definitely have duty + nondisclosure … Ds contend Ps cannot prove reliance though

1. Positive proof of reliance is not necessary in <u>omissions</u> cases if the undisclosed facts were material

a. P can rely on a presumption of reliance for material omissions

i. Omission of material facts → establishes a presumption of reliance → establishes causation

1. Presumption results from the fact the proving actual reliance is v. difficult to do in an omission case (i.e. would have relied on info if I had it)

b. D can rebut presumption though

c. Fraud on the Market Theory

i. Ex: *Basic v. Levinson* II (U.S. 1988): Ps are shareholders who sold their shares after the corporation made statements denying a merger, but before confirmation of the merger was announced

1. Fraud on the Market theory creates a rebuttable presumption of reliance where there is a ***public*** material misstatement <u>or</u> omission, on the theory that the market incorporates such public statements into market price ("efficient market")

a. Notion that an investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price

i. We assume that if the truth had been disclosed, investors would not have traded at the prevailing non-disclosure price

- b. <u>To rebut: D must show</u>:
  - i. The misrepresentation actually did not lead to a distortion of price, or
  - ii. An individual plaintiff traded or would have traded despite his knowing the statement was false (i.e. sold for unrelated concerns – antitrust, political pressure, e.g.) (i.e. P did not actually rely on the price or the statement when choosing to sell/buy)

    … must sever 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
- c. Policy: the practical difficulty of proving reliance for each individual member of a class action would kill class actions for this type of fraud because each member of the class would be required to testify re: what they did in reliance after reading the material misstatement; so, we presume that each class member relied on the integrity of the market, regardless of whether they read the specific statement (i.e. the class can be people who read the misstatement and people who did not – they simply relied on the price of the shares, which was distorted)
  - i. But, P must still plead reliance
  - ii. *Do not* need class action to use fraud on the market theory

2. Efficient Market Hypothesis
   - a. Types of analysts:
     - i. <u>Technical analysts</u>: look at patterns of stock movement to make predictions about what the stock price is going to do
     - ii. <u>Fundamental analysts</u>: look at the company (management, product lines, economic factors) to make predictions about what the stock price is going to do
   - b. Three forms of efficient market hypothesis
     - i. <u>Weak</u>: technical analysis does not work – any information analysts get from patterns would already be incorporated into the stock price
     - ii. <u>Semi-Strong</u>: neither technical nor fundamental analysis works – there are so many people out there that all publically available information is already incorporated into the stock price
     - iii. <u>Strong</u>: stock price reflects all information, including private information – price is driven to correct level by insiders (i.e. you cannot make money on public *or* non-public information)
       1. No support for this theory
   - c. *Basic* uses this empirical foundation to support its conclusion that public information gets incorporated into the stock price very rapidly

- ii. Ex: *West v. Prudential Securities* (7th Cir. 2002): stockbroker told eleven of his customers that he was sure a company was about to merge – this information was false; he did not release the information to the public, and his clients thought that they were receiving and acting on non-public information (the information's value, if any, lay precisely in the fact that other traders did not know the news); Ps are people who bought stock in this company during the period the broker shared "inside" info with his clients alleging that that info caused those investors to buy more shares, inflating the price; Ps argue the fraud on the market presumption of reliance should apply to non-public information too

1. Ps (with standing) can bring a suit for damages caused by non-public information, but Ps have the burden of proving the information affected the stock price – the information must have *caused* changes in the stock price
    a. **Non-public information <u>does not</u> get the fraud on the market theory's presumption of reliance that public information does**

iii. Summary
1. <u>Public statements</u>: P just need to show materiality and that is enough to satisfy the reliance requirement and get the rebuttable presumption
2. <u>Private statements</u>: P has to bring evidence that the private information made it into the stock price
    a. It is not self-evident like it is with public information
    b. You do not need to show individual reliance though

d. NO private right of action for aiding & abetting

i. Ex: *Stoneridge Investment Partners v. Scientific-Atlanta* (U.S. 2008): Charter had an illegal arrangement with Ds Motorola and S-A in order to inflate their quarterly earnings by $17M; Ps are arguing that Ds should be liable to them as purchasers of Charter stock because they thought Charter was profitable (and essentially that Ds knew they were perpetrating a fraudulent agreement and knew it was to inflate the earning statements that would be filed with the SEC and relied on by the public); Ps suing for a material misstatement (i.e. Charter's misleading financial statement, which affected its stock price), but Charter is bankrupt, so Ps allege Ds are aiders & abettors and Ps want the fraud on the market presumption because the earnings statement was material public information that affected the stock price; court: Ds had no duty to disclose and their deceptive acts were not communicated to the investing public during the relevant times – connection is too remote to find that Charter's investors relied on Ds' actions
1. SCOTUS has previously held **<u>no</u>** §10(b)/Rule 10b-5 liability for aiders and abettors (*Central Bank*)
    a. SEC can bring suit, but private actors cannot
2. Charter's investors cannot go after Ds because the investors did not rely upon any misstatement by Ds (i.e. no reliance on **D's** actions)
    a. Charter's investors do have an action against Charter because they relied on Charter's misstatements, but not Ds because Ds did not directly communicate to the public
3. Policy: concern that allowing 10b-5 liability for aiders and abettors will open up too many transactions (slippery slope) – anyone involved in the marketplace could be liable under 10b-5 if what they do somehow gets later misrepresented by some other company
4. Vigorous Dissent: distinguished *Central Bank* (no intentional deception) from this case (intentional fraud)

IX. <u>Scienter</u>

a. D's requisite mental state must be recklessness or intent

i. Ex: *Ernst & Ernst v. Hochfelder* (U.S. 1976): Ps are customers of First Securities who invested in a fraudulent scheme run by First Securities' CEO; Ps are suing the auditing firm on a theory of negligence: a reasonable auditor would have discovered their fraudulent scheme; Ds argue that Ps cannot prove scienter because negligence is not enough – need manipulation or deception; court: auditing firm's negligence in not auditing the company's books (which likely would have revealed the fraud) is not actionable under Rule 10b-5
1. **Private causes of action under Rule 10b-5 require intent or knowledge to deceive or defraud**
    a. Later cases have upheld recklessness as a basis for a 10b-5 action

i. Reckless disregard, e.g.: you suspect something is going on, but you intentionally do not look because your client is paying you a lot of money

b. Negligence is <u>*not*</u> enough

X. <u>Damages</u>
  a. 10b-5 P must show damages in order to recover
  b. The type of damages awarded is determined on a case-by-case basis
    i. Ps will argue for whatever type of damage calculation gives them the highest price
  c. Types:
    i. **Out-of-Pocket or Actual**: measures the difference in the price received and the true value of the shares *at the time of the sale*
      1. Ex: P sold at $30, but shares were worth $50, so P's out-of-pocket is $20
      2. Scenarios:
        a. Buy: price paid – value worth
        b. Sell: value worth – price paid
      3. Problem: difficult to calculate the true market value of the stock at the time P sold his shares
        a. Market value reflects all available information, so if some of that information is incorrect, figuring out what the market price would be without it is necessarily speculative
        b. Some courts just estimate or figure out an average between the time of sale and what happened after the correction
    ii. **Rescission**: give the plaintiff enough money to rescind the transaction by buying back the shares (price determined *at the time of judgment*)
      1. Ex: P sold at $30, at the time of judgment shares are selling at $80, so we give $50 back … essentially undoing/reversing the deal
      2. Problem: judgments can take years to obtain, so the stock price can be v. different at the time of judgment for a variety of reasons, and we cannot be certain about what P would have done with the stock if P had it for the duration of trial (i.e. might have sold at some point)
        a. P may receive a windfall (if price much higher) or nothing (if price drops)
    iii. **Restitution**: take away any ill-gotten gains of the defendant
      1. Ex: D bought at $30 and sold at $80, so the $50 is taken away from D and given to P
      2. Best for direct personal dealings with privity and/or unjust enrichment (i.e. if D misled P into selling at a lower price)
      3. Problem: often D does not benefit from the misleading statement
        a. Ex: Texas Gulf Sulphur did not buy or sell any stock, so there was no restitution damages to be had
    iv. **Cover**: the difference between the sale price and the hypothetical price plaintiff would have repurchased the stock at within a reasonable amount of time after hearing the corrective info
      1. This supposes that sometime after the corrective statement, P made a decision as to whether to be in or out of the stock – so any price change from this point on is not the result of the misstatement
        a. If P thought that the stock would continue to rise after the correction then P could have covered himself by buying the stock back and taking advantage of that rise
          i. Failure to take advantage of that rise is not attributable to the misstatement
        b. Failure to take advantage of the rise between the misstatement and sometime after the correction is attributable to the misstatement

                        2. How this works: P has a reasonable amount of time to stay in/get out of the market and P's reliance after this reasonable amount of time has nothing to do with the misstatement
                        3. Typically courts give P the benefit of the doubt and assume that P would have bought at the highest point during the reasonable amount of time P has to get back in the market
                        4. Given the efficiency of markets today, the "reasonable time" after the corrective statement is made relatively short
                            a. Some courts give P the highest/lowest value within the reasonable time (*Mitchell*)
                            b. Some courts take the average price during the reasonably time

d. Calculating damages for a pessimistic misstatement:
    i. Scenario: P sold shares for $30 after publication printed misleading info; stock traded for $50 the day of correction; in the 2 weeks following the correction, the stock traded in the $50-$60 range (avg. of $54); D later sold the stock for $100; at the time of judgment, stock was trading for $90
        1. Out-of-Pocket: difference between what P sold for and the true market value at the time of sale (hard to measure, but will do by the average reasonable price after the correction)
            a. $54 - $30 = $24
        2. Rescission: difference between the stock price at the time of judgment and the time sold
            a. $90 - $30 = $60
        3. Restitution: difference between what D purchased and sold for
            a. $100 - $30 = $70
        4. Cover: difference between what P sold for and highest point a reasonable amount of time after the correction (with doubt resolved in favor of P)
            a. $60 - $30 = $30 … might also use $54 avg. price

e. Calculating damages for an optimistic misstatement:
    i. Scenario: P bought shares for $80 after publication printed misleading info; stock traded for $40 the day of correction; in the 2 weeks following the correction, the stock traded in the $30-$40 range (avg. of $38); D later bought the stock for $50 (must be before makes material misstatement?); at the time of judgment, stock was trading for $2
        1. Out-of-Pocket: difference between what P bought at and the true market value at the time of purchase (hard to measure, but will do by the average reasonable price after the correction)
            a. $80 - $38 = $42
        2. Rescission: difference between the stock price at the time of judgment and the time bought
            a. $80 - $2 = $78
        3. Restitution: difference between what D sold and purchased for (gains of D, if any)
            a. $80 - $50 = $30
        4. Cover: difference between what P bought for and lowest point a reasonable amount of time after the correction (with doubt resolved in favor of P)
            a. $80 - $30 = $50 … might also use $38 avg. price

f. Resolve doubts in favor of P
    i. Ds are the ones who committed the wrongdoing and should not profit from the uncertainty their wrong created

g. Ex: *Mitchell v. Texas Gulf Sulphur* (10th Cir. 1971): Ps alleging that Ds made material misleading statement about the extent of their ore discovery and Ps relied on these misstatements when they sold their stock; Ds issued a corrective statement four days later; Ds *tried to argue* reliance on the basis that there were a lot of other factors that could have influence their sale, other than the misstatement; Ds *could have also argued* that the market already recognized the misstatement by the time of sale or that plaintiffs should have known about the curative statement by the time of sale

- i. Note that shareholders have a duty to keep reasonably informed about corrective statements
  - 1. Q re: when a reasonable investor would have learned of the corrective statement
- ii. Ps must exercise diligence and good faith in selling their shares in order to recover damages
  - 1. Must sell reasonably after the misstatement comes out – P cannot unreasonably delay
- iii. *Mitchell* court grants cover damages – award the reasonable investor the amount it would have taken him to invest in the Texas Gulf Sulphur market within a reasonable period of time after he became aware of the corrective statement
  - 1. Damages will be based on the highest value of the stock (in this case, was achieved 9 days after the corrective statement was released)
  - 2. Goal is to award the reasonable investor an amount which offsets any loss suffered by a deceitfully induced sale
    - a. If Ps does not reinvest (as Ps here did not), they run the risk of damages being whatever the highest price is in the reasonable period after the curative release

XI. Fashioning a **Rule 10b-5** action out of a **Duty of Loyalty** case

- a. Ex: *Goldberg v. Meridor* (2d Cir. 1977): P bring a derivative action against the directors of a sub that made a deal with the parent that was v. unfavorable to the sub; deal amounted to sale of sub's assets for parent's stock; directors did not disclose deal to sub's minority shareholders … but minority shareholders were not in a position to stop the deal by voting against it; no question about this being a breach of duty of loyalty
  - i. <u>Rule</u>: A corporation is deceived when it is influenced by its controlling shareholder to engage in an adverse transaction and there is nondisclosure or misleading disclosure as to the material facts [or of a breach of fiduciary duty] of the transaction
    - 1. After *Santa Fe*, the existence of a controlling influence and inadequate consideration alone cannot form the basis of a Rule 10b-5 action – must have a misleading disclosure or no disclosure
    - 2. Here, deception is on the minority shareholder
      - a. Corporation (sub) was influenced by its controlling shareholder (parent) to engage in a transaction adverse to its interests
        - i. Not enough information was released to alert the minority shareholders
    - 3. Because all of the sub's directors were interested (installed by the parent), minority shareholders represent the corporation
      - a. Minority shareholders were deceived with the nondisclosure
        - i. Now the question becomes whether the information that was not disclosed is material to the non-interested directors
    - 4. **Materiality**: even though no shareholder action was required to approve the transaction, minority shareholders could have obtained an injunction if they had all of the facts
      - a. Information is material because directors are reasonable in wanting it
    - 5. **Standing**: sub's assets were for sale to the parent – derivative suit on behalf of seller corporation
      - a. Securities were exchanged for consideration in the transaction
    - 6. **Reliance**: "sue/facts theory" → if P knew the information, he would have sued to enjoin under state law

a. Notion that P did not sue relying on the assumption that the parent had given all the facts
   i. Change of behavior based on deception

b. *Goldberg* is criticized as an end-run around *Santa Fe*, and not all courts follow it
   i. This is basically a duty of loyalty case, but one that involves an exchange of securities
      1. Whenever you see this, think about *Goldberg* and whether there is a 10b-5 action, in addition to a state claim re: duty of loyalty
   ii. SCOTUS has yet to resolve the circuit split on this idea
      1. Small opening for duty of loyalty-type cases, but must allege and show deception to get around *Santa Fe*

Insider Trading

I. Insider Trading = a specific application of Rule 10b-5
   a. So as 10b-5 actions, they must satisfy all of the 10b-5 requirements
      i. Deception – omission (failure to disclose once duty kicks in)
      ii. Standing – buyer/seller
      iii. Materiality
      iv. Reliance – fraud on the market theory
      v. Scienter
         1. (i.e. if you do not know the information is nonpublic and you have no reason to know, you lack scienter)
      vi. Damages

II. Types of Insider Trading:
   a. Classic: trading by an insider of a company on the shares of his own corporation
      i. Violating a clear duty to shareholders because the insider is exploiting his informational advantage/corporate position at the expense of the corporation's shareholders or others who deal in the corporation's stock
      ii. Based on an implied right of action under 10b-5
   b. Temporary: trading by a person made privy to insider information – but not part of the company being traded (lawyer, accountant, printer, e.g.) – trading on the shares of the corporation that employed them
      i. Based on an implied right of action under 10b-5
   c. Misappropriation Theory: trading in violation to the source of the information ("fraud on the source")
      i. Misappropriating information from one source and trading on a different set of shares
      ii. No implied right of action under 10b-5 because the duty is *owed to the source* – not the person on the other side of the transaction
   d. Tippee Liability: comes from liability that was tipped in violation of a duty to the source of the information – tippee inherits the duties that the source of the information had
      i. Can come off of any of the other three types of insider trading
      ii. Tippee duty depends on the tipper violating a duty to the corporation by tipping
         1. This means that the tipper, by tipping, is getting some personal benefit/gain (which is construed very broadly)
      iii. Based on an implied right of action under 10b-5, if liability stems from classic or temporary liability

III. Other Sources:
   a. **20(a)**: gives Ps an express private right of action for trading on insider information in violation of the securities laws
      i. 20(a) does not require a duty
      ii. 20(a) can be brought with a 10b-5 action
      iii. 20(a) has certain procedural and damages restrictions 10b-5 does not
   b. **14e-3**: prohibits insider trading in tender offer situations (*Chiarella* Rule)

            i. "Any person who is in possession of material information relating to a tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from (1) the offering person, (2) the issuer of the securities sought or to be sought by such tender offer, or (3) any officer or employee, cannot trade on the information without disclosing it first"
        c. **16(b)**: prophylactic measure for short-swing profits – not a criminal statute

IV. Why Insider Trading Laws?
    a. PRO: insider trading harms corporations, investors, and capital markets
        i. Individual investors: unfair that employee (insider) is able to cheat employer (shareholders – owners of the corporation) out of their profits based on non-public information
        ii. Capital markets: capital system requires there be a conduit between individual savings and investment by firms
            1. If investors lose confidence in the system, they will not turn over their savings to be invested
        iii. Corporation: insiders who run the company will not make decisions in the best interests of the corporation if they are allowed to trade on inside information – they will do what makes them the most money
    b. CON:
        i. Insider trading laws are not effective
        ii. Inside information helps market reflect true value of stock (can argue the other side of this)
        iii. Insider information can be used to compensate management
    c. Most commentators believe insider trading laws do some good

V. <u>Classic Insider Trading</u>
    a. Trading on material, non-public information in breach of a fiduciary duty to a corporation and its shareholders
    b. Ex: *In re Cady Roberts* (S.E.C. 1961): board member made a phone call to broker about dividend cut and had broker sell stock before this information became public
        i. Directors have a duty of loyalty to the corporation and its shareholders
            1. Shareholders are deceived because they do not know the true value of their stock because the buyer/seller on the other side of the transaction is withholding material, non-public information
                a. Considered shareholders *even if* they were not so before purchasing
            2. Duty comes from the relationship of the director to the corporation/shareholders (i.e. not from 10b-5)
        ii. <u>Re: insider information, directors have a duty to</u>:
            1. Abstain from trading on this information, or
            2. Disclose the insider information to trading partner
                a. Once directors trade on the inside information, they have chosen the duty to disclose
                    i. Failure to disclose is a 10b-5 violation (i.e. an omission)
                        1. Duty conditional upon trading
        iii. Obligation to disclose rests on two principle elements
            1. First, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit or anyone; and
            2. Second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing
        iv. Court rejects D's contention that an insider's responsibility is limited to existing stockholders and that he has no special duties when sales of securities are made to non-stockholders because this approach is too narrow and ignores the plight of the buying public – wholly unprotected from the misuse of special information

            1. There is no valid reason why persons who purchase stock from an officer, director or other person having the responsibilities of an insider should not have the same protection afforded by disclosure of special information as persons who sell stock to them
        v. 10b-5 applies to "any person" → if tippees were allowed to trade, this would end-run the statute making it meaningless

VI. Temporary Insider Trading
    a. **Trading by a person made privy to insider information on the shares of the corporation that employed them**
    b. Ex: *Chiarella v. United States* (U.S. 1980): D is an employee at the printing company hired to print tender offer documents, D was able to figure out the names of the target company when handling acquirers documents of the takeover bids; without disclosing his knowledge, D purchased stock in the target company and sold shares immediately after the takeover was made public (made $30K in 4 mos)
        i. The possession of nonpublic information does not give rise to a duty to disclose under §10(b) and Rule 10b-5 (court rejects disparity of information theory)
        ii. Printer could not be convicted on a failure to disclose theory because he had no duty to speak
            1. No prior dealings with the target company, so no duty owed to the people on the other side of the transaction
            2. Not an agent or fiduciary of the target company
            3. Not a person in whom the sellers had placed their trust and confidence
        iii. **Key**: there must be a relationship that gives rise to a duty (and there is no inherent duty in 10b-5)
            1. Need a preexisting duty to the corporation whose shares you are trading
    c. SEC's response to *Chiarella* → Section 14(e)
        i. Rule 14e-3 gives the SEC the power to regulate tender offers under language very similar to §10(b)
            1. Rule prohibits, during the course of a tender offer, trading by anyone (other than the bidder) who:
                a. Has material, nonpublic information about the offer
                b. That he knows (or has reason to know) was obtained from either the target or the bidder
            2. No need to prove that tipper breached a fiduciary duty for a personal benefit
            3. Not a private right of action – only the SEC/DOJ can bring 14e-3 claims
        ii. Rule was upheld in *O'Hagan* because the SEC may prohibit acts, not themselves fraudulent under the common law or §10(b), if the prohibition is "reasonably designed to prevent … acts and practices [that] are fraudulent"
            1. Rule reaches trading in which a breach of duty is likely but difficult to prove
                a. It may be possible to prove circumstantially that a person traded on the basis of material, nonpublic information, but almost impossible to prove that the trader obtained such information in breach of a fiduciary duty
                    i. This is because you would have to show under *Dirks* not only that the insider breached a fiduciary duty but that the tippee knew or should have known of that breach

VII. Misappropriation Theory
    a. A person commits fraud "in connection with" a securities transaction, and thereby violated §10b 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
        i. 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 (*unfairness*)

        ii. Premises liability on a fiduciary turned trader's deception of those who entrusted him with access to confidential information (*relationship*)
        iii. Outlaws trading on the basis of nonpublic information by a corporate "outsider" in breach of a duty, not owed to the trading party but, to the source
        iv. Purpose: to protect the integrity of the securities markets against abuse by outsiders of a corporation who have access to confidential information that will affect the corporation's securities price when revealed, but who own no fiduciary or other duty to shareholders of that corporation
        v. <u>Need deception</u>
            1. No deception if disclosed (but may be liable under state law for breach of loyalty)
    b. Both classical theory and misappropriation theory address efforts to capitalize on nonpublic information through the purchase or sale of securities
        i. Misappropriation theory outlaws trading on the basis of nonpublic information by a corporation "outsider" in breach of a duty owned not to a trading party, but to the source of the information
            1. Ex: if the insider learns that his company will do something that affects the value of another company's stock, trading on this material (and he trades), the insider misappropriates this information at the expense of his firm
                a. Although he trades with shareholders of the other company, he violates a confidence of his firm
        ii. Whereas classic insider trading targets a corporate insider's breach of a duty owed to shareholders with whom the insider transacts
        iii. In either, both parties do not need to be parties to a securities transaction
    c. Rule 14e-3 **does not** create a private right of action under misappropriation theory since the victim is the <u>source</u>, it is usually not a buyer or seller of the securities, and therefore lacks standing under *Blue Chip Stamps*
        i. SEC/DOJ must bring action
    d. Section 20(a) **does** create an express private right of action for insider trading on the grounds of misappropriation
        i. "Any person who violates any provision of this title or the rules and regulations thereunder by purchasing or selling a security while in possession of material, non-public information shall be liable in an action to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased or sold securities of the same class"
        ii. Basically: **(1)** trading on the basis of material, non-public information, <u>and</u> **(2)** doing so was in violation of the Securities Act (i.e. Rule 10b-5 or 14e-3)
            1. **No** duty requirement
                a. Just have to show violation of the securities law (causation and damages)
        iii. Applies to: (i) Chiarella type people, who work for acquiring company and trade shares of the target; and (ii) WSJ reports, who owed a duty to WSJ and traded on non-public information
    e. Ex: *Heard on the Street*: WSJ columnist tipped co-conspirators as to the contents and dates of his column rating stock performance; prosecution alleged that Ds had a preexisting duty to the source of the information (i.e. WSJ, as employees of), so by trading on the information they violated a duty to the WSJ … and that duty is to either abstain from trading or disclose to WSJ
        i. SCOTUS was split 4-4, so no precedential opinion
    f. Ex: *United States v. O'Hagan* (U.S. 1997): almost identical facts to *Chiarella*; same theory as WSJ: D defrauded the source of the information, which came from the acquiring firm – but can criminal liability be imposed because D had no preexisting duty to the person on the other side of the transaction? – this is SCOTUS deciding to speak since the 4-4 split
        i. Misappropriation theory <u>is</u> a basis for 10b-5 insider trading criminal liability

1. Fraud is consummated, not when the fiduciary gains the confidential information, but when, **without disclosure to his principal** (i.e. necessary deception), he uses the information to purchase or sell securities
    a. The securities transaction and the breach of duty thus coincide
        i. This is so even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of non-public information
    b. Note: full disclosure forecloses liability under the misappropriation theory because the deception essential to the misappropriation theory involves feigning fidelity to the source of the information
        i. If the fiduciary discloses to the source that he plans to trade on the non-public information, there is no "deceptive device" and thus no §10(b) violation – although the fiduciary-turned-traded may remain liable under state law for breach of a duty of loyalty

ii. O'Hagan worked for the law firm retained by the acquiring company
    1. If he bought and sold shares in the acquiring company's stock, then classical insider trading would have snagged him because he would have been in a relationship of trust – a temporary insider
    2. Here he bought and sold shares in the target company's stock, to whom he owed no duty, so court said instead he owed a duty to the source of the information (his law firm) and that gave rise to a abstain-or-disclose duty

iii. Problem? *O'Hagan* suggests there can be no 10b-5 liability if no breach of trust or confidence – so a total outsider who simply stole the information would not be guilty of insider trading …

g. Misappropriation + Tippee = liability can flow down the line
    i. Need: (1) breach by the tipper of duty owed to the source of the nonpublic information; and (2) tippee's knowledge that tipper had breached that duty to the source (need scienter all the way down the line)

VIII. <u>Tippee Liability</u>

a. Tippees are typically people who do not have preexisting duties to the shareholders of the corporation they are trading in, but they typically receive the information from someone who does have such a duty

b. Ex: *Dirks v. SEC* (U.S. 1983): Dirks, an officer at a N.Y. broker-dealer firm, got information from Secrist, a former officer of EFA, who told him that the company's assets were overstated because of corporate fraud; Dirks decided to investigate this and corroborated the charges; neither Dirks nor his firm owned any EFA stock, but he discussed the situation with a number of clients and investors, and some of these people sold their holdings in EFA
    i. <u>A tippee inherits a fiduciary duty not to trade on material, nonpublic information only when</u>:
        1. The insider (tipper) has breached his fiduciary duty to shareholders by disclosing the information to the tippee, *and*
            a. **To determine breach**: whether insider received any direct or indirect personal benefit from the disclosure, such as pecuniary gain or reputational benefit that will translate into future earnings
                i. Tipping a relative is enough to satisfy "gain"
        2. The tippee knows there has been a breach
    ii. Tippee's duty to disclose or abstain is derivative from that of the insider's duty
    iii. Key = whether the insider's disclosure is a breach of a fiduciary duty
        1. This depends in large part on the purpose of the disclosure
            a. The test is whether the insider personally will benefit, directly or indirectly, from his disclosure (and this is <u>broadly</u> construed)

        iv. Holding: no 10b-5 violation here because Dirks was not an insider to the corporation – he had no fiduciary relationship – he took no action which gave rise to a relationship of trust and confidence in him
            1. Neither Secrist nor the other EFA employees violated their *Cady Roberts* duty to the corporation's shareholders by providing information about the corporate fraud to Dirks – they received no monetary or personal benefit for the tip, nor was their purpose to make a gift of valuable information to Dirks
                a. Therefore, since Dirks had no duty and Secrist did not breach a fiduciary duty by disclosing, Dirks could not inherit a "tippee" duty
                    i. Court wants to distinguish someone who is tipping against the information of the corporation (illegal) and someone who is tipping as part of the normal informational proceedings of the corporation (every day practice) – like market analysts
    c. *Chiarella* and *Dirks* illustrates that the goal of SEC antifraud provisions, as interpreted by the courts, is not to require equal information among all traders

IX. <u>Section 16(b): Short-Swing Profits</u>
    a. §16(b): imposes strict liability on any director, officer, or 10% shareholder who makes a profit in short-swing transactions within a six (6) month period
        i. Officer/Director on either side of the transaction (so could have official status at the time of either the purchase or sale?)
            1. Ex: *Merrill Lynch v. Livingston* (9th Cir. 1978): must look behind the title of "officer" to find the true duties of the person and the type of information he is eligible to receive; an officer, within the meaning of the section, is someone who would perform important executive duties such that he would be likely to obtain confidential information while discharging those duties
                a. **Functional** definition of what an officer is
                    i. It is immaterial how functions are labeled or defined in the bylaws (i.e. if it merely an honorary title)
        ii. 10% Shareholder must be a 10% shareholder on *both* sides of the transaction (so person must have held more than 10% immediately before both the purchase and sale to be matched?)
        iii. Six (6) Month = a roundtrip transaction (so does not cover all possible forms of insider trading)
    b. A prophylactic rule – not necessary to show that they actually possessed material, nonpublic information
        i. Strict liability → "irrespective of any intentions"
            1. Liability flows from the existence of a relationship with the corporation that makes it more probable than not that the person can access insider information – just hard to detect/prove
                a. Designed to take away the incentives for officers, directors, and 10% shareholders to engage in insider trading
    c. A civil action only
        i. Money goes back to the corporation
    d. There will be cases where §16(b) and Rule 10b-5 can apply
    e. Damages
        i. E&E: matching any *purchase* with any *sale* by a qualifying insider, regardless of order, that occurred during any six-month period in which the sale price was higher than the purchase price
            1. Recovery is frequently measured by matching later lowest-cost purchases with earlier highest-cost sales
            2. There is no need to offset any losses – any purchases and sales in which the sale price is *lower* than the purchase price need not be matched and can be disregarded

ii. Ps can match buy and sell transactions up any way they want as long as they are (i) within 6 months of each other, (ii) only use each transaction once, and (iii) can ignore any losses and count only gains
   1. First thing you do is look for the transaction with the largest profit → P might look at these and look for the biggest swing: selling 1000 at $55, then buying those back at $40 = $15 swing/$15,000 gain; then P can count buying 1000 shares in Sept. at $40 and selling those in Oct. at $45 = $5,000 profit; total = $20,000 back into the corporation treasury

		T1	T2
July	Purchased 1000 shares at $70		
August	Sold 1000 shares at $55	S 1000 at $55	
September	Purchased 2000 shares at $40	P 1000 at $40	P 1000 at $40
October	Sold 2000 shares at $45		S 1000 at $45

COMPARE:	§16(b)	§10b & 10b-5
General:	Specifically addresses **insider trading**. Focuses on **gains to the trader**.	It is a **general anti-fraud statute,** based on deception. Focuses on **losses to victims**.
Transaction Type:	**Round-trip** transaction (buy AND sell) within 6 month span. Requires **profits**	**One** transaction (buy or sell shares) is sufficient Don't need profits; avoidance of loss or just info is sufficient (crim).
Reliance:	**No need** to show reliance. Only need **access** to insider information.	**Reliance needed**. Have to show that trading was done on basis of **material non-public information.**
Knowledge requirement:	**Strict liability** (no knowledge required)	**Scienter** (action had been done intentionally or recklessly)
Defendants:	Defendants can be **officers, directors, 10% shareholders**; NOT people like attorney and printers.	Defendants can be **anyone** with inside information and uses it in violation of duty.
Plaintiffs:	Plaintiff can only be the **corporation**; shareholders can bring a derivative suit on the corporation's behalf.	Plaintiffs are the **people on the other side of the transaction –** the buyers and sellers who are victims of deceit.
Damages:	Damages are limited to **restitution** (defendant must return what profits he made). Returned to **corporation**	Damages can **vary** and can be greater than the defendant's profits. Go to **SH**.
SOL:	Statute of limitations is **explicit** (2 years). **Civil** only.	Statute of limitations different **depend on jurisdiction**. **Civil** or **criminal**.
Disclosure:	Irrelevant. Strict liability.	Satisfies duty.
Standing:	Corporation has **automatic** standing.	Must be **buyer/seller of securities**

<u>Mergers and Acquisition</u>

I. Statutory Mergers
   a. Everything happens by operation of law

    i. Shareholders do not have the option of retaining their shares
    ii. How it works:
        1. Boards of two companies make an agreement
        2. Agreement is put to a shareholder vote (both sets)
            a. Sometimes target shareholders get no voting right – just appraisal rights
            b. If shareholders vote yes, dissenting shareholders can get appraisal rights
        3. Then, by operation of law, all of the assets and liabilities of the target get absorbed by the acquirer (the surviving company)
        4. In exchange, the acquirer gives consideration to the target's shareholders – cash, shares of the acquirer, combo
b. Standard Merger: two companies become one company
    i. Their books get consolidated
    ii. Shares of one of them disappear in exchange for consideration in the form of either cash or shares of the new, merged company
    iii. Target will cease to exist
    iv. Has to be approved by board and shareholders of both companies
c. Consolidation: neither company wants to merger into the other, so they can set up a new corporation
    i. B merges into C – A merges into C
    ii. Shareholders of A and B will receive shares of C
d. Triangular Merger: A and B want to merge B into A, but A does not want B's potential liabilities (or wants to test them first), so A sets up a sub and the sub acquires B – the target
    i. Target disappears for consideration of either cash or shares of A
    ii. In the end, A will own the sub which has all of B's assets and liabilities, but A has limited liability for the sub
e. Reverse Triangular Merger: same as above, except B is the acquirer and sub is the target – sub merges into B
    i. When the dust settles, A owns B as a sub – so target remains intact
    ii. Typically done when B has assets that are not transferrable/assignable (patents, contractual rights, licenses, e.g.)

II. Non-Statutory Mergers (essentially accomplishes the same results as a merger)
a. Asset Purchase: B sells all of its assets to A; B receives consideration in the form of shares of A or cash; B then agrees to dissolve and distribute the consideration to the shareholders
    i. The sale of substantially all or all of a corporation's assets requires approval of the shareholders (but sale of only some does not)
        1. Notion that you can pick and choose the assets (and liabilities?) that you take on (so more flexible than a merger in that sense)
    ii. Transactionally this is expensive and time consuming because you have to transfer title for every single asset – does not happen by operation of law, like a statutory merger (this is just a purchase, no statute for this)
b. Tender Offer: A makes a tender offer to the shareholders of B, offering them money or shares of A in exchange for their shares of B
    i. Quicker than an asset purchase
    ii. Likely will not get all of the shares
        1. Some shareholders are negligent
        2. Some will oppose the deal (potential to get rid of these with a merger later)
    iii. Can be hostile
c. Leveraged Buyout: corporation buys the company using the company's own assets
    i. Company must have stable cash flow in order to pay down increased debt

III. Mergers between Parent and Sub
a. Squeeze-Out or Freeze-Out: sub merges into parent to get rid of minority shareholders

i. If parent owns more than 50% of sub, they will win the shareholder vote and sub will merge into A
ii. The minority shareholders have to take the consideration (usually they are cashed out, since the idea is to get rid of them)
iii. Problem: suspicion that the directors of the parent and the sub have violated their duty of loyalty to the sub (*Goldberg*, e.g.)

b. Short-Form: Del. Section §253: permits a parent corporation owning at least 90% of the stock of a sub to merge with that sub, upon approval by parent's board of directors, and to make payment in cash for the shares of the minority shareholders
   i. "Short-Form" because, in theory, do not need a vote by the shareholders of the parent or the sub (but in practice you typically do because parent always wins because it is the majority of the sub)
      1. Since shareholders of the sub do not get a vote, they get appraisal rights – can go to Chancery Court and argue the consideration is inadequate (*Santa Fe*, e.g.)

IV. Note: tax implications can make or break a merger or acquisition

<u>Takeover Duties</u>

I. Introduction
   a. *Unocal*: enhanced business judgment rule
      i. Reasonable process/investigation
         1. Burden shifted to D
      ii. Reasonable basis for the decision/response
         1. Elevated from a rational basis standard
         2. Burden shifted to D
   b. Two types of *Unocal* cases:
      i. *Revlon* cases
         1. Triggered by a change of control
            a. Do the shareholders lose control over the ability to vote?
            b. Do the shareholders lose any chance of a future control premium?
         2. Judged by *Unocal* with the goal of getting the highest price
      ii. Non-*Revlon* cases
         1. "Just say no" cases – company tries to remain independent & change of control is not inevitable
         2. Judged by *Unocal* with the goal of remaining independent

II. Takeover Strategies
   a. Two-tiered offer: these offers are coercive – they are meant to stampede the shareholders to tender their shares to avoid getting screwed
      i. Bidder will make an attractive front-end offer of cash **premium** for a certain percentage of shares and a less attractive back-end offer of something like debt securities/junk bonds (or they are not forthcoming about what the back-end is) for the shares that don't get tendered or that get tendered after enough shares were already tendered
         1. Because no one wants to get stuck with these back-end securities, everyone wants to tender immediately

III. Takeover Defenses/Deal Protection Devices:
   a. **Poison Pill** (most common): confers rights on all shareholders that are triggered by a specific event/condition (if acquiring company gains more than X% of shares, e.g.) – rights are exercisable by everyone but the acquirer
      i. Poison pills never get exercised – no acquirer would do that
         1. They thwart takeovers
      ii. Ways to get poison pill removed:
         1. Deal with management on a friendly basis to remove it
         2. Proxy battle
         3. Petition to court for an injunction arguing it is unreasonable

b. **Lockup Option** ("crown jewel defense"): target corporation will sell its most valuable assets for cheap, in the event that the acquirer takes over the target – making the corporation less valuable
c. **No Shop Provision**: target company cannot negotiate with or give any information to anyone else
d. **Termination Fee**: a fee paid to the would-be acquirer who gets beat by the hostile acquiring company by the target company – so when the target corporation gets taken over it will already have a $25M debt, e.g., owed to the would-be acquirer
e. **Buy back shares in the open market**: gets rid of cash and remaining shares will be worth more when the market goes up
f. **Exclusionary self-tender**: requires the corporation to take on massive debt
g. **Letters from Bank** re: we will not finance other offers
h. **Repurchase program**: allows corporation to buy out short-term speculators (arbitrageurs) whose actions may have been adverse to long-term shareholders and to give the board time to counteract the ignorance or mistaken belief among shareholders about the company's value (*Unitrin*)

IV. Enhanced Business Judgment Rule
  a. Enhanced Business Judgment Rule:
    i. Burden is on the directors (rather than plaintiffs in the normal business judgment rule)
    ii. The process and the decision are judged by a reasonableness standard (rather than rational basis)
  b. Why an enhanced business judgment rule?
    i. There is an inherent conflict of interest when a board is considering a takeover offer (does not rise to the level of self-dealing though)
      1. Directors cannot have acted solely to perpetuate themselves in office
    ii. Designed to ensure that a defensive measure to thwart/impeded a takeover is motivated by a good faith concern for the welfare of the corporation and its shareholders
  c. Ex: *Unocal v. Mesa Petroleum* (Del. 1985): Mesa/T.Boone Pickens owns 13% of Unocal's stock and launched a two-tier front-loaded cash tender offer for control; Unocal board rejected the offer as inadequate and launched a self-tender offer as a defensive strategy (Mesa was obviously excluded); Mesa is suing on the basis that the board is taking away a reasonable offer from shareholders; court: in the context of this two-tiered coercive tender offer, the poison pill was a reasonable response
    i. **Enhanced Business Judgment Rule will apply to defensive measures taken by the board if directors show:**
      1. Board had reasonable grounds to believe danger to corporate policy and effectiveness existed (process)
        a. Satisfy by showing good faith and reasonable investigation
        b. Proof of reasonableness is materially enhanced when approval is by a board compromised mostly of outside, independent directors who have acted in good faith and with a reasonable investigation
      2. The defensive measure was <u>reasonable</u> in relation to the threat posed (decision)
        a. Possible concerns/threats:
          i. Inadequacy of price offered (even if all-cash)
          ii. Nature and timing of the offer
          iii. Questions of illegality
          iv. Impact on constituencies other than the shareholders (creditors, customers, employees, and maybe even community in general, e.g.)
          v. Risk of nonconsummation
          vi. Quality of securities being offered
          vii. Basic shareholder 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

3. Basically need to have reasonable grounds to believe that the potential acquirer posed both a legally cognizable threat to shareholders and a danger to the corporation's policy and effectiveness

V. Change of Control/Inevitable Breakup

a. Ex: *Revlon v. MacAndrews* (Del. 1986): Pantry Pride made grossly inadequate offer for Revlon; Revlon responded with poison pills: (i) rights plan, (ii) lockup option, (iii) no shop provision, (iv) cancellation fee; Revlon sought a white knight in Forstmann, who became involved in the poison pills; different from *Unocal* because there the company was either going to be sold *or* remain independent (so board wanted to protect the shareholders from forcefully having to sell their company) – here Revlon is going to be sold inevitably: either to Pantry Pride or Forstmann (so board needs to focus on getting the highest price)

   i. **Once the breakup of a company is inevitable, the duty of the board *changes from* the preservation of the company as a corporate entity *to* the maximization of the company's value at a sale for the shareholders' benefit → the board's role becomes that of an auctioneer**

      1. *Unocal*'s standard applies, but the goal is different: get the highest price for the shareholders (<u>not</u> protect corporate policy)

         a. Board's actions must be reasonable and proportional in light of the new goal

   ii. <u>Defensive measures (lockups, no shop provisions & cancellation fees) are not per se illegal, but they cannot breach fiduciary duties to shareholders</u>

      1. Must be a rationally related benefit accruing to the shareholders

   iii. Story here:

      1. Defensive measures before *Revlon* duties kicked in:

         a. Rights Plan: was a valid, reasonably enacted in response to the initial inadequate takeover from Pantry Pride that was intended to spur higher bids

            i. Also said it would remove for Forstmann or any superior offer

      2. When Revlon Board authorized management to negotiate for merger/buyout, this recognized the company as for sale (via their discussions with Forstmann)→ duty changed from preservation of Revlon as a corporate entity – to – maximization of company's value at a sale for shareholders' benefit

      3. Defensive measures became moot once the directors' duties changed:

         a. Lockup Provision: indicated a preference to note holders while ignoring the board's duty of loyalty to the shareholders – but note holders did not need protection at this point because their rights were secured by contract

            i. Board may have regard for various constituencies in discharging its responsibilities, provided they are rationally related to benefits accruing to shareholders

            ii. When a board ends an intense bidding contest on an insubstantial basis and where a significant by-product of that action is to protect the directors against a perceived threat of personal liability for consequences stemming from the adoption of previous defensive measures, the action cannot withstand the enhanced scrutiny which *Unocal* requires

            iii. Lockups that draw bidders into the auction process are beneficial to shareholders, but this Forstmann option had the effect of ending the auction – foreclosure of bidding hurts shareholders

         b. No Shop Provision: impermissible once the board's duties changed

i. Defense is not per se illegal, but is impermissible under Unocal when a board's duty becomes that of an auctioneer responsible for selling the company to the highest bidder

b. What <u>does</u> trigger *Revlon* duties → sale is inevitable
   i. When a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company
   ii. Where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company
   iii. **Look for**: a fundamental change of corporation control occurs or is contemplated; cash-outs of public shareholders; MBO (a LBO in which management receives a substantial stake and continues to manage); a transaction that would result in a sale or change of control to a small group of owners (affiliated) – (i) target is owned by an unaffiliated mass of public shareholders and the acquirer is controlled by a single entity and proposes to merge, (ii) the target shareholders are to be cashed out in the merger – getting cash/securities, instead of equity, for their shares
      1. In close cases especially, the more the merger consideration consists of cash (rather than stock), the more likely it is that *Revlon* duties will be triggered because there is less reason to defer to management where the issue is simply one of valuation of the shares – something we normally rely on the market to do
         a. When consideration is stock, it is more like a business decision/long-term consideration, rather than just dollars

c. What <u>does not</u> trigger *Revlon* duties?
   i. Board declines an unsolicited tender offer
   ii. Control goes from one unaffiliated mass to another (i.e. no change of control)
      1. Public shareholders can still get control premium if company is taken over down the road
   iii. Target decides to merge <u>and</u>:
      1. There is no sale of control,
      2. The decision to merge is before the hostile offer, <u>and</u>
      3. Appears not to be activating a bidding process
   iv. Recapitalization, maybe

VI. *Unocal*/*Revlon* Applied:
   a. Ex: *Ivanhoe v. Newmont* (Del. 1987): Goldfields owns 26% of Newmont and agrees to a standstill agreement that they will not acquire any more shares unless a third party acquires over 9.9%; Ivanhoe acquires 9.95% and complicates matters; Goldfields and Newmont enter a second agreement (in light of the Ivanhoe threat looming): (i) Newmont issues a large dividend, (ii) street-sweep: Goldfields will engage in a street-sweep and increase its holdings to 49.9%, (iii) Goldfields gets 40% of the board representation and agrees to support Newmont management; (iv) another standstill re: won't acquire any more shares and won't sell to anyone who does not agree to the above conditions; P sues to enjoin and argues this triggers *Revlon*; D argues the company is not for sale – company is only trying to keep itself independent against inadequate offers
      i. *Revlon* <u>not</u> triggered because sale of Newmont was not inevitable
         1. Newmont was not up for sale – board held fast to its decision to keep the company independent
         2. There was no bidding contest – P was the only bidder; Goldfields was not a bidder (they had to do the street sweep to protect the interest it already had)
      ii. Because *Revlon* is not trigger, analyze the defensive measures under *Unocal*:
         1. Satisfies *Unocal* because the two essential objectives of the defensive measures were to thwart the inadequate coercive Ivanhoe offer and ensure the continued interest of the public shareholders in the independent control and prosperity of Newmont

            2. No evidence of entrenchment or breach of any other fiduciary duty
        iii. This case is right on the edge of when *Revlon* does not apply
            1. Court thought Newmont was in a tough position and the only way for them to remain independent was through the street sweep, so *Unocal* applied
                a. Result was criticized because control was transferred from the public shareholders to Goldfields – shareholders will never get a premium again because anyone who wants to take over the company will just buy it from Goldfields, and Goldfields' 49.9% is effectively enough to control the company, so shareholders' votes don't really matter
    b. Ex: *Bass v. Evans* (Del. 1988): Macmillan was concerned that it was vulnerable to a takeover, so it decided to break the company into two: publishing and information; Bass made a friendly offer (for $5.65 more than they would get under management) and agreed to a restructuring nearly identical to the management's; Macmillan's board rejected Bass' offer and decided to go forward with a self-tender offer within ten days and without a shareholder vote; management owned 4.5% of the company and after the offer they would own 39.2% of information and 3.2% of publishing (which supposedly equaled the value of their current 4.5%); Bass argues this is a *Revlon* case because 39% control by management is typically enough to control the company and 39.2% is a strategy to avoid *Revlon*; Macmillan argues this is not a *Revlon* case because there is still 61% of the shares still out there, so publicly controlled – not change of control
        i. *Unocal* applied:
            1. PROCESS: if the Bass offer posed a cognizable, reasonably perceived threat, it was only in the minimal sense that Bass's current proposal of $/share, although fair, is less than the highest price Macmillian's financial advisors believed might be obtained if the entire company were put up for sale
                a. Bass' offer was not hostile or coercive
            2. DECISION: the defensive transaction is economically inferior to the outside bid and the shareholders have no choice but to accept it, so on that basis alone, the restructuring is an unreasonable response under *Unocal*
                a. "A defensive step that include a coercive self-tender time to effectively preclude a rational shareholder from accepting the any-and-all offer cannot, in my opinion, be deemed to be reasonable in relation to any minimal threat posed to stockholders by such offer"
                b. Management did not convince the court they were doing anything different than Bass would do
        ii. Reasonable responses would have been to develop a more valuable economic alternative and let the shareholders decide
            1. *If* the directors concluded that the company should be sold, it would be reasonable to solicit higher bids from other bidders, as well as the original offeror
            2. *If* the company was not to be sold, the directors might propose a noncoercive transaction that would offer shareholders higher value, whether immediate or long term, while also enabling them to retain their equity in the corporation
                a. Or, at least equivalent value in different form
    c. Ex: *Paramount v. Time* (Del. 1990): Time wanted to expand its business, so agreed to a stock-for-stock merger with Warner; prior to completion, Paramount came in and made a cash offer for Time (conditioned on the merger not going through); Time and Warner restructured the deal so Time could buy Warner (i.e. cash deal now); Time set up defensive measures (exchange, no-shop, letters from banks re: we will not finance other offers); Paramount raised its all cash offer to buy Time's outstanding shares for $200; Time still said offer is inadequate and maintained that the Warner transaction offered greater long-term value for the shareholders
        i. Court applies *Unocal*:
            1. Paramount's offer was deemed a legitimate threat to Time's corporate culture

            2. Time had a preexisting merger agreement with Warner, so the steps it took were reasonable in light of the corporate determination that a strategic alliance with Warner was in the best interests of the corporation and its shareholders, and Paramount threatened this
        ii. Court holds that *Revlon* is <u>not</u> triggered because:
            1. No sale/control never changed
                a. Time-Warner transactions all left the company in control of public shareholders (so even those Warner is getting 62% ownership, this majority is just ownership shifted from the original unaffiliated public shareholders of Time to the unaffiliated public shareholders of Warner)
                    i. Strategic merger did not result in shareholders losing a control premium or voting rights
            2. Time never abandoned its long-term strategy
        iii. Directors are not obligated to abandon a deliberately conceived (long-term) corporate plan for a short-term shareholder profit, unless there is clearly no basis to sustain the corporate strategy
            1. The initial board decision re: the long-term strategy must have been informed and in good faith with a reasonable investigation
                a. Note that although Time was required, as a result of Paramount's hostile offer, to incur a heavy debt to finance its acquisition of Warner, that fact alone does not render the board's decision unreasonable so long as the directors could reasonably perceive the debt load not to be so injurious to the corporation as to jeopardize its well being
    d. Ex: *Barkan v. Amsted Industries* (Del. 1989): company undertook a MBO to thwart takeover; offered $45/share for all outstanding shares; financial advisers said the price was high in the range of fairness; P (shareholder objecting to MBO) argued this is a *Revlon* case because control is being transferred from the public shareholders to the MBO Group and the MBO was not reasonably calculated to get the highest price – did not do a market survey or seek other alternatives; D argues that this is a *Unocal* non-*Revlon* case, but even if this is a *Revlon* case they satisfy *Revlon* because they did maximize shareholder profit – this MBO was the best the shareholders were ever going to get
        i. *Revlon* applies to MBO (when management puts the sale of the company in the hands of independent, disinterested outside board members)
            1. Multiple bidders are <u>not</u> required to trigger *Revlon*
        ii. If there is an offer that is fair and reasonable, then there is not an absolute duty to solicit bids/hold an auction
            1. <u>When directors can evaluate the fairness of a transaction from reliable evidence, they will not be required to do a vast market survey or seek other bids</u>
                a. Evidence that convinced the court the directors got the best price for the shareholders:
                    i. A known raider acquired a significant stake in the company, so the relevant community knew the company was in play as far as being taken over/changing control and no one came forth to bid
                    ii. Financial opinions said this result was reasonable (but you can always find someone to tell you want you want)
                    iii. The employee stock ownership plan allowed the MBO offer to pay taxes from the ESOP, which allowed MBO to pay more than another bidder (basically tax benefits from ESOP)
                    iv. They are on the edge of financing re: LBO price

            v. The known raider approves of the MBO offer (thinks it is a good price and is not agitating for an auction)
                1. Notion that if he thought the company could go for more, he would have likely demanded it
        b. *But*, usually, a corporation will want to check and see if there are higher bids out there/let the market decide a fair price via an auction
    2. <u>When directors are considering a single offer and the board has no reliable grounds upon which to judge its adequacy, then it is unreasonable to not survey the market to see if higher bids may be elicited</u>

e. Ex: *Mills Acquisition v. Macmillan* (Del. 1989): after the Macmillian restructuring was enjoined in *Bass*, two bidders appeared for the company and the bidding was very close: Maxwell and KKR; a CEO/CFO tipped KKR of M's bid (an $89 all cash offer, vs. M's current bid of $89.50 blended), which caused KKR to increase their bid to $90.05 – tipping was not revealed to the board of disinterested outside directors though; M did not re-bid at the final call for bids point because they did not know of the $90.05 bid; Macmillan shut down the bidding (with a lockup option and termination fee) and accepted KKR's bid; result: P won, auction kept going
    i. *Revlon* unquestionably applies because the company is going to be inevitably sold
        1. Lockup is not per se illegal, but you really have to get some significant return to justify cutting off the auction (i.e. needs to be a considerable difference in the price/bids – a marginal gain is not worth ending the auction via a lockup, especially when there is a good chance the auction would continue)
    ii. **The only excuse for not treating bidders on an even playing field is if doing so benefit the shareholders** (enhances shareholder value)
        1. Case: P must show that the directors of the target treated one or more of the respective bidders on unequal terms → then *Unocal* standard kicks in:
            a. First examine whether the directors properly perceived that shareholder interests were enhanced, and
            b. Board's action must be reasonable in relation to the advantage sought to be achieved (or to the threat which a particular bid allegedly posed to shareholder interests)
    iii. Standard for the Board:
        1. Interested Directors (CEO/CFO): duty of loyalty case – entire fairness standard
            a. Ex: managers involved in a MBO
        2. Disinterested Directors: *Unocal*/*Revlon*
        3. … if either of these directors violates their duties to the shareholders, P has a case

f. Ex: *Blasius v. Atlas* (Del. 1988): Blasius (9% shareholder) wanted to completely restructure Atlas, which includes increasing the board from 7 to 15 (max allowed by the bylaws); Atlas disagrees with Blasius' proposal so they decide to elect 2 more board members; D argues that rejecting the proposal was a business decision because it was bad for the company and adding 2 new board members was also a business decision (no money was exchanged, no seats were up for re-election, no conflicts of interest); P argues that by expanding the board, D is taking away the vote from the shareholders – issue being that Blasius already got consensus for his proposal to increase the board to 15, but the current board short circuits the vote by appointing 2 new members, which results in the current board having 9 members, so whenever the shareholders do get to vote, Blasius will never be able to have a majority; D next says this was a takeover and they satisfy *Unocal* because the proposal was not good for the corporation and adding members was a fair response to the threat; court decides that management cannot impede a shareholder vote, and instead, they should have expended money to inform the shareholders about the inadequacy of the proposal
    i. Court does not seem to apply *Unocal* here (does not fault management at all here because they were just doing what they thought was best for the corporation – this was not management entrenchment)

1. However, there are certain things that management cannot do, even if they are doing them for good reasons
    a. Directors cannot mess with the shareholder vote – cannot take away the franchise
        i. This is not a per se rule, but if directors are going to mess with the shareholder vote they need a compelling justification
            1. "**Compelling justification**" = highest burden, virtually impossible to satisfy

g. Ex: *Unitrin v. American General* (Del. 1995): AG announced that it wanted to merge/takeover Unitrin, so Unitrin adopts a poison pill: shareholders rights plan that authorized a repurchase program for 10M shares – purpose: get rid of cash that makes the company attractive and increase the shares of the company that management would own (23% that could increase to 28%), so 25%+ ownership is enough for management to block the merger (because of a provision in the bylaws that requires 75% approval); AG sues to enjoin the repurchase program as a disproportionate response to the tender offer/alleged threat ; this is not a *Revlon* case because Unitrin is rejecting a takeover offer in an attempt to remain independent (no change of control); P argued this does not satisfy *Unocal* because it takes AG's offer out of the hands of shareholders since the response removes the possibility of the shareholder vote mattering; D argued that management had 23% before AG's offer and 23% is likely enough to block the merger because management's 23% is going to be over 25% of those who actually vote
    i. "In the modern takeover lexicon, it is now clear that since Unocal, this Court has consistently recognized that defensive measures which are either preclusive or coercive are included within the common law definition of draconian"
        1. <u>If the defense is preclusive or coercive, end of story – it does not satisfy *Unocal*</u>
            a. **Preclusive**: looking at the effect on potential acquirers and whether it precludes a takeover/change of control
            b. **Coercive**: looking at whether it is coercive on the shareholders – does the defense cram down on the shareholders an alternative that they might not prefer?
        2. <u>If it is neither, it is not the end of the story – court must examine more closely whether the defense is reasonable</u>
    ii. Court notes three types of threats:
        1. **Opportunity Loss**: where a hostile offer might deprive target shareholders of the opportunity to select a superior alternative offered by target management (or another bidder)
        2. **Structural Coercion**: the risk that disparate treatment of non-tendering shareholders might distort shareholders' tender decisions
        3. **Substantive Coercion**: the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value
    iii. Holding: a limited nondiscriminatory self-tender may thwart a current hostile bid, but is not inherently coercive … moreover, it does not necessarily preclude future bids or proxy contests by stockholders who decline to participate in the repurchase
        1. The adoption of the poison pill and the limited repurchase program was not coercive and the repurchase program may not be preclusive (to be determined on remand)
            a. Although each made a takeover more difficult, individually and collectively, if they were not coercive or preclusive the Court of Chancery must determine whether they were within the range of reasonable defensive measures available to the board

h. Ex: *Paramount v. QVC* (Del. 1994): Paramount and Viacom wanted to merge and agreed to a merger where Paramount would receive from Viacom a combo of cash & stock worth $69/share;

in this merger, public shareholders would become the minority and Redstone (of Viacom) would become the majority shareholder --- change of control = *Revlon* applies (inevitable change of control because of the merger agreement) --- QVC wanted to acquire Paramount, but because Paramount prefers Viacom, Paramount instituted defensive measures: (i) no shop, (ii) termination fee of $100M, (iii) stock option agreement (if the deal does not go through, Viacom gets to purchase 24M shares of Paramount at $69 … but Viacom could pay for these options with debt and there was a "**put option**": instead of actually transferring the share and selling them Viacom can just get the difference (acquiring price – option price) from Paramount, who will keep the shares – the more the acquiring price is bid up, the more money will instantly flow out of the company once acquired); QVC counted for $80, conditioned on invaliding the defensive measures; Viacom raised to $85; QVC raised to $90; Paramount refused to consider the QVC offer because they said it was "illusory" and bad for the long-term interests of the corporation; Paramount argues *Time*: the merger agreement is in place and has been truly protected, and that there was no breakup of the company inevitable (P points out that *Time*'s list of ways to trigger *Revlon* was illustrative, not exclusive); Paramount failed to satisfy its *Revlon* duties

i. <u>*Revlon* is triggered when a corporation undertakes a transaction that will (i) change control, or (ii) breakup the company</u>
    1. Change of control requires a duty to get the highest price because shareholders will (i) lose their leverage in the future to get a control premium – this is their last shot, and (ii) lose their voting powers because the controlling block will determine everything
        a. Voting powers to: elect directors, cause a breakup of the corporation, merge it with another company, cash-out the public stockholders, amend the certification of incorporation, sell all or substantially all of the corporate assets, or otherwise alter materially the nature of the corporation and the public stockholders' interests
    2. Paramount failed to satisfy its *Revlon* duties here because change of control was inevitable and Paramount implemented (and refused to modify) draconian defensive measures that ended the auction; Paramount would not negotiate with QVC on an uninformed belief that somehow QVC's offer was not for real

ii. Paramount ≠ Time
    1. *Paramount* → *Revlon* applies where there is a disaggregated mass of unaffiliated shareholders before the merger and a shareholder with a controlling block after the merger (when the unaffiliated shareholders become the minority or are cashed out)
    2. *Time* → *Revlon* does not apply where there is a disaggregated mass of unaffiliated shareholders before the merger and after the merger

iii. Irrespective of the present Paramount Board's vision of a long-term strategic alliance with Viacom, the proposed sale of control would provide the new controlling stockholder with the power to alter that vision

iv. Contract provisions (no shop, e.g.), whether or not they are presumptively valid in the abstract, may not validly define or limit the director's fiduciary duties under Del. law or prevent the Paramount directors from carrying out their duties
    1. To the extent the provisions are inconsistent with those duties, they are invalid and unenforceable

i. Ex: *Mendel v. Carroll* (Del. 1994): P wanted an injunction to order the Katy board to create a 20% dilution option that would facilitate an offer – P wanted to dilute the Carroll family's control (50%) in order for them to buy the shares, exercise the option and then have a majority of the shares (i.e. control); Katy Board approved Carroll family's offer for $25.75 for the outstanding public shares – and throughout, Carroll family indicated they were not interested in selling their shares; P offered $27.80, board rejected as inadequate, P thinks board should be required to accept the higher offer
    i. Carroll family offer and P's offer are <u>not</u> comparable

            1. Carroll family's offer did not contemplate a change of control, so there is not a control premium built into their offer price
            2. P's offer does contemplate a change of control, so even though it is higher than the Carroll family's, it may be inadequate because it is for controlling shares – and needs to reflect a control premium
        ii. *Revlon* is <u>not</u> triggered because the Carroll family and Katy board did not envision a change of control
            1. The mere fact that the Carroll family offer was to buyout the minority shareholders does not implicate a change of control and does not put the company up for auction
        iii. Dicta: If the board accepted the third party offer, there would have been a lawsuit from the Carroll family (because they would have lost control and been squeezed out)
            1. Carroll family would argue that the board violated their fiduciary duty to the controlling shareholders by seizing control and selling it
                a. By doing this, the board is transferring value from one set of shareholders to another set of shareholders, and thus, violating a duty of loyalty

<u>Majority Shareholder Duties to Minority Shareholders</u>

I. Majority shareholders (not just officers and directors) do have some duties owed to the minority shareholders
    a. Ex: *Perlman v. Feldman* (2d Cir. 1955): controlling shareholder sold his control shares to someone else – one of the corporation's purchasers (i.e. an end user); because of the Feldmann Plan, the controlling shareholder was selling an asset/ revenue generating corporate opportunity: the company's ability to get interest free loans from its end users (which it has been doing since the Korean War rather than raising steel prices during the steel shortage); if D sold his controlling shares to anyone but an end user, no duty would have been violated because the corporate asset would have remained intact
        i. There is <u>no duty</u> to share the *control premium* with minority shareholders
        ii. There is a <u>duty</u> to share any profit from selling a *corporate opportunity* because that is an asset that belongs to all of the shareholders
    b. Majority shareholder can also violate his duty to the minority shareholders if he sells his shares to someone he knows is going to loot the company
        i. Typically these cases involve something relatively egregious

Arguments:
P: This is a Revlon case and they do not satisfy the Revlon standard
Even if this is not a Revlon case, they do not satisfy the Unocal standard (because no cognizable threat to corporate policy or that the response was unreasonable)
D: This is a Unocal case and we satisfy the enhanced business judgment rule

Levels of Judicial Scrutiny

- No liability
- Duty of Loyalty (good faith/duty to monitor)
  - Good Faith Standard: directors must prove they did not engage in a **conscious disregard** for the company
    - Hard for P to prove
    - Director will almost surely win
- Duty of Care
  - Business Judgment Rule: reasonable investigation + decision had a rational basis
- *Unocal*
  - Enhanced Business Judgment: reasonable investigation (burden on D) + decision was reasonable
    - *Revlon* cases
    - Non-*Revlon* cases
- Duty of Loyalty (interested transactions)
  - Fairness Standard: proving the decision was actually fair and reasonable for the corporation
- *Blasius*
  - Compelling justification
    - Easy for P to prove (or, hard for D to satisfy)
    - Director will almost surely lose
- Strict Liability

State vs. Federal

- Federal: 10b-5, insider trading, 16(b)
- State: fiduciary duties, Unocal, Revlon, appraisal rights

Mergers

With any merger, have to ask why no one else came forward and whether there were any devices in place that would prevent someone from coming forward

When you enter into a merger it can look like one of two things:

Time-Warner

If you merge for shares, can probably fashion it to look like Time-Warner

Paramount-QVC

If you have a cash deal or a share deal with a controlling shareholder, then you are going to have a Revlon issue

Once you enter a deal with someone, you must be able to defend the deal against another bidder or be willing to carry out the auction

If you have two possible companies to merge with, tell the client what the implications of choosing one over the other are (and vice versa) and what the implications of the consideration chosen are